

---

**2002 Valuation Actuary Symposium**  
**September 19–20, 2002**  
**Lake Buena Vista, Florida**

**Session 33PD**  
**Fair-Value Reporting**

**Moderator:** Michael J. Hambro  
**Panelists:** Sam Gutterman  
Stephen J. Strommen

*Summary: This session begins with an update of the 2002 progress made by the International Accounting Standards Board and FASB in moving to a type of fair-value reporting for insurance companies. The update is followed by a brief discussion of the key outstanding valuation issues. Panelists will present arguments supporting and opposing fair-value reporting, including rationales as to why fair-value reporting should be adopted or rejected, and if rejected, what accounting system should be put in place.*

**MR. MICHAEL J. HAMBRO:** I'm vice president and managing actuary at Aon Consulting in Avon, Connecticut. The presenters today are Steve Strommen and Sam Gutterman. Steve is senior actuary at Northwestern Mutual. His responsibilities are financial modeling and forecasting. Steve is a member of the Academy's Task Force on Fair Value Reporting, and he has also written many valuable responses to both the International Accounting Standards Board (IASB) and FASB. Sam Gutterman is a consulting actuary at Pricewaterhouse Coopers. Sam is the chairman of the Committee on Insurance Accounting of the International Actuarial Association.

I'm just going to do a very brief introduction. The remainder of the session will focus on the pros and cons of the fair value reporting or, more specifically, the International Accounting Standards Board's draft statement of position on insurance accounting. Sam Gutterman is going to take the pro side, and Steve Strommen is going to take the opposing side.

The International Accounting Standards Board has taken a lead role in changing insurance accounting standards. Currently, there are no international financial reporting standards for insurance contracts. About three years ago, the IASB's predecessor organization, the International Accounting Standards Committee, released an issues paper on insurance contracts. Last November, the IASB began releasing informal draft statements of position for insurance contracts. It's informal, as they didn't feel it was totally ready for prime time, but they wanted to start at least dribbling it out to the industry.

The IASB feels that this collection of documents, along with substantial public debate, will allow them to move to an exposure draft. Also, the International Actuarial Association has started a project to provide the appropriate actuarial guidelines to support these developments.

Some of this material now is a bit dated. There actually have been more recent developments. Essentially, the draft statement of position calls for an accounting approach that is based on an asset/liability valuation, compared to the deferral and matching approach that's taken in U.S. GAAP.

On June 7, 2002, the European Union adopted the regulation that will require all publicly traded EU companies to use international accounting standards and international financial reporting standards by the first of 2005. There will be an extension under certain circumstances for companies that now trade publicly in the U.S. and use U.S. GAAP.

The international financial reporting standards for insurance contracts won't be fully developed by 2005, but certain parts may be. For example, a standard on investment contracts may be implementable in 2005.

What's the impact on U.S. companies? What do we care about the IASB? We care a lot. First, we're in a global economy, and it's critical to have consistent accounting standards and financial reporting across the globe. Many U.S. companies have global operations, or at least have a European parent. Australia, at least, has endorsed the 2005 adoption of the international

financial reporting standards. In Canada, it's still under discussion. So the question is, how will what the IASB is doing affect U.S. companies? With that, I'm going to turn this over to Sam Gutterman.

**MR. GUTTERMAN:** The topics I'm going to address in my opening statement are the following: the IASB's motivation for their project on insurance contracts, why they quickly came to a conclusion that they weren't going to use U.S. GAAP, the approaches taken by the draft statement of principles (DSOP), and some of the principle comments and observations that people have made, principally those that relate to volatility and transparency of financial information. I will conclude with some comments on today's financial reporting environment.

There are several factors that initially motivated the IASB to start their insurance contract project, which can still serve as important benchmarks that we can utilize in deciding whether or not the DSOP and the continuing evolution of the DSOP are satisfactory. First, there clearly has been a wide divergence in accounting methods for insurance contracts worldwide.

As a matter of fact, Sir David Tweedie, who is chairman of the IASB, has stated that for a specific industry, worldwide insurance accounting probably represents the most widely divergent set of practices. In essence, he basically concluded that worldwide accounting practice is currently a mess. So he, being a former chair of the U.K. Accounting Standards Board (ASB), has taken it upon himself to try to push convergence of insurance accounting worldwide.

In addition, the approach generally taken by current insurance accounting is generally inconsistent with that of any other industry. Similar insurance contracts are treated very differently than those issued by banks. There's no current system in use that is consistent with the current IASB framework. Convergence across industries and consistency with common accounting principles are quite important.

It is clear from the comments of most of those who are interested in the financial condition of insurers, that the financial statements of insurers are opaque, even to experts. In addition, current approaches are inconsistent with economic principles. With this in mind, a useful set of criteria

to apply to a financial reporting system is whether or not the system provides useful information to investors, which in many cases, does not exist today.

Why not U.S. GAAP? First and most obviously, U.S. GAAP is internally inconsistent across product type, as well as inconsistent with the increasing emphasis on the balance sheet that is more prevalent today. It is a deferral and matching approach that typically emphasizes the income statement. What's more important, it may be inconsistent with the IASB framework as well. Deferred acquisition cost (DAC) can be viewed as not qualifying as an asset because it isn't controllable and isn't particularly related to the obligation of the company. A retrospective calculation of liabilities, indeed, is generally inconsistent with the concept of an obligation.

Second, U.S. GAAP financial results can be difficult to understand and to develop meaningful benchmark projections. A financial analyst recently said, "It's impossible to predict DAC unlocking." I will discuss this concern a little bit later. In addition, it might be somewhat too prescriptive and rule based, rather than principle based. That is, will the existence of a set of rules result in some companies designing products in order to optimize performance with respect to those rules, rather than to optimize business performance? Now, there is considerable disagreement as to whether or not there is a perfect or effective prescriptive or rule-based system, but some observers have expressed the opinion that U.S. GAAP is too rule-based.

I won't describe in detail the definitions of the methods referred to as (1) deferral and matching or (2) asset/liability based. But I will mention that the asset/liability method that I am arguing in favor of today emphasizes the balance sheet. It calculates assets and obligations consistent with the IASB framework, a very important criterion, while a deferral and matching approach makes use of a smoothing technique, generally frowned upon in today's accounting world, that emphasizes the income statement. Any deferral and matching approach is not completely a pure system. In particular, if you are in an impaired situation, you will switch over to fair values anyway. So, even in today's U.S. GAAP system, there are elements of fair value used. In addition, purchase GAAP is based on fair value at the time of a business combination. Although there is a great deal of fair values as a radical new system, it has always been with us to some extent.

The concept of deferred acquisition costs (DAC) is nice, but I don't believe that it really should be reflected in a realistic measurement of an insurer's future obligations or liabilities that an insurance company faces. Some observers suggest that a locked-in DAC amortization schedule creates unwarranted smoothing, while at the same time, the effect of unlocking creates a very difficult situation to understand, generally failing to provide transparent values to users.

In addition, it is doubtful if any deferral and matching system can meaningfully and properly reflect the emerging costs of embedded options and guarantees. It's really tough to imagine a true deferral and matching system that could anticipate the costs of the many embedded options included in insurance contracts.

In contrast, an asset/liability system is more consistent with the economics of insurance, even though, in some cases, it assumes that assets are fungible, which generates a related issue as to how the interaction between assets and liabilities should be handled. The current discussions regarding such asset/liability systems assumes that they are independently measured. An exception does exist, even in the asset/liability system in the case of a performance-linked product. That is, if the liability or the future benefits are an explicit function of the actual assets held, the linkage is not ignored.

DSOP describes two asset/liability methodologies: fair values and entity-specific values. With the exception of expenses and credit standing adjustment, they're fairly consistent with each other. In some interpretations, the treatment of expenses is entity-specific in both.

One comment before I address some substantive issues. The IASB DSOP is a work in process; therefore, it is open for comments and suggestions. In fact, the IASB is getting comments and suggestions from many parties. It's a really interesting process because the politics are now beginning to be displayed, with some obvious differences of opinion due to the cultures and experiences of the company and the actuary. Differences in opinion have emerged that are related to differences in culture and experience in the U.K., the U.S., Japan, and Germany. It's very much a clash of cultures, so it's an interesting process.

A significant issue underlying much of the discussion is whether or not these concepts are consistent with the financial reporting framework for all entities. A frequented question raised is, what makes insurance different? This is an easy one for most of us to answer because obviously insurance is unique. But if you talk to accountants, or people setting accounting standards, you realize that maybe a lot of aspects of insurance aren't unique after all. Other financial products such as bonds or mortgages are long-term in nature, and other contingencies such as credit risk are provided for by other industries. Maybe we should adopt a system that is more consistent with general accounting for all financial products. The DSOP is far more consistent with general accounting rules than other methods currently in use. If an insurance-type product or insurance risk is covered by other companies, such as through self-insurance, it should be accounted in a similar manner.

A very important factor to consider in this debate with insurers is potential financial reporting volatility. Does fair value introduce too much volatility? The use of an entity-specific approach, which seems to be the direction being taken at the moment should not be as volatile as the results of a full fair value system that reflects market whims of the moment, such as whether or not insurance companies or their contracts are in favor or out of favor with the market. In an entity-specific world, financial results will be based on estimates of future cash flows.

The actual income volatility under the system will depend upon the extent of a company's match or mismatch of their assets and liabilities, as well as the accuracy of the assumptions made. This will place a premium on the accuracy of the initial actuarial estimates made. If the actuaries' estimates are pretty close to what will actually happen, volatility will be held to a minimum. If the actuaries' estimates are inaccurate, you may very well see significant volatility.

To a great extent, the advocacy position that I am taking assumes that actuaries and companies will be up to the task. If you have a distrust of actuarial estimates, then you will most likely have a healthy skepticism about whether such a system can work properly and result in comparable values across companies. But if you have trust in the future effectiveness of actuarial standards,

actuarial guidance, and actuarial professionalism, then I believe that volatility will be held at a minimum. In addition, the volatility that will be reported will indicate volatility in business results that will be appropriate.

An example of the implementation of a relatively similar system can be seen by learning from the Canadians when they introduced their policy premium method (PPM) about a decade ago. Some volatility in results over the next five years did occur. But, in general, most of that volatility was a response to actual underlying changes in the economic performance of the insurance companies involved. When we move to a new insurance accounting system, we should expect a system that provides useful information and that's responsive to changes in economic insurance underlying experience.

Assuming that actuaries are provided with an appropriate amount of guidance, they should be able to produce reasonably comparable values and minimize volatility; the volatility that will occur will generally be "true" volatility that is the result of experience. Discontinuities in income due to the timing of recognition and changes of assumptions will be presented separately. Changes in assumptions will be identified separately, which will put pressure on the actuary to initially set proper and reasonable assumptions.

As for the need for transparency, today's markets currently penalize a lack of transparency. If market participants don't trust a company's accounting system or accounting practices, its stock price will be penalized. Markets, again in current conditions, are suspicious of smoothing. Reported values should be consistent with performance economics. Any system's financial reports need to be understood by more than financial reporting actuaries. We need to have our people, not only in charge of business, but in making financial decisions or investment decisions, to be able to better understand the fundamental economics involved in the business.

In summary, transparency is valued in today's financial reporting environment. An independent assessment of their financial statements is now required to be conducted by the Board and the CEO. Smoothed earnings, although valued by some, currently are viewed with suspicion by many stakeholders in the marketplace.

There has been increased emphasis lately on a principle-based system without detailed rules. U.S. GAAP, generally considered more rules-based, has recently gotten a bad rap as a result of the many business accounting scandals in the last year. I don't know whether this opinion will be held over a short-term or be a permanent phenomenon. However, as long as the current business environment and concerns about honesty and integrity of business reporting continue, we're going to see a movement towards enhanced accounting and more responsible management information. In addition, top management isn't going to just be able to blame the actuary for problems in the future; they are going to have to take responsibility for their reported financial statement numbers themselves. As long as they continue to take their responsibility seriously, we'll get a more honest and open financial reporting system.

In summary, the current DSOP provides the framework that will result in more transparent and useful financial information.

**MR. STEPHEN J. STROMMEN:** I'm in the spot designed for opposing fair value today. I usually like to think of myself as a person with a positive attitude, so I'd like to begin by telling you a little bit about what I am for rather than what I am against.

There are certain qualities of any accounting system that I think are desirable. The accounting system ought to be reliable, people ought to be able to depend upon the estimates that are embedded in it. It should be understandable in the same way by a wide variety of audiences. They should all have the same understanding of what the numbers mean and how they were developed. It should be internally consistent so that similar kinds of contracts, assets, and liabilities are treated in a consistent fashion, and it should be principles-based rather than having a lot of specific rules. The International Accounting Standards Board is trying to achieve this kind of an accounting system. So the intent of the IASB is very good, but the draft statement of principles is flawed, and that's why I'm here to oppose fair value.

Let me give you some reasons why. As described in the DSOP, the fair-value approach is unreliable. It's not well understood. It's internally inconsistent, and it's not principles-based. I think that covers it in a nutshell. So let me spend a few minutes on each one of these points.



It's unreliable because the valuation uses unverifiable assumptions. The intent of fair value is to make some kind of estimate as to what the market value would be if there were a market, but there is no market. There are certain assumptions that you simply cannot set to a market in a reliable fashion if there is no market. Therefore, there is no mechanism for discipline on the valuation. These assumptions can be set anywhere within a fairly wide reasonable range, and you can get the value to be pretty much whatever you want it to be within a reasonable range. This creates a huge opportunity for manipulation of earnings, especially for long-term contracts, which is the mainstay of the life insurance industry.

Let me give you a little example. I looked at a block of single premium life insurance. Suppose we have an in-force block that was issued many years ago. Most of these people are about 60 years of age, and we have enough of this business that the fair value at the end of the prior period was a billion dollars or a thousand million. We have about \$100 million of equity backing up this business. So there's a 10% ratio of equity-to-liability value.

During this period, the actual earnings of the company are a little bit below target. Can you imagine that the actuary, at the end of the current period, might be under some pressure to change assumptions in order to release some earnings? Suppose the actuary might change the valuation interest rate by adding a little extra spread, just 10 basis points. Maybe spreads in the investment markets increased a little bit during the period. If you increased the valuation interest rate by 10 basis points, the beginning period of fair value goes down from a billion dollars to \$988 million. You've released \$12 million of earnings into the current period, which contributes 12% to your return on equity before any real earnings are materialized.

Similarly, if you don't want to play with the interest rate, you could say, "Well, based on observations, I think mortality is improving a little more quickly." We used to assume it improves 1% per year. We'll assume it improves 1.25% per year. Suddenly, you have reduced the beginning of the period fair value by \$8 million and contributed 8% to your return on equity for the period.

I don't think these are terribly large changes in assumptions. With both within the reasonable range that I was talking about before, auditors might have trouble questioning changes within this range. I think we have a huge opportunity for manipulation here; small assumption changes can have very large effects on your return on equity.

Fair value is not well understood. What is fair value anyway? What is entity-specific value? I think we would probably get 50 different answers if we surveyed the group and asked them to determine the fair value of this block of policies. How does one calibrate fair value to market risk preferences? Fair value is supposed to be an estimate of market value taking into account market risk preferences, but there is no market to which we can calibrate those risk preferences.

Will there be a gain or loss at issue? This is an interesting one. There have been written articles and papers that have suggested two different points of view on this. Some have pointed out that since fair value discounts all future cash flows, it must discount all future profits and recognize them at issue, so there ought to be a big profit at issue. Other people have said, "Fair value doesn't allow a DAC asset, so you can't defer your acquisition cost. You must have to charge them off immediately and that will create a big loss at issue." Obviously, this is not understood in a consistent fashion among a lot of different people.

Will the results show increased volatility? A lot of people think that they will. Some think that actuaries can do a good enough job of smoothing that out, that it won't show a lot more volatility unless it's deserved volatility. I worry more about actuaries manipulating that volatility away myself. In any case, there are wide differences of opinion on how fair value will change results in the literature. It's internally inconsistent because held-to-maturity treatment is available for assets, but there is no held-to-maturity treatment for liabilities, and I'll be talking about that a little more later.

There is market value for many kinds of assets, but model value for liabilities. Let me explain what the difference is there. Market value incorporates market risk adjustments, those spreads on bonds that just keep going up and down and up and down. You have a market to which you can calibrate those spreads on the asset side. However, on the liability side, what are you going to

base volatility in risk spreads on? Are you going to have any volatility in risk spreads? If you don't have the volatility on the liability side, but you do have it on the asset side, you have a mismatch.

Under the proposed accounting system, bond issue expenses are to be amortized, while insurance issue expenses are not to be amortized. That seems a little inconsistent. And valuation rules are inconsistent with the valuation objective. The DSOP starts with principles, but then goes on to add all kinds of rules that go beyond principles. One principle is that the valuation objective is to come up with the value of the obligation, assuming orderly settlement over its lifetime. This is the entity-specific value objective rather than fair value. The words are a little different. The valuation principle is that the value ought to be, in the absence of a market, a risk-adjusted present value of future cash flows. This is an objective and a principle that I can salute.

But then they go beyond the principles to several specific rules. They say you cannot reflect income tax preferences. On the asset side, we have tax-exempt bonds, and we have taxable bonds. Market values clearly reflect tax preferences, but you can't reflect such tax preferences under the DSOP. You cannot reflect regulatory capital requirements. Anybody who has followed the Regulation XX debate over the last several years knows that regulatory capital requirements, in the form of reserves, in some cases, have an effect on financial values.

The DSOP attempts to define the risk-free rate, and I'll use it. The risk-free rate is a very fine concept, but if you define the risk-free rate in the United States as being the yield on Treasuries, you're not necessarily in agreement with many academics who will point out that the risk-free rate is the rate attributable to a fixed, certain cash flow at a particular date in the future, but it doesn't have to be tradable between now and then. Treasuries are very liquid and tradable, which has the effect of making their yields lower because their value is higher. Finally, the DSOP suggests that stochastic methods or option pricing methods have to be used for options and guarantees. There are lots of methods other than stochastic methods that can be used, but that's not mentioned in the DSOP.

So what is the alternative? I think we need to fulfill the intent of the International Accounting Standards Board, but we need to improve on the DSOP. We need to find a way of closing that manipulation loophole. I think that is the number one priority. We need to remove the rules that conflict with the valuation principles. Finally, we need to allow held-to-maturity treatment for liabilities. I'd like to spend the rest of my opening statement talking about what held-to-maturity treatment might mean for liabilities.

I would suggest that the valuation assumptions ought to be locked in at issue and include a risk adjustment or provision for adverse deviation (PFAD), similar to what is done under *FAS 60* today under U.S. GAAP. I would suggest calibrating those risk adjustments or PFADs so that there is normally little gain or loss at issue. In other words, I would suggest using an entry cost-type approach. I wouldn't mandate that as a hard-and-fast rule because there are some situations where a gain or loss at issue is appropriate, but that would be a guideline that I would suggest. I would suggest that these assumptions for valuation only get unlocked in the case of loss recognition. Loss recognition would be based upon cash-flow testing; the same kind of cash-flow testing we now do for statutory reserve valuation.

Under cash-flow testing, of course, what you're determining is whether the block of assets supporting liabilities provides enough future cash flow to cover the future liability and expense payments, but not to provide future profit. So in a loss recognition situation, you're recognizing future losses, but you're not necessarily recognizing the loss of all the future profits. So when you're in a loss recognition situation, compare fair value with this kind of approach. If your originally expected earnings were at zero and your new expected earnings were down below zero, under loss recognition, you'd bring the lower part below zero into the current period. Under fair value, you'd take the entire difference of the present value and bring it into the current period, so you would be making a much bigger adjustment under fair value than what I am suggesting.

*FAS 60*, which is similar to what I've been describing, was superseded by *FAS 97* for many kinds of products, particularly, those that have account values. It splits premium between deposits and the remainder of the premium. For products that have account value, I propose that we continue using the same kind of a split, and we use it in the valuation process. So liability could be the account value plus a risk-adjusted present value of the other nondeposit cash flows on a set of locked-in assumptions. If we did that, we would have to make one additional proviso because, in many cases, expenses are recovered through a future interest rate spread rather than through a cash flow. I would propose that the portion of the interest rate spread intended to recover expenses based on assumptions at issue would be used to create an imputed cash flow, which is a fee against the contracts that are intended to cover expenses.

There's one other aspect of this held-to-maturity treatment that I would suggest, which is that on the asset side, bonds that are being held at amortized cost have their capital gains and losses due to trading amortized interest maintenance review (IMR)-style. The statutory IMR could become a part of the financial statement. There are some advantages to this approach. I think that reliability is increased because we have a principle or guideline that suggests there is little gain or loss at issue, and we have locked in the assumptions. So there's not this opportunity for manipulation. There's also less room for misunderstanding or mischaracterization on the part of financial press saying that you are taking future period earnings into the current period because we're just not doing it. It also improves consistency between asset and liability rules because if you have them both at an amortized cost or held-to-maturity-type basis, they are the same.

The approach so far has been to say, "If liabilities are going to be on fair value, then you have to allow all the assets to be on fair value." I turn it around and say, "The current proposal for international accounting says you can have a lot of your assets at amortized cost. Why not do the same kinds of treatment for the liabilities?" I think that would be consistent.

Finally, I think this kind of approach can be termed "principles based." I don't believe there is a lot of need for more rules other than those that are outlined here.

**MR. GUTTERMAN:** Before I launch into my prepared response comments, I will first respond to some of the points that Steve raised. Steve basically agrees with the principles underlying the DSOP. On the other hand, he has raised a lot of concerns with the practical implementation of the principles. His agreement with the principles is important. Nevertheless, the alternative that he has raised is based heavily on a locked-in set of assumptions developed at issue (at least when there is no subsequent loss recognition or impairment). Although it would have solved the problem 20 years ago, it does not address today's product features and problems effectively. These features and problems are the need for more transparent information and the effect of changes in conditions, as well as not being appropriate for today's insurance products.

A locked-in set of assumptions that doesn't respond to changes in economic conditions or for many of the options included in our products or how close you are to being in-the-money seems incompatible with many of today's insurance and savings products. They might be okay for *FAS 60*-type products, but for most insurance companies, the percentage of your liabilities to which it can be meaningfully applied might be relatively small.

We then move to questions of whether such a system will work in practice.

The first question that Steve raised is: Can such a system be implemented in a reliable manner and can comparability among companies be assured? Although he didn't mention it, I would add the question of whether manipulation can be minimized in such a system. I don't believe that any such system can completely avoid these problems. In addition, I don't think we can design a system that's going to be able to completely withstand the product creativity of the industry and its actuaries.

On the other hand, enough structural safeguards are in place that should enable companies to apply any system in a reasonably reliable manner (although certainly they all have their own set of costs). In the U.S. recently, CEOs and chief financial officers (CFOs) have begun to be required to sign off on their company's accounts. Some people are somewhat skeptical of this

new requirement. How much value is that? Aren't they supposed to be responsible now? Aren't actuaries subject to codes of professional conduct and a long list of actuarial standards of practice? Nevertheless, the newly found concern of the market on corporate governance and high quality auditable financial results may result in higher quality financial reporting in the future.

Therefore, top management of each corporation listed on a stock exchange will be held responsible for their accounts. The market will look with skepticism if significant instances of manipulations arise. The key, I believe, is through enhanced disclosures. If all our investors are presented with is a single number saying, "This is the income of your insurance enterprise," it's pretty easy to hide a lot of sins and do a lot of manipulation.

For example, disclosure requirements for property and casualty (P&C) insurers' loss development information make it difficult to hide deficient reserves. You'll see disclosures regarding the extent and reasons why significant estimates are changed. Sufficiently robust disclosure information can minimize the problem in many cases, through explicit indications of the effects of the changes in assumptions. I don't think CEOs are going to say, "We decided to increase our mortality assumption" without any explanation, when other companies are decreasing theirs. If it's not logical, the analysts will clearly ask, "Why was this change made? What was the basis?" In addition, I believe that there's going to be a more diligent audit processes, especially after the accounting and auditing scandals that we've seen lately. We may even see increased peer review and peer review opinions provided to reduce adverse perceptions.

The next question raised related to modeling. As everyone knowledgeable about insurance knows, we don't have many insurance processes where we could just look up in *The Wall Street Journal* to find out what the current assessment of mortality risk is. Actuaries have been proud of being experts in the modeling of financial effects of contingent events. Are we up to what we have claimed to be experts at? We can look to our P&C brethren, who deal with estimates all of the time and use updated and unlocked estimates in their evaluations of insurance liabilities at every valuation date. In addition, we do it all the time in pricing. Actuaries lay the future

financial conditions of their companies on the line all the time in making estimates of their assumptions used in pricing; in the future, those involved in financial reporting will be able to do likewise.

As I mentioned early on, a key criteria for use in determining whether a method is a good one is whether it provides useful information and is preferable to the current one in use. I don't think that a system that uses locked in values, that is, a system that uses a deferral and matching approach provides sufficient insight into an insurer's operations and obligations to warrant its use, particularly if the company has sold any of the complicated insurance products that are being sold today which contain a significant number of options and guarantees.

Embedded value disclosure is popular in some countries because it provides insight into the expected profitability of new business. Enhanced disclosures of expected profitability of new contracts under the new accounting system should also provide such information. Practicality also has to be a key consideration. However, a new system will be required; I don't think there is any question that significant changes will have to be made. We probably won't have any control over that in 2007 when Phase 2 of the IASB's insurance project has been completed. Although we will have the opportunity of providing input to this process, they may not get it exactly right the first time. Nonetheless, I am hopeful that we will have the opportunity of providing appropriate actuarial guidance.

We will have to work hard to arrive at as good a system as is possible. It might be costly in some cases to implement new systems. It might be a challenge. In fact, it might even be an embarrassment, in some cases, in which the price of options has been significantly underestimated. I would agree that the current DSOP is not perfect, but changes will be made as discussions on it will continue. We'll be further refining the approaches taken, but I think that we should make it as good, as realistic, and as useful as possible.

**MR. STROMMEN:** There are some things that Sam and I agree on. We agree that a new system is coming, and we both agree that we need to make it as reliable, consistent, and practical as possible.



There are four major issues that I see in making that happen. We need to impose some kind of discipline on the valuation process, whether that's the lock-in of assumptions or something else. Something has to happen there. We need to find a way of avoiding the creation of spurious volatility. I think that puts the burden on actuaries to figure out, in advance of having to report under this framework, how they would deal with various kinds of changes in the environment for reporting purposes. We need to eliminate rules that conflict with principles, such as the whole list of them that I went through in my presentation. Finally, we need to give some thought to presentation format. It's something that we haven't really talked about in this session, but there are some issues about how results would be presented that will be coming up.

There is room for creative thinking on this. The IASB has not set in stone the accounting standard for insurance contracts. In particular, the treatment of participating business and non-guaranteed elements is still very much up in the air. An earlier draft looked as if it had been written by folks in Europe who are not familiar with the kind of participating contracts and non-guaranteed element contracts that we write in the United States. It simply didn't provide any examples of them. A more recent draft begins to treat them, but I think there's much room for improvement in the way they're addressed.

We need some alternatives to stochastic valuation approaches for the options and guarantees in insurance contracts. We certainly, in my company, have options and guarantees in permanent life insurance contracts that are participating, but we're certainly not going to do four million stochastic valuations on four million different policies. There has to be another way.

We need to look at the treatment of deferred taxes and tax preferences. As I mentioned before, the current proposed rule says that tax preferences can't be reflected in valuation of liabilities outside the DSOP. I believe it also says that deferred taxes cannot be discounted at interest. I think there's some need to address that and make those treatments a little more realistic.

Finally, we need to have ways of defining the cost or risk adjustment, or whatever you call it—the cost of regulatory capital requirements. As I mentioned before, we can't reflect them under the rules in the DSOP. But, again, I will emphasize that “it ain't over 'til it's over.” The

International Accounting Standards Board is far from settled on accounting for insurance contracts. Fair value is not a done deal. So don't be afraid to get in there and express your opinion.

**MR. MILES YAKRE:** I would like to offer some defense of U.S. GAAP. Maybe you could comment on it. I think we need to stop thinking as actuaries for a minute and think as investors because, at the end of the day, accounting systems are really for investors. If they don't satisfy what investors want, then they're useless and shouldn't be used. I just want to offer three instances where fair value fails to address investors' needs, whereas U.S. GAAP addresses them better.

Let's talk about options. There has been a lot of talk about how U.S. GAAP somehow fails to reflect embedded options, but it really doesn't. The way U.S. GAAP deals with options is when there's a problem with an option, it is handled explicitly for all the world to see. We're seeing that now with the guaranteed minimum death benefit (GMDB). Companies will come out and say, "We have this GMDB (or whatever) problem, and we have to take this big write-off." I know that this bothers our sensibilities as actuaries, but is that really bad? Isn't that what investors want? Somebody should ask them.

Investors understand that we have options in our contracts, but I'm not sure they want to hear about them until there is a problem. Putting them in a fair value context is opaque. Burying it in some kind of esoteric fair value valuation is more opaque than the way we do it now, which is very explicit and very clear, although it is not actuarial.

Second, let's talk about the comparability between financial services and other industries. I get very nervous when people say financial services are different and have to be handled specially. That's not really the case when, as investors, we're providing capital to the capital markets. Suppose I'm trying to decide whether to invest in an oil company, a tobacco company, a retailer, or an insurance company. I want all the companies to apply accounting under the same rules, and fair value throws that away. We have to think about not just the financial services industry, but our own capitalist economy where comparability across industries is very important.

Related to that, the third thing is a liquidity basis of accounting versus that of a going concern. A fair value system implies or assumes that everything is for sale all the time, which isn't the case. If you go to a retailer like Sears, where everything really is for sale all the time, they don't fair value their inventories because that's what investors want. So why should we? I just wanted to offer those comments to see if you have any reaction.

**MR. GUTTERMAN:** You have raised several very good points. First, in terms of the treatment of options, the question is whether or not you want to wait for costs or an option to be in-the-money or not before you reflect their expected costs. I don't believe that we want to wait until we get into the money to recognize the costs inherent in our contracts. We want to provide a fair warning before that occurs. Now, the question in front of us is what is the best way to do just that? Regarding modeling, I believe that Steve appropriately observed that stochastic methods might not be the only approaches that an actuary can apply. I hope that this will not be the only approach available in the final guidance.

The second point raised was a desire for consistency across industries. I believe this very issue is probably the main reason why the DSOP has taken as long as it has to develop an actual set of standards. The IASB Board has raised significant concern among its members relating to the current lack of consistency in accounting that exists now across industries. This has certainly been the debate for the last four months, regarding how we can move insurance accounting treatment closer to that of other industries. This is and will be a key and crucial observation.

The last one raised concerns about the use of exit value. I believe that the market tends to concentrate on changes in economic value, which I believe provides useful financial information.

**MR. STROMMEN:** I'd like to focus on the dichotomy on the option valuation issue. I see a dichotomy. If you want to take into account the value of these options before you reach the cliff, you have to include an estimate in your financial statements. That estimate can't be based on any kind of a market reality because there is no market; it's a fungible estimate, one that can lead to an opportunity for manipulation. So one has to weigh the benefit of reflecting the cost of those

options in the accounting framework against the opportunity for manipulation that such valuation introduces. Until actuaries are free from being influenced by their managements, I will continue to believe that there will be manipulation to some degree if we introduce that kind of option valuation into the financial reporting framework.

**MR. GUTTERMAN:** Let me add an additional note. A fundamental difference between actuarial approaches and accounting approaches is the fact that accountants tend to look at recognition and measurement as two separate decisions. First decide whether to recognize something in a probable scenario, rather than the typical actuarial approach that tends to look at recognition in terms of probabilities. If you can measure it, then you should. We are comfortable with measuring probabilities. The approach we're taking is similar to the "in-the-money, out-of-the-money" issue.

In the last meeting of the IASB, they appear to have started to take a more fundamental look at their recognition concepts. Maybe they will move to the actuarial concepts of probability and maybe "in-the-money, out-of-the-money" may not be as "cliffy" as we make it out to be. But Steve's concerns are valid.

**MR. MICHAEL TERNE:** I have a few comments. We have dealt with this issue for five or more years in a very, very significant way at my company, well before the industry recognized that there was a problem with their guaranteed minimum accumulation benefits (GMABs) and their guaranteed minimum income benefits (GMIBs). Basically, the financial analytic techniques are not as opaque as the way that this is being handled now in GAAP, which is not at all.

If I'm an investor, I sure don't want to buy your stock and then, two years later, find out that, the guarantee I had no idea about is suddenly in the money. It was worth something then. Also, from my own internal point of view, how do we price products? We don't price for interest guarantees that no sane person would ever make. A lot of these are coming due now for big-time purposes.

Our products, to some degree, and our financial reporting model are grounded in the 1950s and early 1960s when the asset side of the balance sheet was stable because the government regulated it. You couldn't issue a mortgage above 6% interest. They stabilized that industry, so the auditors went down to the vault and simply counted the bonds. It's a whole different environment out there now. I would suggest that current reporting is so opaque that it has no credibility. They certainly don't with me.

We have companies that, if interest rates go up, make money. If interest rates go down, they make money. No matter what happens out there, they supposedly make money. You know that can't be true. Academics know that can't be true. We have all sorts of put guarantees in our products that are not priced for. They're not reserved for. Nothing. What does it say to wait until, as you say, they fall off the cliff? That's like waiting until your car crashes before you put in the air bags. First, I think that is simply not very reliable for either the investor, the policyholder, or the company.

The second issue I would like to mention is one that's personal to me. In all this discussion, I don't see where policyholder funds are rigorously separated from what's available to shareholders. I have this problem all the time in GAAP. We take capital gains and, if I don't do something, they drop through into income even though I know that those capital gains are required to support our policyholder guarantees. I've managed to overcome that personally, but that's a huge problem because it isn't all our money. A lot of it does belong to the policyholder, which we implicitly recognize in *FAS 97*.

The stochastic elements aren't subject to as much manipulation as you think because the stochastic methodologies are well known in many industries. They're well known by academics. They're well known by financial analysts. So, if you use them, they know what you're doing. These are very explicit, they are very open, and they are subject to criticism by everybody and his brother. On the other hand, when we bury things such as the deterministic interest rate guarantee, it can never be found.

As far as GAAP being immune to manipulation, let me tell you something. The level of aggregation that is used in GAAP can be enough to hide the Queen Mary. When I first started using GAAP, and I'm probably older than everybody here, one of the big issues was what constitutes a category of business for loss recognition. Each firm had its own idea, with the result that there became no categories, and companies now can almost put up the solvency point of view to an entire company loss recognition thing. What's that?

I can tell you right now that GAAP has become increasingly less relevant to the way we price. We price now. We actually do our pricing reflecting our embedded options. We don't pretend we can reinsure it—we can't. And those numbers, by the way, even before they're in the money, are often big, and your management doesn't know a thing about them. They say, "Oh, it's 3%, fine," bang. What they don't know is that the guarantee may have a market value right now that is maybe hundreds of millions of dollars. When that stuff comes through and all of a sudden it has to appear on your balance sheet, that's not going to be fun at all. You've just bet the company on those guarantees because the amounts that surface can be so large that your surplus is long gone if you have to hold them.

So whatever is being done now is not very good. I suggest that whatever we do here as far as either one of those things, they're going to be very dependent upon the audit function. GAAP is very dependent on the audit function, too. If you have a poor audit function, then neither accounting system will work. If you have a rigorous sign-off function, a rigorous responsibility function—somebody to take responsibility in a rigorous audit function—then any of them will work, because you're going to be a little reluctant to put your name down there if you know you can go to jail.

**MR. STROMMEN:** There are a lot of very good comments there. I would only follow-up with one comment, which relates to one of the first items you talked about, regarding companies that make money when interest rates go up and make money when interest rates go down, and how can that possibly be? As long as the guarantees are way out of the money and interest rates are fluctuating in a range that is well away from the guarantees, certainly that can happen.

The real question is how do you value the guarantees and when do those values become significant? As you alluded to, they can become significant well before the guarantee is in the money, but how significant and exactly when is very fuzzy. I worry about building those fuzzy estimates into an accounting system in the income statement rather than, perhaps, just disclosing them in a footnote or some other approach.

**FROM THE FLOOR:** Volatility of interest rates is everything.

**MR. GUTTERMAN:** I'd like to add one thought regarding some of these very excellent comments. Regarding policyholder interests, this is a significant concern, as certainly, actuaries in the companies provide a fiduciary role and should take a fiduciary responsibility for their funds. We should also look at the regulatory aspect of this issue and the potential impact it should have on regulatory reporting.

In Europe, it may very well be that the revised accounting treatment will be used for both financial reporting and for regulatory purposes. This implies a significant role for risk-based capital. In terms of an analysis of the real risk associated with policyholder funds over and above the amount of reported liabilities. The IAA is working on this issue in conjunction with the International Association of Insurance Supervisors (IAIS), of which the NAIC is a member. This is something that actuaries should also be concerned with, in addition to the fair value accounting debate we have discussed during this session. That's because we, as actuaries, are providing useful and enhanced information to investors. We also have to remember that the primary purpose of the products that we offer is to provide for the long-term protection of our policyholders' interests. We should continue to keep this in mind in future discussions about this topic.

**MR. CHARLES WINSTON WISEHART:** Since we're a global company, we seem to calculate results on about every single standard that you can think of, which makes year end an impossible time for us. But in the U.S., we've been focused a lot on U.S. GAAP and embedded value lately.

In response to the volatility comments, embedded value has been volatile. But one of the things that we try to do is separate out the sources of the volatility, and I think we've made management somewhat comfortable with that approach. Once you get management to buy in, one of their jobs is to communicate that to investors. Overseas analysts have gotten used to it, at least those in the U.K. The present value approach of profits, taking it in the first year and offsetting it with the initial expenses, has been valuable for trying to determine what the economic value of what you're doing is. It gives you a comparison between products of really what you think is going to happen.

But therein lies the rub because everybody knows that what we think is going to happen is not going to happen. The only way to deal with it is to have a good mechanism for allocating the surplus based on the risks that you're taking.

This ties in to what you were just saying, Sam. The mechanism for allocating the amount of risk-based capital has to tie into the amount of risk that you're taking. The current discussion has been covering mortality risk, which is predictable. Interest rate risk is not predictable, and it has all killed us in the last 10 years. Option risk is also killing GMDB. But then I worry about the risks that we're not dealing with.

Just about every product, except for lapse-based products up in Canada, has an initial expense that has to be paid off over the term of the product. We just really don't know what the "lapse" is going to be on any product when we issue it. We make a guess, but it's only a guess. As actuaries, we fundamentally say that the past is a guide to the future. I would argue with you that, with lapse, the past is not a guide to the future and that we have to set up enough surplus, enough capital, to cover risks like that. U.S. GAAP takes the same risk through the DAC mechanism that any kind of fair value system does. DAC is opaque, and who knows whether it will ever recover that initial expense.



**MR. GUTTERMAN:** I agree with most of your comments. I also refer you to a very good report by the IAA on risks undertaken by insurance companies, prepared by its Committee on Insurance Regulations. This committee of the IAA is also currently undertaking a project to apply this assessment and categorization of risk to assist the IAIS in its development of a risk-based capital framework. I hope that future discussion of both reports will prove to be quite valuable.