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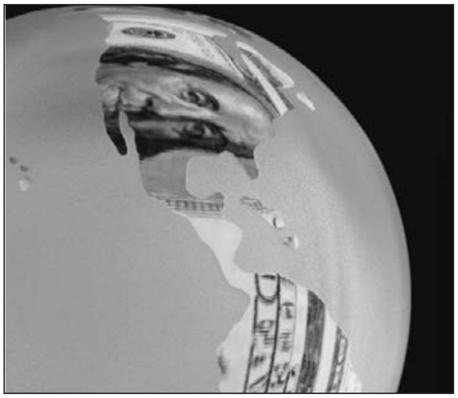

contents

The Euro - Still "Baffling Pigs" Two Years On

by Paul M. Sauve

January 1, 2002 was a date that the scaremongers and consultants had hyped up just as much as January 1, 2000. Money would run out, computers would crash, banks would collapse and confusion and chaos would reign! This was the date on which euro coins and banknotes became official currency in 12 European countries. Fortunately, the parallels to Y2K hype were in fact completely correct, and on January 1, 2002 nothing too dramatic happened. We are now over two years past the introduction of the euro in hard form and it has become a normal part of everyday life for over 300 million people in 12 countries. A lot of work had to be done and not all went perfectly smoothly at first, but the euro introduction was a success overall, and most doomsayers have moved on to other potential apocalypses. Nonetheless, the euro introduction was an event of epic historical significance, and now, as the European Union (EU) faces expansion from 15 to 25 countries, it is a good time to look at the past and the future of the euro.

A brief primer

On January 1, 1999 the euro became the official electronic currency of 11 EU countries. These countries continued to use their old coins and bills, but now at irrevocably fixed rates of exchange to the euro and thereby to each others' currencies. These 11 countries were joined by Greece midway through 2000 when the latter satisfied the economic requirements of euro participation. These 12 countries made the final leap on January 1, 2002 by withdrawing their old notes and coins and replacing them with shiny and crisp new euros. Table 1 on page 5 gives a complete list of the 12 countries, their old currencies

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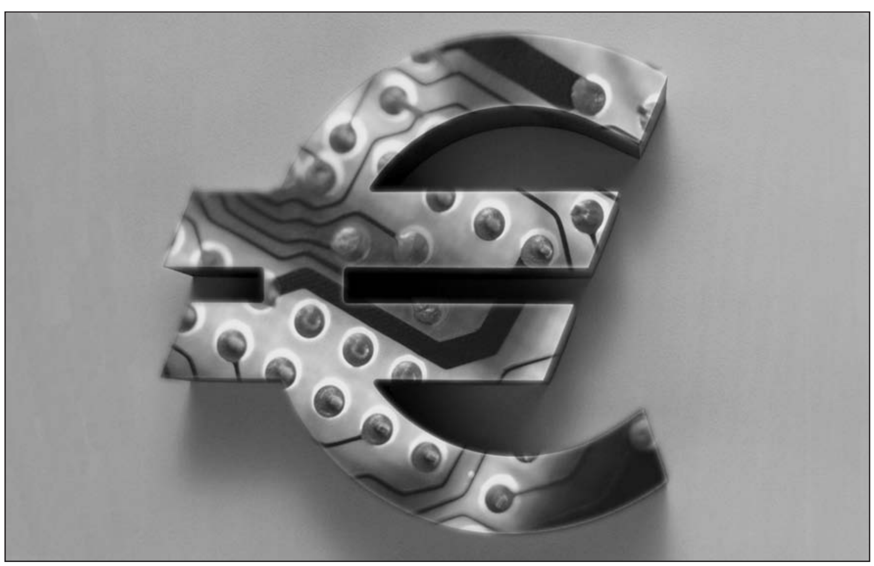

Editor's Note: Be Prepared

Ambassadors Host the Around-the-World Tour

by Randy Makin

Randy Makin, FSA, MAAA, is the chief pricing actuary at Generali USA Life Reassurance in Kansas City, Mo. He can be reached at rmakin@GeneraliUSALifeRE.com.

Be prepared. The Boy Scout motto comes to mind, especially now that my youngest has just moved from Webelos (tame, mostly craft-oriented) to Boy Scouts (not so tame, camping-oriented). Now I went at least through second class myself, but I was unprepared for the statement that this troop took campouts EVERY month. Now, I wish to remind the patient reader that I have never yet realized my vision of doing ex-pat work overseas, perhaps in a climate with only one season. No, I still live in Kansas. Well, barely, but I still do. Anyway our first campout in March featured temperatures down to 29 Fahrenheit (about -2 Celsius for the international reader), with wind blowing fairly briskly, and a Tenderfoot having picked our campsite at the top of a ridge. No, I guess I was not prepared.

Nor can we all be prepared all of the time for the changes that continue to come at us from every side, but this newsletter helps. Several of the authors address the changes that have taken place and are about to take place in Europe. Paul M. Sauve discusses the euro, looking back since its introduction about two years ago. The acronym "Baffling Pigs" was most helpful. We also have two articles discussing some of the latest developments with international accounting standards, one by William Hines, and the other by Doug Doll. Bill Horbatt has contributed yet another article with a European perspective, this one comparing the ratings methodologies between the United States and Europe. We also have a note from Tauno Jaekel on the centennial of the German Actuarial Society (DAV).

Just to show how show how multinational things have become, Paul Chow reports on a talk given by Chris Daykin of the United Kingdom to actuaries in Canada on pensions in China. Jose Berrios was also kind enough to send in an article on managing multinational corporations across various cultural issues. Rounding out this issue is an update by Martha Sikaras on international issues in the SOA, Yiji Starr's Chairperson's Corner and the minutes from our January 2004 Section Council Meeting. ☐

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475 N. Martingale Road • Suite 600
Schaumburg, IL 60173

Phone: (847) 706-3500 • Fax: (847) 706-3599
Web site: www.soa.org

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Chairperson's Corner

by Yiji S. Starr

It seems that I wrote the last Chairperson's Corner only yesterday. In fact, it has been four months. In the last Chairperson's Corner, I introduced the new members to the section council. I thought it would be appropriate that I tell you what the International Section Council has done in the past four months.

Besides the usual responsibilities, such as hosting sessions at the SOA meetings, coordinating with ambassadors, liaising with the SOA on the Web site-related issues, developing and delivering webcast seminars, just to name a few, the International Section Council has been working on two exciting topics to serve its members.

First, let me tell you about the experience study. As you may have read in the previous newsletter, the first phase of the experience study was completed with the involvement of five companies in three markets. The second phase has gotten under way. The task force would like to include more companies and more countries, as well as more experience types such as lapse and expenses. If your company would like to get involved, please feel free to contact Bill Horbatt.

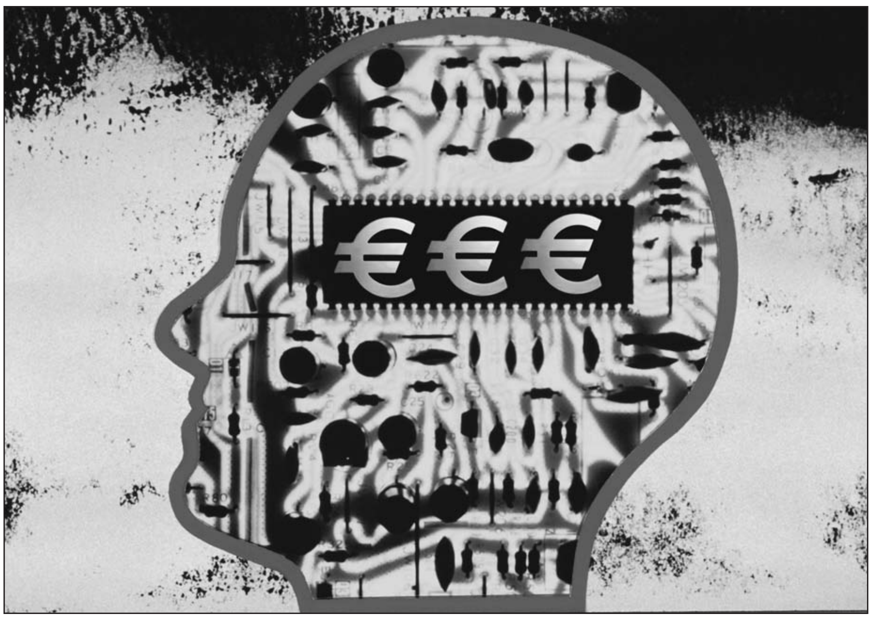
Second, I'll discuss the "Let's Make a Deal" seminar. As the life insurance market continues to consolidate, several prominent deals have taken place in the international market as well. The participants in these deals have graciously agreed to speak about their experience in making a deal in the international market in this exciting and must-attend seminar. Please watch your inbox for additional details for this seminar, scheduled to immediately follow the SOA Annual Meeting. I would like to thank Ronald Poon-Affat for his effort in bringing this seminar to our members.

In my last article, I asked you to consider volunteering. I was overwhelmed by the number of responses I received to my blast e-mail for candidates to run for the International Section Council, as well as to become our next editor-in-chief. Names of all interested candidates for the International Section Council will be presented to the council at our next conference call. The council will nominate a slate to be voted by the members of the section. Randy Makin, our tireless editor-in-chief for the last four years, will contact a few volunteers to become assistant editors with the intention that one will become the editor-in-chief after Randy.

I would like to thank all of you who have responded for your enthusiasm. Even if you are not in any formal positions, I would like to invite you to become "friends" of the council. The council is always grateful for these members who help with the council's initiatives in an informal capacity. If you would like to become a friend, please feel free to contact me. ☐

Yiji S. Starr, FSA, MAAA is senior vice president and chief actuary at John Hancock International Holdings, Inc. in Boston, Mass. She can be reached at ystarr@jhancock.com.

and the fixed rates of exchange to the euro. If you have difficulty remembering the 12 countries (but for some reason have a need to try) the acronym “baffling pigs” (Belgium, Austria, Finland, France, Luxembourg, Ireland, Netherlands, Germany, Portugal, Italy, Greece, Spain), which formed their old currency equivalents when making purchase decisions. This is a testament to the deep-seatedness of the instinctive judgment we make about prices in our daily lives. A Spaniard knows instinctively, for example, that ESP 300 is a reasonable price for a coffee, but EUR 1.81 (or



EUR 2.00 now perhaps) hasn’t yet been burned into his subconscious to allow for the same quick value judgment that we all are accustomed to making. One might hypothesize that Europeans who were slow to make this transition actually had a hidden benefit of improving their mental arithmetic through shear repetition of awkward calculations. Who can doubt that Austrians who had to calculate “multiply by 13.8” every time they bought something got better at math? The die-hards are the few, but not unheard of, older French individuals who still value things in “old francs” (replaced in 1959 100:1 with the new franc which has now disappeared into the euro) and are faced with multiplication by 656! Even the Italians have it easier than this, they can multiply by 2000 and not be far off.

Insurance and Pensions

To date the Euro has not had a revolutionary impact on the development of the European life insurance and pensions industry. It clearly caused the insurance companies the pain of having to convert all their policies, accounts and systems to handle the euro as of January 1, 1999, which then operated exclusively in euro as of January 1, 2002. The greater positive impact of the euro in the industry has been in pensions and employee benefits, where multinational schemes can now be established and administered without having to worry about different currencies and changes in exchange rate between those currencies. The euro has therefore facilitated quicker evolution in a direction that was already taking place due to the quest for scale and portability. In individual insurance there are still too many country-specific effects at play for the euro to have had much effect. Each country and its salespeople and consumers still have enough different demands and desires that euro-induced convergence or growth has been scarce. This convergence will eventually take place, but the common currency was merely a necessary condition, and not a sufficient one.

EU Expansion or Euro Expansion

On May 1, 2004 the 10 countries listed in Table 2, page 5, became members of the EU, swelling the ranks of the EU from 15 to 25 countries (and from 11 to 20 official languages!). While these countries are all expected to join the euro at some point, they must first meet financial criteria with respect to price inflation, government debt and deficits and other indications of market integration. These criteria are laid out in the “Maastricht convergence criteria” and essentially require that countries joining the euro have a sufficiently homogeneous economic makeup that they won’t upset the stability of the common currency. These convergence criteria are also the rules to which euro member states are required to adhere. The fact that Germany and France have recently repeatedly failed these tests and dodged the intended penalties will make it challenging for the EU Council to hold the 10 new countries to these standards. Regardless of how this delicate situation is sorted out, it is likely to be at least two years before any of the new EU members join the common currency, and it could very well be a lot longer for a few of them. (With only one vowel to work with, there is unfortunately no helpful acronym to help you remember the 10 new EU countries listed in Table 2… at least not in English!)

Three countries who could conceivably join the euro before these 10 are the three abstaining current EU members—Denmark, Sweden and the United Kingdom.

Danes rejected the euro in a referendum in September 2000, by a margin of 53 percent to 47 percent. With a voter turnout of almost 90 percent, this was clearly a very passionate issue. Despite this result, I expect Denmark to join the euro after another referendum likely to take place in 2004 or 2005. The last referendum took place when the euro had lost almost 30 percent of its value versus the U.S. dollar in under two years. Since then, the euro has not only recovered this loss but also gained almost a further 10 percent versus its 1999 launch value. Another sign in favor of Denmark joining is that when the real coins and notes started showing up in and around Denmark in 2002, opinion polls showed a surge in support for Danish participation. Given that Denmark is a full EU member and already pegs its currency to the euro, the final step of joining the common currency is largely symbolic. The emotional reasons to keep the krone will, however, surely make the referendum exciting.

Swedes voted on joining the euro in 2003 when the euro was already riding high against the U.S. dollar and the physical familiarity with the euro was already high. Despite this, they rejected it 57 percent to 43 percent, with an 81 percent voter turnout. The anti-euro movement rode a wave of grassroots opposition to joining, and overcame the well-funded, business-backed pro-euro camp. This isolationist mood will need to subside before Sweden joins the euro, unless they get a brave business-friendly government who is willing to ignore the results of this non-binding referendum.

The United Kingdom has never held a referendum on the euro, but opinion polls have consistently highlighted that a majority of Britons are against euro membership. Prime Minister Tony Blair is in favor of joining the euro but has been fighting not only the negative public sentiment, but also strong opposition from within his party and government. Based on the most recent developments, hope of U.K. euro membership during his present term has pretty much faded away, and 2010 may be the earliest realistic accession date. Shaky economies in the large eurozone countries and their non-adherence to the convergence criteria has hurt the U.K. pro-euro movement and the very active anti-euro movement, therefore appears to be prevailing.

Regardless of how any of these countries decide to proceed, the euro has a strong future in Europe and will keep moving gradually east with EU expansion, and eventually north and west to pick up the stragglers. ☐

Table 1 | Euro Predecessor Currencies

Country	Old Currency	Old Per Euro
Austria	Schilling	13.7603
Belgium	Franc	40.3399
Finland	Markka	5.94573
France	Franc	6.55957
Germany	Mark	1.95583
Greece	Drachma	340.750
Ireland	Punt	0.787564
Italy	Lire	1936.27
Luxembourg	Franc	40.3399
Netherlands	Guilder	2.20371
Portugal	Escudo	200.482
Spain	Peseta	166.386

Table 2 | May 1, 2004 New EU Members

Country	Current Currency	Approx Current Market per Euro
Cyprus	Pound	0.6
Czech Republic	Koruna	33
Estonia	Kroon	16
Hungary	Forint	255
Latvia	Lats	0.7
Lithuania	Litas	3.5
Malta	Lira	3.6
Poland	Zloty	4.8
Slovakia	Koruna	41
Slovenia	Tolar	240

Paul M. Sauve, FSA, is managing director at Manulife Reinsurance in Cologne, Germany and a member of the International Section Council. He can be reached at paul_m_sauve@manulife.com.

Comparison of Ratings Methodologies between Europe and the United States

by William Horbatt & Asutosh Chakrabarti

Standard and Poor's (S&P) publishes capital adequacy ratio (CAR) formulas for both the United States and Europe, but these formulas differ in various ways reflecting differences in markets. For example, the European formula explicitly recognizes that future profits on policies in force (embedded value) are available to absorb adverse experience while the U.S. formula, being based upon the detailed NAIC statement, has many more product type specific treatments.

As accounting standards converge between these two markets (in particular, those promulgated by the IASB and FASB), one may expect that these differences will diminish as well. However, by exploring these differences, actuaries may gain insight into risk and capital management that may enhance their abilities to contribute to the solvency of insurance companies on either side of the Atlantic.

This article presents a high-level comparison of S&P's published ratings standards in the United States and Europe. Starting with some background information on differences between the insurance markets on the two sides of the Atlantic, we proceed to compare the formulas used to determine capital adequacy ratios, then illustrate the differences in formulas using simplified examples. Although the article restricts itself to one ratings agency's practices, one may assume that other agencies have similar differences.

Asutosh Chakrabarti, ASA, of the Actuarial Consortium LLC in Short Hills, NJ can be reached at Chakrabarti@ActuarialConsortium.com

Bill Horbatt, FSA, of the Actuarial Consortium LLC in Short Hills, NJ can be reached at Horbatt@ActuarialConsortium.com

Differences between European and U.S. Insurance Markets

A short discussion of differences in markets is appropriate before analyzing the formula differences.

- Although European regulators encourage companies to separate life and non-life operations into separate companies, major European companies continue to have extensive life and non-life operations, unlike most U.S. companies
- Until European directives implement International Accounting Standards (IAS), which is expected to occur in 2005 – 2007, no common accounting standard exists in Europe. Regulatory standards vary from country to country and company reports are frequently not public information. Accounts prepared under local generally accepted accounting standards (GAAP) are published. However, they vary from country to country and are sparser than U.S. standards. In fact, companies frequently apply U.S. GAAP to fill gaps in local standards.
- European life insurance companies focus primarily on savings products, with limited life insurance risk. Whereas in the United States, whole life, universal life and term insurance maintain significant (albeit declining) markets. Traditionally, the most popular European product was endowment insurance. However, pure savings products now dominate the southern European marketplace.
- European life insurance products have an extremely favorable tax treatment, when compared to the United States. For example, after 12 years in force, a German policy can be surrendered with no tax incurred. Contrast this to the United States, where a deferred annuity is taxed on a FIFO basis (withdrawals are first taxed as interest, with untaxed principal the last withdrawal) and is subject to excise taxes for withdrawals prior to age 59.5.
- European life insurance companies are generally not subject to strict limits on common stock investments, as U.S. companies are. They invested heavily in stocks during the 1990s to boost policyholder bonuses on general account products.
- European companies have been subject to minimum regulatory capital requirements varying by company size (frequently 4 percent of reserves plus 0.3 percent of net amount at risk), while the U.S.'s National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) standards were developed around 1990.

Capital Adequacy Ratio

The capital adequacy ratio is probably the single most significant measurement applied by ratings agencies like S&P to evaluate the adequacy of an insurance company's capital. Although the NAIC and other ratings agencies have differences in their formulas, each formula compares the company's actual capital to a standard level of capital that is a function of the risks faced by the company. The higher a company's CAR is, the better the company's ability to absorb adverse financial experience.

In the United States S&P CAR is defined as:

CAR = (Adjusted Surplus—Asset Risk Charges) / (Insurance Risk Charges)

While in Europe, CAR is defined as:

CAR = (Adjusted Surplus—Asset Risk Charges) / (Insurance Risk Charges + Assets Backing Life Insurance Liabilities Risk Charges)

We see the first difference between the formulas in that the European formula includes risk charges related to the assets backing life insurance liabilities in the denominator, just like the NAIC risk-based capital formula. Additional differences occur in the components of this formula between the United States and Europe.

Adjusted Surplus

The next source of difference between the U.S. and European formulas is in the definition of adjusted surplus (called total adjusted capital or TAC by S&P) used in the calculation of CAR. These differences include:

- U.S.-adjusted surplus is based upon statutory surplus while European adjusted surplus is based upon local GAAP surplus, which, for U.S. stock exchange listed foreign companies, may be U.S. GAAP surplus.
- European companies receive a credit for up to 50 percent of the present value of future profits (PVFP) component of embedded value (EV) and non-life deferred acquisition costs (DAC) while U.S. companies receive no such credit.

Commonalities between the U.S. and European definitions of adjusted surplus include:

- No credit is given for goodwill in either formula.
- General fluctuation or equalization reserves are eliminated from liabilities and added to adjusted surplus. For example, the U.S. asset maintenance valuation reserve (AMVR) is added to adjusted surplus, as are European stabilization reserves.
- Non-life insurance claim reserves are adjusted to reflect the best estimate of payouts and then discounted to reflect the time value of money.
- Real estate is valued at approximate market value based upon a formula that capitalizes rental income.
- Credit is given for only a limited amount of hybrid capital, such as surplus relief.

Asset Risk Charges

Asset risk charges, similar to NAIC C-1 charges, are designed to anticipate expected defaults (credit risk) as well as a market volatility and illiquidity that would reduce the realizable value of assets liquidated to cover unforeseen cash draws. These charges are generally identical on both sides of the Atlantic, except for identifiable differences in financial markets. A comparison between the U.S. and European S&P asset risk charges follows:

- <u>Bond and preferred stock</u>: Default charges relate to the credit rating of the issuer and reflect the net cost of default over a 10-year horizon. Identical charges are made in the U.S. and European formulas.
- <u>Common Stock</u>: Market value volatility charges are based upon S&P's studies of historical volatility in various countries where indices exist and may vary considerably. The charges are based upon one standard deviation in observed samples. Examples of the differences are clear in Table 1 on page 8.
- <u>Real Estate</u>: Lack of liquidity varies by country, as do the risk charges. Note that real estate is an important investment in countries like Switzerland where fixed income yields are relatively low. (Figure 2).
- <u>Mortgages</u>: Mortgage practices differ significantly by country. However, the most significant difference is the lack of agencies guaranteeing home mortgages, such as Fannie Mae. For example, the U.S. charge

continued on page 8

Asset risk charges, similar to NAIC C-1 charges, are designed to anticipate expected credit defaults as well as market volatility and illiquidity that would reduce the realizable value of assets liquidated to cover unforeseen cash draws.

Table 1

Country	Volatility Risk Charge
United States, Canada & United Kingdom	15 %
Belgium, Denmark, France, Germany, Italy, Switzerland	20 %
Norway, Spain, Sweden	25 %
Austria	35 %
Finland	55 %

for a guaranteed mortgage in good standing is 0.1 percent, while the lowest European charge is 2 percent.

- Reinsurance Receivables: Both the U.S. and European formulas recognize that reinsurance recoverables (including reserve credits) are more akin to assets than being liability offsets, so a risk charge is made to reflect expected losses due to reinsurer default. The charges are identical on both sides of the Atlantic and relate to the credit standing of the reinsurer.
- Asset-Backed Securities: These are less common in Europe than the United States, but it is anticipated that European ratings will follow procedures followed in sophisticated markets, such as New York or London.

Insurance Risk Charges

Insurance risk charges are intended to quantify risks that prices or reserves may be inadequate (as in NAIC C-2) or that a mismatch between assets or liabilities may result in losses (as in NAIC C-3). One will find significant differences between the magnitude of U.S. and European insurance risk charges.

For rating U.S. companies, the NAIC blanks for both life insurance and property and casualty insurance companies provide an extensive breakdown of financial figures based upon different types of business. No similar breakdown exists in Europe, except for more limited segment reporting that companies may provide for local GAAP reporting purposes. Hence European ratings agencies need to either accept published information or make special requests of the companies for data.

Property & Casualty: Due to the lack of public data in the European marketplace, S&P based its European risk charges for non-life products on

Table 2

Country	Liquidity Risk Charge
Germany	10%
Switzerland	12%
All other countries (including the United States)	18%

reports prepared by the American Academy of Actuaries Property/Casualty Risk-Based Capital Task Force. Hence, one may expect European charges to be consistent with U.S. P&C company risk charges.

Health Insurance: Due to the existence of nationalized medicine and generous social benefits for disability, unemployment and retirement, European companies offer more limited accident and health insurance products than U.S. companies.

S&P's European premium related accident and health (A&H) risk charges are 18 percent of accident premiums and 12 percent of health premiums. For comparison purposes, U.S. products similar to common European products are shown in Table 3 on page 9.

In addition, S&P's European A&H risk charges are 28 percent of accident reserves and 5 percent of health reserves. No risk charge related to reserves is applied to the U.S. products listed except for a U.S. risk charge equal to 5 percent of disability insurance reserves, which is the same as would be applied in Europe.

Life Insurance and Annuities: Prior to 2003, S&P's European risk charge for life insurance and annuities was calculated as 125 percent of the local regulatory minimum capital, which frequently equalled 4 percent of general account reserves, 0.3 percent of net amount at risk and up to 1 percent of separate accounts. S&P has begun to revise their European formula to reflect differences in risk by country. The 2003 S&P European factors are shown in Table 4 on page 9.

In addition to these factors, a bond volatility factor (similar in purpose to the NAIC C-3) is calculated that depends upon the bond's remaining term whenever the European insurer's asset duration mismatches its liability duration by more than 1.5 years; otherwise a 1 percent factor is applied to bonds backing pension and savings product liabilities. The European bond volatility factors are shown in Table 5.

Adding the factors together in the two tables above, it can be seen that the reserve related general account risk factor for life insurance and annuities ranges from a low of 4 percent of reserves (for insurance written in France, Germany, Italy or Switzerland that has asset and liability durations sufficiently matched) to as much as 13 percent of reserves (for insurance written elsewhere with significantly unmatched asset/liability durations).

These factors appear to be significantly higher than the U.S. formula factors.

For example, European factors applied to the net amount at risk (NAR) range from 0.20 percent to 0.375 percent of the net amount of risk. The corresponding U.S. factors are split between individual and group insurance and have a reduction above $500 million. Starting at 0.16 percent for group (0.20 percent for individual), they reduce to 0.07 percent for group (0.08 percent for individual) for NAR above $20 billion.

Table 6, which contains selected U.S. reserve factors, can be used to illustrate differences for savings products like U.S. deferred annuities.

Typical European savings products are similar to U.S. deferred annuities with surrender charges, yet their reserve-based risk charge is twice the U.S. risk charge (4 percent versus U.S. 2 percent for products backed by bonds).

One potential reason for these differences is differences in asset liability management practices on the two sides of the Atlantic. Asset adequacy analyses, including the application of the "New York 7" scenarios, has been a regulatory requirement in the United States for well over a decade while European regulators have historically imposed limited testing requirements, if any, on their companies.

Table 3

U.S. Product	% Premium
Hospital Indemnity, ADD & other non-anticipating rate increases	8%
Dental	7%-10% *
Noncancelable individual disability (guaranteed premium rates)	18%-45% *
Other individual disability	9%-30% *
Group long term disability	4%-18% *

* lower factor applies to higher premium volumes

Table 4

Basis	Product	France, Germany, Italy, Switzerland	All other countries
Net Amount at Risk		0.200%	0.375%
General Amount Reserves	Pension & Savings	3.000%	5.000%
Separate Account	Unit Linked	0.250%	0.500%

Table 5

Bond Maturity	Mismatch Risk Charge
1 year to maturity	1%
2 years to maturity	2%
2-5 years to maturity	4%
5-10 years to maturity	6%
Over 10 years to maturity	8%

Table 6

U.S. Product	Risk factor applied to reserves.
Life insurance reserves net of policy loans	050%
Annuity reserves with market value adjustment	1.00%
Annuity reserves with surrender charges	2.00%
Annuity reserves with no adjustments	3.00%

Comparisons Based Upon Hypothetical Company Data

In order to better understand the impact of the differences between the U.S. and European formulas, an example was developed for a hypothetical company with $100 million general account assets and almost $5 million statutory capital and surplus that underwrites individual life insurance and annuities. The company's simplified financial statements are presented in Table 7 on the following page.

Based on this information, the company's CAR can be calculated as shown in Table 8. Notice that the two formulas produce approximately the same ratio, which is within the "A" rating range of 125 – 150 percent. The additional GAAP capital resulting from including unrealized capital gains and intangible assets (DAC) in the European formula offsets the higher liability risk charges.

continued on page 10

Table 7

		SAP	GAAP
Assets		SAP	GAAP
	Bonds	100,00	105,00
	Equities	-	-
	Separate Accounts	25,000	25,000
		125,000	130,000
	DAC		4,769
Liabilities			134,769
	Policy Reserves	95,133	96,850
	Separate Accounts	25,000	25,000
		120,133	121,850
	Deferred Tax		3,419
			125,269
Equity			
		4,867	9,500

Table 8

	U.S.	Europe
Reported Capital	4,867	9,500
Eliminate 50% of DAC (net of tax)	-	(1,500)
TAC	4,867	7,950
Asset default risk charges	(1,495)	-
Asset volatility risk charges	-	-
Numerator	3,372	7,950
Asset default risk charges		1,495
Asset volatility risk charges		1,000
European asset risk charges		2,495
Reserve & other risk charges	2,452	3,280
Denominator	2,452	5,775
CAR	138%	138%
CAR in the Ratings Range of:	A	A

Table 9

	U.S.	Europe
Reported Capital	5,029-	9,500
Eliminate 50% of DAC (net of tax)	-	(1,550)
TAC	5,029	7,950
Asset default risk charges	(1,420)	-
Asset volatility risk charges	(750)	-
Numerator	2,860	7,950
Asset default risk charges		1,420
Asset volatility risk charges		1,700
European asset risk charges		3,120
Reserve & other risk charges	2,419	3,130
Denominator	2,419	6,250
CAR	118%	127%
CAR in the Ratings Range of:	BBB	A

Having seen the impact from applying the two different formulas to a U.S. company, the company data can be modified to better reflect a typical European company:

- European companies frequently invest in common stocks in order to enhance the investment returns credited to policyholders, so the general account assets are reallocated to include 5,000 stocks.
- European companies sell less permanent "risk" life insurance and their savings products frequently have no surrender charges, so we will change the assumption that the general account liabilities are one-third low risk (life insurance), one-third medium risk single premium deferred annuity (SPDA with surrender charges) and one-third high risk (no surrender charges) to the assumption that ¼ are low risk and the remainder split between medium and high risk.

Table 9 reflects these changes in the investment strategy and product mix. It shows the capital adequacy ratio declining and the European formula producing a more favorable ratio.

In this case, the U.S. formula CAR drops 20 percent, while the European CAR drops half that amount. The effect is that the typical European company would maintain its "A" rating using the European formula while dropping one rating using the U.S. formula.

Note that there may be very good reasons for this difference since European policyholder behavior may be different from that in the United States. For example, Europeans tend to lapse policies at a much lower rate than Americans during the early contract years due to adverse personal tax consequences for early lapse.

Conclusion

The two most significant differences between the U.S. and European S&P capital adequacy ratio formulas are:

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A German Centennial

by Tauno Jaekel

The actuarial organizations of Germany, the Deutsche Aktuarvereinigung e.V. (DAV) and the Deutsche Gesellschaft fuer Versicherungs – und Finanzmathematik e.V. (DGVFM), held their centennial celebration last November in Berlin. It was in this historic city, on April 4, 1903, that the Department of Insurance Mathematics (Abteilung fuer Versicherungsmathematik) was established as a section of the Deutscher Verein fuer Versicherungswissenschaft e.V. (German Society for Insurance Sciences).

It is from this department that today's two actuarial organizations got their start. While DAV is the actual professional organization of actuaries, the DGVFM is—similar to the American Academy of Actuaries—a membership body for all who are contributing to the furtherance of the actuarial and finance mathematical sciences. It was not until 1993, when the then-only actuarial organization DGVM split into a professional organization (DAV) requiring formal training and education for membership and a body for all those furthering the actuarial and finance mathematical sciences through research and publications (DGVFM), that the professional designation Versicherungsmathematiker Aktuar (actuary) was formally established. Until then, actuaries had been called Versicherungsmathematiker (insurance mathematicians). Today, with membership at around 2,000 and several hundred actuarial students in the examination process, the DAV has grown to be the second-largest actuarial body in the EU, surpassed only by the traditional British Institute of Actuaries.

The centennial celebration began with a gala evening and continued the next day with a ceremony. Many members, retired members and accompanying spouses, as well as representatives of other international actuarial organizations, participated in this wonderful and memorable event.

Looking back on 100 successful years, the German actuarial profession can confidently face today's challenges when capital markets are more volatile; regulatory, legal, tax and accounting environments seem constantly changing when the actuarial field itself appears to be broadening. □

Dr. Tauno Jaekel, ASA, is head of planning and special projects, Swiss Re Germany Holding AG, in Munich. He can be reached at Tauno_Jaekel@swissre.com.

Comparison of Ratings ... | from page 10

- The European formula credits adjusted surplus with a portion of unrealized capital gains and future earnings.
- The U.S. formula requires less reserve related risk charges, including charges related to ALM.

These differences are offsetting in direction, so no conclusion can be made as to the relative rigor of the two formulas without applying them to particular facts and circumstances.

However, the European practice of crediting some portion of embedded value PVFP appears to be a reasonable practice in light of the fact that a company suffering adverse experience may have the ability to increase capital by selective sales of portfolios or reinsurance purchases. Similarly, recent reductions in European life insurance reserve related risk charges appear to be warranted when comparing European products to similar U.S. products.

Finally, a very important caveat needs to be stated. Standard and Poors and other ratings agencies rely heavily on their ratings analysts' judgment and their analyses evaluate many factors other than capital levels. In addition, an increasing number of companies are having their capital levels evaluated using more sophisticated methodologies than the CAR formula described in this article. □

Management Across Cultures

Challenges, Issues and Conflict Resolution

by Jose L. Berrios

For any professional working in a multinational organization, one of the most challenging and, at the same time, rewarding, career milestones is to have the opportunity to work in one of the organization's foreign business units. It represents an incredible opportunity from a personal and professional perspective because it involves, in many cases, a significant professional commitment as well as the need to learn and understand another language and live and work in another business culture.

Although some of the ideas presented in this article are drawn from experiences in the financial services industry, they could equally apply to other industries. Some major challenges to consider in the context of differences in expectations and business practices between a home office culture and a local culture are: 1) The balance between profitable growth and competitive pressures. 2) Finding the right people for the right job. 3) Communication and delivery of results.

Jose Berrios, ASA, is a consulting actuary with Milliman U.S.A., in Denver, Colo. His e-mail address is jose.berrios@milliman.com.

Some Challenges to Anticipate

1. Profitable Growth versus Competitive Pressures. European and North American insurance companies that have ventured into insurance markets outside of their domestic markets are driven by strategies that call for diversification of their business, leverage of their capital base and the expectation of profitable growth.

Early on these companies realized that the balance between profitable growth and competitive pressures is very delicate and requires a different paradigm in the context of a different cultural environment. In an increasingly global playing field with reduced margins due to declining interest rates and constant pressure to manage expenses, new strategies must be developed to face new entrants and local competitive pressures. Many multinationals also find that their domestic competitors have operated with a different set of rules, some of which appear as irrational business practices when looked at from the mature-market perspective of their domestic markets.

Typically, within a given market or region, many insurance products (life insurance and pension annuities in particular) are very similar across companies. The main differentiation may be via premium discounts and/or higher levels of commissions in order to push the product as part of a market-share strategy. The distribution platform is also similar (mostly agents and brokers, sometimes bancassurance) and loyalty, in some cases, is still more important than rational cost management. To a large extent, little emphasis still exists on the promotion of insurance products to educate consumers and develop a recognizable brand name and image. Historically, a large part of the sales process is left to the producer. In countries where the field force is not tied to the company, this process may be highly ineffective and have little standardization.

In this environment, how can companies develop a differentiating strategy to achieve their profit and market share objectives? Many of the concepts these companies have employed successfully in their domestic markets have an application in these new markets, but it is critical to understand how to adapt them and introduce them in a new environment colored by different market practices, regulations and culture.

On the marketing and distribution side, concepts such as segmentation, target marketing and positioning are usually some of the elements to consider in order to achieve a sustainable balance between market share and profitability. On the operational side, expense management, technology applications and better pricing and analysis can also contribute to this effort. Therefore, a balanced marketing-mix of selling the right product(s) with sound pricing and sound marketing is critical.

The best way to address the above issues and forge a true high-performing team (made up of local management, expatriates and home office staff) is to have the right people in charge of each area of responsibility and each accountable for specific deliverables, while having sufficient authority to drive the intended changes related to the creation of core competitive strategies. The decision-making authority and influence must be equally shared among locals as well as expatriates in order to have a balanced sense of ownership in the team.

2. Finding the right people for the right jobs. To achieve the best results, it is critical to have the right people in place. In this age of globalization and market openness, there seem to be three critical elements to consider when identifying and selecting the best candidates for any given position: 1) Is the candidate capable of doing the job? 2) Is the candidate willing to do the job? and 3) Does the candidate possess the sufficient level of flexibility to adapt to change? Beyond the obvious qualifications that a candidate should have, such as technical qualifications, professionalism and honesty ("can" qualities), attitude and flexibility ("will" qualities) must be at the top of the list because the most critical aspect of the interaction between the home office and the local company must be the ability to learn and accept new paradigms, methods and practices.

The same attributes of attitude and flexibility are critical for the expatriate candidate being sent to work in a foreign environment in order to work with the local staff, to listen to their perspective, to learn from their cultural context and be able to assess and develop the local staff. In order for this person to succeed in his/her assignment, this person will need to learn from the local staff as well as teach them new and better techniques, helping them understand the reasoning behind some of these changes and help them transition from the "old" ways, to which they might have a strong attachment, to the "new" way of doing their jobs.

Furthermore, while assessing the local talent, "can" attributes are relatively easy to identify or develop, whereas "will" attributes are much harder to identify and develop, and it has to do with people either accepting or rejecting/resisting change. For expatriates to succeed in their assignment, the home office and local management must make an effort to identify both "can" and "will" skills in a way such that expatriates and local staff complement each other's attributes—especially on the "will" side. This obviously requires very clear and consistent job descriptions of roles and responsibilities to avoid or reduce potential conflict and cultural frictions, as well as provide the necessary levels of authority that are commensurate with the assigned responsibilities.

3. Communication and Delivery of Results. Clear and consistent communication is a key element for achieving desired results. Open and honest communication is the only way to build upon trust, both internally and externally, be it with regulators, the field force, investment media or the home office. Trust is a two-way street and clear and consistent communication should be the means of transportation. Bottom-line results and accountability should be established to the various areas of the company to measure progress and make the necessary structural changes. Although it is important to integrate home office requirements and the most critical best practices, these should be carefully planned and implemented in a way such that the benefits are well understood by everyone, but more importantly, embraced by local staff. Without the local staff perceiving a sense of ownership, implementation efforts could waste valuable time and resources.

Clear and consistent communication is a key element for achieving desired results.

Some Sources of Potential Conflicts

1. Pride and Ownership. People in Latin America, for example, are very proud of their heritage and their accomplishments. This

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goes back to colonial times and the influence from the Spanish culture as well as their own native heritage. People are also proud of their work and accomplishments and tend to equate these with personal esteem.

Change, per se, without a rational explanation as to the need for it, and an awareness of potential sensitivity as to how it is implemented, can therefore be viewed as a personal erosion of self esteem and can be very disruptive for the local staff. In some cultures, control of the information goes along with the "status" or the relative level of the person in the organization, creating a very hierarchical structure, which is difficult to crack down. The focus then for managing conflict should be on building upon pride of the new things to come, the new challenges to address, the benefits of the new tools and finally, the rewards of ownership of a much bigger asset by being a participating shareholder. Corporate culture change and accountability for results plays a big role in allowing this shift to take place.

2. Control and Decision-Making Authority. There are several forms of control and, in other cultures, many individuals use them as a means of getting ahead and exercising or retaining decision-making power. The first is wealth and family "inheritance," which is usually at the upper echelon of society. The second is knowledge and control of the information, which leads to a "key person" status, usually at senior and mid-level management of companies. The third is rank and level in the organization, usually at senior and mid-level management of companies. Conflict may arise due to lack of a clear organizational structure or rules, or an ongoing change without a clear focus that only creates confusion and mistrust. In order to manage conflict, the levels of control and decision-making power should be very clearly established early on, so that everyone understands the structure and the rules and has a clear and consistent road map to achieve the objectives of the company.

3. Perceptions of "Us" versus "Them." First impressions and distorted perceptions may create a feeling of "us" versus "them." In today's global world, this type of conflict creates inefficiency and unnecessary "turf battles." Another reason for this kind of potential conflict is lack of cultural training from both sides (foreigners, as well as locals) on how business should be conducted (both locally and mandated by the home office) and ways to minimize friction and personality differences. Personality differences will always be present, but not having a clear understanding of cross-cultural differences from both sides makes matters more difficult, especially when people are not used to working together as teams, much less cross-cultural teams, and toward a new paradigm. One way to address this type of potential conflict is to create an environment where these perceptions and sources of misinformation are eliminated.

4. Trust. Trust is a two-way street. The U.S. business culture is highly trusting and therefore expects the same from foreign business partners. This might lead to naïve and disappointing experiences with partnership relationships in other regions. As a necessary ingredient in any lasting business relationship, there has to be a positive rapport, a connection, a sense of personal friendship, objective compromise, a mutual sense of shared benefit and mutual respect before foreign business partners will embark on a two-way street. This implies that in order to succeed in conflict management, finding the right people is of crucial importance.

Conflict Resolution and Summary

Working and living in another culture or in another country can be challenging, but it is a rewarding experience for people who have been able to make a difference. In order to manage conflict and resolution, which should be the first objective, each and every situation should be evaluated in its totality—there is no cookie cutter approach since each situation is different. In certain cases, it is best to obtain the assistance from an outsider that can provide an independent, unbiased and objective opinion. This advice may lead to the need for restructuring the entire organization or certain areas of work and moving people to the appropriate roles where they can be more effective. This will help your organization, as well as the individuals involved. □

The views and opinions expressed in this article are my own and do not reflect those of my employer.

Update on International Accounting, March 2004

by William Hines

The recent activity around International Financial Reporting Standards (IFRS) has been intense. This article will describe each of the following events that have occurred in the last month or that are imminent:

- IASB approves issuing IFRS 4 to be released on March 31, 2004
- EU Commission needs to vote on adopting IFRS 4 and IAS 32 and 39
- IASB creates European financial institution advisory group
- IAA to expose draft actuarial guidance McCrossan outlines issues for actuaries' professional responsibility
- Penrose report calls actuaries to task for insurer failures
- U.K. government asked to look at alternative regulation of actuarial profession

IASB Approves IFRS 4 for Issue

In a very close vote, the IASB approved IFRS 4, Insurance Contracts, for issuance. Released on March 31, 2004, this standard governs the financial reporting of insurance contracts. It amends other certain IASB standards to make the definitions of insurance contracts consistent with IFRS 4, and to provide guidance on application of IASB standards to certain non-insurance contracts and the treatment of embedded derivatives. IFRS 4 is to be effective starting in 2005. While it is meant to be an interim standard, it will remain in place until the IASB has finalized its ultimate solution to insurance accounting. IFRS 4 concerns insurers because it couples FAS 115-style asset treatment with current book value liabilities. As a result, there is a mismatch that will result in volatile fluctuations in reported income and/or equity. This same mismatch exists under U.S. GAAP, but the change in amortization of DAC or shadow DAC caused by changes in the market value of assets serves to substantially dampen the impact of those changes.

The IASB has introduced shadow accounting adjustments that will mitigate some of the mismatch effects for insurers that use liability systems (including DAC as a contra liability) to reflect unrealized gains or losses. The IASB has also introduced a "current interest rate option" that can be used to adjust actuarial liabilities, which has the potential to substantially reduce the mismatch problems.

EU Commission to Vote on IASB Standards

It remains to be seen if the EU will adopt IFRS 4, since additional changes have been requested by the EU. In a speech to the Institute of Chartered Accountants in England and Wales in early March, the EU Commissioner asked the IASB to rethink its position. The EU Commission is charged with approving each IASB standard after receiving a recommendation from the European Financial Reporting Advisory Group (EFRAG). EFRAG is likely to give its recommendation during mid-March and, since its members were divided at the time of writing this report, it is a very real possibility that EFRAG will recommend against adopting IFRS 4 and against adopting the revised versions of IAS 32 and 39. The key issue for IFRS 4 is the potential mismatch between the methods used to value insurance contract liabilities in IFRS 4 and those used to value the assets that back those liabilities in IAS 39. The other key issue of concern in the EU is the accounting for macro-hedging of banks under IAS 32 and 39.

IASB Creates Financial Institutions Advisory Group

Senior officials from European banking, securities and insurance regulators and from the accounting, banking and insurance industries have been asked to form a high-level European consultative group to advise the IASB. The group will focus specifically on certain basic long-term issues related to the application of accounting standards to financial institutions, which center predominantly on the application and extent of fair value accounting appropriate for regulated financial institutions in the banking and insurance industries.

While acknowledging this new group, EU Commissioner Fritz Bolkenstein has called on the IASB to work on finding acceptable temporary solutions to the critical issues related to accounting in the banking and insurance

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William Hines, FSA, is a consulting actuary with Milliman U.S.A., in Wakefield, Mass. He can be reached at william.hines@milliman.com.

industries. "I have urged Sir David Tweedie to continue working in the short term with technical experts—around the clock if necessary—to try to find such appropriate solutions. One of the problems we have, unfortunately, is

a lack of trust between the interested parties. Due process has not been optimal so far and must improve in future."

IAA to Expose Draft Guidance

A subcommittee of the IAA Insurance Accounting Committee has been working to develop guidance for actuaries involved in financial reporting under IFRS. It is expected that draft guidance will be exposed to IAA members in April with a six-month exposure period. A report of the subcommittee deliberations will be discussed at the June IAA meeting in Stockholm. Guidance is expected to cover both investment and insurance contracts issued by insurers. The March newsletter of the IAA will include more background on the process.

Professional Actuarial Issues related to Accounting Standards

In a speech at the recent Global Association of Risk Professionals (GARP) Conference, Paul McCrossan, the International Actuarial Association's representative to the IASB, outlined potential issues the actuarial profession should consider with the adoption of the IASB's new accounting standards. The primary issue involves the expected mismatch between how insurers using IFRS will account for insurance liabilities and the assets backing those liabilities. Under IFRS 4, insurance liabilities will be valued according to local accounting guidance. In the vast majority of the world, local accounting guidance prescribes methods that are akin to amortized cost valuation. Under IFRS, insurer financial assets will be accounted for using IAS 39, the requirements of which are very similar to a combination of FAS 115 and FAS 133 from U.S. GAAP accounting. As under U.S. GAAP, the ability to hold assets at amortized cost is severely restricted, and thus most will have to be carried at fair value in the balance sheet. The result is that either equity or earnings, or both, will potentially exhibit volatility purely as a consequence of the accounting mismatch between the valuation of assets and liabilities. McCrossan questions whether financial reports created under IFRS involving such mismatch are, in fact, misleading. What obligation does the actuarial profession have to the public interest to not provide misleading information or to disclose when information that is provided may be potentially misleading? A follow-up report was written for the March bulletin of the Canadian Institute of Actuaries.

Penrose Report

A government report focusing on the problems at the U.K. Equitable Life was issued on March 8, two and a half years after the government ordered an inquiry. At the center of the problems are participating products known as "with-profits" and the writing of annuitization guarantees in such products. The report concludes Equitable Life overpaid bonuses to with-profits contracts and ran its business in an "uncommon, even unique" way. Equitable Life was closed to new business on December 8, 2000.

While placing primary blame for Equitable Life's problems with company management and complacency on the part of the regulator, the Penrose report criticizes the U.K. actuarial profession for not setting appropriate performance standards in its guidance issued to appointed actuaries. Actuaries in the United Kingdom have no legal standing to prevent a company from any course of action, but the appointed actuary does have an obligation to report to the regulator situations that he or she judges potentially detrimental to policy holders. Although the legal responsibility to regulate and monitor the actions of insurance companies and the appointed actuary lies with the regulator, Penrose nonetheless concludes that the actuarial profession should have done more to prevent Equitable Life's problems.

The implication of the Penrose report is clear—all actuaries are supposed to work in the public interest and, in this case, Penrose believes that the profession was found wanting.

U.K. Government Calls for Inquiry

The U.K. government has responded to the Penrose report by requiring, among other things, a review of the actuarial profession to "consider what professional and/or other regulatory framework would best promote recognized, high-quality and continuously developing actuarial standards, openness in the application of actuarial skills, transparency in the professional conduct of actuaries, accountability for their actions and an open and competitive market for actuarial advice in the U.K."

While this is currently a national issue, there may well be implications for the actuarial profession in Europe and beyond. Self-regulation of the actuarial profession is at stake and, more importantly, so is the long-term role of actuarial professionals. Very recently, U.S. accountants, a much larger profession, lost self-regulation following Enron and other "accounting scandals." The Faculty and Institute of Actuaries regard the Penrose report and subsequent investigation as very serious and are working hard to respond on behalf of the profession.

Conclusion

Clearly the activity regarding IFRS has been intense and the consequences are great. With the increasing globalization of the financial services industry, it is essential that actuaries understand issues arising in other jurisdictions. This is especially true for actuaries operating in the financial reporting arena. The accounting and actuarial standards that will govern how we operate tomorrow are under development today. ☐

U.K. Government Actuary Speaks on Pensions in China

by Paul Chow

On February 20, 2004, the Pacific Rim Actuaries' Club of Toronto hosted a unique event where actuaries from three continents celebrated the Chinese New Year. Chris Daykin, the U.K. Government actuary, came to Canada to speak about developments in social security and private pensions in China.

What does the U.K. government actuary have to do with pensions in China? Chris Daykin is a very prominent actuary in England and very well-known internationally. He is a former president of the Institute of Actuaries and played a major role in the development of the joint examinations of the Institute of Actuaries and the Faculty of Actuaries. To promote actuarial education, Chris has travelled extensively all over Europe and internationally, including China. Chris has been closely involved with the development of the actuarial profession in China since 1992 and visits China regularly to support university actuarial programs that focus on the Institute of Actuaries' examinations. In 1998, Chris was named an honorary visiting professor at the Shanghai University of Finance and Economics.

The Pacific Rim Actuaries' Club of Toronto is one of two actuarial clubs in Toronto. It provides a forum for actuaries to discuss international issues mainly connected with the Asia Pacific region. Catherine Lyn, the president of the club, worked at Watson Wyatt in England a number of years ago and knew Chris Daykin. Catherine invited Chris to speak to the club about China. Coincidently, Chris had planned to visit Mexico and New York shortly after the Chinese New Year. He included Toronto on his itinerary and gave a very informative and interesting presentation on pensions in China.

Chris' presentation started with a demographic profile of the Chinese population. Currently, only 10 percent of the population is over 60. By 2050, that group is projected to increase to 26 percent, due partly to the "one-child" policy and to substantial improvement in life expectancy. Currently, there are nine working-age persons (aged 15 to 64) for every one retirement-age person (aged 65 or older). By 2050, that ratio is projected to decrease to 2:5. The average age in China is currently 31. By 2050, the average age is projected to increase to 40. China is growing old before it can get rich.

We heard that in the early stages of pension development, pension coverage in China was restricted mainly to civil servants and workers in state-owned enterprises (SOEs). Problems arose because many SOEs were financially weak, contribution compliance was poor, the schemes were run on a pay-as-you-go basis (which began to collapse as the number of retirees increased) and there was very limited portability.

In the 1990s, the World Bank did some studies and concluded that with the rapidly aging population in China, pension plans could no longer rely on the next generation of workers to support the current pensioners. Therefore, current employers and employees must pay in advance toward the cost of their pensions.

More recently, China's Ministry of Labor and Social Security (MOLSS) introduced a two-part basic pension plan consisting of a flat pension (20 percent of wages) plus a notional defined-contribution plan. Due to a lack of fully qualified actuaries, this scheme is also running into funding problems, as no proper actuarial evaluations of future costs have been made.

With the aging of China's population, occupational pension plans must now be developed under the new MOLSS regulations, which require funding. MOLSS has recommended that pension funds be allowed to invest in stocks to provide for higher long-term rates of return. Accordingly, the challenges are to

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Paul Chow, FSA, is the president of Chow Consultants, Inc. in Toronto, Ontario, and can be reached at paulchowactuary@hotmail.com.

What's New in the SOA's International Arena?

by Martha Sikaras

International Strategy

The Board Level Advisory Group on International Issues, chaired by Stuart Wason, continues work on formalizing international strategy that would support a variety of initiatives. At the January 2004 Board of Governors meeting, a set of guiding principles was approved. These international strategy guiding principles are:

1. The SOA seeks to provide altruistic support to the global profession and its constituents by working with and through the International Actuarial Association (IAA) from both a financial and volunteer perspective.
2. In its international activities, the SOA will adhere to its basic purposes, among them the continued evolution of actuarial education and research.
3. The SOA will focus efforts on programs within specific regions. Individual efforts will be considered within the scope of the SOA strategy for that region and in concert with the efforts of the IAA.
4. International requests requiring financial, staff and/or volunteer resources beyond what the SOA is currently able to commit will be referred to the IAA or perhaps for collaboration with other individual actuarial associations.
5. The SOA should respect the role of applicable national standards setting organizations (e.g., AAA in the U.S., CIA in Canada etc.).

These principles will be translated into a series of concrete tactics across five primary areas:

- Education and examination
- Continuing professional development
- Membership services
- Research
- Professionalism

Over the coming weeks, the international strategy design team will be consulting with a variety of SOA constituent groups including our local regionally focused committees, the International Section, board members and others. Comments and questions are always welcome. Please contact Martha Sikaras at *msikaras@soa.org*.

IAA and other Event News

The IAA's Working Party on Insurer Solvency has issued its draft report, "A Global Framework for Insurer Solvency." Individuals with IAA member IDs and passwords may access the report via the IAA Web site, *www.actuaries.org*. Alternatively, you may order a copy using the form available at *http://www.actuaries.org/public/en/order_form.cfm*.

The second International Health Colloquium was held on April 27-29, 2004 in Dresden, Germany. The colloquium covered topics for health actuaries as well as other scientists and practitioners with interest in health insurance and health issues. Sessions covered both health policy and practical health insurance product issues. Details can be found at the colloquium Web site at *http://www.iaahs2004.de/* Actuaries with interest in health issues are strongly encouraged to join the new IAA Health Section. Information on joining is available at http://www.actuaries.org/public/en/IAAHS/index.cfm

The IAA recently released a newsletter with a focus on the development of potential IAA Standards for Application with standards promulgated by the International Accounting Standards Board (IASB). The development of actuarial standards is a new process for the IAA. An increasing number of actuaries have been active in developing guidance for those actuaries who will be performing the actuarial work necessary to implement the new IASB standards. It is expected that the IAA Council will act conservatively in order to obtain the maximum consensus as it embarks on this new initiative of international actuarial standard setting. SOA members involved in the process will be called upon to provide regular updates to the board of governors and members. Be sure to watch for more developments in the near future.

The Swiss Actuarial Association is sponsoring the 17th International Summer School 2004 on Equity and Interest Rate Models: Theory and Applications, which will be held Monday, August 2 through Friday, August 6, 2004. More information can be obtained by contacting François Dufresne at *Francois.Dufresne@hec.unil.ch*. □

Martha Sikaras is manager of Global Initiatives at the SOA office in Schaumburg, Ill. She can be reached at msikaras@soa.org.

Meeting Minutes of the International Section Council

Conference Call
January 20, 2004 – 8 A.M. EST

1. Roll Call

Rejean Besner, Michael Enright, Bill Horbatt, Tom Leonard, Marc Slutzky, Yiji Starr, Ronald Poon-Affat, Carl Khor, Randy Makin and Shyamalkumer Nariankadu attended all or part of the meeting by teleconference. From the SOA, Lois Chinnock, Martha Sikaras and Emily Kessler attended all or part of the meeting by teleconference as well. Paul Sauvé, Anna Louie and August Chow did not participate.

2. Approval of Minutes

The minutes for the meeting of December 9, 2003 were approved as amended.

3. Treasury Update

- Lois is working with Pat Kum to effect the payment of U.S. $2000 to the Society of Actuaries of China.
- Approved sponsorship at the silver level (CAN $250) for the Pacific Rim Actuaries' Club of Toronto. Lois will coordinate payment.

4. 2004 SOA Meeting Sessions

- Spring session topics are closed.
  We are still looking for speakers for the international sessions. Descriptions are listed below:
  - Session IN01 (Actuarial Employment) – both meetings
  - Session IN02 (International Benchmarking) – San Antonio only
- Annual meeting planning for NewYork (Fall 2005) begins soon with sessions determined in January and February of 2004. Ideas for annual meeting sessions are welcome.
- Annual meeting reception ideas were also discussed. Possible ideas were a visit to the United Nations and a boat tour.

5. Webcasts

- The Financial Reporting Section has expressed interest in co-sponsoring a webcast.
- One possible topic that was discussed is International Accounting Standards, which is of interest to both the International and Financial Reporting Sections.
- Carl will discuss and coordinate with Mark Freedman, Chairperson of the Financial Reporting Section.
- Bill has volunteered to help recruit a potential European representative for the debate.

6. Website Liaison

- Shyamalkumer is awaiting the SOA Web site redesign.
- Lois reported that this should happen in 1st quarter 2004.

7. Seminar

- Three potential topics were discussed:
  - Risk Management (disadvantage: SOA meeting likely to have significant sessions on topic)
  - Experience Studies (advantage: dovetails nicely with ISC experience study push)
  - M&A/Due Diligence Seminar (advantage: big interest in recent China Life IPO)
- Suggested timing was either before or after the SOA meeting to take advantage of the large number of actuaries expected at the meeting.
- It was expressed that speakers are the key to a good seminar. Also good to include are multiple countries with potential to be interactive and competitive (i.e. split into teams).
- Given that the SOA Annual Meeting planning and recruiting is being done in March and April, the following timeline was suggested for the seminar:
  - March ISC conference call—Follow-up discussions on ideas/topics
  - April ISC conference call—Final definition as to the seminar topics/times/etc.

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- Sandy Neukirchen of the SOA should be contacted for support.

8. Newsletter

- The February newsletter will have the Country Feature contest.
- The June newsletter must have all stories in by April 4th.
- We discussed creating regular columns that could appear with every issue such as monthly country updates (currently done by other actuarial organizations around the world), ambassador annual reports and country features.
- The October newsletter must have all stories in by August 6, 2004.
- Randy Makin confirmed that he would be retiring after the fall newsletter. We are looking for a new editor and should include this in the next newsletter.

9. Ambassador Program

- Anna reported that Thomas Lee has volunteered to be the new Hong Kong ambassador.
- Martha has responsibility for the approval process. Mr. Lee will basically need to apply and then be formally approved.
- The need to send out a general reminder of the obligations and roles of the ambassador was discussed along with the idea of term limits for the ambassadors. This will be discussed with the ambassador coordinator and reported back to the ISC on the next conference call.

10. Governance Issues

- Yiji reported back on the potential effect on the sections of the recent SOA moves. In general, the sections may be asked to take on larger roles, but additional responsibilities would not be required. Likely to affect Life and Health Sections more so than others.

11. Other

- The University Reference Program was discussed as a resource for actuarial study material for the SOA exams.

Meeting adjourned at 10 a.m. □

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develop plans that are properly funded, sort out annuitization issues and begin proper management of investments. There is currently an urgent need in China for experts in pensions to work and train locally.

Today, almost all actuaries in China work in insurance. With the growth of pension plans, that will likely change as the need for pension actuaries will increase quickly. There is also a growing demand for actuaries in property and casualty insurance. The Institute of Actuaries and the Society of Actuaries both organize actuarial examinations in China. Several universities in China now offer actuarial courses. With the number of actuaries growing in China, the Society of Actuaries of China was founded in July 2001.

For this event, the Pacific Rim Actuaries' Club of Toronto received tremendous support from the actuarial community with 24 corporate sponsors (including the Society of Actuaries International Section) who donated cash and door prizes. There was a record crowd of 145 members in attendance due partly to the importance of this growing area of actuarial expertise and knowledge required in China.

The club holds three regular events each year, two of which are dinner meetings featuring an international topic connected with the Asia Pacific region, the other is a summer barbecue. Harry Panjer, a prominent Canadian actuary who is very well known internationally, will be the speaker for the club's next meeting in September 2004. More information about the club and future events can be obtained from their Web site at *www.pacificrimactuaries.com*.□

International Accounting Standards—Phase I is "Finished"

by Doug Doll and Peter Wright

Doug Doll, FSA, is a consultant with Towers Perrin in Atlanta, Ga. He can be reached at doug.doll@ tillinghast.com.

Peter Wright is a consultant for Towers Perrin in the London office and is a Fellow of the Institute of Actuaries.

Introduction

The process of developing international accounting standards for insurance contracts has been long and arduous. There have been numerous articles detailing the deliberations to date. For a good summary of background and considerations, we recommend the articles in the February 2004 issue of *The Actuary*, available on the SOA's Web site.

The European Union has stated that, beginning in 2005, public companies must report their earnings using international financial reporting standards (IFRS) adopted by the International Accounting Standards Board (IASB), provided that these have been endorsed by the European Union. IFRS is needed for insurance contracts, but the 2005 deadline proved impossible to meet, so the project was divided into Phase I and Phase II, where Phase I is a temporary measure until Phase II can be completed. An exposure draft (ED5) was issued July 2003, with proposed Phase I rules. Some of these were controversial, and changes have been made during the past few months.

The IASB published its IFRS 4 on March 31, 2004, which, in theory, completed Phase I of its insurance project. The IASB also published a Basis for Conclusions and Implementation Guidance which covers the following:

- Examples of what is, and is not, an insurance contract
- Examples of embedded derivatives and whether these have to be accounted for at fair value in accordance with IAS 39, which covers financial assets and liabilities
- How to unbundle the deposit component of a financial reinsurance contract
- Shadow accounting, which allows for some relief from the mismatch caused by inconsistent accounting between assets and liabilities
- Examples of the types of detailed disclosure that may be required

In an accompanying press release, the IASB announced its intention to establish an international working party of around 15 members drawn from the insurance industry, the accounting profession, supervisory authorities and investment analysts. The primary role of this working party will be to assist the IASB in the second phase of the insurance project, but the IASB indicates that it may be willing to revise IFRS 4 in the short term "in the light of any immediate solutions arising from the working party's discussions."

As yet, the IASB's standards on financial instruments (IAS 32 and 39) have not been endorsed by the European Union even though the revised versions, issued in December 2003, met many of the banks' objections regarding hedge accounting. It is possible that IFRS 4 may not be endorsed, as some continental countries are known to be unhappy at the IASB's solution to the asset/liability mismatch issues described below. It is not clear whether the whole European project to adopt the IASB's standards can continue if all the standards are not endorsed.

Main features of IFRS 4 Definition of an Insurance Contract

A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Insurance Risk—Risk, other than financial risk, transferred from the holder of a contract to the insurer.

There are some exclusions, but these are not relevant to insurance companies. The definitions are applied on an individual contract basis. This test is applied at outset, and once a contract is designated as insurance, it remains so throughout its life.

The importance attached to the definition of an insurance contract arises from the fact that the accounting treatment of a financial instrument may differ from an insurance contract. The definition of a financial instrument in IAS 32 and 39 will, in turn, exclude from its scope insurance contract as defined above.

The difficult aspect of the definition is clearly what constitutes "significant" insurance risk. It seems likely that this will not be a problem for most general insurance products, other than possibly financial reinsurance arrangements and some heavily experience-rated schemes. The inclusion of a surrender penalty, waived on death, is insufficient to justify classification as an insurance contract.

Exemption from Paragraphs five and six of IAS 8

Paragraphs five and six of IAS 8 set out a hierarchy of sources for selection of an accounting policy in the absence of an IAS/IFRS. IFRS 4 gives insurance companies an exemption from applying this hierarchy.

The general exemption from applying paragraphs five and six of IAS 8 comes at the cost of certain specific rules which the IASB deems to flow from these paragraphs.

- Catastrophe and equalization provisions should not be recognized.

- A liability adequacy test should apply (on a block of business basis) to the insurance liabilities less any deferred acquisition cost asset.
- An insurance liability shall be derecognized only when it is extinguished.
- Reinsurance should not be netted off against obligations to direct policyholders.

Embedded Derivatives

Under IAS 39, embedded derivatives that are not closely related to a host contract have to be separated out and accounted at fair value with movements in fair value going through the income statement. An exception to this rule applies if the whole contract is already valued on this basis. This requirement is not restricted to financial instruments and, hence, applies to derivatives embedded in insurance contracts, too.

Phase I gives an exemption to embedded derivatives that are themselves insurance contracts. This exempts, for example, guaranteed annuity options, and for this type of exemption, enhanced disclosure requirements apply. Phase I also exempts from this requirement a policyholder's option to surrender a policy for a fixed amount or an amount based on an interest rate.

Accounting for Reinsurance

The IASB is concerned at the possibility that reinsurance may be used to manipulate reported results. An earlier proposal, which prohibited the reporting of income at the inception of a reinsurance treaty, has been replaced by a requirement to disclose the extent of any such profit taken.

Asset/Liability Accounting Mismatch

The IASB made a number of last-minute changes to try to accommodate concerns that earlier proposals could force an artificial asset/liability mismatch arising from the adoption of IAS 39 for asset valuations. IAS 39 is similar to FAS 115 in that only assets satisfying strict "held to maturity" rules are held at book value.

Some countries' accounting bases adopt a "locked-in" valuation rate of interest for liabilities aligned to the use of historical or amortized cost for assets. In other cases, policyholder liabilities under with-profits (participating) contracts differ as to whether gains are realized or unrealized. This can cause a mismatch in the balance sheet where assets are classified as available for sale and, hence, reported at market value in the balance sheet.
The changes include:

- Making it permissible to unlock a valuation rate of interest for the purposes of assessing liabilities for particular blocks of business. This will solve the first problem referred to above if companies are willing to value backing assets at fair value and put changes in fair value through the income statement. An available "for sale" classification would still result in a mismatch arising in the income statement.
- Shadow accounting is made permissible, whereby liabilities can be revalued in the balance sheet as if all unrealized gains were realized. This is aimed at resolving the second problem referred to above.

Disclosure Requirements

The disclosure requirements for Phase I were amongst the most controversial and onerous requirements of previous drafts.

Disclosure is based around two high-level principles:

- Explanation of recognized amounts
  "An insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts."
- Amount, timing and uncertainty of cash flows
  "An insurer shall disclose information that helps users to understand the amount, timing and uncertainty of future cashflows from insurance contracts."

It was explained in ED5 that these principles, in addition to supporting implementation guidance, were considered to be a better approach than prescribing a long list of detailed disclosures. In response to comments that the required disclosures are onerous and proprietary, the IASB has added guidance to the effect that an insurer should not typically have to disclose all the information suggested in the guidance in order to satisfy high-level principles. Furthermore, the guidance does not create additional requirements and an insurer must decide, in the context of its circumstances, how much detail it needs to disclose in order to meet the requirements. Nevertheless, the guidance, at 61 paragraphs, remains very extensive.

In order to satisfy the first principle, companies will need to disclose:

- Accounting policies
- Assets, liabilities, income and expense arising from insurance contracts
- The process used to determine material assumptions and, where practicable, the actual assumptions
- The sensitivity of results to changes in assumptions
- Material changes in insurance liabilities, reinsurance assets and deferred acquisition costs.

Disclosure of assumptions is clearly essential to any proper understanding of the financial statements. The guidance recognizes that, while disclosure of

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some assumptions such as discount rates and future inflation will be straightforward, full disclosure of, for example, mortality or persistency assumptions is not practicable. For these assumptions it emphasizes disclosure of the process used to generate the assumptions. This should include disclosure as to whether assumptions are intended to be best estimates or to include margins, the extent to which they are derived from actual company data rather than industry data and how they relate to actual experience.

The second principle will require disclosure of:

- Risk management policies and processes
- Terms and conditions of insurance contracts that have a material effect on future cash flows
- Information on insurance risk, including claims development data for general insurance
- Information on interest rate risk and credit risk comparable with the disclosure requirements of IAS 32
- Information on exposures to interest rate risk and market risk under embedded derivatives not measured at fair market.

The requirement to disclose the terms and conditions of policies is likely to be controversial. The guidance suggests disclosure, by each broad class of insurance liabilities and reinsurance assets, of:

- The nature of the risk covered
- Concentration of risk and any factors mitigating those risks
- Claims development data
- The basis for determining investment returns credited to policyholders
- The general nature of any participation features, including the extent of any discretion held by the insurer.

It is also suggested that insurers disclose information analyzing insurance liabilities and reinsurance assets by the period in which net cash flows are expected, as well as a description as to how these would change if policyholders exercised lapse or surrender options in different ways.

Claims development data is required for the period going back to the earlier year for which material incurred claims are still outstanding but need not go back more than 10 years (or five years before the end of the first financial year in which IFRS 4 is applied). There is an exemption from this requirement, subject to disclosure, if it is not practicable to prepare data about claims development occurring prior to the period for which full comparative information complying with IFRS 4 is prepared.

It will not be a requirement to disclose comparative data in accordance with IFRS 4 for years beginning before January 1, 2005, except for accounting policies and recognized assets, liabilities, income and expense.

Outlook for Phase II

The IASB will now turn its attention to Phase II of the insurance project. In January 2003, the board reached tentative conclusions regarding Phase II of the project, including the following:

- The general approach should be one of "fair values" rather than deferral and matching.
- Assumptions used for setting provisions can be entity specific, when market-based information is not available without undue cost and effort.
- The interpretation of "fair value" should be to an "entry" rather than the more usual prospective "exit" value. This has the implication that "a policy issuer would not recognize a net gain at inception of an insurance contract" unless its own premium rates or policy charges are demonstrably higher than the market rates.
- Except where policyholder liabilities are directly dependent upon investment returns from a defined asset pool, discounting should be at a "risk-free" rate rather than a rate that has regard to backing assets.
- Fair value should incorporate "market value margins." This is a difficult area to define.
- Future premiums should be recognized only if (a) policyholders hold uncancellable continuation or renewal rights that restrain the ability of the insurer to reprice the contract and (b) those rights will lapse if policyholders stop paying premiums.
- Fair values should reflect the credit standing of the insurance company. The IASB did, however, state that the allowance for credit standing should reflect the existence of policyholder protection schemes, although the logic for this is not entirely clear.

At its November 2003 meeting, the IASB agreed to revisit all of these conclusions and also the rule in IAS 39 that liabilities must be no less than any amount payable on demand. It is to be hoped that the board does indeed look again at these with an open mind, although the use of an entry approach to fair value and the demand deposit feature do seem to be well engrained in the IASB's thinking. ☐