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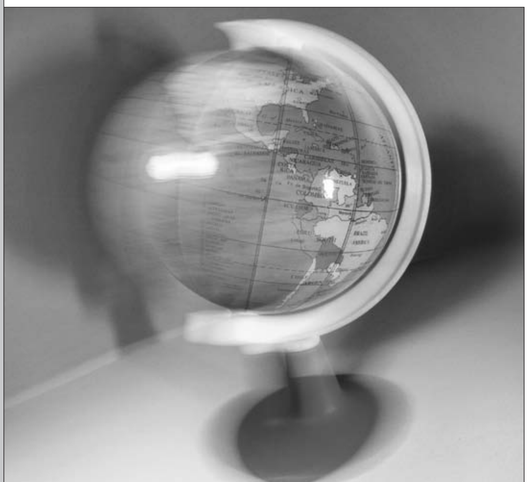
Chairperson's Corner

Mark J. Freedman



Jerry Enoch told me that for my last chairperson's article, I need to take a much more serious approach than I did in the others. I'm assuming he was afraid I'd resist, which got him to hire someone to interview me, under the pretext of "trying to make my life easier." I reluctantly went along with the request, once I agreed on my interviewer.

For those of you old enough to remember the cartoon "Bullwinkle," Boris Badenov, the Russian spy, now spends his retirement years interviewing actuaries.

Mark Freedman: Hi, Boris. Before we start, I want you to understand that the views expressed in this interview will be my personal views and not necessarily the views of my employer.

Boris Badenov: I don't have time for chit-chat or caveats, so let's get started. Where do you think financial reporting for insurance companies is headed in the next 10 years?

MF: I think a number of things will occur. The two most important are that (1) accounting for insurance (and other financial instruments) will become more principle-based than rules-based, and (2) accounting standards will converge globally.

BB: Do you think the North American accounting systems are principle-based?

MF: Canadian GAAP is the most principle-based, U.S. statutory is probably the least and U.S. GAAP is in between. However, all three of these systems have problems.

BB: Can you give examples of problems?

MF: In Canadian GAAP, there are too many smoothing mechanisms, sometimes making it difficult to measure whether or not a company's financial position changed. In U.S. GAAP accounting, earnings patterns are a function of product classification, and sometimes a slight product design tweak can materially change the incidence of earnings. In U.S. statutory accounting, there is very little judgment, except in asset adequacy testing. But, in most cases, the reserves booked are formula reserves, and the asset adequacy test is merely used to demonstrate reserve adequacy.

BB: What about embedded value or fair value?

MF: Embedded value (EV) is consistent with the way insurers currently price insurance products and acquisitions. However, EV also has difficulties, in that two companies with the same market value of assets and the same liability cash flows will show different embedded values, if the asset qualities are different. Depending upon how "fair value" is defined, it might be inconsistent with current product and acquisition pricing. But, the world may be headed down this route.

BB: What makes you think that?

MF: U.S. GAAP has been slowly moving down that route for years. SFAS 115 got companies halfway there with most of their invested assets. SFAS 133 took most derivatives and embedded derivatives there. SOP 03-1 forced a quasi-fair value type valuation of guarantees and options that SFAS 133 did not cover. FASB came out with Concepts Paper 7 and a recent exposure draft clarifying fair value concepts.

Canadian GAAP has a lot of fair value concepts in that reserves are prospective in nature with continual unlocking. And in Europe, the IASB strongly considered fair value, first unsuccessfully for financial instruments and then for insurance products. It will be interesting to see what direction the Board takes in defining Phase II for insurance products. And remember, FASB and IASB have agreed to ultimately converge accounting standards.

BB: What about on the regulatory side?

MF: Statutory standards in the U.S. are moving toward principle-based standards, given some of the recent RBC work, but this will probably happen at a slower pace than in GAAP. Europe seems to be moving faster with respect to economic capital requirements. Canada is effectively there.

BB: What about Russian GAAP?

MF: I don't know anything about Russian GAAP.

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BB: I've heard analysts are frustrated that by the time of the analyst conference call, the data is already obsolete. How will the industry deal with this issue?

MF: Accounting systems will need to evolve to the point of providing an instantaneous flow of information and analysis. This means that in the future world, when an analyst asks a question, the company can answer the question with up-to-the-minute data. Companies have a lot to gain from this. Once accounting becomes principle-based, understandable and up-to-date, the cost of capital should decrease.

BB: What type of actuarial skills are needed in this type of environment?

MF: Obviously there is always a need for technical abilities, especially related to valuation systems development. But sound business judgment and communication skills are becoming much more important traits than having the ability to get around rules.

BB: What will be the role of professional actuarial organizations, such as the Society of Actuaries?

MF: These organizations need to keep their eyes on the future in terms of who needs their services and exactly what they need. Then, they need to fine-tune education as needed and be in front of the public. Their major role is to keep their members professional and relevant.

BB: Natasha and I have been looking for the Squirrel and Moose for a long time. Do you think we'll ever succeed?

MF: Actuaries are also concerned about the longer term and the real key is patience. Chances are that if you wait long enough, you'll bump into them and do what you have to do.

BB: But, Natasha and I are well into our retirement years and can't get around as fast as we used to.

MF: Rocky and Bullwinkle are no youngsters, so maybe you'll run into them in a retirement village. And maybe you'll end up friends. By the way, Boris, you look pretty good for your age.

BB: Speaking of retirement villages, I understand that's where the council is putting you once your term ends. How would you like to be remembered and what do you plan to do?

MF: I've really enjoyed the work I've done with the Section Council and would like to stay involved in any manner that makes sense with the new Section Council. But, mostly I'd like to be remembered as the first Section Chair to clean the "smelly green jacket." How would you like to be remembered, Boris?

BB: I want to be remembered as the Russian spy who, along with his wife Natasha, catches Rocky and Bullwinkle. $

>> European CFO Embedded Value Guidelines from page 5

Principle 12: "Embedded value results should be disclosed at consolidated group level using a business classification consistent with the primary statements."

The accounting influence is obvious in the European CFO Group's detailed standards for public disclosure of embedded value information. Table 2 compares certain required disclosures with the survey of current practices:

Sensitivities currently disclosed include changes in the discount rate or investment yield (16 each), persistency (10), expenses or mortality/morbidity (six each), and the spread between general account earnings and crediting rates (three).

In addition to these required disclosures, each company must state whether the company is in compliance with the EVM, and if not, identify areas of compliance, provide a subdivision of critical information by groupings (segments) used in primary financial reporting and include a statement by the board of directors.

Conclusions

The European CFO Forum embedded value guidelines are expecting a hearty welcome from readers of embedded value reports. The improved disclosures are particularly appreciated since current practices vary widely among companies, making quantitative comparisons difficult to make, at best. Actuaries are already feeling the impact of the requirement to value embedded options and guarantees, as senior management asks them, sometimes for the first time, to quantify them. The awareness of their cost throughout organizations should improve company pricing and risk management.

The next frontier for embedded value appears to be the valuation of business outside traditional life insurance companies, be it in banks, mutual funds or other legal entities. The guidelines are sufficiently broad to permit companies to cross this frontier by disclosing how they apply the principles. This will be quite interesting to watch. $