2000 Valuation Actuary Symposium
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Session 1GS
General Session

Moderator: Errol Cramer
Panelists: Douglas C. Doll
Sam Gutterman

The session provides a brief overview of a variety of financial reporting topics, most of which are discussed in more detail in the subsequent sessions.

The overview includes topical issues as follows:

- *National Association of Insurance Commissioners (NAIC) Life and Health Actuarial Task Force developments and directions*
- *Other NAIC/regulatory development*
- *American Academy of Actuaries (AAA)/Actuarial Standards Board (ASB) developments*
- *Financial Accounting Standards Board/Security Exchange Commission (FASB/SEC) and Generally Accepted Accounting Principles (GAAP) developments*
- *Tax developments*
- *Reinsurance development*
- *Gramm-Leach-Bliley Financial Modernization Act*

MR. ERROL CRAMER: I am an actuary with Allstate Corporation and chairperson of the Valuation Actuary Symposium.

The first speaker for this session is Doug Doll, a consultant with Tillinghast-Towers Perrin in the Atlanta office. He is a board member of the Society of Actuaries, and has a long history with the Valuation Actuary Symposium, as well as with regulatory actuarial issues.

Chart(s) referred to in the text can be found at the end of the manuscript.

Doug's topic will be, "Regulatory Issues." Rather than merely providing a laundry list of the current state regulatory activities, Doug will focus on key concepts and themes, in particular, the trend towards requiring more judgment of the valuation actuary.

The next speaker will be Sam Gutterman who is director and consultant with PricewaterhouseCoopers LLP. He is a former president of the Society of Actuaries and currently chairs the International Actuarial Association's Committee on Insurance Accounting Standards. The latter group, comprising both actuaries and accountants of various countries, is working on ways to increase standardization of reporting throughout all financial institutions. This is a very important position that Sam has taken on. Sam will cover current items relating to GAAP, both in the U.S. and abroad. He will also discuss how this appears to be headed towards market-value reporting.

I will briefly cover financial services integration, which can be considered a current hot topic.

MR. DOUGLAS C. DOLL: As Errol mentioned, in past Valuation Actuary Symposiums, this time slot has been generally used to give a summary of each of the actuarial-related issues being addressed by the NAIC. However, at least as far as the life and annuity topics are concerned, those items are being covered in Session No. 2, and we didn't want to be duplicative. I have a list of the current NAIC actuarial agenda topics, and I'll go over them quickly. If you find yourself interested in any of those topics, be sure to try to get more details in later sessions.

Allow me to give an outline of my talk. First, I'm going to give a recent historical review of events relating to actuaries being given more responsibilities to use their judgment in regulatory areas. Second, I'll give an update on two issues that have a broad potential for actuaries to exercise judgment. These issues are the Unified Valuation System (UVS) and a potential new Standard Nonforfeiture Law. Third, as already noted, I will briefly go over the list of actuarial issues currently on the NAIC agenda. Last, I will offer a couple of editorial comments about whether valuation actuaries are ready to handle the increased responsibility that is envisioned for them.

First, let's go over recent history. Some of you might disagree that 1985 qualifies as a recent year, but having actuarial standards was a key building block to gaining the regulator's trust that the actuarial profession was ready to handle new responsibilities. Prior to 1985, there was a code of professional conduct, and the Academy had promulgated financial reporting recommendations and interpretations for statutory and GAAP reporting, but that was about it. Life insurance had gotten more complicated in the 1970s and early 1980s, and many believed that more standards were needed.

By the way, I would encourage you to go home and read the preface to the Actuarial Standards of Practice. I had not read them for a very long time, and I re-read them recently. I found it very readable and helpful in clarifying what the role of these standards is.

The 1980s was a time of intense professional activities for increasing the role of the valuation actuary. *The Valuation Actuary Handbook* was completed in 1987. I think the first valuation actuary symposium was also held in 1987, although Errol and I were thinking that maybe that was the second one. Actuarial Standard of Practice No. 7, "Performing Cash-Flow Testing for Insurers," was issued in 1988, and Standard of Practice No. 14, "When to do Cash-Flow Testing" was issued in 1990. At year-end 1990, the NAIC adopted the Actuarial Opinion and Memorandum (AOM) model law and regulation calling for an appointed actuary and an asset adequacy opinion, except for some exempted small companies. The Actuarial Standards Board did its part by issuing Actuarial Standard of Practice No. 22 on "How to Comply With the Asset Adequacy Opinions" and issuing a compliance guideline for those who did not need to provide an asset adequacy opinion. The new law was somewhat controversial. Some felt actuaries weren't up to the task. Others felt that the effort was a waste of money. Still others felt that the new opinion might put the valuation actuary in conflict with senior management and make the actuary less a part of the management team and thus make him or her less effective.

These same objections became very strong a couple of years later when the Academy was considering a proposal that valuation actuaries prepare an opinion on the adequacy of surplus. In addition to this controversy within the actuarial profession, the life insurance industry was opposed to it. The Academy changed its mind and instead called for an actuarial report (rather than an opinion) to measure surplus adequacy. The SOA published, in early 1995, the *Dynamic Financial Condition Analysis Handbook*, which was basically a compendium of considerations for what you should do if you were to perform a surplus adequacy analysis. From a regulatory initiative standpoint, things calmed down considerably after 1992.

Meanwhile, insurance products continued to get more complex and the reserve formula methodology continued to show strain. In 1995, I gave a presentation at the Valuation Actuary Symposium on the status of the Academy of Actuaries Annuity Valuation Task Force. (It happens that Errol and I were co-chairs of the task force at that time.)

This task force had been charged with recommending changes to the standard valuation law for annuities, but retaining the traditional Commissioners Reserve Valuation Method (CRVM) valuation methodology to the extent possible. In our report to the NAIC the following month, our first recommendation was as follows: "We would prefer a change away from a reserve methodology based primarily on traditional formula minimum reserves towards more responsibility being placed on the valuation actuary for establishing reserves. We recognize that such a change is beyond the scope of our charge and such change is unlikely to be adopted by the regulators at this time." We went on to say that we could suggest several improvements to the Standard Valuation Law, but it really wasn't worth it compared with the amount of effort it would take to change a law. We believed that current issues, or at least issues at that time, could be addressed piecemeal by, for example, actuarial guidelines.

It would be nice to be able to say that, in 1997, the NAIC acted on our recommendation. Actually, though, I doubt that the annuity task force had a whole lot to do with the UVS initiative. It's just that the timing was right. The regulators and valuation actuaries were becoming increasingly frustrated in trying to fit new products into formula requirements. There was awareness by this time that cash-flow testing was actually working reasonably well. So in 1997, the NAIC asked the Academy to initiate a thorough study regarding current valuation methodologies applicable to life annuities and health insurance and to develop a model valuation system, unencumbered by existing legal, regulatory, and practical constraints. (I particularly like the aspect that it was to be unencumbered by practical constraints.) This effort is ongoing today, and I'll give a status report on this momentarily.

Let's backtrack a couple of years to 1995. The NAIC opened the door to nonformula-based nonforfeiture values, asking the SOA and the Academy to develop methodologies based on actuarial principles. This is an ongoing effort, but has a lower profile than the UVS.

Finally and more recently, we have some real changes in which actuarial judgment, in terms of assumption, will be used to affect reserves. Regulation XXX, adopted in 1999, allows us to use expected mortality in determining the X factor for deficiency reserves. Admittedly, there are some constraints, such as not assuming future mortality improvement. You can argue that it must be based on current experience, but for all practical purposes, there's a significant amount of actuarial judgment in the setting of mortality assumptions in calculating the X factor.

Starting in 2000, some companies will be using their cash-flow testing assumptions to calculate the C-3 component of their risk-based capital (RBC). This should cause valuation actuaries to think harder about their models and about their assumptions. It's one thing to have a set of model assumptions where you opine on meeting a threshold. In other words, are your reserves high enough? It's another thing to use them to actually set an amount. The methodology requires everyone to use the same set of interest scenarios, which I think is absolutely appropriate. Economic scenarios are one assumption set where there should not be individual actuarial judgment with regard to reserves or required capital.

So the trend has clearly been towards giving more regulatory responsibility to the valuation actuary, and it appears that there could be big changes for actuaries in the future. I have some additional thoughts on this that I'm going to save for the end of my presentation.

I want to spend some time giving a status report on the unified valuation system. A year ago, the UVS Task Force had reached a view on future methodologies. The methodology was as follows: We would keep the future formula reserve minimums. However, some innovative products not now covered by formulaic rules could have reserves based on a stochastic basis—say an 80 or 85 percentile adequacy.

The valuation actuary would calculate required capital, such as assets or adequate-to-cover in-force liabilities with some probability—say 95%. We're already seeing something like this with the new C-3 testing for risk-based capital.

The valuation actuary would prepare a viability analysis or dynamic financial analysis that includes new business. Low probability, high-impact risk (for example market conduct losses), would be addressed via disclosure, but they would not be quantified. There would be an outside reviewing actuary. This would be a peer review of the opining actuary's work against the applicable actuarial standards of practice.

Recent discussions have centered on the viability analysis. The Life and Health Actuarial Task Force (LHATF) of the NAIC has discussed adopting a required viability analysis report as a first step towards implementing UVS. This could have significant opposition by the insurance industry. Companies do not want to publicize their plans of operation. Even some of the regulators are skeptical of this. They think they can get the information they need via private discussions with the companies, and they believe that mandatory reports might not be forthcoming with complete information. The industry is generally opposed to new requirements on top of existing requirements, but they might consider something like this as part of a package deal, as part of a complete UVS system.

Let's turn now to nonforfeiture. This is an issue that refuses to die. It also refuses to stay stable. Formula minimums have just been added. It might no longer deserve to be a shining example of increased reliance on actuarial judgment. Let me walk you through the history.

It begins in the early 1980s with the adoption of the Universal Life Model Regulation. The regulators note that, among other things, the regulation allows mortality charges to exceed 1980 CSO, which, at face value, would appear inconsistent with the Standard Nonforfeiture Law. A few states decided to limit mortality charges. The NAIC decided to revisit nonforfeiture requirements for universal life and, later, nonforfeiture values for all life insurance. These efforts didn't get very far. The main problem was that minimum formula requirements, if based on a prospective approach, didn't work well for flexible products like universal life. On a retrospective approach, a meaningful requirement would appear to be rate regulation.

In 1985, the NAIC invited the SOA and the Academy to develop an approach using an "blank sheet" and to use actuarial principles to determine appropriate values. This they did. Proposals were developed that would have an actuary determine the appropriate equitable nonforfeiture values. One problem with the concept was that the evaluation of the appropriate actuarial value of the contract also requires evaluation of the future nonguaranteed elements. A requirement of a plan for nonguaranteed elements filed with the state and changed only with state permission is not one that the industry looks at fondly. Various proposals were considered. The role of the actuary varied. Some had no criteria, no minimum values, and just disclosure. The effort stalled in late 1997, rested for a while and has been picked up again. Up until the summer of 2000, the latest version would still eliminate formula minimums, but require values to comply with actuarial standards of practice. I'm not sure what that was supposed to mean.

At the June NAIC meeting, it was decided that any proposed new law should provide guaranteed minimum values, so the latest draft has a retrospective minimum formula. The minimums are not very onerous, but some will probably oppose it on the basis that it includes the concept of rate regulation, even if it isn't a constraint for practical purposes. There is a concern that once the concept is approved, the limits will be tightened. There's also a required plan for nonguaranteed elements. It's not clear what the professional role of the actuary will be. There is the determination of values that's supposed to comply with actuarial standards of practice, but this might not mean much unless there's some requirement that values meet actuarial principles. It might be as limited as ensuring that alternative nonforfeiture benefits have equivalent actuarial present values.

So this has a long way to go, and given its history, it is tempting to ignore. However, the American Council of Life Insurers' (ACLI) Actuarial Committee recently submitted to the NAIC its own version of a proposed new standard nonforfeiture law. I think if the industry is willing to work on this, something might actually happen.

Now, I'd like to quickly go over the list on a recent NAIC agenda. Many of these topics are being covered in more detail in other sessions. I just want to make sure that you're aware of the existence of these issues.

There were eight topics for the Life and Health Actuarial Task Force (LHATF). First, there were proposed changes to the Actuarial Opinion Memorandum Regulation (AOMR). There's an effort to change the actuarial opinion from a state-of-filing basis to a state-of-domicile basis. In making this change, the Life and Health Actuarial Task Force took this as an opportunity to toughen the opinion requirements on small companies. The current draft would require an asset adequacy opinion for everyone. This doesn't necessarily have to mean cash-flow testing.

The Actuarial Standards Board is working with the Actuarial Task Force on this and making modifications to Actuarial Standards of Practice No. 7 and 22. The drafting is nearly done. It's exposed for comments. There is some opposition by the small insurance companies, which might make individual state adoption less likely, even if it passes the NAIC.

Another topic of LHATF was variable annuities with guaranteed living benefits. The Academy has a proposal similar to Actuarial Guideline 34, which addresses reserving for guaranteed death benefits. The focus is on multiple years' poor fund performance. The actuarial task force is still digesting the proposal.

The third topic is nonforfeiture for products with secondary guarantees. This so-called NAIC Actuarial Guideline XYZ would require nonforfeiture calculations on level premium segments of universal life contracts with secondary guarantees. The required cash values would be large compared with typical premiums. Recently, an alternative retrospective approach was proposed that would have much lower cash values.

I've already discussed general nonforfeiture and unified valuation systems, which were the fourth and fifth topics.

Sixth was the new CSO table as a replacement to the 1980 CSO table. The SOA is on track to develop a base valuation mortality table by this year-end. The Academy has a task force looking at how to convert this into a valuation mortality table. What should the margins be? Note that it is expected that there is going to be some basis by which a company can modify the table for its own experience, like with the X-factor in Regulation XXX.

Seventh is reserving for variable life and variable universal life. An actuarial guideline proposed by an Academy task force is being exposed for comment. The intent here is not dramatic change, but clarification and consistency. The eighth topic is revisions to Actuarial Guideline 9A, which permits higher mortality and lower reserves, for substandard structure settlement annuities. A proposal to allow higher mortality for other kinds of substandard annuities is being exposed for comment.

There are a couple of topics that are no longer on the agenda. The first addressed reserving and nonforfeiture issues for life insurance extended beyond age 100. The second addressed issues related to cash-value strategy products, which are products whose credited rates are linked to total returns of general account assets. Both of these projects were deemed to overlap with the general reserving and nonforfeiture projects and were dropped.

There were seven items on the agenda of the Accident and Health (A&H) Working Group. I'm a life actuary, and I don't know much about health insurance. Julia Phillips helped me with these items.

The first item is the *Health Reserves Guidance Manual*. This is a good one for valuation actuaries. In health insurance, statutory reserve requirements are not as specific as they are for life and annuities. Reserving relies more heavily on judgment, and there was not a whole lot of guidance. The Guidance Manual was believed to be a good thing to help valuation actuaries and reviewing regulators. The Academy developed a manual, and the A&H working group has spent the last year finishing it. The draft is available on the NAIC website and is expected to be adopted in December.

The second item, codification, is not a big issue. The A&H working group has asked whether cost containment expenses should be treated as part of claims in the annual statement because these are payments in lieu of claims. It would define what kinds of expenses should be treated as claims, and this should go into effect in the 2002 statement.

The third item is the Medicare Supplement Compliance Manual. This pertains to rate filing. It's an update to an existing document. The document is a compendium of requirements for Medicare Supplement filing. It was recently adapted by the NAIC's B Committees.

Fourth is Medicare supplement insurance issues. The concern here is large rate increases. The Academy issued a study in June that analyzed Medicare Supplement claim plans in many different ways. The A&H working group will now decide what it wants to do with it. It might do something similar to what it did with long-term care. That would be the fifth agenda topic, which is Rate Adequacy Long-Term Care.

The A&H working group, with industry and consumer support, has been working on a set of amendments to the NAIC's long-term-care model regulation to address concerns over rate stabilization issues.

The goals are to increase the likelihood that premium rates offered by companies will be adequate over the life of the policy, to decrease the frequency of rate increases, and to reduce the levels of necessary increases. The amendments eliminate the initial loss-ratio requirements, which is a good thing. They also put some additional restrictions on insurance companies. They put limits on the expense allowance increases.

They also would do the following: (1) require reimbursement of unnecessary rate increases; (2) provide policyholders the option to escape the effect of rising rate spirals by guaranteeing the right to switch to currently sold insurance without underwriting; (3) authorize the Commissioner to bar from the marketplace for five years, companies that persist in filing inadequate initial premiums; (4) require companies to provide actuarial certifications regarding adequacy of all rates. These amendments were adopted in March 2000, and now work is proceeding on a guidance manual.

The A&H Rate Filing Guidelines are the sixth item. That agenda heading is nondescriptive. This covers rate filings of individual medical expense contracts. Basically, the Actuarial Task Force is reviewing rate regulations on a product-by-product basis. They just finished long-term care. They are addressing individual medical expense and disability income in 2000. They will do Medicare Supplements in 2001.

The seventh item is small employer availability model regulations. This regulation is being updated by the regulatory framework task force. The A&H working group has just started looking at it to see if they want to make any changes.

That takes care of the NAIC's A&H Working Group. Regarding other items of interest, I've already noted the new cash-flow testing requirements for certain companies for risk-based capital C-3 testing. It is applicable for this year-end. The next item will be to develop a scenario-based approach for C-3 risk for equity-linked assets.

The final item on my list is the life liquidity risk working group. This was an outgrowth of concern about GIC contracts with bailout provisions linked to credit ratings of the insurance company. Initial discussions considered whether the actuarial opinion should address liquidity, but the answer was no. Now they are considering a set of annual statement interrogatories similar to those in New York Circular Letter No. 35. The Academy has a draft report on liquidity analysis that should be available on its Website.

I'd like to finish with three questions about whether we will continue to see valuation actuaries get more responsibility and the right to use more judgment. The first question is, are actuaries technically ready? I would have to say, probably not right now, but they will be. I think a lot of actuaries probably would not be ready right now to calculate required capital if it was just thrown into their laps. Much more knowledge needs to be gained. There are probably more tools that companies will have to obtain. I think the actuaries would tend to rise to the challenge. I think the same thing was true with cash-flow testing. When the law got passed in 1990, not everyone was ready to do it right away, but by the time it was effective and companies had to do it, I think most of them were ready to do a pretty good job.

If UVS goes through and valuation actuaries are required to provide or calculate a level of required capital (given the lead time before these kinds of things become effective), I think they'll be able to do it. I think we'll see an amazing amount of research and tools developed if everybody knew that this was going to be effective in a couple of years.

The second question is: Are actuaries professionally ready? That means, given the responsibility, can actuaries be trusted to do the right thing? I think so. I struggled a bit with this because, while I was preparing this presentation, there were some articles coming out in the *National Underwriter* about creative companies dodging the requirements of Regulation XXX. In other words, companies are following the letter and not the intent.

I think if I were a regulator, my knee-jerk reaction would be to tighten regulatory requirements, not loosen them. However, I liked one of the quotes by Jim Van Elsen in the August 14th *National Underwriter*. He said, "One of the general problems is that if you draw a line, people go right up to it." I think that's true. He might have also added that if artificial limits are out of line, people feel justified in creatively going around them. I think valuation actuaries want to do the right thing. They want standards to back them up when they do the right thing. If we get away from these restrictive formula minimums and just say, "Do the right thing," I think that will happen.

The last question is, will the trend for giving more responsibility to the valuation actuary continue? My answer to that is absolutely, yes. We have increasing complexity in our products. I don't think the regulators are going to be able to continue to maintain this flurry of actuarial guidelines to keep up with it. The other thing is, we have increased competition. With increased competition, the cost of redundant reserves, and having excess capital, is just becoming something that the life industry can't have. In the old days, if you had a regulation like XXX where the reserves were too large, companies might just put them up, but these days you just can't afford to do that.

I think that the near turn stimulus will be that the mortality changes will lead the way. We've already seen that on Regulation XXX with the X-factor. We may see the same thing when we get the replacement to the 1980 CSO. There's going to have to be some provision in there for companies to modify the valuation standard on mortality and reflect their own company experience. I think if that goes far enough, then that leads naturally to changing mortality experience or mortality assumptions underlying nonforfeiture requirements. I think that will be the stimulus that will keep this trend going.

In conclusion, I hope that five years from now, we won't be having many concurrent sessions that talk about the 20 actuarial guidelines and 10 regulations that are in the process of development to handle all these specific cases. We'll be talking about how to handle the broader issues of how to set reserves and how to set required capital? There will definitely be valuation actuary symposiums in years to come.

MR. SAM GUTTERMAN: I'll focus my presentation on what I consider to be the most significant recent development in general purpose accounting or GAAP. That is the move to the fair valuation of assets and liabilities. I'll also be covering some other developments in the GAAP-related world including: recent activities and emphasis of the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), the seemingly all-powerful, Securities & Exchange Commission (SEC), and on the international front, the International Accounting Standards Committee (IASC). It is a veritable alphabet soup of accounting-related organizations.

I'll address three principal questions regarding fair valuations. First, what is this method all about anyway? This has been creeping on to a vision screen of some actuaries and has been on the agenda at the Society of Actuaries meetings for a number of years, but I don't think that most of us have realized how significant this accounting concept will be to our future.

Second, the key, as I see it, is whether moving to such an accounting system for insurance liabilities is conceptually desirable and practical. Although details are not yet available, the current status of the broad outline of the methodology is known. This lack of final details, however, regarding its measurement and scope makes it difficult to assess its merits. Once the concept is agreed to, the next question will be where and how to use them, which obviously depends on whether this movement will continue. It's either an exhorting push toward measuring more values in the financial statements, or it will be stopped in its tracks. The final question is when to apply fair values. They're increasingly applied to more and more assets. Why shouldn't they also be applied to the valuation liabilities and the remaining assets?

There are several forums in which fair valuation is now being considered. I'll be dealing with the two obvious ones that we'll be applying to the American actuary—the U.S. and the international scene. In the U.S., FASB has obviously been a current focus where fair values are now being discussed and implemented. In addition to the FASB, which is one of the most significant proponents of fair values, I'll also spend some time discussing the international accounting scene, which is of increasing importance in and of itself. It might play a much larger role in the development of convergence of international accounting. By the way, U.S. actuaries and Americans, in general, have typically focused our attention only on the U.S. We are the biggest economic country in the world, so why should we care about international development?

To provide us with an indication of how important international is getting, I'd like to conduct a quick poll of the people in the audience. How many people are either employed by a non-U.S. company, a subsidiary of a non-U.S. company, or a company that has a subsidiary outside the U.S.? I don't see many without a hand up. That's an interesting development. Five years ago, I think we would probably have seen the opposite.

Internationally, the two most important players in the midst of this fair value discussion are the IASC, and the joint working group of Independent Accounting Standard Setters, which consists of staff members of accounting standard-setting organizations around the world, including the FASB and the IASC that are working on a number of related research projects with the aim of promoting worldwide convergence. What is of specific interest to us and the entire actuarial profession is the IASC's effort to develop a set of international accounting standards for insurance and the joint working group's upcoming report discussing issues involved in the fair value of financial instruments, which I consider to be a warm-up for future revisions to U.S. GAAP.

What are fair values and what do they apply to? Fair values now apply in a variety of accounting contexts: to purchase accounting; to impairment tests; to many financial instruments as assets; and, very soon, to derivatives. Although current applications primarily relate to assets, the most heated discussion now relates to determining how this valuation method can apply to liabilities. Discussions regarding comprehensive application to financial instruments or all financial assets and liabilities are now underway.

You might ask, why should the method used to value financial instruments such as stocks and bonds that are traded on open markets be at all related to insureds and the value for the liability for insurance obligations that are not so traded? First and most obvious, most invested assets of insurance companies are financial instruments. Therefore, they'll be affected. Second, what's more important to the valuation actuary? Insurance contracts are considered to be financial instruments as well, even though there's no active liquid market.

This leads us to examine the definition of fair values. The one used by FASB is the amount at which the financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, then the current transaction price or a current transaction price should be the basis for its fair value. If not, other indicators determined by using available market indicators as a guide for establishing certain aspects of such value will be used; an example is the present value of future cash flows associated with the instrument (strictly a prospective approach).

Although relatively new to most actuaries, fair values in the general purpose accounting context have already been applied in a number of standards. Many of the factors that have led to the current situation are rooted in financial and business trends that have been around for some time. That is a gradual movement toward a balance-sheet-oriented accounting system due to an increased importance of capital markets. This can be seen in the insurance industry's move to demutualization. There is more concern with effective uses of capital, as Doug mentioned, and more demand for increased transparency in reporting. There is more recognition of the need for risk management, as evidenced by increased use of derivatives in hedging. Otherwise, decisions will be made to take advantage of accounting arbitrage—decisions to enhance the firm's balance sheet as well as to take advantage of tax rules rather than economic soundness of transactions.

Currently, the existing standards that prescribe methods to be used to estimate values of future cash flows are not required to be reported on the basis of fair value and are not necessarily being updated. However, every new standard and old standard being updated for other reasons are being evaluated in this context. Some argue that this process or this approach will result in a mixed attribute system that has multiple accounting methodologies. However, we've always had, and we probably always will have, some form of a mixed attribute system.

The IASC has far fewer standards in place (as compared with the U.S.), and it has recently adopted international standards. It is more likely that existing standards will be revisited if a decision to go to full fair values is made.

In summary, there's limited activity to revise existing standards. On the other hand, I think this process is in the works and will be continuing.

Three FASB developments related to the move to fair values over the last few years are worth noting. First is the implementation process for *FAS 133* and the amendment of *FAS 138* managed the actions of the derivatives implementation group (DIG). Second, is the present value concept statement No. 7 on using cash-flow information in present values in accounting measurements. Third is FASB's Preliminary Views Paper that has been recently exposed as a comprehensive implementation of fair values for financial instruments.

A significant controversy developed a couple of years ago over FASB's attempt to require fair values for all derivatives on the balance sheet. Previously, only their volumes were provided, and even then, it was just in financial disclosure in financial footnotes. Note that even though most people think of it as being applied all to assets, it also applies to liabilities as well.

In the case of financial assets, requirements affected both derivatives and embedded derivatives, covering forwards, futures, swaps, and options. Many debt instruments with floors, caps, floaters, collars, and so on are also affected. Generally, most convertible debt instruments include embedded derivatives, the values of which must be bifurcated.

Many insurance policies also have embedded options, the body of which should also be bifurcated from the liability, unless specifically exempted. Even though the most obvious one is equity-linked products, there are many others as well. I won't go into this any further because we have a number of sessions that are related to this topic at this valuation actuary symposium.

Second is FASB's present value concept statement. After long deliberations taking more than 15 years, the FASB finally adopted in 2000 a concept statement on present values. In the past, FASB has incorporated present values in a number of its standards, but on an inconsistent basis. This concept statement is an effort to provide a rigorous framework, which any new or revised standard, including fair values, can look to for guidance regarding the measurement of present values.

A FASB concept statement is similar to an actuarial principle—something that should provide guidance to its establishment of standards later on. It does not, by itself, change any existing standards. In fact, this concept statement doesn't address the question of when to apply present values. It just looks at measurement issues. However, it does establish a framework from which fair values can be determined (when determined appropriate to do so), serving as a surrogate to market values or market prices when there is no active market available. It also sets the stage for future developments of GAAP, including insurance accounting. FASB's belief that present values are always more relevant than undiscounted values is certainly an early warning to the property and casualty insurance industry. A great deal of discussion is devoted to expected values in this document. This sounds strange because actuaries have been used to this for decades. On the other hand, accountants are still more used to dealing with concepts such as best estimate or most likely values.

There is another interesting aspect of this concept statement. FASB has indicated that as long as the market reflects risks in the prices of similar instruments, it will be permissible to reflect this market assessment in a calculation of present values, a movement away from *FAS 97*. A concept that actuaries are not used to is how the value of a liability would be independent of the value of any supporting assets. The basis for this conclusion is that an insurer can trade its assets on a market at any time, so even though the current value of the assets would be at their fair value, the actual assets shouldn't affect the discount rates of those liabilities. Rather it has come out in favor of the use of a risk for the interest discount rate.

One of the most controversial issues is that FASB has come up very strongly in favor of reflecting the firm's credit risk as a discount applied to all its liabilities. This is controversial in the comment submissions to the IASC and its insurance issues paper. I believe the vote was 95 to 5, but unfortunately, from some people's views, FASB's staff comments were included in those five.

Third is FASB's Preliminary Views Paper. The FASB has been discussing the possibility of developing a comprehensive standard requiring a fair valuation of all financial assets and liabilities, including insurance. This discussion has been going on for a couple of decades, but this has increasing motivation or incentives because the discussion of the derivative issue has gone along. The preliminary views were published in December 1999, and its comments are due by May. The big issue with respect to the preliminary views is that this might be a preliminary round for an overhaul of all insurance accounting. The American Academy of Actuaries made comments on that, which will be dealt with in a later session.

On the international scene, the IASC has had a steering committee on insurance accounting standards for more than three years. It was the IASC's first effort and an industry-specific standard, but it has been a very difficult one for the IASC and the insurance industry. Only recently has the industry itself become engaged in these discussions, but I'm glad to say that through the efforts of the International Actuarial Association, the actuarial profession has so far had significant influence in its developments, and I hope that it will continue to do so.

The IASC put out an insurance issues paper in late 1999. Although the issues paper did not contain a specific proposal, it has significantly influenced the debate regarding insurance accounting for the last year. Note that the IASC's insurance committee currently believes that fair value should be applied to insurance because it assumes that the accounting community is moving to fair value of all of assets. There are many issues outstanding in this project, from the basic in terms of scope, to the basic in terms of practicality and comparability. Other issues include whether there should be a minimum liability floor—that is for cash values for term insurance with zero being a minimum. There are many issues that are being discussed. As a matter of fact, there is a meeting being held in London very soon. With regards to this issues paper, the International Actuarial Association (IAA), came up with a set of comments that run up to 200 pages, which you can see by looking at the IASC Website.

Another development is an upcoming project on present values, which is similar and will present an issues paper in another two months. This will be another thing for actuaries involved in actuarial organizations to spend their time on.

The last item that I would mention on the international side is something called the Joint Working Group of Independent Accounting Setters. This is an important group that most people probably have not heard about because they're studying some of the issues relating to fair value (particularly liabilities on an in-depth basis covering all financial services industries). This will be an important one. It's now scheduled to be distributed the first week of November 2000, and it will be a significant one because it discusses fair values of all financial instruments, not just insurance.

Of course, a wide number of other issues have been addressed over the past year. In summer 2000, the FASB issued an exposure draft of possible standards on the accounting for the impairment or disposal of long-lived assets and for obligations associated with disposal obligations. It will be the first application of FASB's Statement No. 7. It is important in that respect. The FASB was exposed to draft standards on business combinations and related intangible assets in the fall of 1999. This has been under discussion during 2000. The draft would require all business combinations to be accounted for based on the purchase method of accounting, rather than the pooling method that has been very popular. The exposure draft would require the amortization of all intangible assets over the lesser of their useful economic life or 20 years. Recent deliberations show that the FASB is considering the elimination of that maximum life stipulation.

The FASB's interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, might be significant, partly due to the definition of its applicability. The directors are included, but agents will not be able to be covered by employee stock compensation plans.

Of interest to some is the Emerging Issues Task Force that deals with current topics of interest and interpretation. It's Issue No. 99-2 covers weather derivatives. This distinction is between trading and nontrading activities involving these financial instruments. Those who trade these instruments, such as some insurers, will be deemed to be traders and subject to fair-value reporting or marked-to-market requirements with changes in fair-value reporting coming into earnings directly. At its issue, the value of a nonexchange-traded forward weather derivative will be based on its intrinsic value with the premium amortized in a rational manner. Thus, not everything in front of FASB is moving directly to fair values.

Issue 99-4 will be more directly relevant to life insurers. The task force reached a consensus that stock received from a demutualization should be accounted for at fair value with a gain recognized in income from continuing operations.

AICPA issues. In the fall of 1999, the AICPA got rid of its insurance committee. It is still in the process of figuring out how it's going to manage insurance issues. It has released its new audit guide for life and health insurers. This new guide isn't revolutionary, but it does incorporate most recent accounting developments over the last several years and will be a useful reference work. I found one section on the use of an actuary to be interesting. The guide requires the use of an outside qualified actuary. It must be an actuary who is neither an officer nor an employee of the entity whose financial statements are being audited, in connection with auditing reserves, deferred acquisition costs (DAC), and other actuarially determined amounts in all audit engagements to which the guide applies. Therefore, you'll see audit firms using actuaries even more.

The AICPA put out a Statement of Position (SOP) to provide guidance on accounting for the formatting of a mutual insurance holding company and demutualization accounting for insurers. It indicates that the closed block should be presented together with the rest of the company's financial statement. It classifies demutualization expense as ordinary expense and insurers should generally continue to account for participating contracts in the same way as before it changed its corporate form. It also covers a number of applicable presentation issues.

For various nontraditional insurance contracts, the AICPA has developed or has been providing guidance to the FASB's Derivatives Implementation Group and has established a task force to study the approach that should be taken to various accounting issues for such products issued in conjunction with separate accounts and those with the minimum death benefit guarantees, for which no guidance has been provided heretofore. It also is addressing issues such as interest and persistency bonuses, which would be expensed as incurred or over the relevant vesting period using the interest method. Those contracts with minimum death benefit guarantees would be treated as either *FAS 97*, universal life, or *FAS 97*, investment contracts (depending on the significance of the guarantees measured) by comparing the present value of these expected guaranteed payments to the present value of assessments under the contracts. In a separate project, the AICPA is looking at various accounting issues associated with health insurance products, but has been coming up with a lot of problems in this project.

Let's briefly discuss coverage on a few items of interest being addressed by the SEC. Standards Accounting Bulletin (SAB 99) covers the topic of materiality—always a challenging area for both accountants and actuaries. The primary conclusion reached is the determination of materiality should be based on the specific situation involved. It never defines materiality; rather it indicates that a numerical or percentage threshold that many have been using for assessing unadjusted differences, such as 5% of a given balance sheet item, might provide only a basis for a preliminary assumption as to materiality. This basis can only be used at the beginning of the process of evaluation and needs to be supplemented by qualitative elements. SAB 100 provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations. For example, it highlights the SEC staff's concerns regarding situations when assumed liabilities are recorded in amounts materially different than those historically reported by the acquired company. The SEC formally requested opinions from the public regarding the effectiveness of the International Accounting Standards Committee's (IASC) set of standards. The SEC is interested in seeing if they should allow or permit IASC standards to be used for companies from outside the U.S. who want a list inside the U.S rather than for domestic companies.

The SEC continues to emphasize, in dealing with filings, its concerns about the management of earnings and the reporting of excess amounts of reserves. The SEC has recently required more uniform disclosure. In the last couple of weeks, it came out with a statement that selective disclosure material to selected financial analysts are not to be used.

This presentation wouldn't be complete without briefly mentioning the SEC's enforcement of independence as it affects accounting firms. It seems that the SEC is forcing each of the big five firms to divest itself of a significant portion of their consulting practices. It certainly will affect a number of actuaries, maybe even some in this room. Another notable development is a report from the panel of audit effectiveness, appointed by the public oversight group, another accounting group, to enhance the effectiveness of the audit. Over the last year or two, increasing attention has been given to the role and effectiveness of audit committees.

The IASC is being reorganized because of lack of transparency, and the fact that it has not been as objective as it should have been over the last couple of years. I have been told that the incoming chairman starting January 1, has expressed a belief that the development of a new insurance accounting standard is quite high on his priority list. It might be the highest substantive issue, if for no other reason than to prove that the IASC can serve a valuable function. There is current wide divergence in international practice on insurance accounting. This is viewed by the new English incoming chairman, Sir Tweedie, who happens to be an honorary fellow of the Institute of Actuaries, as foretelling some more immediate action on the insurance accounting standard.

In addition, the IASC is planning on distributing an issue paper on present values probably in November 2000. In addition, it has begun a project on performance reporting, which will also have a potential impact on insurers.

Just like Doug, I want to open up my crystal ball and see what will happen next year. It's difficult to predict what the future will hold in any area, particularly in this transitional period in the middle of possibly a significant change in accounting paradigms. This difficulty especially applies in the area of insurance.

Important discussions covering various aspects of fair values will certainly occur during 2001. The outcome is unknown because of opposition from many in the financial service industries, particularly banks and because the insurance industry (a number of insurers) is becoming involved. In addition, particularly in Europe, there might be a spill-over effect on the statutory accounting, where the Economic Union (EU) is trying to get regulatory and GAAP reporting on a consistent base (just as it currently is in Canada). During 2001, the implications for insurance accounting will certainly become clear. Based on discussions so far, I believe that general purpose accounting will be experiencing a revolution on the international scene, through the IASC, which many actuaries have looked at as something that won't affect them. There will also be a revolution in the U.S. as FASB develops its thoughts about moving to a fair valuation of assets and a fair value of liabilities.

MR. CRAMER: I'd like to finish off with a discussion on financial services integration. What do we mean by financial services integration? We mean banks are buying other banks to achieve scale and pyramiding into conglomerates. *Bancassurance* comprises banks selling insurance directly, bank alliances with insurers, banks buying insurers and vice-versa, insurers acquiring other insurers, demutualization, foreign companies introducing products and distribution methods in the U.S., insurers getting into asset management, banks underwriting securities, and so on. There is a lot of interaction currently occurring among the different financial service institutions.

Hardly a day goes by without news of another major financial services deal. Not so long ago, $40 billion deals were considered extraordinary, but now they are commonplace. Those who read this morning's newspaper saw the front page header, "Banking Titans Bury Hatchet in $35 Billion Deal." Chase Manhattan is buying J. P. Morgan, so these deals are certainly happening.

There are three topics I'd like to cover. First is the Gramm-Leach-Bliley (GLB) Act. It is unlikely that many of us have read the act as it's rather lengthy and extraordinarily difficult to get through. I'll provide you the thumbnail sketch. Second, is mergers and acquisitions (M&As), which is always a popular topic with financial services integration. Third, I will make a few comments on globalization of financial services.

To understand Gramm-Leach-Bliley, let's review a history of major acts that have had significant impact on the financial industry in the U.S. The Glass-Steagall Act of 1933 followed the stock market crash, and legislators, feeling that the banking industry heavily added to the crash, considered it prudent at that time to strictly separate commercial from investment banking. At first, banks were not permitted to do any security underwriting whatsoever; however, over time, Section 20 of the Act was creatively reinterpreted so that banks were eventually permitted to engage in up to 25% of its business in investment banking.

The next act of importance to us is McCarran-Ferguson of 1945 with which we are all very familiar. It delegated regulation of insurance and insurers to the individual states, which is the genesis of our current state regulatory environment.

A subsequent major act is the Bank Holding Company Act of 1956, which restricted what nonbanking activities a bank could get involved in through its subsidiaries. Over time, its restrictions have been relaxed. You may recall, in the early 1990s, there was a lot of activity of banks trying to enter into insurance business. In 1993, Section 92 of the National Bank Act permitted banks who were in a town of less than 5,000 people to sell insurance. This created a loophole when it was later clarified that a bank could merely establish a branch in a town of less than 5,000 people and then sell to anyone else outside the town. In any case, the banks were beginning to make inroads into insurance.

In 1998, Citicorp Bank and Travelers Insurance merged to form Citigroup—the largest M&A merger deal ever. Shortly thereafter, in 1999, congress enacted the Gramm-Leach-Bliley Act, which is also known as the Financial Services Modernization Act. It would facilitate these types of deals going forward.

It should be noted that Gramm-Leach-Bliley is only a partial solution to integrating the financial industry. It is at best a trend in the right direction—a mix of the good, the bad and the ugly. The "good" part is that it allows for formation of what's called a financial holding company (FHC), which is the parent organization of subsidiaries, each engaged in its own various type of financial services business. This then is a way to form a conglomerate out of the separate financial service businesses. The easiest way to form an FHC is for an existing bank to apply for approval to convert into an FHC, as I believe this is almost an automatic approval filing. Other companies would first have to go through the lengthy and probably extraordinarily difficult process of getting approval as a bank before becoming an FHC. Essentially, GLB is centered on banks becoming the core of the financial services industry.

The "bad" part is not what's in the law, but what's not in the law. Given the enormous complexities involved, it was not feasible to thrash out a comprehensive law to apply to all financial industries. For example, even within our industry, we've spent 20 years trying unsuccessfully to develop a relatively simple item of a new Standard Nonforfeiture Law. It just couldn't happen in any reasonable timeframe. Nevertheless, there are two key items that the law doesn't address, namely tax and capital requirements.

Regarding tax, each subsidiary continues to follow its own tax rules. This retains the current industry variations and disparity in treatment. There is the way capital gains are treated in banks versus insurance companies, and the fact that only insurers do tax reserve calculations. This is bad in terms of the economic sense of a level playing field. However, this could be an advantage in terms of individual corporations—it allows tax arbitrage, and it will certainly keep a lot of people employed in the tax business.

The other "bad" item is that the act doesn't address the varying capitalization requirements of each industry or each subsidiary. Arguably, the main driver of integrating financial services is to employ capital more efficiently and a key outcome of financial integration is to lessen economic risk through diversification. An example is Citigroup where the ratings were increased above what they were for the individual pieces.

The "ugly" part is that the act does not change the regulating bodies for each subsidiary. We know how complicated it is for us to deal with our insurance system of individual state regulation. There are potentially conflicting laws and just the sheer volume of keeping abreast of everything. If you're management of a financial holding corporation, you don't just have the insurance regulatory environment to deal with. You have the banking regulators, the thrift supervision, the SEC, and so on. That's going to be quite a tough job.

Also, the act comes with an additional layer of regulation at the federal level. The first taste we've seen of this federal regulation has been the discussions on consumer privacy—it is hard to argue against consumers' rights to privacy, but, this is a political issue. The concern of the financial industry, especially the banks, is the undue restrictions on their ability to conduct business.

Chart 1 shows the last three-and-a-half years of life insurer M&A activity. The blue bars show the dollar amounts of the deals ($10 billion in 1997, $30 billion in 1998, $16 billion in 1999, and $7 billion for first half 2000). The red line shows the number of deals (45 in 1997, 75 in 1998, 49 in 1999, and 27 for first half 2000). There was a spike of activity in 1998, which included the large acquisition by AIG of Sun America, which alone was $18 billion. Some big deals since then include the $11 billion Aegon acquisition of Transamerica and the $5 billion ING acquisition of Reliastar. The point is that there are some fairly large deals happening, and M&A activity, even within the narrow life insurance sector, looks like it will be continuing unabated.

The last topic to cover is globalization. We know of Axa buying Equitable, and there are the Aegon and ING deals. The Europeans are coming to the U.S. because that's where the large financial markets are, and America is going to Asia because that's the emerging market. However, I want to focus on something very narrow—*bancassurance* sales globally. Let's discuss bank sales of life insurance products as a percentage of the total life sales, by country in France, Spain, Italy, the U.K., Germany and the USA. In Germany, it's 15% and this percentage goes up to 50% in France. The U.K. banks sell substantial amounts of insurance, but in the U.S., sales make up only 2%. The key reason for the difference in bank sales in the USA versus foreign countries has to do more with differences in banking laws than with differences in consumers' preferences. U.S. banks will likely, at some time in the future, want to get more into insurance sales.

One should consider the market capitalization of banks versus the insurance industry. For example, I believe Citigroup alone has a higher market capitalization than the entire life insurance industry. It might not be entirely a fair comparison because not all companies are stock companies and have market valuations. The banks are a lot bigger than insurers. A famous outlaw was once asked why he robbed banks, and he replied, "That's where the money is."

CHART 1
Life Company M&A