



SOCIETY OF ACTUARIES

Article from:

# International Section News

October 1999 – Issue No. 20



## **An Overview of Health Care Privatisation in Latin America**

*by Dominique Hierro & Peter Wrede*

**T**he privatisation of social security systems is an exciting experience for a country's insurance industry. Not only does it almost always increase the industry's growth potential by a significant degree, but it also changes the regulatory environment, customer needs, and the market place in general. The intent of this article is to show the diversity of results brought about by partial privatisation of social security health care systems in four major Latin American insurance markets.

### **Mexico**

The Mexican Social Security Institute (IMSS) was created in 1943 and was operated by the state. Benefits were financed by contributions made by

*(continued on page 3, column 1)*

## **International Opportunities for Stable Value**

*by Paul J. Donahue*

### **Stable Value and Its Foundations**

Stable value is among the defined-contribution plan options most popular with participants. In 1998, despite the dilution caused by six years of booming equity values, stable value options contained 11.7% of corporate defined-contribution plan assets.<sup>1</sup>

Key to the popularity of stable value is its offer of a guarantee of principal with higher returns than those available in money market funds. What makes a guarantee of principal possible for stable value, as for money market funds, is accounting for assets at amortized cost and accrued interest ("book value"). Credited interest is determined in a way that reduces return volatility, which is another characteristic investors find highly desirable. The foundation for book value accounting for defined-contribution plan assets is compliance with the American Institute of Certified Public Accountants Statement of Position 94-4 ("AICPA SOP 94-4").<sup>2</sup>

### **Characteristics of the Market Demand for Stable Value**

Stable value is an option popular both with conservative investors and with investors who want to moderate the overall volatility of the return of their portfolios.<sup>3</sup> This fits the return profile of investors outside the United States far better than it does domestic investors, especially since the equity boom of the middle and late '90s has dramatically increased the degree of comfort individual investors have investing in equities.

*(continued on page 4, column 1)*

## **In This Issue**

page		page	page
	International Opportunities for Stable Value <i>by Paul J. Donahue</i> .....	Life in China: Part One <i>by Cao Qing Yang</i> .....	Change and Opportunity <i>by Dov Raphael</i> .....
1		10	19
	An Overview of Health Care Privatisation in Latin America <i>by Dominique Hierro &amp; Peter Wrede</i> .....	A Social Security System for the 21st Century: Part II <i>by Chiu-Cheng Chang &amp; Geraldine Chen</i> .....	IACA Meets, Reduces Dues 55%.....
1		13	20
	Editor's Note <i>by Kevin M. Law</i> .....	The Egyptian Society of Actuaries <i>by Mohamed F. Amer</i> .....	Help a Future Actuary .....
2		17	21
	Election Results .....	An American Actuary in Shangri-La <i>by James E. Norris</i> .....	International Section's List of Meeting Sessions <i>by Bob Lyle</i> .....
5		18	22
	Ley 100 (Law 100) in Colombia <i>by Rod Mangrum</i> .....	Seminar: Financial Reporting Issues for International Actuaries <i>by Angelica Michail</i> .....	IACA Meeting in Year 2000 Slated for Hershey, PA.....
9		19	23

## International Opportunities for Stable Value

*continued from page 1*

According to the Federal Reserve Bank, in the United States as of the end of 1998 households and nonprofit organizations had only 13.6% of their financial assets in currency, bank deposits and mutual fund money market fund shares. They had 31.2% in life insurance and pension reserves, while they held 20.8% in direct equity investments and 8.25% in mutual funds other than money market funds.<sup>4</sup> According to the Bank of Japan, in that country, households held 55% of their wealth in currency and bank deposits, 27% in life insurance and pension reserves, and only 14.4% in shares and securities.<sup>5</sup>

### Contribution to the Efficiency of Financial Markets

Stable value can make an important contribution to improving the efficiency of financial markets abroad, both for institutions and for individuals. For individuals with a low tolerance for risk, stable value will increase wealth by providing the principal guarantee they value while increasing return relative to other guaranteed principal products. Under conditions permitted by defined contribution pension plans, stable value is absolutely superior not only to money market investments but to many intermediate bond funds as well. Further, stable value's markedly lower volatility leads many investors to prefer it to more volatile investments with greater returns.

For such individuals, in addition to making available an additional asset class better suited to their risk preferences, and thus enhancing market completeness, stable value can assist individuals in making a transition from the mentality of saving to the mentality of investing. Stable value has played this role in the United States.

Stable value adds to the completeness and thus to the efficiency of the financial markets for institutions as well. Stable Value funds are important direct and indirect<sup>6</sup> investors in a wide variety of fixed-income instruments, including Treasuries,

intermediate tranches of asset-backed securities and commercial mortgage-backed securities, collateralized loan obligations and corporate bonds. This increases the market for such assets, improving liquidity and, frequently, increasing the availability of non-bank financing.

the Financial Accounting Standards Board is the most important non-governmental source of financial regulation in the world. In the United States, it is easy to determine where to turn for resolution of accounting issues, and relatively easy to determine relative roles where there are other than accounting

---

***“Stable value can assist individuals in making a transition from the mentality of saving to the mentality of investing.”***

---

### Accounting and Regulatory Challenges to the Export of Stable Value

Despite its very evident advantages, there are significant obstacles that could delay or rule out altogether the growth of stable value in different foreign markets.

The most significant of these obstacles is establishing the acceptability of the amortized cost accounting treatment that is the *sine qua non* of stable value. AICPA SOP 94-4 makes it possible to transact on behalf of participants at amortized cost plus accrued interest even though the market value of the assets underlying the participant's account

value will nearly always differ from the account value. Without this feature, it would not be possible to offer the guarantee of principal that distinguishes stable value from assets offering comparable or greater returns.

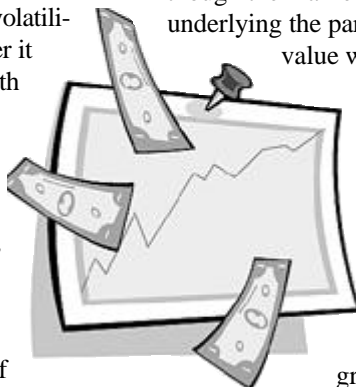
The conclusions about accounting that AICPA SOP 94-4 reaches are sound and well reasoned, but unfortunately that does not guarantee their acceptance elsewhere. The United States is fortunate that the accounting profession is solidly established, autonomous and self-governing. There can be little doubt that

questions. Where, for example, the Department of Labor, in discharging the duties assigned to it by ERISA, imposes regulations that impinge on accounting, the boundary between the regulation and the underlying accounting treatment is generally relatively easy to determine.

It is often not so outside the United States. In Japan, the Business Accounting Deliberation Council, a division of the Ministry of Finance, establishes Financial Accounting Standards for business enterprises. In striking contrast to the United States, the accounting profession, as represented by the Japanese Institute of Certified Public Accountants, has little role in setting accounting standards; its role is to provide guidance on the implementation of standards. The Japanese cultural preference for consensus, an acceptance of limited disclosure, and general conservatism can impose significant barriers to innovation.<sup>7</sup> When pensions are at issue, the Ministries of Health and Welfare, Industry and Trade, and Labor can also be involved.<sup>8</sup>

Many of us find dealing with government bureaucracy a challenge even in the United States, where governmental institutions are “quick-turnaround” specialists by international standards. The burden of establishing a firm accounting and regulatory foundation for a product that does not fit easily within the established framework is a formidable task, and will not prove possible everywhere.

By way of contrast, accountants in the



United Kingdom have as individuals even more flexibility than their American counterparts. Further, where an accounting treatment has no solid United Kingdom precedents, looking to American best practice is an acceptable way of resolving an issue.<sup>9</sup> Establishing the required accounting and regulatory foundations should prove much easier in the United Kingdom than in Japan.

## Investment Challenges

As noted above, the key to the attractiveness of stable value as an investment class is its guarantee of principal while offering a return superior to that of money market funds. In the United States, a normally shaped yield curve and modestly priced contracts that provide principal guarantees are the usual financial market inputs, as opposed to accounting and regulatory inputs, to a successful stable value product. At the moment, both in the United Kingdom and in Japan, yield curves are more compressed than in the United States.

Further, the costs of the contracts to guarantee principal are likely to be significantly higher, at least initially. Issuers will need to recover development costs, and risk charges will, rationally, need to be higher, if for no other reason than the absence of an experience base from which to develop a pricing model. The combination of the two leaves open the question whether or not a stable value product with market appeal is possible in either of these two markets using



traditional investment inputs. Success in these countries may require investment innovation, at least until the yield curve environment becomes more favorable.

## Conclusion

Stable value has the potential to contribute to the development both of individual welfare and capital market completeness in economies outside the United States. Promoting the development of Stable Value abroad offers an opportunity for growth in a product segment that has matured in the United States, with margins potentially much larger than those available domestically, where Stable Value, like other mature product segments, has become a price sensitive, low margin business. However, in order to reap the potential profits, developers of stable value abroad will have to surmount an array of accounting, regulatory and investment challenges.

*Paul J. Donahue, FSA, is director of Product Development at PRIMCO Capital Management in Louisville, KY.*

## Footnotes

1) This figure comes from a table prepared by John Hancock and forwarded to me attached to an email dated August 5, 1999, by Klaus Shigley, FSA, Senior Vice President.

2) My article discussing in far greater detail stable value market demand, accounting, contract and investment issues is forthcoming in *Benefits Quarterly*.

3) The essence of the operation of stable value is the amortization of any difference between the book and market values of a portfolio over a future period. The industry standard for the length of the period is the duration of the portfolio. This effectively smoothes credited interest rates and so reduces return volatility.

4) Flow of Funds Accounts of the United States, Flows and Outstandings First Quarter 1999, Board of Governors of the Federal Reserve System, Washington, DC, June 11, 1999.

5) Flow of funds of Japan, Fiscal 1998, Bank of Japan, Research and Statistics Department, July 1, 1999, <http://www.boj.or.jp/en/siryosiryof.htm>.

6) Stable value funds are indirect investors when they invest in insurance company general account and pooled separate account products.

7) See Accounting in Japan, Lisa Gao, Devin Williams, and Mo Xie, [msm.byu.edu/c&i/cim/account/Japan.htm](http://msm.byu.edu/c&i/cim/account/Japan.htm).

8) Email dated August 30, 1999, from Toshiyuki Kanaya to the author.

9) Conference call with Graeme Proudfoot and Rodney Smythe, Invesco, London, June 23, 1999.

## NEWLY-ELECTED MEMBERS OF THE INTERNATIONAL SECTION COUNCIL

1) **Lisa S. Kuklinski-Ramirez**, *Metropolitan Life*, New York, NY

2) **Hubert B. Mueller**, *Tillinghast-Towers Perrin*, Cologne, Germany

3) **Hans J. Wagner**, *National Mutual Holdings*, Melbourne Australia

\* *All were elected to three-year terms.*