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**OPINION**

# The regulated road to ruin

*by Irwin T. Vanderhoof*

The investing community will soon start to recognize that the accounting profession, as goaded by the Securities and Exchange Commission (SEC), has developed a set of regulations for the insurance industry that might have severe adverse effects on U.S. capital markets.

It is possible for investors to find three companies with identical business and investments that report strikingly different results. The first shows good earnings and growth of capital; the second shows good earnings but a reduction in capital; the third shows poor earnings passed through to a comparable reduction in capital. What may not be easily evident is that the third company might be the best managed one. This situation is created by FAS 115, in which financial statements provide less information about companies than in the past, where comparability of statements between companies is reduced and, finally, where management is encouraged by accounting to do the wrong thing.

Why does this matter to the capital markets? Because the bond market is dominated by insurance companies. Fixed-rate, long-term borrowing by business and industry is dependent on the existence of $2 trillion of assets in the insurance industry. If insurance companies no longer lend at fixed rates, then the nature of business expansion in the low-savings-rate United States must disintegrate. These various distortions in reporting financial results could adversely affect growth of insurance business and its willingness to make long-term, fixed-rate loans.

How did FAS 115 go so wrong? It began with the dirty little secret of the insurance industry, which periodically goes underwater: market value of assets less than book value of liabilities. It

happened during the Great Depression. When bonds had big drops in market price, the insurance commissioners said that companies could ignore the market prices and use values that showed they were solvent. Since none of the big companies actually went under, the industry sailed through the '30s with a pretty good record.

It happened again during the '80s. The market values of all life insurance company assets were well below the values that would be paid if all policies were surrendered. However, this was as irrelevant as worrying about the Verranzano Bridge collapsing if all the New York marathoners went across it all in step. Runners go over the bridge at their individual paces. Similarly, policyholders don't surrender their policies en masse. Since companies did not report the market value of their assets had fallen, no one was concerned, and the "run on the bank" did not occur.

However, the companies realized how close that barely dodgeable bullet came. They worked with regulators to clean up their act. High-tech computers became available that could model the group behavior of various policyholders over possible patterns of future interest rate movement. Actual company assets also could be modeled, assuming bonds were called en masse and collateralized mortgage obligations (CMOs) were paid off in conformance with historic norms. Using hundreds of projections based on different assumed interest rate scenarios, companies could determine asset structures that would allow them to pay off all legitimate policyholder claims as they came due under all plausible possibilities. State regulators set up requirements that company actuaries certify if actual company assets were adequate to pay off liabilities under some specified sets of interest rate scenarios. In addition, new industry standards were set for relating the capital a company needed to the riskiness of the assets. The Executive Life situation would not be repeated.

However, the SEC thought market values were needed to help investors judge a company's value. The values of both the assets and liabilities change with fluctuations in interest rates, but nobody could come up with a generally acceptable way to obtain the market values of an insurance company's liabilities. So, the Financial Accounting Standards Board (FASB) came up with FAS 115. It failed to pass on the first vote. The SEC was rumored to have lobbied vigorously, and the next day the Standards Board barely passed the standard. I haven't met an accounting firm working with insurance companies that will defend it.

This stupid standard attempts to adjust the balance sheet of insurance companies the easy way by simply adjusting the values of the assets without adjusting the value of new liabilities. Since the net worth of a company is the assets less the liabilities when interest rates go up 300 bp, as they did in 1994, we say the value of the companies' capital goes down about $200 billion. This wipes out the industry's capital.

It would look bad for the SEC and the accountants to wipe out the bond market so quickly, so they needed a way to blame the industry for the problem. This follows the pattern of blaming the George Baileys of the savings and loan industry for being unable to cope with interest rate problems in the '80s. The SEC and accountants thus decided to allow companies to determine how they wished to die.

Companies are therefore allowed to classify their bond holdings into three groups. Group I is hold to maturity. Holdings in this class are not marked to market at all. Group II is available for sale. Holdings in this group are marked to market, but the changes in value don't go through earnings. They are marked directly to the capital account. Group III is the trading account. Holdings in this group have changes in value posted to earnings.

Under the old system of book values for assets and liabilities, the stockholder had some confidence that, since the assets were adequate to cover demands of the liabilities, the value of capital was about as stated. That assurance no longer exists. Because companies may decide how many bonds go into each group, comparability between company statements is reduced. Since the balance sheet and earnings are protected by classifying all bonds as hold to maturity, companies are encouraged to limit their ability to adjust to changes in the economy and to invest in illiquid assets.

The three companies in the opening illustration were assumed to have had identical assets and businesses. The first company had elected to make its assets illiquid by calling the hold to maturity. It had protected its earnings and net worth. The second company had said its assets were available for sale. Assets can be sold, but the number of transactions seems limited. It had protected its earnings. The last company had called its bonds a trading account. It had preserved its flexibility to adjust assets, as was required by safety considerations. It would show an operating loss adequate to eliminate its net worth. The resulting run on the company by frightened policyholders would be used by the federal government as reason for more regulation and by the FASB as a reason for more accounting standards.

The situation is even stranger when you consider the preceding applies only to generally accepted accounting principle (GAAP) statements. Statutory statements, the ones regulators use, stick to book values and are at least consistent over the years. Mutual companies, owned by their policyholders, won't have to be involved in FAS 115 until next year and then only if they want a clean audit opinion. The strongest companies may elect to refuse to follow FAS 115. Obedience to the SEC dictum would then be a sign of company weakness, and the additional weakness conferred by a foolish standard.

The adherence to the inappropriate market standard is another example of the damage that can be done by regulators preferring orthodoxy to understanding the business they regulate.

Stay tuned for the results of the Market Valuation of Liabilities call for papers, sponsored by the Society of Actuaries.

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## Upcoming conferences

### A. C. Aitken conference call for papers

The A. C. Aitken conference will be in Dunedin, New Zealand, from August 28 to September 1. Honoring the centenary of the birth of actuary A. C. Aitken, mathematician and statistician, the meeting will examine both the academics of actuarial science and its practice. For information on attending or presenting a paper, fax Leigh Roberts at 64-4-495-5118, or e-mail: leigh.roberts@vuw.ac.nz

### Issues in Insurance Regulation Symposium

Jointly sponsored by the National Association of Insurance Commissioners (NAIC) and the American Risk and Insurance Association (ARIA), this symposium will be held December 1-2, 1995, at the Marriott Riverwalk in San Antonio, Texas. The theme of this first insurance regulation symposium is "Alternative Approaches to Insurance Regulation." Queries about this meeting should be addressed to Dr. Robert W. Klein, director of research for the NAIC. E-mail: sso!naicp01!rwk@naicgate.attmail.com or fax: 816/889-4446.

### Derivatives and Financial Mathematics call for papers

The American Mathematical Society meeting March 22-23, 1996, at the University of Iowa in Iowa City, will include a special session on "Derivatives and Financial Mathematics." Those interested in attending or presenting a paper should write John Price, Department of Mathematics, DB 1127, Maharishi International University, 1000 North Fourth Street, Fairfield, Iowa 52557-1127, phone: 515/472-7000, ext. 3335; or e-mail: jprice@miu.edu, or 75444,1465@compuserve.com. The deadline for paper abstracts is September 30.