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Summary: This session provides an update on the current status of the various issues being addressed in financial reporting for companies doing business in Canada. Some of the topics discussed will be:

- *valuation technique papers*
 - valuation of participating policies*
 - the cash-flow valuation methods*
 - status of other papers*
- *consolidated standards of practice and its impact on financial reporting*
- *disclosure of actuarial matters in life insurance company financial statements*
- *external influence (e.g., banks) on Canadian generally accepted accounting principles (GAAP) for life insurance enterprises*

Mr. Mike Lombardi: The program outline indicates that this will be an update on the current status of the various issues being addressed in financial reporting for companies doing business in Canada. Dan and I will give you a quick overview of the issues by briefly indicating what they are and their likely impact on financial reporting.

We thought the best way to present this forum would be to discuss the various committees that are working on different financial reporting issues. Most of them are Canadian Institute of Actuaries' (CIA) committees. Some of them are regulatory

g3

or accounting profession committees, some are accountants of the Canadian Institute of Chartered Accountants (CICA) or of the industry itself, the Canadian Life and Health Insurance Association (CLHIA).

Before we get into specifics, we thought it would be a good idea to talk about some of the issues that are circulating these days with respect to financial reporting. The first is managing changes in financial reporting standards. When you introduce a new valuation technique paper (VTP) or cash-flow valuation method, is that a change in method or a change in estimate and does it flow through the income statement or the balance sheet? There are also memorandums that typically come out towards the end of the year from the Committee on Life Insurance Financial Reporting. For example, with respect to the Canadian Life and Health Insurance Compensation Corporation (CompCorp) estimates or AIDS, that issue comes up. The chief financial officers (CFO) and chief actuaries often complain about surprises or year-end shocks with respect to the way they were planning their financial reporting for the first 11 months of the year.

The second issue we have is globalization which generally means consistency by country. With respect to actuarial issues, there isn't a current trend to get consistency by country. If anything, they're diverging from U.S. GAAP, the Canadian policy premium method (PPM), Australian margin on services, and the U.K. accrued or achieved profits. Regulatory requirements are really diverging. On the accounting side there is convergence. I think over time that will affect the work of the actuary. One other point on globalization is how it's becoming of some value to certain insurance companies to be listed on the U.S. New York stock exchange. By default U.S. GAAP is getting some preeminence or dominance in financial reporting just so that companies can be listed on U.S. exchanges.

Another general issue is harmonization which is consistency with similar financial service companies. We don't have a lot of harmonization at the moment. In Canada, in particular, guaranteed investment contracts (GICs) and segregated funds are accounted for differently between say an insurance company, a bank, or a trust company. There's a lot of arbitrage possibilities with respect to differences in capital requirements, taxation, or GAAP financial reporting.

Finally, the actuarial role is moving toward the trend of more responsibility. There's more disclosure; there are more opinions on future financial condition, and there's talk about using integrated scenarios rather than just a single assumption sensitivity test.

Mr. Daniel N. Barron: The only comment that I would like to make is that regulators are involved in the harmonization process. They would like to see some of the reporting harmonized and that may create a push for statutory basis going off GAAP, or some ultimate reporting. They're already asking for things which the CICA is not asking for. So we may see some top-down harmonization.

Mr. Lombardi: Let's start with the Life Practice Committee. They've been relatively inactive, but they've been active in two areas. One is on sales illustration standards and the other is standards for dividend determination and illustration. What's the significance of that on financial reporting? The CLHIA is the equivalent to the American Council of Life Insurance (ACLI) in the U.S. They have come up with new sales illustration guidelines, and they require the use of scenarios. There's little specificity at this point about what those scenarios or dividend scales should be. However, they will form part of policyholder expectations. Arguably the actuary doing the valuation needs to take this into account when valuing policies. The corollary is also that the actuary needs to be aware of his company's illustration practices in determining the appropriate level of these reserves and actuarial assumptions. That's sales illustration standards.

There are very weak, if any, standards for determining dividends and illustrations. The standards that do exist relate primarily to the contents of the corporate dividend policy. This is under possible review. Nothing is expected for 1996. There's talk about holding a liability for lawsuits or potential lawsuits on things like vanishing premiums or similar policies. One other thing that this committee came up with is a discussion paper from August 1994, which gave guidance to the appointed actuary giving an opinion on financial condition. In Canada you don't yet have to give an opinion on financial condition, so this is a prelude to the issues that would come up. Because it is a discussion paper, there are no binding standards there, although there's some good practices and ideas listed.

Mr. Barron: Just a comment on the illustration standards. You're going to need to understand how a universal life product was illustrated and sold because it has significant implications to how you value and how you set assumptions in terms of premiums, lapses, and the like.

Mr. Lombardi: The next committee that we're going to talk about is the Committee on Life Insurance Financial Reporting (CLIFR). This is a very busy, very active committee. People love or hate it, because they either come up with too many standards or not enough. The first one that we're going to talk about is VTP 10. This is effective January 1, 1997.

Mr. Barron: The draft of this was around for a long time. We finally received a final version a few weeks ago. One of the key things to note in this standard is that it's on an expected experience basis as opposed to a current experience, which was in part of the draft. However, the standard does allow you to use current dividend and current experience if it's consistent within itself and within what you would otherwise produce on an expected basis. Does the specific consideration made to adhere to the policy, the ability of the company, or the desire of the company to make changes? In particular, there's something which Mike alluded to before in terms of policyholder expectations that the standard sets out. If the company is expecting to get sued on a market conduct issue, and is going to basically not be able to realize its dividend reductions, or have to give back dividend reductions, then it's appropriate for the actuary to reserve for that.

The other big issue that's worth noting is what exactly you need to reserve for in terms of dividends. This was a matter of dispute for a number of years. What was decided was that basically all dividends need to be reserved for with the exception of what's termed ownership dividends, which are dividends that are derived from earnings which do not result from a specific policy or set of policies.

Finally something worth noting is, the interest rates that are used to discount the reserves are not according to VTP 3. It's an expected rate so that the curve is likely to be either upward sloping or flat. More than likely it's not tailing to 5% as it is in VTP 3. As in the past, the provision for adverse deviation (PAD) on par business is lower than more guaranteed-type products.

Mr. Lombardi: The next point is consolidated standards of practice and there are really two parts to this. One is that the whole actuarial profession in Canada is trying to come up with standards of practice that cut across property and casualty, life, and pension practices. You'd have one generic set of standards for all actuaries, and then within that there would be practice specific standards. For example, the life section would have some life-specific standards. I'm going to talk about those. This whole idea of consolidated standards of practice has been incubating for about ten years now and may never see the light of day according to some people. Nonetheless, the profession is talking about implementation by 1999.

One of the things you see when you look at standards like VTP 1 through VTP 10, is that some of them read differently, so in the process of consolidating, you come up with general principles or guidelines that don't look like just the consolidation of what's been there. It almost looks like a new standard. I'll give you a few examples. The September 1996 paper came up with the following concepts that seem to be new or were old but are now articulated a bit better. The concept of the term of the liability has come up. How long should you be reserving for? Five-year policies

should be reserved for five. If it renews to 65, should you go to 65? That was the one people were most familiar with. When you get to things like segregated funds, which don't have an obvious end date on them, or group insurance, determining the term of the liability gets tricky. The paper talks a lot about policyholder rights to renew unconditionally as being one thing to consider. Clearly, if you have varying diversity of opinion on what the term of liability should be, you can get a diversity of results, which is something that people are trying to avoid but seems to be inevitable if you consider the way they're going down this track.

The other issue is deferred acquisition costs. We talked about group and segregated funds, and how there is a deferred acquisition cost that's not recoverable up to the end of the term of the liability. Apparently the exposure draft says that you can have a deferred acquisition cost which is either an asset on your balance sheet or a deduction from your liability. The life practice consolidation is trying to standardize the margin spread for adverse deviation. They talked about a range of 5–20%, as opposed to things that were all over the map before. For example, mortality was something over the life expectancy at a particular attained age. Some assumptions such as asset default never actually had a standard for margin for adverse deviation. It introduces the concept of mortality improvement. Up to now, actuaries shied away from using mortality improvement in their valuation. It actually prescribes one now. The prescription for life is 0%. It was silent before now, so you're allowed to use 0%. For annuities, it's 0.5%. There's no logic in this except that people feel 0.5% is conservative on annuities and 0% is conservative on life insurance.

There's some write up on expense improvements, but there isn't really any specific standard on when you should be allowed to factor an expense improvement. There are only some clear words of caution about being careful, how it has to be realizable, or almost realizable and that type of thing. It talks about ownership dividends. These should be ignored if three conditions are met: (1) if the company has a policy on paying ownership dividends, (2) if the ownership dividends have not been illustrated when selling policies to the policyholders, and (3) if the ownership dividends come from other earnings other than the class of business that you're valuing. To my knowledge there's only one company that fits those three conditions, and you might almost say that these were written to capture just that one company.

The cash-flow valuation method talks about scenarios, which is the next topic in the standard of practice paper. I think they are prescribing some scenarios that ought to be used. You can use a whole lot more in determining cash-flow valuation method liabilities. But there are some listed in the paper that will now, for the first time, become prescribed scenarios. To comment on diversity of practice, it's not clear

that this committee, by promulgating this new paper, will achieve their goal of having a narrower diversity of practice.

The universal life education note was going to be a valuation technique paper, but there seems to be some controversy about its adoption. Some of the issues are whether you should use the cash-flow valuation method or discounted cash flows. The question is about what is the duration over which you're valuing liabilities since reserves under universal life policies tend to be the present value of any spread. You clearly are going to get a big number, or a small number if you have a short duration or long duration for your present value. Also, there's no next renewal as there would be under annuities. That issue is still up in the air.

Last, on universal life, fund projection is a big issue. You can get a wide variation in results over 20, 30, or 40 years, if you have varying assumptions on the amount of premium payment, their frequency, and the growth of the fund. If it's in equities, there's no standard. You could use 3% equity growth, or 10% equity growth and no one could prove you wrong. With the magic of compounding, you can get wide differences in results. On the other hand, by applying VTP 3 you could also get a large strain up front, particularly if you have some of these older universal life policies that have something like a 4% guarantee. Then there's the 5% world, which is the ultimate reinvestment rate of VTP 3. You have only a 1% spread to cover commissions and all sorts of other things. It has been calculated that you have a negative 2% spread by that time. That could really hurt you upfront.

The next topic that the committee is working on is CompCorp assessments. There will be a letter coming out soon if it hasn't already come out. It says that the actuary should value for only known insolvencies. In 1995, they recommended a three-year maximum assessment. In 1996 they will recommend two years, which is consistent with their view of what the known insolvencies are going to cost. This two-year assessment in the liabilities can and should be reduced by any recoverable amounts or accounting provisions elsewhere in the balance sheet.

Regarding lapse rates, there's a new study coming out, and they'll have some results soon. A preliminary version of this was distributed at the appointed actuary seminar recently. As far as CLIFR goes, they're saying there is no new prescription or memo coming out as to what actuaries ought to use on term-to-100 lapse rates.

The next point is transitional solvency provision. There was a long-standing agreement with the Office of the Superintendent of Financial Institutions (OSFI), and the profession will remind them that there was this agreement: once a par paper became a standard of practice (apparently it will become a standard of practice in January 1997), the transitional solvency provision would be eliminated. Of course,

we can't, as a profession, eliminate it on our own. We'll need OSFI to make those changes. The other question that comes up is, will this be a balance sheet change or an income statement? CLIFR is recommending that this be flow through income and that there be a note disclosing the impact. Also, there is a component in the minimum continuing capital and surplus requirements (MCCSR) or solvency formula. That takes the transitional solvency provision into account as a 50% credit. That should and ought to disappear. But again, that's an OSFI call.

Last on AIDS, up to about two or three years ago, we had an older version of the CIA table. I believe it was 1982 to 1986 or 1988 that was done before AIDS became widespread as an epidemic. A few years after that study was put together, VTP 8 came around and said, you really should be reserving for extra AIDS claims. There's a new study out, and that one has some, but not all AIDS deaths in it. You could argue that it's not mature so there might be an element of double counting. Again, there will be a CLIFR memo coming out before the end of 1996 saying that if you're using a table that has some AIDS deaths already included in the basic experience, all you need to hold is 80% of the VTP 8 rather than a 100%. Now why 80%? I guess it's an arbitrary number. They're talking about a 5-year phase out, so if things go according to plan, 1997's memo will say, 60%, then 40%, then 20%, and then 0%.

Mr. Barron: The one area that Mike left for me is the education note on cash-flow assumptions which is somewhat contrary to some of the things Mike has said. This is just another example of the inconsistency in what we're seeing coming out from the CIA. A new approach to margins for adverse deviations for mortality, which is not consistent with the 5–20% range, is based on some logarithmic approach as to the actual number. It's far too difficult to explain to management or a board and certainly not in line with the approach that we have been using up until now. I guess it's supposed to be a little more scientific.

There's a fair bit of detail on antiselect lapsation and the impact that has on reserving. It talks about an approach for additional mortality on AIDS. Again, that's not consistent with Mike's comments, which is the 80%, 60%, 40%, 20% roll down. There is still formula based for computing extra mortality for AIDS. There's some guidance on expenses and lapses, which is nothing new. There's a table which gives you a tool or rule of thumb for using credibility for mortality which I think is actually quite useful. How does that compare to more traditional approaches? It does give you a sense in terms of weighing your mortality credibility for your own company.

I'll comment on the universal life note. I don't think that's actually out. I think they were holding back on the educational note, so I don't think it's publicly available.

From the Floor: At a seminar they said it would be out at the end of 1996.

Mr. Barron: In terms of the consolidated centers of practice in terms of some of the accounting treatment, there's an inconsistency with allowance for deferred acquisition cost (DAC) which is not explicitly allowed within the accounting standards because PPM is supposed to negate the requirement for any DACs. They seem to be backing off from the true PPM approach and allowing DACs. On the other hand, with regard to the Securities and Exchange Commission (SEC) funds, there's an approach to make it more consistent with mutual fund accounting and not allow front-ending of profits. They're looking at some U.K. businesses. When you look at the better values, which are not that different than the effect on PPM, you can see massive differences, depending on what your growth assumptions are.

Finally, with respect to the SEC funds, companies are taking present value profit, and some are not. OSFI is asking for disclosure in 1997, and we'll get to some of the OSFI requirements for reporting later. That is one thing that they're looking at, and based on the paper, it seems to be something that's going to be eliminated.

There's one last thing on universal life that was not in the education note. The chair suggested the need to focus on the lapse-supported elements of universal life, particularly because of the low cost of insurance (COI) coverage and the impact that it should have on long-term lapse rates and because of looking at the experience on term to 100, and how it's going to translate over to universal life over the long term.

Mr. Lombardi: Let's discuss changes to the MCCSR, test of adequacy of assets (TAA) formula. The Committee on Solvency Standards is working together with the CLHIA and OSFI to come up with some changes to the MCCSR formula. I understand none of them will be in effect by year-end 1996, but they might be in effect in 1997. Let's look at three components at the moment. One is the lapse risk, particularly on lapse-supported products. They're looking at negative reserves. There's also realized capital gains. The net effect or the desired effect that they're hoping to achieve is that there will be no overall change in the industry level of available capital. Changing some of these components and factors may hit some companies particularly hard, or give them some particular relief they don't already have. There's possible duplicate valuation. That refers to the lapse risk. Basically the thinking is they won't apply a factor to a net amount of risk or some percentage of assets. On the lapse risk, the actuary actually performs two different valuations. One with a stronger lapse assumption, one with the standard year-end reserves. That difference would be quantified as a margin element or required capital element, and the effect on negative reserves would also be part of the balancing item.

The margins task force of the CIA, the Solvency Standards Committee, and CLIFR look at any possible double accounting of provisions for adverse deviation (PAD) and required capital. Clearly a PAD would have an effect on income, but any MCCSR component on top of that affects surplus. It's not always clear what the adequate level of PAD or MCCSR is. Where do you draw the line? In any case, there's no near term impact of their study. It gets pretty hypothetical and they claim they're a long way off from coming up with anything really definite that they can share with the industry.

Finally there's dynamic capital adequacy testing (DCAT) for deposit taking institutions. There's no plan to update the current document. My understanding is that the current document is a guideline, and it addresses insurance companies that have subsidiaries that are banks or trust companies. We're doing DCAT for the company as a whole. You ought to consider adverse scenarios for the subsidiaries as well.

Mr. Barron: There's the disclosure issue on MCCSR, which we'll get to. It's something that companies are focusing on when managing their MCCSR. The expectation is that 1997 will be disclosed in financial statements. The other comment I would make is that there's still a lot of issues in terms of nontraditional products. I'm aware of a situation where someone is coming out with a new type of health product, but there aren't really any standards. The existing standards aren't appropriate, and it has been brought to OSFI. OSFI thinks that within a year or so we're going to be finished with the MCCSR formula, but I highly doubt it. We're probably going to continue to see the changes.

From the Floor: I understood that. It's not even necessarily placed until the end of 1996 reporting or even possibly 1997 reporting.

Mr. Barron: DCAT for property and casualty may be required for 1997, but we're probably a little late on that.

Mr. Lombardi: Let's discuss another interesting committee. Do you ever get the feeling that the actuarial profession is very fragmented? The Committee on the Role of the Appointed Actuary was set up to integrate all the other financial reporting committees. It makes sure that we're all heading in the same direction. What this committee is currently concerned with are things like disclosure, dynamic solvency testing (DST) opinions, and the exclusion of property and casualty companies. We'll get into disclosure later. Standards for expressing a DST opinion have been in place for some time. The effective date of that opinion has progressively moved forward from 1995 year-end to 1996-97, but I think the latest it will be is 1998. They're getting serious. It's moving forward more slowly, but we'll be converging

very quickly. Property and casualty companies do not yet have to do DST or DCAT as it is now called.

They'd like to come up with a standard opinion that all actuaries can sign by year-end. There will be no reference to future financial condition in this opinion, and it will strengthen reference to the sufficiency of the liabilities. That's mostly wording. There's a draft of what their intentions are that came out in September 1996 that was distributed to members as well as attendees at the appointed actuary seminar. I was at their recent meeting and they're still hammering out the final wording so you can expect some other changes to the wording of the opinion.

Let's discuss the role of the appointed actuary. The committee felt it was important that what the appointed actuary does for a company should be disclosed in more detail. Right now it focuses only on the description of the role in determining liabilities. There's a feeling that it should also clarify the role of the appointed actuary in performing DCAT, and various comments have come back saying we should probably also describe the role that the appointed actuary has for determining the adequacy of the data, the scenarios test under DST, and the fact that we look at the asset side of the balance sheet as well. How they're going to incorporate all that in a paragraph describing the role of the appointed actuary remains to be seen.

Finally the DCAT opinion. This one actually has some implications. The existing standards say that the so-called DST opinion is supposed to be a public opinion distributed to all. They've had some thinking or rethinking about that. The standard they're going to come up with says that the DCAT opinion should be communicated to the board, but not to the public. It should be and continues to be confidential. There's some fussing about what the wording should be. There's not much controversy about what the wording should be if everything is satisfactory. The real controversy is, what should you say if you fail a scenario? Perhaps you can say, "The company failed, but given the following actions I am confident the company will pass." What exactly should you say? What if you don't believe that management's actions are going to be appropriate? They're talking about a January 1, 1998 implementation date for this DCAT opinion, which for most companies means year-end 1998 for the opinion. If you report quarterly, and they're audited, it might be as early as March 1998, but I don't think there's any company like that.

Mr. Barron: So it would be reported? There is one company or a couple of companies audited at the third quarter or October, but nobody is audited on a quarterly basis.

Mr. Lombardi: This would include property and casualty companies.

Mr. Barron: You said the wording on the DCAT is noncontroversial. I think that it is less controversial, when you pass, but there is still some controversy. There's still a fairly strong opinion on the part of the actuary about the future financial condition of the company and the company remaining solvent. I think that on a personal basis, there are some strong concerns about providing this opinion. Maybe the committee doesn't.

Mr. Lombardi: The next one is not a committee at all. It's the federal regulator, or the Office of the Superintendent of Financial Institutions.

Mr. Barron: The first thing is year 2000 exposure. I'm sure you've all heard that the day the clocks change to the year 2000, all the computer systems in the world are going to crash and burn. There's a concern expressed by OSFI, which shows up in the memorandum to the actuary, in terms of some requirements to deal with this issue. There are some comments by John Thompson at the CIA. Basically, the actuaries have a responsibility to look at the data that he or she will be receiving when we hit the year 2000, and to see that the reserving systems are adequate to go beyond the year 2000. On a practical note, I think that you know, most companies are looking at this and it goes beyond just what the actuaries are using, and it goes through all the systems that a company is using. It's not limited to insurance. Companies to great or less extent are dealing with it. To the extent that they don't deal with it sooner, then the cost of computer consultants is expected to rise over the next couple of years dramatically. It's not an actuarial issue.

On the reserving side there's a practical suggestion of what companies can do. They can just roll forward the valuation date and pretend it's the year 2000, and just make sure that there will be no unusual changes from 1999 to 2000 in a mock valuation. That should provide a fairly rigorous test. That doesn't deal with the data issue which is going to be a lot more difficult to deal with. Frankly, the legacy administration systems out there clearly are going to have issues because they only have two digit-year dates.

Mr. Barron: OSFI is very proud that each and every year they have been able to get that out a little bit earlier. In fact, this year it came in September or early October which is impressive, because other years, it has come as late as December. What I'll do is just run through some points that are different than the prior year. Each and every year they've added more to this in terms of reporting requirements. There's a lot of focus on details that are part of the standards, emphasizing those that OSFI feels are important, as well as stating the requirements for the report of the appointed actuary that goes along with the filed statements.

The first thing that changes is that OSFI is now requiring the DST or the DCAT within 30 days after presentation to the board, or December 31, whichever comes first. It's not a major issue, but I know that OSFI does get a little antsy if they don't see the report. An important issue is that OSFI still refuses to allow the use of a cash-flow valuation method for anything but those products anticipated in VTP 9. Although some companies have looked at it for disability, universal life, and other products, OSFI is still not allowing this. I guess they are too concerned that there would be too much of a release of reserves.

However, in the papers that we talked to you about before, there's a strong consideration of moving to a large extent to a cash-flow valuation method. There's now the expectation that PADs will be shown by line of business, assumption and territory which is not that far off from the disclosure requirements, which are part of the financial statement. OSFI is concerned that there are minimum PADs for mortality at older ages. The feeling is that they're not adequate. This is the fourth dimension on margins and mortality and I'm not sure what they're looking for in that. In fact, one of the CIA papers went the other direction and was looking at low mortality rates as needing more of a beef up. That's where you expect more fluctuation.

OSFI does confirm they're going to allow this 80% treatment on AIDS, which is, to some extent, becoming a CIA standard. The quantification of the interest rate PAD should include the scaling down of the interest rate to 5% on nonparticipating (policies on which dividends are not paid) business. That way, when you look at the total PAD, it's not just the 50- or 100-basis-point margin; it's also the whole effect of not using the expected rate. There's also this rate tailing down to 5%. In most companies significant amounts of nonparticipating business will be material and not PADs. This should, from a disclosure point of view, improve the perception of the financial strength of the company. OSFI is looking for a disclosure of how much the investment income tax (IIT), as well as income tax itself is included in expenses. We're going to discuss later the whole issue of taxes and what taxes are included in the reserves.

OSFI is looking for approval or is requiring approval on any back-to-back reinsurance agreements. A back-to-back reinsurance agreement is where you cede out a block of business on one basis, and then retrocede the same block back on a different basis. There's one particular insurance company that has been promoting this to alleviate some capital requirements, and OSFI has had some concerns about this for a couple of years. I guess they finally said that they want to approve all of these deals. It was a way to skirt around some of the MCCSR requirements. If your company has it, you're going to need to get OSFI approval quickly. I didn't read it that carefully, but I assume it applies to in-force agreements as well because it's a

reporting issue. Similarly, they're looking for the actuary to ensure this transfer of risk on the reinsurance. There are no real standards in Canada like in the U.S. for reinsurance and risk transfer. I think they do look at the U.S. standards, to some extent, as a measure of transfer risk. From a Canadian tax point of view, there have been issues around financial reinsurance.

OSFI is looking for details of the nonparticipating test on participating business. We're required to test the business as though the dividends could be reduced, but you'd have more guaranteed, and you have the guaranteed element with more nonparticipating type assumptions. That moves away from the participating paper, which has gone away from the traditional approach with a nonparticipating test. There are more generalized scenario tests. As I mentioned before, they're looking for a table on segment funds and how much profits are being front-ended, and what reserving is taking place for any guarantees within the segment funds. OSFI is looking for discussion of measurement of risk on new contingencies and new products. If you issue a new product you're going to have some discussion as how you developed that assumption. Finally they've added a yes/no type questionnaire that actuaries need to address in addition to the compliance questionnaire.

The OSFI is moving towards electronic filing for the financial statements, and they're also developing electronic filing for the actuarial document. This does not apply to the verbiage but to the increasing number of tables that they're requiring; I would imagine that they will continue to increase that in later years now that they have the means to build onto them from an electronic basis.

Mr. Lombardi: Let's get to the accounting profession and the Institute of Chartered Accounts. They've been quite busy as well. Here are a number of things they've been working on.

Mr. Barron: Section 4210 came in 1991, in advance of the insurance companies act which required actuaries to report on a PPM basis. There has been some dissatisfaction with this action and the accountants set a task force to review this and had considered revising it. So far that hasn't really gone anywhere. It's going to be revisited again in 1997. What they came out with instead is a guideline clarifying some of the elements within 4210. I'll just note some of the important ones.

One of the things, as I mentioned before, relates to deferred acquisition costs and is in contrast to the information that came out from the draft consolidated centers of practice. They wanted to ensure that companies are allocating the full amount of indirect cost to the administration costs. This has been a bit of an issue. It has been

a concern to us in terms of the adequacy of expenses that are being allowed for in the valuation.

A big issue for companies with large real estate and equity portfolios or particularly large real estate portfolios is this whole issue that you can pull things at historic value until there's a permanent impairment. Then you're required to write them down. You need to separate your equity portfolio from your real estate portfolio, because they are subject to different cycles. There's an intent to isolate the real estate portfolio.

OSFI has indicated they do not want companies taking major write downs in the real estate portfolio for permanent impairment reasons. They don't want to see last minute major losses accruing to companies, because it may create some unnecessary concern. We are fairly long in the tooth, in terms of the real estate cycle. I think the view of some in the accounting profession and real estate profession is that we have seen a permanent impairment on segments of the real estate market.

There's a concern, with changes to some of the treatment of assets and writedowns and credit losses, that there isn't double counting between what the actuary is doing and what the accountants are doing on the left-hand side of the balance sheet. If you are involved in setting credit allowances in the liabilities, and you have assets subject to this kind of writedown, (mortgages, real estate, etc.) then you must liaise closely with the accounting people. There is a specific requirement that if you disinvest a portfolio of business, you must realize the unamortized gains and losses associated with that block of business immediately as opposed to amortizing that over a period of time. Also, policyholder dividends are supposed to be included in income and that's fairly normal. The only exception to this is if there was a large dividend payment that may be mostly surplus as opposed to income. I'm not sure that I've ever seen anything that qualified as an unusually large dividend payment. I could see that if a mutual company was demutualizing or there was some other one-time circumstance.

There is an issue in terms of the income on participating policies for stock companies. The income related to the shareholder portion should be recognized, even if it's not distributed. There should be some disclosure of whatever shareholders stake there is in the participating funds. For some companies, that actually is greater than the amount of the participating fund, for example, if the participating fund is negative. The income tax is to be included in the liabilities if the taxes are on a tax payable basis. If they're on a tax allocation or deferred tax basis, then you need to consider the impact on investment income. I think we should defer discussion of the treatment of taxes until we get to the whole discussion on taxes.

Capital taxes get the same type of treatment. With capital taxes, a further complication is in terms of whether that would be recoverable against future income tax or not. That relates to a clarification of the Section 4210. There aren't any major changes there. There are major changes to the measurement uncertainty, Section 1508, and financial instruments disclosure Section 3860. These two sections drive this whole disclosure issue, and I'll get to that in a moment.

First, on the measurement uncertainty, there's a new standard that has come in, that basically says that if there's a significant amount of uncertainty in an accounting item, and reserves certainly qualify in that regard, there needs to be a disclosure that there is an uncertainty there. In some circumstances, there has to be quantification. That leads to the impact of assumption changes, the way assumptions are set and the whole actuarial process.

More importantly is a standard that has come out, which reflects some of the globalization of accounting and some of the changes in the financial instruments. With the growth of derivatives there are a lot of accounting issues, and issues around off-balance sheet transactions that were not being reflected in the financial statements. They were not being disclosed, hence the international accounting standards board developed a prototype to deal with this. The basic principle is that you don't net out everything unless there's a true net with no credit risk. If you have a transaction where there's a liability on one side, and an asset on the other side, and even though they may be matching, you don't net the amount. We'll see the implications of that for life insurance in a moment.

In addition, there's a greater emphasis on market value measurement as opposed to historical cost because historical cost doesn't really mean a lot when you're dealing with derivatives, which may have no historical cost. Therefore, it wouldn't show up in the balance sheet. Over time it could result in a large positive or negative value, depending on market movements and on whether the companies hedged. The banks are a bit ahead of the life insurance companies. If you pick up a Canadian bank financial report, you might see a lot of detail under derivatives, their hedging, and their exposures. It provides a fairly useful guideline to where I think the life insurance industry will be in a few years time.

In the interim, there is a standard on disclosure, and there are some implications for reporting. Let's first discuss the reporting on the property and casualty side. Companies are now required to show the gross reserves that they never had to before, and there's some challenges in quantifying that. We've traditionally had to calculate the gross reserves, and then show net reserves, so there's no big issue on the life side. On the life side, we're not required under the standard to show the

gross impact on reserves, and certainly on an earnings basis that has been eliminated.

Section 1508 is in place for 1996, even for life insurance companies. Section 3860 is in place as well, for all companies except life insurance companies. It will come into place for life insurance companies in 1997. The big issue around the financial instruments is the market value and requirement for market value measurement. This applies on the asset side, which is fairly easy. Life insurance companies are already reporting that. The market value on the liability side is not easy. There is no agreement in terms of how that is developed. There are some questions in terms of whether we're just looking at the asset side, i.e., taking the fair value of the assets back into liabilities, or actually attempting to come up with a fair value of liabilities from an appraisal value type approach. The guidelines have deferred this to 1997. There's a desire that the actuarial and accounting profession come up with an approach to fair value of liabilities. The view of the actuarial profession is that it's maybe appropriate to disclose fair value of the surplus, but fair value of liabilities, at least at this stage, is not appropriate to attempt to disclose and there is currently no requirement.

Mr. Lombardi: I have some general comments on disclosure of actuarial liabilities. The CLHIA has its own financial reporting committee. Its comment to the CICA was generally supportive of disclosure in general. The members had a number of concerns with respect to some issues that they weren't comfortable with. One was the disclosure of PAD. They thought it was premature because it wasn't quite clear what a PAD is because some of the current CIA standards don't make such a distinction. For example, is VTP 8 AIDS reserve expected or is it a PAD? What about default assumptions? The ultimate reinvestment rate of 5%? There is some clarification from OSFI on what that is.

Dan alluded to the fair value of liabilities as being a concept that's not clear to many people. That is an issue that we'll have to wrestle with in 1997. There are two issues here. One is that the rating agencies are becoming more popular or more active in Canada and they'd like to see a whole lot more being disclosed, even though they get that kind of information when they visit the companies on site. Maybe it's an excuse to shorten the visit and attempt to get the information right off the Internet or something.

The second issue that's driving it is the collapse of Confederation Life about two years ago. There's a concern among the public and maybe the regulators that somebody wasn't doing their job. Perhaps if people had more information this could have been avoided and maybe in the future we could share more information with the public. Therefore, the issue pertains to disclosure of all this black box stuff and actuarial liabilities. I think those are the two things that are driving disclosure.

There maybe one or more other things driving it. For example, there's comparability with other countries. The generic issue you come up with is, if you start with a financial statement and notes that are 5 pages long, and you go to something that's 100—500 pages long, it may be more complete. Is it more understandable? To whom? Are we trying to address the rating agencies? Many investors are companies issuing debt securities, and they have to disclose a whole lot more about their operations. They will need much more information than the public will generally want. There's a big gap between how much is too little, and how much is enough. The last comment the CLHIA had was on cost. This is going to be quite costly. Are we sure we're doing the right thing and that we're getting a proper cost benefit return on this?

Mr. Barron: Let me share a little bit in terms of what the disclosure is. I'll discuss some comments from CIA and then what OSFI has said in its draft guideline. Rather than go into all the details, there are some samples available. Some of the accounting firms have come up with alternate samples. Some of the companies have already developed some models. In fact, if you look at the 1995 statements of some of the companies, they've already implemented some of this. You're explaining what actuarial liabilities are and what underlays them and that, in itself, is a challenge. The nature of the measurement uncertainty is quite useful. You're looking on the descriptive basis, as well as looking at changes in some of the key actuarial assumptions of what impact it would have on reserves or on the financial position of the company. The impact of any changes in actuarial liabilities is a breakdown of what changes were due to assumption changes versus natural changes in liability. I think that will be crucial to anybody looking at the income of the insurance company. Things like interest rate risk, credit risk, and reinsurance risk are hopefully done on a consistent basis, so that somebody looking at this has the ability to measure the relative risks of different insurance companies.

Disclosure is not just for the public, but also for agents and brokers who need to select companies for their clients. They're looking for more information. I cannot comment on whether they have better knowledge in terms of assessing the financial position of a company than the general public. They are probably a little bit less sophisticated than the rating agencies and the corporate investors.

CIA came out with some comments, and the CICA guidelines said you might want to consider disclosing PAD. The CIA came out and said you must disclose PAD. Then the CLHIA, which is populated by some actuaries, came out and said it didn't like that idea. I'm not sure if there's any cross representation of those committees.

There is some concern about disclosing interest rate risk, because we're already dealing with that to a large extent in VTP 9. The suggestion is just to show what the

impact would be on reserves because that kind of sensitivity testing is already absorbed into the C-3 component of the reserves. The CIA was quite adamant that it didn't want to calculate the fair value of liabilities. There is a significant cost associated with this and there are some questions as to what the value of all that would be and what the meaning of a fair value of liabilities is. One approach that has been suggested is that the fair value of liabilities is that amount that is needed to be held on the statements to meet future obligations and requirements. In other words, the fair value of liabilities is what's being held on the statements because you can't hold anything less. So even if you're discounting the value of PADs to some positive value, it doesn't help you much from the financial reporting point of view.

A guideline came out from OSFI in summer 1996, and this is in response to both the CICA guidelines and the CIA comments, and the CIA examples. First, they mentioned that companies quarterly information is being released to the public. This is worthwhile noting whether you're a branch or a company. To some extent, in the early days of quarterly reporting, people weren't so concerned about income presentation. They could deal with it. Now, you should be aware that this is publicly disclosed and needs a consideration every quarter what the impact on income is, even for nontraded companies.

Second, they expect all companies to be willing to release the audit portion of the statutory filing. There's no current requirement for companies to publish financial statements, and I don't think it's anticipated that they will be required to publish financial statements. Therefore, this whole disclosure issue doesn't apply to branches, because disclosure only is part of the financial statements. Therefore, if you're running a branch, you don't need to worry about this. If you publish a financial statement, then you need to comply with all the disclosure requirements.

OSFI wasn't satisfied with all the CICA and the CIA disclosure elements. It has more things it wants disclosed, which includes details on any large portfolio holdings, i.e., something over 10% of a specific class. If you have a subsidiary or a large equity holding or something of that nature, that would need to be disclosed. They want segmented information, which means that you have to report not only reserves by class, but also income and assets by line of business and territory. Most large companies are doing this on an internal basis, but having to disclose that will mean a much greater level of scrutiny of those numbers especially since this means disclosing to competitors how you're doing. Segmented reporting is required for SEC companies in the U.S. for major lines of business, so it's not something new. I think the CICA's target is 1997, which probably means a 1998 implementation date on this segmented reporting.

OSFI is also looking for discussion of risk management and control practices. We talked about disclosure of issues and all the actuarial risks—the interest rate risk, the credit risk, and the insurance risk. They've added foreign exchange risk and liquidity risks. They also want a discussion of how a company manages these risks which is more than the disclosure part under CICA guidelines. Mike is going to talk a little bit about some new standards coming out of the CLHIA in terms of risk management and control practices. That's really all the issues that I had on disclosure and I think the best way to get a picture of that is to get a copy of one of the samples. That will give you a fairly good idea of what's going to be there.

Mr. Lombardi: For the sake of completeness we have these other CICA standards or drafts. We didn't intend to go through each of them in any particular detail. I'll just read them. There's clarification that tax reassessments and litigation charges are not prior period adjustments. They are both income. Economic dependence: if you're relying on one major producer that should be disclosed. It might become a DCAT or DST issue if the loss of such a producer or distributor had some significant implications on a company. Contingent gains and losses: this is a disclosure item. Foreign currency translation is scheduled for 1997. They want to eliminate the amortization deferral of gains and losses on the foreign exchange. If you're hedging, then you should do the accounting on a book-value basis. You're reporting by line of business the same way that you measure yourself internally with the same kinds of splits. There isn't really that much related to going concern. Talking about completeness and adequacy of disclosure. Finally, with regard to cash-flow statements instead of starting with net income and doing subtraction, they're recommending the direct method.

Mr. Barron: I wanted to comment on impaired loans, which is something a little more practical for insurance companies who do have impaired loans. As of 1996 year-end, and there was a disclosure 1995 year-end, companies are required to write down impaired loans to the discounted. Present value of cash flows management assumes will be realized on those impaired loans. The discount rate is the original lending rate. In this current low-interest-rate environment these assets are likely to be held at a lower rate or discounted to the lower rate than the valuation interest rate. There are some implications as to whether these should be held in surplus or liabilities. To the extent that you have a large book of these liabilities, you need to pay close attention in terms of the allocation and the implications for current profitability and future profitability as well.

Mr. Lombardi: I'll just quickly give you an introduction on the latest Revenue Canada guidelines are on tax. They just came out a few weeks ago. Basically, the old tax environment was 1.5 year full preliminary term for all business. They've covered the concept of old and new and the magic date is January 1, 1996.

Basically, any policy sold prior to that will continue on the old basis. Any policy sold after January 1, 1996 will be on the new basis which is defined as PPM, the statutory reserving basis. When we get into line-of-business specific items, life insurance annuities that involve life contingencies will both be PPM. I'm describing the new basis by the way. Annuities not involving life contingencies will be on the accrued liability basis.

There's still some controversy on whether these reserves are going to be certified by an actuary. If there is certification, the actuary would certify that the post-1995 life reserves and health reserves, and the nonlife claim reserves are a reasonable amount. The actuary would also state the assumptions used and that they're in accordance with generally accepted actuarial principles. There's no comment or intent to include segregated funds in all this. There should be no tax component in the reserves except for premium tax and investment income tax. There's some relief on a temporary basis for negative reserves on post-1995 business, which is the only business with tax reserves on the new basis. To the extent that exceeds 5% of post-1995 premium, that will be an additional deduction. That has a 5-year grade down from 100% at year-end 1996 to 80%, 60%, 20%, and to 0% by the fifth year.

Some issues are still unresolved on taxes. What do you do about reinsurance of any kind if the regulations aren't clear? What do you do if you reinsure old business, but the effective date of the treaty is after January 1996. Is that old business or new business, and which rules apply? When you're doing annuities under VTP 9, where you come up with an aggregate number, how do you split the aggregate number into pre- and post-business? Also, it's a bit unclear about what you do with the preferred net gains.

Mr. Barron: There's an issue for Canadian companies that are multinational. There's the whole treatment of the investment increment and how it's allocated. The Canadian Investment Fund has not been resolved. It's an open question, although it's effective January 1, 1996. I don't think they anticipate it being resolved before year-end 1996. There was some issue which I think is being resolved with respect to what products are considered new for 1996. At one time they had in the regulations that any universal life products would have to be on the new basis. I think that you need to pay close attention to the treatment of any revisions to products, reissues, and conversions in terms of what the detail in the regulations are.

Mr. Lombardi: The CLHIA has standards of practice for the life insurance industry. This does not directly address the appointed actuary. These standards are parallel to the Canadian Deposit Insurance Corporation standards for bank and other deposit-taking institutions. Ten draft standards have come out to date. If they follow the

same track as the banks and deposit-taking institutions, eventually companies will have to sign a standard of compliance every time they do their annual reporting that will say they have complied with these standards of practices for the life insurance industry. We're not going to go into details of what those are at this stage.