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Fair value disclosure requirements — a new era

by Peter J. Bondy

The Financial Accounting Standards Board has promulgated its Statement of Financial Accounting Standards No. 107 (SFAS 107), "Disclosures about Fair Value of Financial Instruments." This statement applies to 1992 reports for most stock and mutual life insurance companies. It requires disclosure of fair market value of certain assets and liabilities.

SFAS 107 does not identify each balance sheet item affected. It is broad in its requirements on coverage of the balance sheet items and in defining methodology to determine fair market value of those items. Other than requiring that fair market value be disclosed either within the financials or within the footnotes that follow the financials, SFAS 107 does not prescribe a set format for how disclosure is to be presented to the reader. Much of that decision is left to the individual company and its outside auditors.

Fair market value disclosure for all entries in the balance sheet, whether required by SFAS 107 or not, is not prohibited. As a result, it is likely companies will differ in the balance sheet items included in the disclosure, the methodology used in determining fair market value, or the format in which the disclosure is accomplished.

The asset side of the balance sheet

Assets like bonds and stocks clearly are subject to the requirements of SFAS 107. It is not entirely clear whether policy loans are subject to fair market value disclosure. One faction argues that they are because they fall within the definition of "financial instrument." Another side argues policy loans represent a portion of life insurance contract reserves reported on the liability side of the balance sheet, which is not subject to disclosure. The latter group believes it would be unreasonable to report a portion of the reserve on a fair market value basis while the more significant part, i.e., the liability side, is not.

The liability side of the balance sheet

Companies must disclose fair market value for all reserves on contracts that are classified as investment contracts under SFAS 97, i.e., contracts that do not provide for significant mortality risk. Types of contracts covered would include guaranteed investment contracts (GICs), certain-only immediate annuities, and single premium deferred annuities (SPDAs).

In addition to deciding whether a particular contract type is covered, a company needs to determine the methodology for arriving at the contracts's fair market value. Should it be based on that company's current pricing assumptions for similar contracts offered to the public? Or, should it be based on market interest rates available on, say, bonds with the same maturities as the benefits stream of the investment contract?

Format for information

How will each company choose to disclose fair market value information? This question has probably generated more discussion than other SFAS 107 topics. Two main concerns are: 1) that the public not be misled by the availability of this additional information and that it realize the shortcomings of that data; and 2) that the format and style chosen the first time, i.e., for the 1992 financials, be acceptable and useable for providing consistent information in subsequent financial statements.

At this point, two alternatives for the presentation format seem to exist. The first one discloses the numerical data and the limitations in using this data in one comprehensive footnote. The second approach is to disperse the information throughout the various footnotes now included with the financial statement, with one final footnote for information not covered elsewhere. Regardless of the alternative chosen, many companies will include a very extensive discussion of the use that may be properly made of the information provided.

Financial statements will vary in approach

This article has addressed only a small sample of the issues arising from SFAS 107 implementation. It will be interesting to review the financial statements of different companies to see how they have chosen to determine and disclose the fair market value of various items in their balance sheet. Because of the broad guidance provided in SFAS 107, it is likely that practices will vary, perhaps significantly, among companies.

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Early-release copies of *TSA* papers

The following papers have been accepted for publication in Volume 45 of the *Transactions*. Members who would like an early-release copy before it is published in a preprint should send $5 for each paper to the SOA Books and Publications Department.

"Multivariate Stochastic Immunization Theory" by Robert Reitano

This paper introduces a theory of immunization where the approach is multivariate and the goal is stochastic in the sense of minimizing stochastic risk. The risk measure used is reminiscent of the Markowitz approach of variance minimization but generalized to reflect also a measure of worst case risk. The approach is multivariate in that full yield curve risk to nonparallel shifts is reflected as in Reitano's earlier paper, by modelling the yield curve as a vector of yield curve drivers. Explicit solutions to the risk minimization problems are developed, subject to constraints on portfolio returns and various portfolio directional durations. In addition, solutions are

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determined so as to be achievable by trading a given collection of assets. Applications are developed in detail and are exemplified by an analysis of the example introduced in an earlier paper.

"Durational-Based Policy Reserves" by William F. Bluhm
This paper proposes a hypothesis that durational rating strategies, now used in the individual and small group markets, fail to maintain an important part of insurers' original promise.

The proposed solution is a required reserve basis that deviates in two major ways from current standards: (1) It pre-funds expected durational increases in claim costs, as well as the excess of expected claim cost increases over premium increases, and (2) it provides a dynamic methodology to adjust for excessive lapses and corresponding cumulative antiselection.

It is asserted that the proposed method is consistent with reasonable public policy goals in the individual and small group markets and corrects certain inadequacies in current methodologies and regulatory standards.

"Level of OASDI Trust Fund Assets Needed to Compensate for Adverse Contingencies" by Richard S. Foster
Many actuaries are active participants in the debate on the long-range financial outlook for the Social Security program and how that program should be funded. The OASDI program generally has operated on a "pay-as-you-go" basis, with annual tax collections approximately equal to program expenditures and trust fund assets at a level sufficient to cover only temporary adverse contingencies.

Although the financing of the program is now on a "partial advance funded" basis, there has been considerable interest in a return to pay-as-you-go financing. In particular, the new chairman of the Senate Finance Committee, Senator Daniel Patrick Moynihan, has been an active supporter of this view, as has Robert J. Myers, former Social Security chief actuary. The appropriate minimum level of assets needed to serve as a contingency reserve under pay-as-you-go financing has been a subject of extensive discussion. This study helps answer that question analytically by estimating the reduction in OASDI trust fund assets that would occur if various past periods of adverse economic conditions were to repeat themselves.

The analysis indicates that an asset level of from 50 to 105% of annual OASDI expenditures generally would be sufficient to cover the effects of a period of adverse economic conditions for about 5 to 10 years. The paper suggests adding another 10 to 25% for the possibility of simultaneous, noneconomic adverse experience, resulting in a fund ratio of from 60 to 130%. A level of 100%, roughly midpoint of this range, is recommended as a reasonable "target" ratio for contingency purposes.

SECTION CORNER

This column reports on activities and newsletters of all special interest Sections on a rotating basis. This issue covers Nontraditional Marketing and Product Development Sections.

Nontraditional Marketing
Nancy Manning is the editor of Nontraditional Marketing Section's newsletter, "NewsDirect," and Kiran Desai is the Section Council's chairperson. Desai has dubbed 1993 the "Year of Research," with the Section sponsoring two major research projects: a credit life mortality study and a direct-response persistency and mortality study.

Section members also are planning spring meeting sessions, including a panel discussion at the Boston SOA meeting in May with an actuary (Jay Jaffe), a marketing executive from an insurance company, and a senior executive from a leading agency. The panel will discuss new dimensions of development and risk selection for direct-response insurance products.

The council plans to meet quarterly by teleconference, with the only "face-to-face" meetings at annual meetings.

Product Development
Product Development News, the newsletter of the Individual Life Insurance and Annuity Product Development Section, is edited by Timothy Pfeifer. Front-page articles in the December 1992 issue include "Term Universal Life — the Best of Both Worlds" by Barry Jacobson and "Unit Expense Factors for Risk Based Capital Requirements" by Klaus Shigley. John Palmer brings readers up to date on tax rulings in "Tax Notes." Thomas Marra, chairperson of the Section, tells of plans for panels on the implications of a low-interest-rate environment for product development actuaries at the SOA meetings in Boston in May and in Quebec City in June. Economist Arthur Laffer, who was a member of President Reagan's economic policy advisory board, will speak at a Section breakfast May 4 in Boston. A seminar on annuities will follow the Boston meeting.

Research plans include contributing to a joint SOA/LIMRA research project on universal life interest sensitive cash flows (which follows a similar SPDA study last year) and sponsoring research on the NAIC's proposed changes to the Standard Nonforfeiture Law.

Exam seminars

Waterloo Actuarial Seminars has scheduled the following seminars:

- April 17-25, 1993
  St. Louis
  150, 200, 340, 443, 520, 525, 540, 550, 564
- April 16-May 2, 1993
  Waterloo
  150, 151, 161, 162, 165, 200, 420, 421, 422, 442, 480, 580

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