2005 Valuation Actuary Symposium*

Orlando, FL
September 22-23, 2005

Session 12 PD
Financial Statement Disclosure

Panelists: Pavel Blinchik
Robert Frasca

Summary: Investors, analysts, regulators and policyholders rely upon the information provided in statutory and GAAP financial assessments to assess the financial health and prospects of life insurance companies. But how complete a picture do financial statements provide? Do they accurately portray the financial risks assumed by companies and the impact on the companies' financial health under adverse circumstances? How useful is the information that companies disclose?

This session covers issues related to financial statement disclosure. Panelists discuss financial statement disclosure requirements in the United States and other jurisdictions and examine the quantity and quality of financial risk disclosures by life insurance companies.

Following this session, participants have an appreciation of financial statement disclosure requirements and how well the information disclosed by life insurance companies serves the needs of the public.

MR. ROBERT FRASCA: I'm an actuary with Ernst & Young. Prior to that, I worked in financial reporting roles, mainly at different insurance companies. When I think back to when I was doing financial reporting in insurance companies, my focus was on getting the numbers out at that time. I was concerned about the end of the quarter and making that sure the numbers were out, were right, got reported and posted. At that time, I never thought that much about the people who look at those numbers in the financial statements and what the numbers mean to them. If you think about a financial statement, you can't tell that much from the numbers. What you need is the disclosure. What are the words that you put into the financial

*Copyright © 2005, Society of Actuaries

Note: All charts referred to in the manuscript can be downloaded at:
http://handouts.soa.org/conted/cearchive/valact05/012Bk.pdf

statements? What are the things that you can say that help illuminate what the numbers don't tell you?

Our other panelist, Pavel Blinchik, is with Lehman Brothers. He follows the life insurance industry quite closely. Mr. Blinchik reads a lot of 10-Ks. He reads a lot of 10-Qs. He reads a lot of disclosures. He listens to a lot of earnings calls. There are things that Mr. Blinchik likes about financial statement disclosure in insurance companies and things that he doesn't like about insurance company disclosure. I'm going to talk about research work that we've done in financial statement disclosure practices at insurance companies. In particular, I'm going to focus on financial statement disclosure surrounding financial risk.

There's a whole range of things that you could talk about with respect to disclosure. I picked financial risk for a few reasons. The most obvious is that we're all actuaries, and financial risk is probably one of the most critical things that we look at. I think that financial risk is an interesting topic because it gets at the issue of why people use financial statements. If you think of financial reporting, it's the income statement that tells you how a company performed in the past. It's the balance sheet that gives you the snapshot of what the company looks like today. Those are only useful to the readers of the financial statement in terms of how they help the readers understand what might happen in the future. Nobody is that interested (aside from an academic standpoint) in what happened in the past. Readers of the financial statement want to know if a company is going to earn money in the future. What are the risks surrounding a company? Is this a company in which they want to invest?

For that reason, I want to talk about financial risk and disclosure regarding financial risk. I'll also talk about requirements in the United States, Canada and some other jurisdictions. I'll discuss accounting bases and how they help to shape financial disclosure. The purpose of financial disclosure is to complement what the numbers don't tell you. How effectively the numbers themselves tell you something is going to shape how much additional disclosure you need within your financial statements.

In looking at the quality of financial statements, I'm looking at five different measures. The first is forward-looking statements. That disclosure that addresses how a company might earn money in the future is useful and helpful disclosure. I'm not alone on this. The FASB right now has a task force on looking at the conceptual framework. One of the things that they're looking at is disclosure in the context of predictive ability. What sorts of things are disclosed that can help you see the future for the company?

Regarding quantitative measures versus qualitative measures, clearly, anything that gives quantity on an issue is more valuable than qualitative types of descriptions. Sensitivity tests can be run to discover if anything in the financial statement can be related to how things might change if either the assumptions or the economic environment changes. The SEC recently came out with Financial

Reporting Release No. 60, which said that the organization wants to see sensitivity tests on the key issues in the financial statements.

Another measure is comparability across companies. Some of the more recent financial pronouncements, whether it be Standard of Practice (SOP) 03-1, which dealt with liabilities, or Emerging Issues Task Force (EITF) 03-1, which is based on the asset side on temporary impairments, have relatively prescriptive descriptions of what you have to disclose. This makes for better comparability across companies. If you get one company that's providing good disclosure on a particular risk, that's great, but it doesn't do the observers of the industry very much good if that's the only company doing it. You only can make judgments insofar as you can compare from company to company.

Finally, in any accounting basis or regime at which you look, disclosure of assumptions is critical, whether it's U.S. or Canadian GAAP, embedded value or International Financial Reporting Standards (IFRS). There are varying roles in disclosing assumptions. How rigorously and how well companies do that leads me to judge how well they're doing in terms of financial statement disclosure.

The basis of what I'm going to talk about is observations that we've made by looking at 25 different companies' filings (10-K filings, primarily) over the last five or six years. We've looked at medium and large companies, both U.S. companies and foreign filers (20-F statements in the United States). Our research included a relatively good range of practices, I think. All of the Big 4 accounting firms are covered. I'm going to outline a relatively good snapshot of where the industry is today.

We concluded that both the volume and the quality of disclosure have improved quite markedly over the last five years. I don't think that anybody could argue with the quantity comment. I don't think that you can find a financial statement today that's not more than double the size of what it was five or six years ago. That's a testament to a greater quantity of information. I would argue that the quality has improved fairly substantially in the context of more quantitative disclosure; there is more discussion of issues regarding risk, with a fair amount of backup to support it. That's not to say that statements are as good as they could be, but I think that there is a remarkable improvement in both the size and the quality that we've seen.

Having said that, the quality remains very uneven. From company to company, practices vary quite widely, as well as how well companies disclose information from risk to risk. Within a particular company, you might see a very fulsome disclosure on a particular issue, and other issues are given very short shrift.

The third issue is that the extent of disclosure is not necessarily commensurate with the risk. This is an observation that somewhat gets at the prescriptive nature of some disclosure requirements. For example, if a company has guaranteed-minimum-death-benefit (GMDB) exposure, SOP 03-1 tells them what they're supposed to say. You can have three or four pages of disclosure regarding that risk, which may or may not be very important for that particular company. But they may have very little disclosure and discussion of other risks that are much more material. In reading the financial statements, it's difficult sometimes to put your finger on what's important and what isn't, because the size of the disclosure varies so much from the actual size of the risk.

I think that prescribed practices are a hindrance in that regard. But they are also a help in terms of comparability. You can compare company to company because of prescribed standards. Also, disclosure practices tend to be reactive. There can be risks in the marketplace that are important, and maybe companies should let investors know about them. But it's not until those risks come to fruition that the disclosure becomes rigorous. For things like declining equity markets or low interest rate environments, you only start to see the disclosure as that risk is coming to pass.

Let me talk about specifics. I'm going to start with the risk of equity market decline. By "equity market decline," I mean three levels of risk. The first, which is the most important, is for companies that hold equities in their general accounts. If the market goes down, there is a direct impact on the company's surplus from equities that are held in the account. For many years, we've seen that companies that have a substantial exposure to this risk have done a good job of disclosing it in the past. Five or six years ago, you would see companies with large equity positions disclosing what the impact would be if the market went down 10 percent. At least, it would give some quantitative feel for what it would mean.

We haven't seen full disclosure on the secondary and tertiary risks. The secondary risks would be things like fee-based revenue off of equity-based subaccounts in variable annuity (VA) business, for example. A third-level effect might be deferred acquisition cost (DAC) amortization, which is rather tied into the equity market performance but isn't a direct or a secondary effect. Five or six years ago, companies weren't saying much about those risks. They might say that they existed, but they wouldn't do much to quantify them. More recently, we're seeing far more companies quantifying those risks. In 2000, we only saw nine out of 25 companies with any sort of quantitative disclosure of equity market risk. Now, we're seeing that about 80 percent of companies have some quantitative disclosure.

I have a couple of examples from 10-K filings. The first one is from a 1999 10-K filing, and it involves equity risk. It said that asset fees calculated as a percentage of the separate account assets are a significant source of revenue to the company. On December 31, 1999, 88 percent of separate account assets were invested in equity mutual funds. Gains and losses in the equity markets will result in corresponding increases and decreases in the company's separate account assets and the reported asset fee revenue. In addition, a decrease in separate account assets may decrease the company's expectations of future profit margins, which may require the company to accelerate the amortization of deferred policy acquisition costs. Everything that it disclosed is true. It's important information, but it's all very nonquantitative; it’s very qualitative.

The same company basically used all of those words in the 2004 disclosure. But then it went into a little more detail. It said that the company's long-term assumption for net separate account returns is 8 percent annual growth earned evenly throughout the year. If equity markets were unchanged throughout a given year, the company estimates that its net income per diluted share would be approximately five to 10 cents less than had the company's long-term assumption for net separate account returns been realized. The company, at least, started quantifying the words that it had been describing in its statements.

I'll give you one other example from a 10-K in 2004. I would take this as another step in the right direction in terms of disclosure. The company says that at December 31, 2004, its portfolio of equity investments had a beta of 0.85 compared to a beta of 0.84 on December 31, 2003. Beta represents a widely used methodology to describe quantitatively an investment's market-risk characteristics relative to Standard & Poor's (S&P) 500. Based on the data analysis, we estimate that if the S&P 500 decreases by 10 percent, the fair value of our equity investments will decrease by approximately 8.5 percent. Based upon the information and assumptions that we use to calculate beta, we estimate that an immediate decrease of the S&P 500 by 10 percent would decrease the net fair value of equity investments by approximately $569 million, compared to $478 million on December 31, 2003. That's all based on that primary effect.

The company went on to talk about the effect on fee-based revenue from a 10 percent decline and the impact on DAC from a 10 percent decline. Again, they're addressing the issues. They're showing a complete picture of the possible impacts and putting some quantification on it, which, I think, is pretty good. The other thing that I like about this disclosure, in particular, is that it relates the impact to the decrease in the S&P, which is an industry benchmark. It is not just saying what would happen if the assets in its portfolio would go down by 10 percent; it is relating it to something that's universal. If all of the other companies did the same sort of thing, you could get a better comparability from company disclosure to company disclosure.

In terms of disclosure improvement in equity market decline, I would look for more sensitivity tests on relevant items and a better alignment of the sensitivities with common industry benchmarks, such as maybe relating things to the decline in the S&P 500 or some other reasonable benchmark. The last recommendation would be for companies to try to introduce probabilistic measures into elements like equity market risk. Right now, all companies tout quite proudly the techniques that they have in place to manage and assess risk from equity market declines, like stochastic testing and all sorts of analyses, but we see very little disclosure of the result of the analysis. As we as a profession increase our quantitative tools and analyze risk, disclosing some of those numbers would be useful to the investment community and is something that people should consider adding in the future.

I want to turn to the risk from benefit guarantees. This is a risk that's very closely related to risk from equity market declines. In particular, we'll talk about the risks of guarantees under VA products. You have two different accounting paradigms, if you will, for these types of guarantees. You have SOP 03-1, which deals with how you value and disclose issues of risk regarding GMDBs. You also have Financial Accounting Standard (FAS) 133, which deals with other types of benefits, like guaranteed minimum withdrawal benefits (GMWBs) and guaranteed minimum accumulation benefits (GMABs). In a way, these are very similar benefits under a single product with different accounting paradigms for dealing with them.

In particular, with SOP 03-1, the descriptions of what you should disclose are laid out for you. There are examples of how to disclose issues of risk for GMDBs. Companies have become quite uniform in terms of what they disclose regarding this risk. Just about every company that has a GMDB will have a roll-forward of the reserve. You'll see disclosure of the net amount at risk. You'll see a description of the separate accounts that are backing the business. You'll see a relatively lengthy description of the methodologies and the assumptions that went into calculating the liability.

I have information from an excerpt from a financial statement regarding GMDB. The company described the assumptions and the methodologies. It said that it uses 250 stochastically generated investment-performance scenarios. Returns representing the company's long-term assumptions varied by asset class, with a low of 3 percent for cash, a high of 11 percent for aggressive equities and a weighted average of 9 percent. It talked about volatilities varying by asset class, with a low of 1 percent for cash, a high of 15 percent for equities and a weighted average of 12 percent. They used 80 percent of the 1983 Group Annuity Mortality Table for mortality. Lapse rates vary from an 8 percent low to a 14 percent high, with an average of 12 percent. The discount rate they used was 7.5 percent. You'll see this type of disclosure for a lot of companies.

Everybody that has GMDB is going to talk about these things. If you look at the disclosure regarding FAS 133 liabilities, like GMWBs, you don't see any of that disclosure around assumptions and how the calculations were done. That is mainly, I think, because FAS 133 came out earlier, and the rigor of the disclosure requirements that were imposed upon it was not as great. I would argue that knowing what went into valuing embedded derivatives within products and knowing those assumptions and those methodologies is probably just as important as it is for SOP 03-1.

Another issue related to this is the whole thought of disclosure and the numbers being commensurate with the risk. You'll get a situation in which liabilities on GMDBs could be relatively modest for one company, just because the accounting basis doesn't build up a reserve that quickly. The liability for a FAS 133-type of embedded derivative could be quite a bit larger because of the accounting basis. Again, it compromises the comparability from Company A to Company B in terms of the numbers and the amount of disclosure not being commensurate with the risk.

In terms of improvements on risks from guarantees, I would suggest disclosure under FAS 133 be similar to SOP 03-1, with respect to the disclosure of assumptions. If you look at financial statements of the valuation of derivatives, the only place that you'll find a description of methodology and of assumptions—things like volatilities and risk-free rates—is in the disclosure of the valuation of stock-based compensation, usually right at the end of the financial statement. That's just because FASB Pronouncement 123 tells you that you have to do that. So companies do that, but they don't extend that level of disclosure to other issues with the liability side of the balance sheet. I'd suggest that sensitivity tests for assumptions would be very valuable in these statements. I know of only one company that shows sensitivity tests for things like GMDB liability and how much the liability would go up and down if mortality assumptions were greater or if the volatilities were greater.

Prescriptive versus nonprescriptive disclosure is an issue for which I'm going to give you two competing views. On the one hand, I'm a fan of prescriptive disclosure in that it requires companies to say the same things. You can look at Company A versus Company B versus Company C and make an apples-to-apples comparison. I like it for that reason, but I'm less favorably inclined to prescriptive disclosure from a holistic point of view when you read a company's financial statement. It tends to have a lot of words associated with certain items that aren't as material as other items that get very short shrift.

I would suggest disclosing fair values of guaranteed benefits for which fair values aren't required on the balance sheet—things like death benefit liabilities. On the asset side, you have to disclose fair values of assets, even if you're not recording the assets at fair value in your balance sheet and through your income statement. From a comparability perspective, it would be a good idea to disclose fair values of all guarantees so the companies that have a lot of GMDB don't get a free ride relative to those that have a lot of GMWB.

Now I will talk about credit risk. Companies have been disclosing issues regarding credit risk for quite some time, probably because it has been an issue that people have cared about for a long time—observers of the industry, the SEC, whomever. But the uniformity of disclosure has increased in the last several years with the adoption of EITF 03-1, which deals with other-than-temporary impairments. If you go to just about any company's statement, you're going to see very similar disclosures of other-than-temporary impairments—things like unrealized losses by sector, criteria for writing down assets and details of distressed holdings. All of these things are in almost everybody's statements nowadays. Going back to 1999, you saw those types of details in very few statements.

Having said that, there still are differences that arise in disclosure of credit risk. There are some companies that go above and beyond the requirements of EITF 03-1. There are some companies that have taken a more rigorous application of that EITF than others have. You still tend to see differences in practice. The one issue that I want to point out with respect to credit risk gets back to this issue of prescribed disclosure practices. There's a fair amount of controversy that has arisen in the industry regarding the requirements of this EITF on other-than-temporary impairments. It has been interpreted to require you to write down assets whether or not the reason for an unrealized loss is purely credit-driven or is happening because of interest rate movements, rises in interest rates or a narrowing of sector spreads.

The accounting industry has been up in arms regarding this requirement. FASB has taken up the issue and is looking to release a FASB Staff Position (FSP) FAS 115-1, which is supposed to deal with mixing up two different risks in requiring companies to write down these assets. I would look to that for clarification on this issue. But in the absence of any additional clarification, we have a prescribed practice and a prescribed disclosure requirement that tells companies that they have to mix up two issues, both credit risk issues and interest rate movement issues, without any sort of comparable offset on the liability side of the balance sheet. I would argue that by complying with this very prescribed regulation, you're giving the reader of the financial statement almost less of an accurate description of the risks with the company than if you didn't comply with it.

In terms of credit risk potential for improvements, resolving this EITF 03-1 controversy would help. EITF 03-1 has increased comparability, but I think that there is room for improvement. Companies could be more comparable in what they're disclosing on credit risk. I would suggest that companies think more broadly in terms of credit risk and what they disclose. There are some companies that talk fairly extensively about risk. They talk, for example, about credit risk in the context of reinsurance and exposure to reinsurers. But not all companies take that more global point of view. I think that it's time that companies did take that more encompassing view.

Now I will talk about interest rate risk in the context of asset/liability matching and about the risk from mismatches. I don't think that you'll find a company that doesn't have at least several paragraphs that tell what a great job the company does in managing interest rate risk, how they monitor durations and key rate durations and cash flows, and how they have very little risk with respect to mismatches and movements in interest rates. Having said that, it's very difficult to find a company that will put any quantification on this. In particular, you will find that most companies disclose what would happen if interest rates were to rise or fall by 1 percent, a parallel shift in the yield curve. Quite often, all they'll tell you is what that does to the asset side of the portfolio. What does it do to the asset side of the balance sheet without any comparable disclosure of what it means on the liability side? It's only sort of a half disclosure. In that context, I don't think that it gives an impression of the real quantitative risk.

This information is from a 2004 disclosure in a 10-K. It is fairly typical, I think. It said that one of the key measures that the company uses to quantify interest rate exposure is duration, a measure of the sensitivity of the fair value of assets and liabilities to changes in interest rates. For example, if interest rates increase by 100 basis points, or 1 percent, the fair value of an asset with a duration of five years is expected to decrease by 5 percent. We believe that, as of December 31, 2004, our asset-and-liability portfolio durations were well-matched, especially for our largest and most interest-sensitive segments. Since our insurance products have variable interest rates, we regularly undertake a sensitivity analysis that calculates liability durations under various cash flow scenarios. The company includes a table that shows the estimated interest rate sensitivity of its fixed-income financial instruments measured in terms of fair value. Given that its asset-and-liability portfolio durations were well-matched for the periods indicated, it expects market value gains or losses in assets to be largely offset by corresponding changes in liabilities. It's very descriptive, but not very quantitative regarding a very important risk and one that I think the industry analysts are very concerned about.

We might like to see improvements in sensitivity tests, first of all, to be sure that companies include both the asset and the liability side of the balance sheet. Otherwise, in terms of disclosure of risk, I'm not sure how much value a shift of 1 percent in the yield curve tells people. Second, we would suggest some quantitative discussion of nonparallel shifts in the yield curve and maybe disclosure of the yield-curve scenarios that have the most problems for a particular company. Some companies actually do that, but they're very few and very far between. Finally, some sort of probability-based measure could be useful. It could give the company the language with which to describe the risk surrounding asset/liability matching. What is the interest rate risk as opposed to giving a one-scenario-fits-all type of sensitivity test?

Another interest rate risk from minimum-interest-rate guarantees is one that I'm not going to talk too much about right now. The only thing that I'll say is that the variety of disclosure that you find on this risk is probably as wide as it is for any other risk that we see in financial statements, with some companies barely mentioning it and other companies giving very detailed disclosure in terms of how susceptible they are if the interest rate environment goes down by another 50 basis points. It is quite interesting to see the diversity of practice.

I'm going to talk about insurance risk, which I define as mortality and morbidity risk. I think that this is one of the most ironic observations in our review of financial statement disclosure in that it's probably the risk that you see the least sensitivity testing and discussion in a quantitative sense. I'm not entirely sure why that is. I have a few thoughts on it. It's possible that it's just not a huge risk for companies; that would certainly be a legitimate reason for not talking about it too much. I think that one of the main reasons is that, when you look at how effectively U.S. GAAP enables you to quantify risk and show the impact of different sensitivities, it's not that great at being able to tell you what happens if mortality ends up being 1 percent worse than what you thought. There's not a single number that you can grasp as to what that would mean under U.S. GAAP. You might be able to say what it would mean for earnings in the next year, or you might be able to say what it would mean for accumulated surplus after 30 years, but that doesn't give you a good basis number. Something like embedded-value measures would be able to do that. This is an area in which by introducing other types of measurement techniques, whether it be embedded value, etc., you'd at least have the language to quantify these types of risks and be able to disclose the impact on companies more effectively.

Most companies disclose reinsurance practices. You've got to give them credit for that in terms of quantifying retention limits and so forth. I know of at least one company that discloses the quantitative impact if everybody lived a year longer or a year shorter than expected. But outside of that, there is very little that you see of disclosure practices on insurance risk, which, I think, is a fairly ironic observation. Potential improvements include more sensitivity tests. I'd suggest that mortality risk is very conducive to probability-based, statistically-based types of sensitivity measurement technique.

In talking with insurance industry analysts, aggregation tends to be the issue with which they are most disappointed. Companies aggregate results up to too high of a level to enable them to tell what are the sources of earnings.

We know which businesses are generating profits and which aren't. I don't think that you generally hear much complaint with respect to timeliness of issues. Most analysts say that when an issue arises, companies do a fairly decent job of raising the issue.

A number of analysts would like to see more in terms of source-of-earnings analysis. I think that the psychological value is as important as the numbers that you get out of it. When you're able to disclose source of earnings—identify exactly that you know about where you made money and where you lost money—it gives the reader of the financial statement a better comfort level that management knows what's going on and is able to communicate effectively how they make money and lose money. You'll hear analysts talk a lot about the disclosure practices in Canada. In particular, Canadian companies routinely are starting to disclose source-of-earnings analysis. But if you look at those disclosures, they're very high-level. They usually have seven or eight items, and they really are aggregated up to a company level. It's not so much the additional numerical information that you get out of that type of disclosure, rather it's more of an indication that management knows what they're doing that is so attractive to source-of-earnings analysis.

Finally, with respect to disclosure practices, I think that market perception is a key item that companies have to get over. You don't want to be the first company to talk about a particular risk. Would you want to be the first company to disclose in its 10-K that it has $3 billion net amount at risk on GMDB? Probably not. Maybe it's the right thing to disclose, but if you're the only company doing that, you're going to give the market the impression that you're the only one that has this huge problem. By doing the right thing and disclosing more effectively where your risks are, you're almost hurting yourself. I'm not exactly sure how to get over this market-perception issue and the issue of not wanting to be the first out there. Maybe it's another argument why you need more prescriptive disclosure requirements in order to force the information out of a company. But it's certainly there, and it's an issue that, I think, hinders complete disclosure.

Now I will summarize some of the recommendations that I've talked about. Consider disaggregation where appropriate. Provide source-of-earnings analysis. Use alternative measures to convey risk sensitivities where useful. Where U.S. GAAP doesn't do the job, come up with another risk measure that can help people to understand. Increase the use of sensitivity tests. Use common industry benchmarks (relate everything to movements in the S&P 500, as opposed to your own portfolio). Introduce probability-based measures of risk, and disclose more advanced techniques that you're using to manage your business. Finally, maybe it's a good idea to have more prescribed disclosure requirements, or maybe it's not, but I think that it's an issue that you need to consider.

I want to sidetrack to talk about accounting bases and disclosure practices. I'll talk briefly about four different bases: U.S. GAAP, Canadian GAAP, embedded value and international financial reporting requirements. I'm trying to make one point: to the extent that an accounting basis doesn't convey all of the information within the numbers, that's what drives the need for a particular type of disclosure. The disclosure needs under these different bases are very different because these different bases tell the story within the numbers differently.

To start with, U.S. GAAP is an income-statement-based reporting standard. It relies on the old principle of matching revenues to expenses. As a result, whenever there is an event that happens, whether it be an economic event or an event involving risk in the company, you don't get a full quantification of that event within the financial statements in the period that it happens. I keep going back to GMDBs. If the market crashes, the reserve that you're going to put up for GMDB is going to be far less than the real fair-value economic impact of the market having crashed. For that reason, I would suggest that the disclosure requirements under U.S. GAAP be fairly extensive in order to give the reader more of an impression of the real risk in the company, because the balance sheet doesn't cover it entirely. The income statement doesn't cover it entirely. You need additional disclosure to cover it entirely.

I'd suggest that because U.S. GAAP has become an accumulation of principles-based and rules-based accounting, has been around for so long and hasn't been overhauled fully, I think that requires additional disclosure. Unfortunately, to figure out what you have to disclose and what you don't, U.S. GAAP requires reading so many different sources, whether it be from the FASB, the AICPA or the SEC. It's virtually impossible to have a set of all of the things that you have to disclose, because the requirements come from so many different places. As a result, it becomes quite difficult. The needs are very great, but complying is quite difficult.

Canadian GAAP is much more balance-sheet-based. You see much more of a capitalization of economic movements immediately within the balance sheet and flowing through the income statement. That's not to say that that's complete or absolute. But it certainly does more than does U.S. GAAP, and, therefore, I'd suggest that some of the disclosure requirements are different. Probably the biggest complaint about Canadian GAAP is that it's highly related to assumptions. The appointing actuary can change the assumptions in the valuation from period to period, and because of that, it retains a taint of subjectivity. For the very weakness of the statement, the item for which that type of reporting is most susceptible, most of the disclosure around Canadian GAAP has to focus on the setting of assumptions. What was the quantification for each of the changes in assumptions? Canadian companies go to great pains to disclose that information because it is the very weakness of the basis, and in order to have a full understanding, you have to disclose quite fully in words and numbers what happened with respect to assumptions.

That comment really carries over more to embedded value, which is purely a balance-sheet-based measurement tool. Everything gets reflected immediately within the statements. Again, it's very assumption-oriented. The good news on embedded value and on European embedded value, if you look at the foreign filers, is that they are rather uniform in terms of doing sensitivity tests on each of the major assumptions that go into embedded value filings. Every company will ask: What would happen if the discount rate changed by 1 percent? What would happen if lapse assumption was different by 10 percent? What would be the difference if mortality went up by 1 percent? These questions are disclosed fairly uniformly across companies. In order for it to be an effective reporting basis, you must have complete and full disclosure of assumptions.

Having said that, if you talk to industry analysts, you'll get a wide range of views as to whether embedded value is of any use or not. On the one extreme, you'll have some that say that it's a great way to understand the value of a company and how it changes from period to period. But for every person that says that, you'll have another analyst that will say that it's useless because it is so susceptible to manipulation in terms of assumption setting that they can't compare Company A to Company B to Company C. The only thing that it does for them is that they can compare reporting periods within Company A. But they can't compare anything across companies. There's a fairly wide range of views on embedded value.

Finally, if you look into the future with respect to International Financial Reporting Standards, the disclosure requirements here are very rigorous. IFRS is trying to make you have full disclosure on anything that's not observable in the market. Companies that are complying with it this year are putting forth quite substantial disclosures. It is presumable that that will continue as IFRS continues to develop and expand.

MR. PAVEL BLINCHIK: I work with Lehman Brothers. Before that, I was working in financial services trading. Life insurance analysts at investment banks are in the business of helping the largest investors in this country make informed decisions about whether to buy or sell stocks of insurance companies that you work for. It's interesting that, in many cases, it is very difficult for us to make an informed call on whether a stock is a buy or a sell, simply because there's no basis for that and disclosure is very limited. Primarily, we work with GAAP financial statements, such as 10-K, 10-Q, etc. In 99 percent of cases, investors care about GAAP disclosure rather than statutory disclosure, because that's what's affecting their stock price. In addition to 10-Q and 10-K, we work with documents that companies make available to all investors. Before they report on the Form 10-Q, these documents are usually called statistical financial supplements. They usually are filed on the Form 8-K. They provide much more detail on some of the trends in each of the businesses in which a company is operating.

The purpose of this presentation is to help insurance companies identify how they can better serve the needs of the investment community, as far as disclosure is concerned. We decided to actually mention names of companies, which sometimes is provocative. There is no one company that provides best-in-class disclosure across the board in all risks. Each company can be better than others in disclosure of one type of risk, and it may need improvement in other types of risks. Blinchik Slide 2 shows two financial statements, compared back to back, for Jefferson Pilot Financial Insurance Co., a large individual life and group insurer headquartered in North Carolina. These financial statements are more similar than they are different, although the first financial statement was reported at the end of 2004 and the second was reported 20 years ago.

The company has gone through dramatic changes in terms of the risks of the products that it is writing. It has completed several acquisitions. Most recently, there was acquisition in 2004 of a large group benefits block. Many products simply did not exist 20 years ago, such as some of the universal life (UL) products, especially UL with no-lapse guarantees that Jefferson Pilot is writing. Still, the type of disclosure that we are getting is similar to what was there 20 years ago. That's the problem that we are facing when we analyze these companies, because we have to improve our analysis as companies increase the complexity of their products. While the quantity of disclosure increases, the quality may lag in certain circumstances.

One of the most frequent problems that we are facing is the aggregation of two types of products that are very difficult to track on the aggregate basis. Specifically, we're talking about the FAS 60 and FAS 97 product. Blinchik Slide 3 shows the example of Protective Life Corp., which is a very large term-life player that is now transitioning into UL business. It has been writing UL policies, but it is making it more of a focus. It is very difficult for investors or analysts to track. Whether Protective Life is successful in it or not, revenues have been growing rapidly while earnings have been declining. We don't know whether this is a result of changes in business mix or if there's something more at play. If anything, there's a trend toward more aggregation rather than more detailed disclosure. This particular company, in the past, was reporting numbers separately for West Coast Life, Empire General and Protective Life operations. Now, all of these businesses report just one income statement.

What kind of problems do we have? Why is it difficult to analyze these financial results? First of all, it's difficult to answer the question of what company is the best term-life underwriter. Is it possible to say that Protective Life is more profitable in term life than Genworth Financial or any other term-life player? It's difficult to say that, because the benefits line is aggregate for UL and term-life products, and the expense line is not broken out. The DAC rules are very different for capitalization and amortization. So it's quite difficult to make any conclusions based on this financial statement, especially given that, in the case of this company, there were several changes in reinsurance relationships over the last few years.

This problem is not unique to the life insurance business. We have very similar issues in the annuities business, for which aggregation is a common practice in the industry. We don't know of one company that reports results in fixed annuities and VAs separately. Every public company that we follow aggregates these results. Blinchik Slide 4 provides the example of Nationwide Financial, which used to be the number-two writer of VAs in this country and is still a very large writer of annuities. This is an example of best-in-class disclosure, because the company provides separate net investment income disclosure for investment capital for earnings and for net investment income on general account assets. But it's difficult to analyze these products because DAC rules are different. It's not clear whether the company has had any success in managing its expenses in order to absorb some of the strain from the lower interest rates that are causing decreasing returns to the fixed annuities business.

There are dramatic differences in quality of disclosure on interest rates. We can't say that any one company provides the best disclosure, but we provide two examples in Blinchik Slide 5 that are strikingly different. Lincoln National is giving a lot of numerical detail, business-by-business, separately for fixed annuities and UL-type contracts, and for all of the levels of spreads between the current level of crediting interest rate and the minimum guaranteed interest rates. Looking at MetLife, for which interest-rate-sensitive products are very important as well, the company is giving investors some idea of how a change in interest rates will affect its operations. But investors need more. For example, the company says that spreads likely will be in certain ranges, but investors want to know the assumptions for new investment yields that go into these ranges and the assumptions for the company's ability to lower its crediting rates in fixed annuities business, which also drive these ranges on net investment spreads. That results in quite a substantial difference in disclosure.

Investors would like to see the type of disclosure that we see for Lincoln National, where there's a lot of quantitative detail. At the same time, there is room for improvement. Some criticism that we hear from companies is that no amount of disclosure is enough for Wall Street analysts. But even this disclosure may be a little tricky, because we don't know the surrender charges that are currently in force on each of these blocks. There can be quite significant differences in surrender charges on different mature blocks of fixed annuities across companies.

We just spoke about the interest rate risk and how companies disclose their exposure to interest rates. We're now going to talk about how companies manage this exposure through active asset/liability management. Every company will say in their 10-K that it is extremely active in managing the risk on assets and liabilities, but very rarely will we get quantitative detail. In most cases, it simply would be disclosure of duration on the asset side of the business, and this duration would be disclosed for the entire business that would be aggregated for different products. For example, group products would be in the same disclosure as individual fixed annuity products.

Investors want to know very simple metrics that would cover everything. Clearly, modified duration and convexity would be something with which investors are very familiar, but they want to have these metrics for the entire balance sheet. For example, MetLife's CFO said that it doesn't matter what happens to interest rates, as long as changes are within 100 basis points, because MetLife has executed a very sophisticated hedging strategy that protects itself from minor decreases and increases in interest rates.

Blinchik Slide 6 shows that Lincoln National's disclosure probably could be considered best-in-class. It provides an enormous amount of detail on each type of business, including interest rates by year of maturity for every type of asset, liability and derivative that they are using. Is there room for improvement? We think so. We think that, for example, the sensitivity of mortgage loans, which have a very high degree of complexity, shouldn't be described by such things as simply the face amount of these mortgage loans. We need to know interest rate sensitivity, rather than the level of interest rates and the amount of loans on the books. So while this is best-in-class disclosure, it is still difficult to answer a simple question. What happens to each of the businesses of this company if interest rates change, first, in the parallel fashion, and second, if the yield curve becomes steeper or flatter?

Blinchik Slide 7 addresses VA guarantees, primarily the living benefit guarantees. There has been great improvement in disclosure for GMDB, and companies have been not only increasing the quantity of that disclosure, but quality has improved remarkably. Unfortunately, most investors are not interested in what's happening with GMDB risk in a company. Very rarely do we get asked how exposed a particular company is to risks of GMDB. The reason is that the largest annuity writer doesn't talk much about competition in the GMDB arena. The entire discussion is usually about the competition in the living-benefits-guarantee market. That's where disclosure has been lagging behind in GMDB. I wouldn't say that most of the disclosure is inadequate, but it would be very difficult for an interested party, such as a large investor in an annuity company, to say with confidence that he or she understands the type of scenario that would result in adverse volatility in the income statement of a particular, say, GMWB writer.

Let's look at the kind of disclosure that we get from one of the largest companies in the VA business that we follow. Blinchik Slide 7 shows two statements by The Hartford, which was the leader in writing VA products with guarantees in 2004. The first presentation gives us details on the fair value and the notional amount of GMWB riders. It also provides us with some detail on the types of hedging contracts that are used to mitigate the risk on these guarantees, their fair value and notional amount.

If we look at Hartford's 10-K, we get more information on its hedging of statutory reserves. We understand that the company hedges both economic risk and the statutory risk. Blinchik Slide 7 shows that The Hartford is hedging three types of risks (delta, vega and rho) using very sophisticated derivatives contracts. For example, it's using different types of options, swaptions, swaps, etc. The key point from this presentation is that The Hartford has identified the key risks and the right instruments to hedge all of these types of risks, but if we ask this company (or any other company for that matter) what the level of this risk is and how can we quantify these risks (for example, what's the level of delta or rho on the unhedged position that Hartford is trying to hedge with these contracts?), this disclosure is not available, and we don't know what options are being traded or what other contracts are being traded by the company.

Until recently, one of the largest writers, Lincoln National, discussed its VA hedging strategy in detail. It has talked about the delta hedging. But in its 10-K, it would say that, up to date, there were no transactions in futures contracts. Because the market has been going up all of this time, there was no need to make any transactions. The hedging strategy was in place, but no transactions actually were made. Recently this hedging strategy has become more sophisticated, given the evolution of products at Lincoln National.

There is a way to get more detail on the type of hedging that companies are doing. We would need to turn to statutory financial statements for that. Ideally, we would like to get a similar level of detail in GAAP financial statements. I'm going to explain why. Blinchik Slide 8 shows disclosure for the same company, The Hartford. It shows all trades in put options that were hedging GMWB liability during 2004. If you look at the entire set of statutory financial statements of The Hartford, you will be able to determine the level of delta, vega and rho at any point in time. You can't tell the mismatch between these levels of risk on the hedging position and the GMWB liability at that point in time. Clearly there are mismatches, because the company does not rebalance the portfolio every day, but we don't know how large these mismatches get.

Still, this is best-in-class disclosure. I don't think that there's any other VA writer that writes business on The Hartford's scale that provides this type of disclosure. The reason is that most companies have created offshore reinsurance entities that do most of the hedging for them, and they don't report statutory financial statements. Ideally, we would get a similar type of disclosure but on a company-wide basis in GAAP financial statements that will be available for all companies.

Another type of risk that we'd like to talk about is the prepayments risk. Certainly prepayment has been incredibly important, especially for companies that had a large degree of exposure to it. Usually, these are companies that invest heavily in mortgage loans or collateralized mortgage obligations. The first presentation in Blinchik Slide 9 gives you an idea of how important this interest rate prepayment risk has been. It provides actual details on interest rate margins for Lincoln National. Over the last couple of years, when interest rates on new money investments or new money yields actually have been lower than the portfolio yields, the interest rate margin has increased. It's an interesting phenomena.

It comes from two sources. The first is the very active strategy of lowering the crediting rates. It's all limited by the company's ability to do so, given the minimum crediting rate guarantees. Another important aspect of that is the increase in mortgage loan prepayments and contingent interest that, last year, has accounted for 100 percent of the increase in interest rate margin. This is clearly a very important issue for most companies that are publicly trading. Yet, if we look at the type of disclosure that we are getting for mortgage loans, investments and the types of risks there, usually it's about the geographic area or the type of investments, whether this is a mortgage loan underlying an apartment or anything else.

Insurers are usually telling us how many Tacoma apartment mortgages they hold, but we don't know much about prepayments risks. I'm originally from Russia; I'm not even 100 percent sure where Tacoma is. But what I do know is that the moment we talk about mortgage loans, investors would ask us the level of potential prepayments that these companies can get. There's really no way for us to tell, at this point. Any type of disclosure on potential future prepayments, at least ranges, or something like that, would be extremely helpful.

Another type of investment recently has become very important. Blinchik Slide 10 shows two exhibits for MetLife and The Phoenix Companies. They reveal that there has been tremendous volatility in the yield in these investments. Until recently, these investments have been an underperforming class. They were yielding in the neighborhood of 2 to 3 percent a year. In many cases, they resulted in negative returns. But starting with 2004, there was a spike in returns. This has created an enormous windfall in earnings for many of these companies, something that caught investors off-guard and resulted in dramatic volatility in share prices.

For MetLife, equity-partnership venture-capital investments has increased to 10 percent in 2004. I can tell that in the second quarter of 2005, earnings from these types of investment were so large for MetLife that they actually were larger than the entire earnings contribution from the whole individual life operation. This is incredibly important for investors. Yet, most investors to whom we talk don't really understand these investments. They don't understand the accounting for them. They don't understand the risks, and they don't understand whether returns are real or not. We're not suggesting that the returns are not real. We are saying that we would appreciate if companies would provide better disclosure on exactly where these returns are coming from and what they are.

I'm going to give you an example of one of the things that may be skewing the results. Under FAS 115, the recognition of gains and losses may result in either earnings windfall or negative earnings. It's on the company's discretion whether net income in a particular quarter would be positive or negative under some of the special available-for-sale securities. But one way that the investment community tries to discern whether income is recurring or nonrecurring is focusing on operating earnings rather than net earnings of the company. It excludes realized gains and losses.

To cut a long story short, when companies invest in equity partnerships, and these equity partnerships invest in, say, hedge funds, any gains and losses realized by hedge funds would flow through to the equity partnerships and be realized as net investment income by the companies that invest in these partnerships. If these same companies invested in the underlying investments themselves, directly carrying these investments on the balance sheet, this would become realized gain or loss, and most investors simply would exclude it. The bottom line is that it depends on whether you carry investments as part of a partnership or as a stand-alone investment, and this can drive your earnings results completely, not net earnings but operating income, which is the recurring part that's focused on by investors.

I will now focus on what's recurring and what's not. We hear routinely from many companies that they pay a great deal of attention to underwriting, and they have very talented actuaries on staff who take care of underwriting and any potential underwriting problems. Is it possible for investors to determine which company has done a better job of underwriting any particular product line than other companies? For us, it is very difficult.

Blinchik Slide 11 shows two types of disclosure; one we find somewhat more helpful than the other. Protective Life disclosure is more helpful than MetLife disclosure. In actual-to-expected underwriting experience, MetLife consistently is getting dramatically better experience than expected. Does any part of this better-than-expected experience actually belong to the shareholders? That is not 100 percent clear, because, as MetLife tells us, most of this business is reinsured. As MetLife sometimes acknowledges, this number can be somewhat misleading, because it may be the case that actual-to-expected is in the neighborhood of 78 percent, but reinsurers take care of that in terms of setting the price for reinsuring the business. MetLife shareholders really do not benefit from these better-than-expected underwriting results. In the case of Protective Life, Blinchik Slide 11 shows the kind of disclosure that investors really like, because it's clear what it means for them. For example, in 2004, it means that the life marketing segment had earned $4 million more than its expected, net of reinsurance. That's very clear to investors.

Reinsurance affects actual-to-expected results disclosure. We're talking about the trends in the reinsurance business itself. If you look at the exhibit on the right in Blinchik Slide 12, you'll see that one of the largest reinsurers in the United States, Reinsurance Group of America, is saying that the reinsurance market has undergone a significant degree of consolidation and, as a consequence, they believe that the life reinsurance pricing environment may reflect higher prices in the future.

We hear from companies on the direct side of the business that reinsurance prices already have gone up and are affecting their business profoundly. We can't say from existing disclosure how profoundly the business is affected. We understand that it's a change in language in the treaties; it's a change in some of the terms in the treaties. But if we could put any metric, or several metrics for that matter, on changes in reinsurance prices at any given company, that would be incredibly useful to investors, because the kind of disclosure that we're getting most often is similar to the disclosure by Prudential Financial shown in Blinchik Slide 12. This is actually one of the better types of disclosure because it provides you with some idea of reinsurance, business-by-business. Many companies don't give you that amount of detail. How do changes in reinsurance prices affect Prudential's results, and what does that mean for investors? Right now, it's difficult for us to say. If companies could use some metric to give quantitative detail regarding how prices of reinsurance have affected them, that would be incredibly useful. Many investors would benefit from that.

In summary, many insurance companies have improved their disclosure dramatically recently. A good example would be disclosure of risks on UL secondary guarantees. Several companies, for example, Jefferson Pilot and Lincoln, already have disclosed to investors how much additional capital they will need in order to comply with the new statutory requirements and how that will affect their financial statements. That's where companies have caught up with investors' needs for greater quantitative disclosure. But in many other cases, there are fundamental questions that we're trying to answer. Is our company a good underwriter? What's really driving net investment income? What are these investments into which the company is putting shareholders' money? It takes a lot of investigative work with third-party sources for us to get some understanding of what's driving the results.