2005 Valuation Actuary Symposium*

Orlando, Fla.
September 22-23, 2005

Session 13 PD
International Accounting Standards

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Summary: The International Accounting Standards Board is working to finalize reporting standards for insurance and investment products. Companies domiciled in European Union (EU) countries will be required to report financial statements under international accounting standards in the near future. Panelists provide a brief overview of the emerging standards for investment and insurance, followed by a more in-depth discussion of key issues and recent developments.

MR. WILLIAM HINES: We will talk about a couple of topics. The first one that I'm going to deal with is international actuarial practice guidelines. I'm a consulting actuary with Milliman, Inc., and for quite a while I have been following international accounting standards, how actuaries are reacting to the standards and the development of the standards.

With me on the panel are David Sandberg and Henry Siegel. They will talk about the current discussions that are taking place in the development of new standards by the International Accounting Standards Board (IASB). Mr. Sandberg is a vice president with Allianz Life Insurance Co. in its corporate actuary department. He is very active in Academy work regarding financial reporting and solvency, as well as at the International Actuarial Association (IAA). Mr. Siegel is a vice president with New York Life Insurance Co. and is the incoming chair of the Academy's Financial Reporting Committee, which is the group that deals with the topics that we'll be talking about from a professional point of view.

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Around the year 1995, the IASB started an insurance accounting project. It was decided that, after more than five years' worth of work, it was a bigger issue than the group could deal with by 2005, when the European Union would start putting these standards in place. It divided the project into Phase I and Phase II.

Phase I was an interim standard that was put out in 2004 and was meant to be a stopgap measure as IASB continued to deal with particular issues regarding insurance products and how to account for them. But the group did put out something, and, like all good principle-based accounting systems, it relied, to a great extent, on the professional judgment of the accountants and actuaries who do the reporting, reviewing or auditing under those standards. Its expectation is that further guidance would be provided by the professional organizations that support those people. The IAA is one of the groups that has stepped forward to put in place guidance for actuaries who are going to report under international accounting standards.

I will talk about that guidance that the IAA has put together. I will talk about what those International Actuarial Practice Guidelines (IAPGs) are and where they come from. How were they developed? How might they affect you? Where might the future be for them? Currently there are eight IAPGs, plus a glossary document. There's one that has been out regarding Social Security schemes; I will not talk about that one. I will talk about numbers two through eight that deal with reporting under International Financial Reporting Standards (IFRS) and the glossary associated with that.

What are these IAPGs? They are advisory, nonbinding guidance that actuaries may wish to take into account when providing professional services related to financial reporting of insurance contracts, financial instruments or service contracts issued by a reporting entity in accordance with applicable IFRSs. That means that they offer nonbinding guidance specifically related to reporting or reviewing statements under IFRS accounting. They're limited in scope to reporting for insurance contracts, investment contracts or service contracts (in other words, the types of contracts that you might find insurance companies issuing). But they do not relate to anything that might be in the company's own pension scheme. For example, its own employee benefit program relates to the invested assets of the entity. Think about the actuarial aspects of reporting, primarily the liability side of the balance sheet, but also the assets related to those liabilities. Generally, they're similar in nature to the Academy's practice notes.

The second actuarial practice guideline is very different from numbers three through eight. It deals with how actuaries go about providing professional actuarial service and whether they are part of a company, a consulting actuary, etc. It describes things like data quality, what you might do in an actuarial report and so on. Items three through eight deal specifically with technical topics that come up under IFRS. Why do we have the second one? There are two benefits to it. One is that the IAA deals with actuaries throughout the entire world. There are a number

of jurisdictions in which actuaries have no organizations that provide standards. There are no standards set in many small countries in which the actuarial profession is getting off the ground or you don't have enough volume of individuals to put together actuarial standards. It's meant to be a template for a standard that they may adopt in order to go about their work. The other reason is to put into context the other practice guidelines.

The contract classification guideline (the third guideline) is straightforward. It tells you what you need to do in order to classify contracts under each of the accounting standards. Which accounting standard relates to which contract or parts of contracts? Measurement (the fourth guideline) relates to the measurement of investment contracts, primarily. If you are familiar with the interim standard that the IASB has put in place for insurance contracts, it advises to continue your current accounting practice, whatever that is. But for investment contracts, it may change the way that you account for things, and, therefore, you may need guidance along those lines. The fifth guideline is on current estimates. You may think of this as best estimate, but it really means how you go about determining a current estimate of cash flows that you may use in your liability valuation framework.

One of the other issues that has come out is, in surveying the current practice for insurance contracts (or even investment contracts, but primarily insurance contracts), what is an acceptable minimum liability adequacy test? IFRS 4, which deals with insurance contracts, advises that if your current accounting policy has a rigorous test, continue to use that. But if it does not have a rigorous test, you need to put one in place. In the sixth guideline, IAA is trying to provide guidance on what that would look like, given the IASB's definitions.

The seventh guideline deals with things called "discretionary participation features." This is a technical term that the IASB has used to distinguish between contracts that are purely pass-through contracts, in the sense that there's no discretion on the part of management in terms of crediting an interest rate (a purely variable contract, for example, would not be a discretionary participation feature) versus contracts for which you get some element of a return as a policyholder but management has some discretion on when you might get that return or how much that return might be. That's one of the tricky features: trying to figure out how to project cash flows into the future that are at management's discretion. IAA deferred that to Phase II and hasn’t come up with anything to address that. There's some guidance on figuring out when you have a discretionary participation feature and what to do about it. There's also an element addressing changes in accounting policy, which may seem odd in an actuarial context, but actuaries are often called upon to help figure out when a company actually is changing accounting policy and what that might look like.

Where do IAPGs come from? They are issued by the IAA. That's an association of associations. All SOA and Academy members are also members of the IAA. Part of

the dues that you pay to the SOA and the the Academy go to pay for dues for the IAA. Why is the IAA putting out standards? Accounting standards, in general, are no longer jurisdictional-specific. Especially as you look at Europe now, there is one standard for all countries. No single actuarial organization, other than the IAA, covers multiple jurisdictions. The IAA's function is to represent the actuarial profession in discussions with other international bodies.

The IAA has been interacting with the IASB for almost a decade as it has been going through its insurance accounting project. But the IAA has this very important principle with subsidiaries. It restricts its activities to situations that require international coordination or direction or can be handled more efficiently across national or regional boundaries. Of course if it were asked to help a jurisdiction, it would come in and help actuaries there. But this is clearly a situation in which accounting standards are going global, and the IAA is trying to respond on a global basis with guidance on what actuaries might be able to do.

The IAA has several classes of standards. The lowest class, Class 4, is what it calls "practice guidelines." This is nonbinding guidance that has been published. There are a couple of other classes. Right now, there are no Class 1 (mandatory), 2 (voluntary) and 3 (recommended practice) standards issued by the IAA. The IAA Council, the voting body that makes decisions, has decided that nothing will become a Class 3, 2 or 1 standard unless it has first been issued as a Class 4 document or practice guideline. It remains to be seen if the practice guidelines will be upgraded to a different class status over time.

The IAA standards are slightly different in classes from the U.S. Actuarial Standards Board (ASB) standards. The ASB standards are more like what you might think of as the IAA's Class 3. There is currently no equivalent to Class 2 and Class 1. It's a different process as to how they are voted on. The Actuarial Standards Board process, primarily, is issuing an exposure draft for comment, getting board review and acting on that. There are provisions for having a public hearing, if necessary.

The IAA process is a little different. There is no corresponding body to the ASB under the IAA. All of the work that's done there is carried out by committees, and the development of individual standards first needs to get approval. The work itself is given to a particular committee or subcommittee that's convened expressly for that purpose. Exposure drafts are released by the president for comment to all of the associations that are members and all the individual members. Then a committee report is put together on the comments received and the committee's response. If you get an 80 percent majority vote of the council, they are adopted or endorsed. It's a different process and takes a tremendous amount of discussion on the issues and caveats to try to understand things from different perspectives.

How does this affect you? Many people presume that we already are reporting under IFRS. This affects you if your association adopts one of these IAPGs for use. To date, this has not happened. The other way that this could affect you is if IAPGs

are required by law or statute to be considered. That can happen. So far, I'm not aware of any jurisdiction in the United States requiring these to be used. If you represent that your work is going to be in compliance with these practice guidelines, your code of conduct requires you to follow the guidelines. That's another way that it could affect you. Your employer or client might require you to consider the IAPGs when you do your work; that may be the situation in which most people get involved with these practice guidelines.

The practice guidelines are available to everyone who's a member of the IAA. There are some concerns with the way that these things have come out. The concerns primarily are regarding the description of what a Class 4 standard is under the IAA rules and the preamble. It's of concern that in litigious environments (like the United States and North America, generally), the wording could lead the plaintiff's bar to hold actuaries to the guidance as the only guidance, even though it clearly states up front that it's nonbinding and there are other ways to do things. There could be some issues regarding that. The Academy is considering coming up with a U.S. version of the practice guidelines, primarily for IAPG No. 2 (actuarial practice), that may be more protective in terms of the legal exposure that it presents for actuaries.

The other issue is regarding when explanation becomes interpretation when you're talking about accounting standards. IAPGs Nos. 3 through 8 are technical in nature and are meant to describe how actuaries might go about the process of valuing contracts or dealing with accounting standards as we move forward. The question arises, are we making an accounting interpretation versus giving an explanation of what's going on? Actuaries and accountants, in general, are not allowed to make interpretations. It's only the accounting authorities like the IASB and the International Financial Reporting Interpretations Committee that are allowed to make real interpretations. We're going to continue to review to make sure that we don't go too far in making interpretations in terms of these practice guidelines. We've been working closely with the IASB. It looks over our practice guidelines as they're being developed. The group has an opportunity to tell us when we're stepping over the line or when we inadvertently may have put something in that actually violates some other accounting standard.

We're very fortunate to have a good working relationship between the IAA and the IASB as we're developing this guidance. There are more of these to come. We're considering some exposure drafts of practice guidelines on reinsurance and business combinations. There will be some on disclosure and embedded derivatives. We came up with a list of 15 topics on which we might give some guidance. We've got four more in the hopper, if you will.

Based on the concerns that have been voiced about the potential legal interpretation of the preamble in the United States and how the classes of standards of the IAA may be described, the Professionalism Committee is going to examine how the the IAPGs refer to educational guidance and the classifications of

standards and maybe change that to be more palatable to actuaries and not put them in jeopardy unnecessarily. One of the other issues that we worry about is how we manage these practice guidelines after they've been adopted. As accounting standards change over time and practice evolves, how do these items get updated? It is the same issue that we face with all of the practice or educational guidelines in the United States. It's something that will be considered moving forward.

MR. DAVID SANDBERG: Actuaries are trying to create something that is defined by expectations that are out there. We are trying to define the kind of musical score that we're going to dance to or that we're going to operate under as actuaries. But we are going to move from the individual model to a team, and we need to coordinate our steps and learn how to interact with other bodies. The standards show fundamental work in how we interact across countries.

I'm going to give more background on some of the preparation that has been going on over the last five years. One thing to keep in mind that, historically, has influenced how we got to where we are today is the importance and predominance of banks. In the 1970s and 1980s, when we went through the savings-and-loan crisis, we found that financial reporting hid a whole bunch of surprises from taxpayers. That concept led to what I would call the professional acceptance, or credence, of financial economics.

Think about risk management for banks today. A bank, from an enterprise risk management (ERM) standpoint, needs to be able to close out its balance sheet in a very short period of time. If some event occurs, whether it's a "Russian flu" epidemic with the bonds, a change in interest rates or a change in lending practices, a bank must be able to terminate everything and still end up in a positive situation. Over the last 10 years, we've seen accounting move to a very market-oriented basis for an enterprise that basically gives away money to people so that they can get an asset, which is the loan that's going to come back. This is 180 degrees different from what happens with an insurance company. An insurance company collects money from people and gives out a liability. Our liabilities do not close out in 30, 60 or 90 days. They may have a very long time horizon.

How do we deal with that? We have a different kind of risk situation. The bank risk involves speed. If I'm trying to hedge a series of things and I miss the market, I could lose. I want to make sure that I'm on top of that. Our ERM question is, how do I deal with the long-term horizon? Insurance contracts are some of the longest-term contracts that are there. They carry guarantees for a lengthy period of time. You have to deal with mortality. The risk factors can change significantly over the life of the contract. You can't solve it by paying a lump sum up front. Both parties have options in how they are going to move through the risks that they have accepted.

There are some practical solutions that we've developed in order to deal with this risk that we've taken on. One is that the insurer has a valuable right that says that

the person could be insured forever or for some period of time. We make a long commitment. We take on the fact that a person may have bad genes or bad habits. We don't know that, but we'll cover that. Often, policyholders can't afford to pay immediately. They want to pay small premiums up front, but they want to provide for their families. That has been the basic story. The end result is that we usually end up with a package of rights and obligations, and a contract, so that the risk of future uncertainty is not defined by a lump sum, nor does the insurance company charge a large sum of money up front.

It becomes what I'll call a "risk-sharing arrangement." There are generally three different ways that you can do it. You can charge a very large premium. Typically, a mutual company will charge a larger premium, but they are going to share that with the insured. They know that they are going to cover the extreme events. As they take on that risk, they will share it with the insured, so that the insured will get it back. On the other hand, those interested in getting term insurance for as cheap as possible simply would take the least-expensive available today. These are the polarities of risk-sharing arrangements. Universal life (UL) products focus on a minimum level of premium, but we can vary some charges as we go forward.

There are two separate behaviors that need to be modeled. We're looking at the business reality of what happens in a company when it goes through this risk-making decision. Policyholders can decide whether or not to pay premiums. They can decide to lapse, or they can decide to exercise some optional benefits. The insurer has to accept the premiums. An insurance company is exposing itself to risk, but at the same time, it is giving itself some flexibility in how to handle it. Traditionally, accounting takes each option, values it individually and adds them up. We're running into some conflict in how to go about handling that situation.

Accounting is trying to mirror the reality of the business. The business has identified the drivers of profitability. One is policyholder behavior. The accountants have some behavioral options. They do some modeling. They do stress testing and scenario testing. The background of accounting and financial economics has been driven by how you determine the market value of a firm. Everybody says that they can determine the market value of assets. They can determine the market value of liabilities. There's something called franchise value. Those are things that we can't measure. There's some controversy about whether or not companies can declare bankruptcy and leave obligations for others to take care of. There must be some value in that. That's what has been framing the discussion for the last five years or so.

Let's spend a little more time on the value of the firm. Another way to define brand value or franchise value is the ability of a company to manage assets other than by passively buying them. You can buy an asset or some stock or a bond, and then sit and watch it. The value that we see reflects what's there, but we don't manage it. We tend to buy stock in companies for which we believe management can do something somewhat unique with their assets. That company has the ability to

manage its assets of employees to create customer relationships that are loyal. That company has rocket scientists that are able to develop leading-edge ideas. Traditionally we've said, "Let's just track the tangible assets. We can measure those. I've got a physical obligation of a liability, and we'll measure that." That's the traditional accounting story.

Insurance has a set of assets to manage, and it is going to use a risk-sharing mechanism to do it. Because of the fact that we manage the assets and liabilities together, whether it's a mutual company with dividends or a stock company that has nonguaranteed elements, in both cases, they're able to share their future risk with the policyholder. We can model that in aggregate. Mergers and acquisitions occur because buyers and sellers can do joint modeling and come to some common agreement that says that they can capture a value, agree upon a price and something is sold. Traditional accounting dictates that you must exclude that. That's franchise value. You don't want to report on that. That's at the heart of what we've been trained to look at as actuaries. We look at the interaction of these options and rights together.

There's another way to think about this. Several members of the IASB feel very strongly that, for example, if I promise to pay someone $1,000, and that person realizes that I have four kids in college and I may not make it through, that that person should be willing to settle that debt for $700 and call it square. If that person sees that I'm in trouble, he or she would rather get some money than none, and so these members of the IASB feel that ought to somehow flow through the accounting statement.

Let's think about what happens in a company in which they have bad experience. You could argue that that should lead to a lower credit rating. Therefore, you should discount their liabilities so that they're lower. Actually, the risk-sharing mechanism almost does that automatically. Management is going to be first to know of emerging bad experience. They're tracking it. Before the accounting period is even over, they have taken some corrective action. or they realize that they can't, and then there's an unlocking or disclosure in the accounting statement. I just want to use this as an illustration of how something that has had a lot of controversy, historically, starts to take on a different flavor when we think about the dynamics of what's driving how an insurance company operates.

How do we solve the dilemma? What I really have is a set of guaranteed rights. There is a floor of benefits that I've promised as a company. There is a set of risk-free assets that I can buy to fund those. The idea is that if there is a future share of policyholder benefits and shareholder value that is about to be earned over the 20 years in this contract, how do you tell that story? That's the answer you're trying to get. How do you split between those two, realizing that, historically, banks think in terms of what they can do in the next 30 to 60 days to maximize the value?

In each year, I'm earning a small risk margin because of my decisions to manage. But that behavior is counterproductive to succeeding in an insurance company, because the idea that I'll cut everything to my guarantees to maximize my short-run value will destroy franchise value. I lost trust in the marketplace. There's a discipline that's changing the dynamic of that. How are you going to tell the story of that? That's why this hasn't been solved, and that's why the IASB is contemplating it. Insurance is the location for all of the contradictions or challenges that we've had in traditional accounting. For the most part, we can brush them to the side. But this question seems to be at the core of it.

Since accountants are accustomed to considering an asset as something that they can manage and have control over, one of the big concerns is that when they look at life insurance, they're going to say that a future premium is not an asset that can be controlled by the company. It should be ignored entirely until they receive it. This is an important choice. If the expected policyholder behavior is relevant—most people would say that that makes sense, and some on the board are starting to realize why it does, particularly in the context of a long-duration risk-sharing contract—then you must make decisions about how you model that in the future. You have to think about expected values versus minimums versus worst-case versus best-case. Do you use a single estimate of that behavior? If so, how do you change or modify it in the future?

If you decide that policyholder behavior is irrelevant, and you're going to stick to the traditional, pure accounting background, you end up with a possible scenario. How would you handle that? You're going to use a risk-free discount rate, the expected value of all of these future values (ignoring premium) and come up with a value. What is the reward for buying a stock or a bond? You can let go. You don’t think, "I bought General Motors. Should I design a new car? How do I handle expenses?" Somebody else is worrying about that. If we use what I'd call the traditional risk-free definition of discounting insurance liabilities, what's the cost to fund that so that we don't have to worry about it anymore? We can hedge all of our risk and go back to bed. In most cases, people would pay a premium to take on the right to manage that. Those that understand risk, those that understand hedging and those that understand underwriting and marketing would pay a premium for that.

In the market, value would start to accrue. On a simple basis, you could argue that many investment firms would say that if you gave them $1 billion worth of Treasuries to manage $1 billion worth of hedged liabilities, they would pay you some premium above that. What would I, as an investor in the company, want to know? What's your expected future value? This isn't traditional embedded value. You're trying to figure out the potential for the part of the benefit stream that will go to the shareholder versus the part that goes to the policyholder. Knowing that, companies probably will trade much closer to that value than the other.

Certainly insurance regulators care about this, as well. In many countries, international accounting will be the accounting that occurs in their country. They want to make sure that they have a way to understand the solvency questions that come out of the accounting regime. Because of that, insurance regulators have an active committee working with the IASB to determine insurance regulation concerns. The IAA is going to try to answer the question of how you tell the story about risk and report on it. I remember somebody saying, "This is so consuming. I don't have to worry about all of those other issues that the board's worrying about, like oil-drilling rights." Why invest money up front for a right that may have a payoff over 20 or 30 years? How do I account for that? Maybe there are some similarities to the things that we do need to worry about.

MR. HENRY SIEGEL: I'm not talking on behalf of the Academy. I'm talking on behalf of an organization that we refer to as Group of North American Insurance Enterprises (GNAIE), which is a group made up of 12 very large insurance enterprises from North America whose sole purpose is international and U.S. accounting. We've been working on international accounting standards for about two years. In July 2005, we issued a set of international accounting principles jointly with a group of Japanese life insurance companies. At the same time, the Chief Financial Officer (CFO) Forum (which is a group of 20 large European companies and their CFOs) issued a set of principles that are nearly identical to the ones issued by GNAIE. That's not a surprise, because we wrote them together. There was one issue on which we couldn't agree that has to do with whether property and casualty (P&C) reserves should be discounted or not. We ended up issuing them separately. But as far as life insurance is concerned, essentially, the two groups are in total agreement.

That means that the companies that are responsible for writing roughly 95 percent of all of the life insurance in the world have agreed on something. That is probably unprecedented. There are 13 basic principles, but I want to explain what we were trying to do. What if I told you that I have a new policy with no regulations, no laws and no accounting standards? All I have is a pricing run for which our actuaries figured the expected benefits and expenses and calculated some premiums. I then told you that I need you to calculate what you think we should hold as a reserve. Probably all of the people in the room would go about it the same way.

Basically, you'd find the present value of future benefits and expenses and subtract the present value of future premiums. You'd say that I have to hold that as a liability. Essentially, that's what the principles advise that you do, because we got tired of arguing what market values things are and what you do about this issue or that issue. We asked, if we were starting all over again and we had no restrictions, what would we do? Every so often, people will come up to me and say, "That's not the way the banks handle it." I know. The banks got it wrong. Why should we continue that? The banks got it wrong? It is shocking, but they do.

I'm not going to go through every one of the principles. There are four that I want to make sure that you understand how radical they are. The first one mandates that there will be no gain or loss at issue. I wouldn't say that this is radical, but it's controversial. Somebody asked me the other day, "If you're with a P&C company that issued a homeowner's policy, and, because the underwriting cycle goes a certain way, you are able to get it for an expected loss ratio of 30 percent and your expenses are going to be only 20 percent, shouldn't you be able to book some of that profit the moment you issued it?" I said, "Of course you can, but you don't have an insurance policy, because IFRS says that there has to be a possibility of loss. Make up your mind. Either you're sure that you're going to have a profit, then you don't have an insurance policy, or you're not sure that you're going to have a loss, so you can't book the profit." That's a controversial issue that you need to think about. Otherwise, you're going to set up reserves based on your best estimates plus margins so that the present value of premiums and the present value of expenses and benefits are equal. Over time, experience will emerge. To the extent that those margins aren't needed, they'll run out into profit.

The next issue that I want to talk about is the fourth principle, risk and uncertainty. It mandates that you should have margins in your reserves. The question becomes, how do you deal with loss recognition? The first principle mandates that there'll be no loss at issue unless a loss recognition test indicates that you need one. How do you deal with loss recognition? U.S. GAAP mandates that you figure out a loss recognition without margins. This principle dictates that there always should be a margin in the reserves. This is very different from what's in U.S. GAAP. But in order to be consistent with what we think are sound reserving principles, you never should have a reserve in your financial statements that doesn't have adequate provision for risk and uncertainty. When you do loss recognition, you have to include not just your best estimates, but your best estimates including some provisions for risk and uncertainty.

The next issue that I want to talk about is the sixth principle, because this is another hot button. People call this "unlocking." "Unlocking" is a very undefined term. We tend to talk about it in two ways. We talk about reviewing the assumptions, which we believe should be done all of the time, and changing the assumptions, which we most likely don't think should be done very often. Insurance experience unfolds over a period of time. New York Life once had the pleasure of owning a British company for which management was paid based on embedded value. Every year, management would say that they did a new experience study and the lapse rates had gone down or the lapse rates had gone up, so they'd change our lapse assumption in the embedded value to reflect last year's experience. They did this for four years. Finally, we were able to sell the company. So I didn't have to tell them that this was ridiculous. Every year they changed this assumption. Why didn't they wait a few years? It will go down; it will come back up. It will go back. They don't have to change the assumption.

The other thing that's important about this is that it works two ways. You unlock for worse experience, but you unlock for better experience, too. That causes problems. I have problems with positive unlocking because it sounds as though you're taking credit for profits that you haven't earned yet. That's an issue. The other issue with this is that for many countries (not so much in the United States and many of the other countries with which we're familiar with), this is the only accounting basis that exists. That means that it gets used for taxes, too. Whether the taxing authorities will allow the actuary to unlock his assumptions in a year that he has good experience so that he can absorb some of that experience and not pay taxes on it, I think, is dubious. My guess is that the taxing authority is going to mandate that you lock in your experience. Then we'll live with it, however it turns out.

As I mentioned before, the banks got it wrong. A retired actuary wrote a wonderful paper on how reserves should take into account policyholder behavior. Anybody would agree that not taking into account renewal premiums on life insurance or not taking into account the fact that policies lapse would be an insane system for a general accounting practice. We all live with it on statutory, but that's a different issue. You should be able to take into account the fact that you will get future premiums and the fact that policies are going to lapse.

However, banks hold the value of all of their deposits as their liability. They assume that anybody can walk in and take all of his or her deposits tomorrow. The reality is that people don't. You should reflect reality in your statements. But the banks don't do that. The banks have it wrong. You should be able to reflect policyholder behavior. There was an early paper on fair value accounting that was published by the predecessor of the IASB that said that for renewal premiums, you probably shouldn't count a lot of them because it's not to a policyholder's advantage to pay them. After all, much of that renewal premium is used to recover acquisition expenses, and that's not to the policyholder's advantage. Why should they pay them? The reality is that they do pay them, and we think that they should be reflected.

I want to tell you what's going on in the future. GNAIE, the Japanese insurance companies and the European CFO Forum are continuing to talk about publishing more detailed principles of accounting. At the same time, the Academy is trying to deal with all of the wonderful work coming out of the IAA on principles, as well as developing an American perspective on this accounting work. There are not enough people actively involved. We can find a place for you if you want to be involved. GNAIE is open to any company that is domesticated in the United States. Dues are about $100,000.

MR. DOUGLAS VAN DAM: You stated that you review the experience often, but change it not often. It seems to me that every time you make a change, it's going to be a big change. Don't you think that you'd be better off making those changes as they evolve on a regular basis?

MR. SIEGEL: That's a question of policy for the company. It depends on whether you're sure that it's not going to turn around and go back the other way. I think that if you're continually unlocking and following an assigned curve of random numbers, probably not. You need to run some numbers and see how it looks. I will tell you that what I've seen suggests that not unlocking usually gives you a more reasonable representation of what actually happened that year. I prefer to lock in rather than unlock. Every company would have to make that decision for itself.

MR. SANDBERG: One of the things that I think is important in this issue is how we create credibility. How are we able to set a base for other people to respond to? I think that we traditionally have been of the attitude that, as an actuary, "I have good judgment. I will make an assumption. I will put it in my modeling. Next year, I'll do another little lapse study. Maybe I'll tweak this one a bit." One of the key things that is happening on this international accounting issue and that will be happening on the statutory side as we talk about a principle-based approach is, how do you start setting up a discipline around credibility? When is data credible enough that it should be recognized?

Financial Accounting Standard (FAS) 97 mandates that you use inception to date. Unlocking has a big impact. But I can temper it with my GAAP or my deferred acquisition cost (DAC). That's one way to do it. Australia's guidelines require you to unlock, and it all goes into a future margin, like an interest maintenance reserve. So I keep my earnings stream. You'd think, from an analyst's perspective, that if I actually had documented that this company had made these adjustments to their past earnings, I then would give a best guess as to how those earnings are going to flow. I'm actually getting a nice actual-to-expected analysis. That may be another way to look at it.

I have a question for Mr. Siegel. I think that Principle No. 3, gains and losses, should be recognized in line with the release from risk. We've got to fill in the details. What does that release from risk look like? What's defining it? What's the driver of the release from risk? Between premiums, investment income, margins—FAS 97 gave one definition of risk. FAS 60 gives a different one. What would make sense? What would be usable?

MR. SIEGEL: If you look on the GNAIE Web site, there are a couple of reports by Watson Wyatt that we commissioned, in which we talk about how you apply margins. There's a lot of leeway. Companies will do it based on how they price and how they look at their risks. We are trying to avoid having the IASB define for us how to do that, because it's not really something that is an accounting issue. It's an actuarial issue. I'm counting on the IAA, at some point, to come out with a set of guidelines. There has to be some kind of symbiosis between the IASB and the IAA. I know that you are working on that. If the IASB is going to put out principles, the IAA will have to write the rules, or at least more detailed guidance, on how those principles are implemented. If you start having the IASB write actuarial principles, we're in trouble.

FROM THE FLOOR: I've seen partial excerpts from the CFO Forum. What do you hope to accomplish? Are you going to accomplish anything that fully cooperates and works with the IASB directly (outside of the realm of a forum)? It's fine to come up with your own set of principles, but where are they going to go?

MR. SIEGEL: They already have been published and sent to the IASB.

FROM THE FLOOR: Who's going to use them? They're not mandated. You can write anything you want.

MR. SANDBERG: They're part of a very fruitful dialogue. There's an Insurance Working Group of the IASB that has about five board members on it and 30 invited panelists. They've been meeting for about a year to talk through the principles that we should use when the IASB writes its paper. Mr. Siegel and I presented part of the information that I presented earlier on this risk-sharing contract to that Insurance Working Group, and it was very well received. Mr. Siegel and a couple of others presented GNAIE's preliminary views. I suspect that they're discussing them next week. There's a very active dialogue going on. They *are* going some place.

FROM THE FLOOR: So the goal is for very learned people in many large companies to gather as a group and exchange ideas and present them formally to the IASB, but stop there.

MR. SIEGEL: Absolutely.

FROM THE FLOOR: If you lose, you lose, right?

MR. SIEGEL: If you don't play the game, you can't win.

FROM THE FLOOR: I agree. I just want to know where you're headed.

MR. SIEGEL: GNAIE has four members on the Insurance Working Group. The CFO Forum, I think, has six. There's one member from Canada and two from Japan, because their life and P&C have different interests. We're all very active in talking to the IASB.

MR. SANDBERG: The panel is made up of accountants, actuaries, ratings analysts and a couple of regulators.

FROM THE FLOOR: There seems to be a lot of discrepancy between the new proposed rules. I agree with you that they are not very good in the way that they are proposed right now. One simple example is that in the way that the IASB and IFRS 4 currently define an insurance product, there can be a lot of room for arbitrage if the treatment of an insurance product is going to be considerably different from the treatment of an investment contract. An investment contract is going to be outside of that realm, according to some fair value rules, and it appears

that a release-from-risk approach is not really a fair value approach. I don't know how you can force it to be a fair value approach. Some economists talk about market-consistent accounting and so forth. You're miles apart. The door has been opened to a continuation of significant arbitrage. What is the GNAIE and CFO Forum response to this?

MR. SIEGEL: First of all, I'm not sure that the difference between an investment contract and the way that we envision insurance accounting working is all that different. It may be a little different in appearance, but I'm not sure that it is in actual results. You'd have to do modeling to see. We don't think that it's that different. Second of all, there are a number of us who get annoyed every time somebody brings up the concept of fair value of insurance liabilities as if you could trade insurance liabilities, and you can't. You can sell some of the rights of an insurance policy, but you can't trade the liability. My guess is that whatever ends up as the IASB's definition of how to do liabilities will become the definition of fair value of an insurance liability, per se. One of the problems that we had with the earlier definitions of fair value of liability is that it didn't take into account the cost of capital. That was a problem because when you do an appraisal, you have to take into account the cost of capital, or you don't get the appropriate value of the company. There were a lot of issues that we're trying to work our way through.

MR. SANDBERG: One other way that the answer is being resolved is through the traditional view of defining investment and insurance contract arbitrarily. This goes back to why it's important to articulate why an insurance contract is different. To the extent that an insurance contract locks in an investment return, and that's all it's doing, that should be accounted consistently across the board so you avoid the arbitrage. But if it is a different kind of contract, the real question is, how do you account for a risk-sharing mechanism contract? You can say that that's how you should account for it, and then I can come up with oil-drilling rights or frequent flyer miles or warranties. There are concepts in accounting that have been pushed off to the side. But they are starting to realize that a long-duration, risk-sharing contract with mutual rights and obligations may be a way to help avoid some of the arbitrage issues. There isn't the trading back and forth. Remember, banks want to arbitrage everything out in 30 days. So the accountants and the banks are accustomed to thinking that way. We really had to push to say that in different situations, different rules are needed.

MR. HINES: One thing to remember is that the IASB had to get an accounting standard in place for 2005 because Europe was going to start using it. The accounting standards are not where the IASB wants them to be from top to bottom. Their accounting framework is not compatible with some of their standards. The underlying principles of how it accounts for things are not consistent. It knows that. But as a political expedient, to make sure that it continues to be able to do its work, it has put things in place that, unfortunately, contribute to the arbitrage situation that we're in now. IFRS 4 is an interim standard. But there is some feeling that the definition of insurance is not going to change as we move forward. That doesn't

mean that it feels comfortable with the investment contract, IAS 39, etc. It convened a separate group on the financial instruments to examine moving everything that's under that standard to fair value. So you may end up with different arbitrage opportunities for different things altogether. But remember, they're in a situation in which they're moving things forward at different paces. Different standards have different paces. It's not a complete package.

MR. THOMAS HERGET: The FASB has long professed that it would like to go in the direction of fair value. You can see that in FAS 115. It actually states that. They get the assets first. You get the liabilities later. The FASB also has said that they'd like to work with the IASB. Hopefully, everything will be in sync. How do you see this rolling out in the near future when FASB says that fair value is something that we should consider? How is it going to be able to reconcile what's going on now with the process that it has in which American companies and individuals can step forward and shape and mold its recommendations?

MR. HINES: It is a different process with the IASB, as it moves forward in its constituencies. It doesn't have a direct analog with a single jurisdiction. You don't have the SEC holding it over FASB. It has many organizations that are considering adopting IASB rules. There's always controversy about advocacy groups looking for different treatment. Banking issues were very big in Europe, specifically regarding the hedging of those portfolios. But they're still working out the relationships between the FASB and the IASB. They're trying a couple of different approaches to how they might be able to work together. Specifically for insurance, they are trying to work together on this project by having one board take a lead. While it is trying to provide input into the development of this discussion paper, the FASB is at the table in this Insurance Working Group, which is where they're developing the discussion document. It hasn't had that much direct input. But the theory is that once this discussion document is put together, FASB would expose it in the United States for comment and feedback in its traditional way.

FROM THE FLOOR: How soon do you think that might be?

MR. HINES: The way that this process has been going, it's likely to be mid-2006 before you see the discussion document. It's not an exposure draft in terms of an exposure on a standard. It's a discussion paper.

MR. SANDBERG: The significance of that discussion draft is that it will set the stage for much later discussions, in a sense. That's why there's so much concern about being involved and engaged now to make sure that the right kinds of issues are being addressed.

MR. HARRY JAMISON: I'd like to challenge Mr. Siegel's premise that the banks have it all wrong. After all, you said that Principle No. 3, gains and losses, should be recognized in line with release from risk. Principle No. 11 states that policyholder behavior should be recognized. The banks' idea is that they don't set up a liability

until they receive the deposit from the policyholder. Why did you go on the premise of present value of benefits minus present value of premiums, as opposed to having the liability at cash value or a reduced paid-up option, more in line that the banks do have it right and the actuaries have it wrong?

MR. SIEGEL: I've never known an actuary to make a mistake, because you don't get the right results. If you examine our products and you do it on that basis, you don't get a set of financial statements that make sense. The reality is, you do expect to get renewal premiums. We all price on that basis. We all have that expectation. It seemed insane not to do that. I don't think that the banks have everything wrong. I just refuse to be bound by where they do.

MR. SANDBERG: I'll introduce one area in which we all might be wrong, which is the timeline that we've talked about. This still could be in the discussion draft four years later. But if you look at these principles, every one of them has been addressed by the UL Working Group dealing with statutory proposal for principle-based approaches. I would like to remind you that you are the experts on these questions. You all deal with margins. These areas are things that are going to come to regulatory attention in the United States in a different framework in a very significant way within the next 12 months. Whether it's on the international accounting side or the statutory side, it's going to be there. I encourage you to challenge your company internally to make sure that you get a chance to contribute your expertise.

MR. VAN DAM: I'm speaking on behalf of myself, not the company. One of the issues referred to intangible assets. I was looking forward to DAC going away forever when international accounting came in. Can you explain what's happening with DAC?

MR. SIEGEL: DAC may go away. The problem is that, in order for DAC to go away, you have to be allowed to hold a negative reserve on some policies. That's going to be a hard sell. DAC preserves the "optics," and that's why it is included for now.

MR. SANDBERG: Another way to talk about DAC is risk margin. If you said that you are going to replace DAC, instead, call it the risk margin, which is another way to get out of negative liabilities (but it's an unreleased risk margin).

MR. SIEGEL: You just call it something different.

MR. SANDBERG: Yes.

MR. SIEGEL: There's also a discussion, instead of calling it DAC, you can call it the value of policyholder relationships, or something like that. The question is, do you hold a contract asset or not? Or do you hold a negative liability? For our products, in the first year, the liability will be negative net. I hope that all of you who are interested in this will find a way to participate.

FROM THE FLOOR: Have the eight IAPGs formally been adopted or approved by the IAA?

MR. HINES: Yes.

FROM THE FLOOR: But the American societies have not accepted them or they have problems with them. What value are they if the international organization adopts them, but all of the supporting associations don't? That seems a little confusing to me. It seems that if the international association approved them, by definition, all of the supporting organizations would. But if they don't, do I really pay attention to them? Do they have any value? I would want to pay attention to what my association says are the recognized practices.

MR. HINES: American societies have issues not with the substance of the standards themselves so much as the introduction and what these practice guidelines represent. In the United States, the practice guidelines may be misinterpreted by nonactuaries, such as legal people looking to sue insurance companies and actuaries for malpractice when something goes bad. They may use these in a way that is not intended and certainly not the way that the IAA had intended them. It's not a substance issue regarding what guidance is contained and how might an actuary go about working under classifying an insurance contract versus an investment contract versus a service contract under IASB standards. The issues are with the front end of it, the introduction and the caveats. That's the controversial piece. Should you be interested in these? If you have to report under IFRS, yes. There's nothing else. The Academy is coming to grips with the fact that a large percentage of their membership actually has to deal with IFRS, not just U.S. GAAP and not just U.S. statutory. It still is trying to work through the issues of what this means for us. What does this mean for us as the Academy, our profession in general or hundreds of actuaries who work at companies that have to deal with the reality that this is the only actuarial guidance that may be of help?

MR. SANDBERG: In order to get to a Class 1, 2 or 3, IAPGs have to start as a 4. There are 4s out there. While you might feel that that is only interesting, they have the potential to become binding. That's a significant step, as well.

MR. HOLLAND: I've heard that maybe premiums shouldn't be reported as an asset, because the insurance company doesn't have control over them as an asset. Are they talking about splitting a gross premium liability into a present value of benefits component on the liability side and premiums on the asset side?

MR. SIEGEL: That's how some of the financial economists think about reserves. That's the problem that policyholder-behavior principle attempts to isolate.

MR. HINES: I interpret it a little differently. You're suggesting that you split up a net reserve between the present value of benefits and present value of premiums

on the balance sheet. That isn't what they're talking about. They're talking about not allowing the present value of premiums in the calculation reserve itself. It wouldn't show up anywhere else.

MR. HOLLAND: So it might not just be a geographic consideration.

MR. HINES: Correct.

MR. HOLLAND: It might be whether or not you're going to bring renewal premiums into the calculation at all?

MR. HINES: That's right.

MR. SANDBERG: Mr. Hines was instrumental in putting together a project for which we examined a UL policy and addressed how you would account for it when you only recognized the first premium. You still have all of the liability, and you get a huge loss and additional premiums. You get a very challenging pattern. That report is accessible if you want to explore that a little bit more. It's an American Council of Life Insurance/IAA-sponsored report.