PD-2: Implementation of CICA 3855 (LIFE)

TR-2 : Mise en œuvre du chapitre 3855 du manuel de l'ICCA (ASSURANCE–VIE)

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(?? = Inaudible/Indecipherable; ph = phonetic; U-M = Unidentified Male; U-F = Unidentified Female)

Moderator Ben Meckler: Good morning, everyone, and welcome to life track session PD-2 which is called, "Implementation of CICA 3855". 3855 is, of course, The New Accounting Section on Financial Instruments, dealing with recognition and measurement.

My name is Ben Meckler, and it's my pleasure to be standing here in front of you as moderator for this session. Actually, given what I've gone through the past ten months, it's my pleasure to be standing here in front of you under any circumstances. (Applause)

Now, in advance of the effective date of 3855 this section has created quite a buzz over the past few months. And if I continue with the analogy to a bee, many actuaries have been feeling the 'sting' of the extra work and complexities they will soon be facing. There has been quite a lot of discussion generated on the subject. We had a town hall in the spring and we had a session at the annual meeting in June. Also in June CLIFR published an educational note on the subject.

There likely will be modifications to other educational notes, such as the one on Best Estimate Assumption for Expenses, Approximations to CALM, and Future Income and Alternative Taxes.

As well, OSFI entered the fray with its Guideline B-10 which largely deals with the Fair Value Option and the need for certain controls such as a documented risk management strategy. In addition, OSFI has been working to sort out how the MCCSR should be changed. And the CLHIA Committee on Taxes has been involved with correspondence with Finance to get closure on the tax treatment.

For this morning's session we have an interesting line-up of speakers. Our first panelist is David Thomson, an audit partner with KPMG. Dave will walk us through the section and discuss audit and accounting implications as well as related tax issues. As an added bonus he will also touch on other new sections—1530 on comprehensive income as well as 3865 on hedges. Now I realize that a number of you have strong feelings on the subject and really resent the extra complexities on the valuation generated by the new accounting provisions. I ask, though, that you resist the temptation to shoot the messenger, or at the very least please wait until the end of the session.

Our second panellist is Bernard Dupont. Bernard will give us OSFI's perspectives on the subject with particular emphasis on the MCCSR.

Our last speaker is Lesley Thomson—no relation, by the way to David. Lesley will bring it all together and speak on the actuarial challenges. Her focus will be on the application of CALM, including the potential new dimensions of volatility to the so-called

CALM valuation. She will also touch on the approximations to CALM and the impact of future taxes. Now, this is a subject that has been on Lesley's mind for some time. She made presentations on this at both the town hall and at the CIA meeting in June. Her presentation this morning is a substantial expansion of her presentation in June, so stay tuned for fresh material. I understand that Lesley will also include comments as to how her company is dealing with some of these challenges.

After the presentations we'll hopefully have time for questions, answers and comments. Well that's it for the introductions, so without further ado let me call on Dave. Thank you.

Speaker David A. Thomson: Well good morning ladies and gentlemen. It's a pleasure to be here with you. Thank you to Ben for that introduction, and I certainly echo his instructions to you not to shoot the messenger. It's interesting to be introduced in a session where people have such strong feelings about a topic.

So we're going to talk this morning about the new real world of financial instruments accounting and fair value accounting. However, before I get there I was reminded this morning of just how unreal the world is that we live in when I heard on 680 News that Tie Domi is dating Belinda Stronach. I don't know if anybody else heard that but I thought, did I actually hear the right thing? And what could they possibly have in common? There's Tie Domi – very successful, a real goon and questionable IQ. Then there's Belinda Stronach – actually that might be a good match. (Laughter)

So what I'm going to cover this morning is just a little bit of background on why we are where we are, review what the changes are and then get to the perhaps more important issues of how to apply it now that it's a reality, and how it's going to impact financial reporting.

So, just a little bit of background. First of all, there is definitely a global trend toward international financial reporting standards. The CICA, the Canadian accounting body, has announced a plan to move to IFRS within the next five years, so by 2111 there will be no more Canadian GAAP. Companies will be preparing their financial statements according to IFRS; auditors will be auditing according to IFRS. If you also report under US GAAP there is a project underway in the US where the FASBI and the SEC are considering whether those that report on IFRS at that time will still have to reconcile to Canadian GAAP. Obviously the hope is that we don't and that there will be one international reporting standard that could apply in Canada.

The IFRS accounting model is a fair value measurement model. It's been described as the most relevant measure for financial assets and liabilities and the only relevant measure for derivatives. As I am sure you know, there's a whole separate project underway to look at developing insurance standards under IFRS. The IFRS-4 has already been issued and is being followed by companies that currently report under IFRS, which deals with essentially presentation and disclosure. It's avoided the measurement principles for accounting for insurance policy liabilities. So essentially those are carried forward by those that report under IFRS according to their old basis of accounting, whether that be German GAAP, Japanese GAAP, US GAAP, Canadian GAAP.

So what are the changes? There are three new accounting standards, and Ben referred to the bonus of talking about hedges and comprehensive income. The only reason they're here is because these three standards are interlinked. And they were issued by the CICA simultaneously and they must be applied simultaneously. You can't choose one without the other.

And then there were some consequential amendments to the existing handbook, "Sections Guidance." Section 4211 will replace 4210 and reflect the new accounting for financial instruments and Accounting Guideline 9 will also be updated.

So, again continuing on what are the changes, first of all applies to all entities—manufacturing companies, retailers, oil and gas companies, banks and insurance companies. However, as you all know it affects the life insurance industry in a very unique way due to the linkage of assets and liabilities for measurement purposes. And again as you know, there was an extensive lobby movement mounted by the life industry for either an exemption, or at least a deferral from the application of 3855 in particular. However, the CICA, I guess, was unconvinced, and so the train has left the station. This is coming into effect very shortly. And it will significantly change the measurement of financial instruments and how they're presented in the financial statements, and how the financial statements look.

Usually we end with timing and transition, but we'll start here just so that you all are focused on that. This is coming into effect just around the corner. Essentially, Q1-2007 is the first time the companies will have to report on this new basis. The new Guidance is effective for fiscal years beginning on or after October 1st 2006,for publicly accountable enterprises, which would include life insurers. For calendar year-end companies, it's going to be Q1 2007.

The transition—no restatement of prior periods, so it's a fresh start as of the application date. And so, therefore, everybody must designate all your assets and liabilities at the beginning of that first period. So that's January 1st 2007—a little over two months away. And the Guidance requires a restatement of that opening balance sheet. So you don't restate your old financial statements for this new accounting policy presentation. It's essentially a clean start January 1 and adjust that opening balance sheet when you file the first quarter 2007.

The application of this new Section is to all financial assets and liabilities that meet the definition. And essentially the definition is a financial asset is the cash or a contractual right to receive cash or an equity instrument. And a financial liability is a contractual obligation to deliver cash. That's a summarized version; there are a couple of nuances to that, but that's essentially the definition.

So, insurance contract liabilities do meet the definition of a financial instrument, but they are specifically exempted and, therefore, the existing Guidance in the handbook, or what will be the new Guidance 42-11 Measurement basis continues, i.e., CALM. So that results in a bit of hybrid or a mixed measurement model between the left and right hand side of the balance sheet.

Before we get into the financial instrument's measurement section proper we'll deal with the other bonus sections. First of all on hedges—and this is a particularly complex area. There is existing accounting guidance in ACG 13—Accounting Guideline 13, which outlines when an entity can apply hedge accounting and gives guidance on how to apply. A lot of that has been carried forward in this new Section 3865. But it does introduce three different types of hedges, and there is a new requirement that any ineffective portion of a hedge instrument must be recorded immediately in income. And there are lots of disclosure requirements.

The key message is, you really have to want to apply hedge accounting to go through all of the documentation requirements that go with this. Hedge accounting is viewed by the accountants, I guess, as a privilege and not a right. And you have to earn that privilege by jumping through a whole series of hoops in terms of internal documentation and procedures. So you really have to evaluate whether it's worthwhile for you before you head down this path.

The current GAAP on hedge accounting is to measure the hedge instrument on the same basis as the hedged item; otherwise, derivatives are measured as equities, which in life insurance companies' case would be under this "Moving to Market" method, which is under current GAAP.

GAAP next year will be that all derivatives are measured at fair value. Changes in fair value would go to income, except for cash flow hedges where the ineffective portion goes to "Other Comprehensive Income."

So what is comprehensive income? Comprehensive income is changes in equity of an enterprise during a period from transactions and other events and circumstances from non-owner sources—so external sources to the company; things like changes in fair value of assets. So Other Comprehensive Income is revenues, expenses, gains and losses that are included in comprehensive income and that are not part of net income.

There will be a separate statement in 2007 financial statements. Currently, balance sheet, income statement, statement of retained earnings, statement of cash flows. To that will be added a new statement, Statement of Comprehensive Income. And it has to be displayed with the same prominence as the other financial statements.

This category of Other Comprehensive Income is essentially a sub-category of shareholders' equity, and it's a temporary parking lot for these gains and losses that are derived from external sources—from non-owner sources. So this component of equity gets transferred to income, and through that means gets back into equity—you know, when certain items happen, when you

sell one of the investments where the unrealized gain or loss is parked in Other Comprehensive Income. When you sell that investment, then it's a realized gain or loss, then it would be transferred through income.

So Section 4211 will be the replacement for the current 4210. It essentially replaces all of the existing guidance on the moving to market method of accounting, but it does retain it for what's defined as life insurance investments. Those are investments that are not dealt with through the financial instruments section that we're just about to get into. In practical life that likely means that there won't be much left in the old accounting rules under this moving to market method. Investment real estate is a common example that people come up with, and I'm not sure if there are any others or too many others.

The classification of assets under the financial instruments guidance is probably the most significant aspect of it. Essentially you have to colour code every investment that the company owns into one of these four buckets: hold to maturity, held for trading, available for sale, and loans and receivables. It's essentially a once and for all designation at inception. There is some ability to transfer from hold to maturity or held for trading out of those areas into available for sale. You cannot go the other way – you can't transfer something out of available for sale into these other categories. The classification is based on management's intent, and we should add to that, and ability—so management has to have both the intent and the ability.

Held to maturity — that means when you buy the asset you have to have the intent and the ability to hold it to maturity. If there's any intention to trade those investments for yield improvement or anything else, then you can't classify it as held to maturity.

Held for trading — when you buy the asset you have the intention of trading it in the short term.

Loans and receivables are assets with fixed payment patterns, but are not quoted in an active market. So that would exclude things like debentures and so on that are publicly traded.

I skipped over available for sale, because that's the default category. If it doesn't fit into one of those other three, then it becomes available for sale.

And this is broadly similar to US GAAP. They have three colour codes. Loans and receivables is not separately identified in the US GAAP literature, because it's already dealt with elsewhere, but essentially you get to the same end result. If you are reporting on US GAAP, there are some nuances of difference between the two that remain.

So when you look at the implications of the different classifications, held to maturity investments are carried on the balance sheet at amortized cost.. The issues that are related to that are what's called Portfolio Tainting Rules. What that means is, say you're going to hold it to maturity and then you don't, under Canadian GAAP you're in the penalty box and you have to transfer all of your held to maturity assets—not just the one you traded. - the one that you traded is gone—but all of the assets that you classified as held to maturity they all have to be reclassified as available of sale. And you don't get out of the penalty box for two years. Under US GAAP they don't have this two-year limitation. Once you trade investments that are categorized that way, then you essentially have to classify everything as available for sale. On that issue it's going to be difficult to maintain held to maturity classification, I would think, in practice for most life insurers.

Held for trading - on the balance sheet at fair value, changes in fair value go through P&L, and the issues with that one is that as a one-time opportunity you can elect held for trading treatment for any financial instrument. You don't have to justify that your intention when you bought it was to hold it for trading. You have the free choice to categorize it as a held for trading. So essentially you get a free pass into fair value on the balance sheets—gains and losses going through P&L.

Available for sale—fair value on the balance sheet again. This time unrealized gains and losses don't go through P&L; they go through this new statement that I referred to earlier called Other Comprehensive Income, so essentially straight into equity. You still do have to track the available for sale bonds and debentures on a cost basis and amortize your premiums and discounts. Premiums and discounts would get amortized through P&L, but it's that fair value change over and above that that would go through Other Comprehensive Income. So for a life insurance context, then, for assets that are backing policy liabilities there's that clear mismatch, and loans and receivables under the current GAAP accounting policy of amortized cost.

So we've got this new concept of Other Comprehensive Income—net income from your income statement. Other Comprehensive Income equals total comprehensive income—very simple. But income will be accounted for quite differently depending on the classification. This will likely change the way investors and analysts look at a life insurer's financial statements.

Again, this is just a slide that summarizes the impact that I just went over on the impact on net income and other comprehensive income, and again just emphasizing the matched or mismatched implications for actuarial liabilities.

So the impact on the policy liability measurement—under CALM policy liabilities reflect the carrying value of assets used to support liabilities. So if you've got these available for sale assets you do have this mismatch arising because your change in policy liability is going through P&L, change in the fair value of the asset on the left hand side of the balance sheet going through equity, essentially. So the likely outcome for most of you for assets backing policy liabilities is this fair value option, this free pass into fair value accounting, changes going through P&L to get that matching.

The designation is trading, and the use of the fair value option gives you that theoretical matching and eliminates or minimizes, at least, the income statement volatility. So, what are the key significant practical implications?

The first one is there will be lots of new controls and procedures that the actuaries will have to follow in the valuation process. And don't forget the auditors—auditing guideline 43 requires the auditors to understand the company's valuation process, review the documentation and test it. So that would be a significant new issue—auditing guideline 43 is a whole topic on its own, but it applies for the first time in 2006 year-end, so you get a dry run under the old rules before you have to apply the new financial instrument's accounting.

There will be difficulties with roll forward techniques for companies, and certainly most of you in the room, I'm sure, are doing valuation techniques pre year-end and using roll forward procedures. You're going to have to plan for market volatility in that fourth quarter, and with Murphy's Law the first time that you apply this will probably be significant volatility right at the end of March 2007. That's a prediction from me. So, it will require lots of new controls and procedures.

One of the biggest issues of the whole application of financial instruments is this issue of determining fair value. Obviously it's easy when there's an active market valuation, published prices, but in a non active market situation where you're using models and techniques there's lots of internal analysis that needs to be done and documented to support the value versus external evidence, which is clearly much more reliable. Obviously this is a major concern for OSFI and I would add to that, ourselves as auditors.

In light of that, OSFI has issued Guideline D-10 and I am sure Bernard will have some more comments on this. But, essentially, it limits the use of this fair value option—this free pass into fair value accounting with the changes going through P&L, and requires lots of rigour in the process. Certainly for most of you this is something that you would already have in place anyway. These are best practices, but, essentially, you need to have a documented risk management strategy and, as I say, that has to be documented and approved by management. That will also feed into the auditors' verification of that work.

There are other restrictions under Guideline D-10—that you can't use the fair value option for any asset for which fair values can't be reasonably estimated or reliably estimated. And there's a specific requirement, somewhat oddly, I guess, in my view, that you can't use it for loans and mortgages to individuals or companies with revenue under a certain dollar threshold. I'm not sure where $62.5M came from; maybe Bernard can enlighten us on that—$50M US at old exchange rates. (Laughter) There you go.

Just one point to note again for those that are reporting under US GAAP. This fair value option or the free pass is available under Canadian GAAP and international financial reporting standards, but it is not currently available under US GAAP. But there is an exposure draft currently issued in the US that would allow for that fair value option.

So, to summarize on the categorization of classification of investments. Financial investments backing policy liabilities are likely to be categorized as held for trading. Investments that are backing surplus are likely to be categorized as available for sale. Real estate continues on in the old method essentially—moving to market method. Loans and receivables—same as the

current method, amortized cost. Policy liabilities are still to CALM valuation, but obviously with the significant implications of the changes on the left hand side of the balance sheet. Deferred realized gains and losses—no longer applicable, and so realized gains are included in income when they happen. And other liabilities at amortized cost.

Other implementation issues—systems and processes—clearly a significant one. There's lots more tracking that needs to be done both on a fair value basis. First of all the categorization of the colour-coding. Secondly, the tracking on both the cost and fair value basis, particularly for available for sale securities where you have to amortize the premiums and discounts through income and also take the fair value change through other comprehensive income.

The new rules also call for the use of bid prices rather than last trade prices as market values.. That caused a bit of a ruckus in the mutual fund industry where NAV values, net asset values, are computed on a last trade basis. And I think just earlier this week the OSC announced that they would accept NAV values being calculated on the current basis, while the financial statements do reflect the bid prices, as required. So there was a significant lobby effort in that industry that was successful in this case.

Tax purposes - Ben asked me to include a few slides on tax. I know enough about tax to be dangerous, but the key issue here is that assets will be carried at fair value under this new guidance for financial reporting purposes, but they will not be marked to market property for tax purposes under the current rules. So there will be a big tax deduction available because of the significant increase that is going to result from this in policy liabilities, while the assets on the assets side of the balance sheet for tax purposes will not be marked to market. But don't get too excited about that. That's a huge concern to Finance and the numbers involved—I don't have an estimate of the number, but for the industry it's certainly a very, very significant number. So this is one issue. Here we are a little over two months from application, and the issue has not yet been resolved, but I believe the likely outcome is that there will be some form of transition rule where that significantly increased deduction through the policy liability increase will be phased in for tax purposes. I'm not sure over what period yet, because that hasn't been announced, but that's the likely outcome.

The last point on that page that I didn't mention is, clearly, there will be an impact on the future tax discount adjustment that is included in actuarial reserves. I think Lesley is going to cover that point. With apologies, this slide is slightly out of order, but I think I've covered those issues.

Reporting timetables will also be significantly impacted, and will need to be planned for. There will be a lot more stress on the reporting timetable clearly from the need to address this new guidance. Asset carrying values will be a lot more volatile. And actuarial liability calculations will have to reflect those changes in asset movements right up to year-end. And so, some process will have to be developed to take into account latent period asset volatility.

The overall impact on earnings will be not much in terms of assets backing insurance liabilities, once the actuaries have done their work. It will increase sharply for assets backing surplus, and clearly without the restatement of prior periods there will be a loss of comparability with prior year results or prior period results.

On the balance sheet asset values will be a lot higher; surplus will be higher, because of this Other Comprehensive Income component, and that's going to impact the calculation of ROEs.

So asset values I think in general should be more readily understandable by readers, investors and life insurance companies. I'm not sure how many would actually understand this moving to market concept, but people can understand fair value or market value. But thankfully, I guess, for all the people in the room the policy liabilities will be just as opaque as ever.

And with that I think Bernard is up next. (Applause)

Speaker Bernard Dupont: Thank you Dave. As Ben mentioned at the beginning I will concentrate on the impact 3855 is going to have on the MCCSR. But before I do talk about the impact on the MCCSR per se I would like to talk about the process we have put in place for updating the MCCSR.

Over the last few years a couple of companies have approached us and said, we like the fact that you are updating the MCCSR every year; it makes it more risk sensitive, and following whatever developments are being done in the industry. But, the problem is that we have difficulties making financial projections now, because we don't know what our capital requirements are going to be next year. Also internally at OSFI we had concerns that maybe we weren't making the right changes at the right time—which ones should we make next year, and which ones the following year, etc. etc.

So we sat down with the industry and we tried to develop a process to determine what changes should be made every year, and which ones should be postponed. What we have concluded is that certain modifications should be made every three years. These are for new and material requirements for risks not currently covered. A good example of that would be counterparty risk for re-insurance. That's something we discussed with the industry this year, but we decided to postpone it to three years.

Also substantial modification of existing requirements for risks currently covered. Another good example was the changes to the mortality requirement last year. These are the kinds of changes that we would like sort of cluster every three years.

Also we're now planning to make those changes only on January 1st rather than on December 31st like in the past. So for this year and every year, the changes that wouldn't be made every three years would be changes that are made to correct errors, close a material loophole, provide clarification to the MCCSR or reflect new accounting or actuarial standards. One of the changes we are making this year, actually, is the new opinion for the actuary on the MCCSR.

For this year-end, companies are still subject to the current MCCSR requirements. The assets are valued at amortized cost for bonds and mortgages, and on moving-average-market for equities. For assets supporting surplus, they are recognized at market net of taxes for capital available purposes. This is accomplished by having 55% of the unrealized unamortized gains recognized in tier 2C.

Now, 3855 allows the use of the fair value option. We, however, at OSFI had concerns with the reliability of the valuation of certain assets and also on the use of the fair value option. So what we have done is we have issued guideline D-10 as mentioned by Dave earlier. What it does is that it narrows GAAP a little bit. It says that you cannot use fair value option whenever you want; you have to use it whenever it eliminates or significantly reduces a mismatch, or when a group of financial assets, financial liabilities, or both, is managed and its performance is evaluated on a fair value basis in accordance with a documented risk management strategy.

OSFI didn't issue any guidance on what exactly we mean by significantly reduced mismatch, but we're expecting companies in collaboration with their external auditors to determine what it is for them. We are referring them, though, to the Basel supervisory guideline on that issue.

We're expecting, as I mentioned earlier also, companies to use the fair value option to value their assets backing their liabilities, and to use available for sale for their assets backing their surplus.

Now the capital treatment under 3855—for the held for trading and fair value option instruments: the accumulated net after-tax unrealized gain or losses will be included in tier 1 capital available. The balance sheet values will be used to determine the capital required. The treatment I will be talking about in the next few slides is fairly similar for the three sectors, either the banks, the life or P&C insurance companies.

For AFS loans the accumulated net after-tax unrealized gains or losses will not be included in capital available, and the amortized cost will be used to determine the capital required. For AFS debt and equities the accumulated net after-tax unrealized gains will be included in tier 2A capital, and the balance sheet values used to determine capital will be used to determine the capital required. The unrealized gains included in tier 2A are different from what we had before since we had these included in tier 2C.

For the held to maturity instruments, the accumulated net after-tax unrealized gains and losses will not be included in capital available. Also the balance sheet values, so the amortized costs, will be used to determine the capital required. For other assets no changes to the current accounting and capital treatment will be made this year.

Finally, the impact on the capital required will vary by company. The survey done by the CLHIA on a couple of companies indicated MCCSR will vary between zero and 100 points. The impact on the CALM valuation should be minimal. The valuation methodology will be the same, but if the assets are going up then the liabilities will go up. Therefore capital available shouldn't change. But capital required will change, because having higher liabilities and higher assets and the C1 requirement being applied to the balance sheet value, capital required will be higher. Also, the insurance margins will be higher. The lapsed component and the C3 risk will attract more capital, especially, I think, for smaller companies for which usually the lapse and the C3 components are larger—at least larger in proportion of total capital.

The transitional provision. We had extensive discussions with the CLHIA and a couple of companies. What we were proposing was to use a two-year phase-in with a weighted average in between the MCCSR current methodology and the new one under 38-55.

Lots of companies were concerned that they wouldn't retain their current methodology in the future, at least the current valuation basis, so they couldn't do it. So what the CLHIA was proposing was to use a three-year phase-in with just a bulk amount calculated as the difference in the MCCSR requirement between December 31st and January 1st. Our concern with the three-year phase-in was the fact that if interest rates start going up, then the impact is becoming beneficial for the industry and then you still had an amount to help the company. So, the compromise we decided to make was to use the fixed amount methodology, as proposed by the CLHIA, but you have only a two-year phase-in for the moment.

So that's all I have for today. If you have any questions at the end I'll be happy to answer them. (Applause)

Speaker Lesley B. Thomson: Now, I get to go last, which is apparently a good thing. Hope you're all still awake and can listen to this. I will do my best not to repeat too much of what especially Dave covered—he covered a lot of the stuff that I had previously covered in presentations. So I'll try not to overlap too much.

This slide is really just a summary of what's been described a couple of times. The new reporting depends on the asset designation. And it talks a bit about the fair value option; Dave talked about that a lot. Now he called it a free pass. Given the restrictions that OSFI has put on it I wouldn't say it's exactly free, but I guess not much in life is free, right?

Other Comprehensive Income Dave also described. Basically it's a below-the-line item of income, or income that hasn't been recognized yet. What this does, though, is create a disconnect between the balance sheet and the income statement. And that's what's new to Canadian GAAP, and that's what's causing the headaches to all the actuaries.

Now, because of the exemption of insurance liabilities from 3855, CALM valuation is still going to apply. Insurance contract liabilities are still covered under 4210, which is now going to be 4211. The basic principle of CALM hasn't changed—that the liability is the statement value of assets needed to discharge the obligations. So if the statement value of assets changes, then the liability is changing by the same amount. CALM gets the balance sheet right. So what's the problem? That's what we used to say.

But, it's the disconnect between the balance sheet and the income statement for AFS assets which is the problem. I know some accountants have said that the problem is the fact that CALM links the value of the liabilities to the value of the assets. But that's their perspective; our perspective is that they are the ones causing the problem by disconnecting. We've never had a situation where a change in the balance sheet amount doesn't result in income, and that's a problem. So the trouble is if you use AFS to back liabilities you would get the balance sheet right, but your income statement would be wrong. And I had a very simple example here to illustrate it, which I won't go through. The ironic thing is if you had AFS assets backing liabilities and they had an unrealized gain you would actually show a loss on your income statement; and if your assets had an unrealized loss you would show a gain on your income statement. That's just silly; it doesn't make any sense.

Also, as Dave mentioned, the insurance industry and the CIA as well, did lobby with the CICA to try and get something that would work, but basically the problem is unique to the insurance industry and the CICA wasn't willing to put in place special rules for the insurance industry. The end result is that insurance companies won't use AFS assets to back liabilities. So, such is life. Now, that does create a minor annoyance for those of us who report on Canadian GAAP and US GAAP, in that we'll have

the same assets with different designations for Canadian GAAP and for US GAAP. As Dave mentioned before, there was no fair value option in US GAAP, but there's going to be. So you could say that we could make them the same, but that would mess up the US GAAP income statements. You couldn't have held for trading assets backing US GAAP liabilities, because then you would have exactly the same problem in reverse—than if you use AFS assets to back Canadian GAAP liabilities.

So now I'll go through some of the issues—and again, some of these have been briefly touched on by others.

The first one is the valuation timing issue. CALM valuation is often done a quarter in arrears, at least in our company. We just don't have the asset information available in time to do a CALM valuation at year-end in the tight timeframes for reporting. I know many of you do your CALM valuation at the reporting date with all the information. You're the lucky ones, believe me.

The difficulty is that the increased volatility of asset values means that using that Q3 testing information to set your Q4 liabilities is just more difficult. And at Sun we're taking different approaches for different blocks of business, depending on the character of the blocks and the information that's actually available.

The first approach that is quite common I've called PPM with fair value adjustment. This is used for blocks of business that use a proxy PPM approach. They do their CALM valuation and then solve for a valuation interest rate or an interest rate track that gives them the right answer, and then apply that valuation interest rate to the liability cash flows at year-end.

So, for those blocks you can use exactly the same approach, except the result you get at Q4 would be a book value liability. What you have to do is take that book value liability and gross it up by the new asset value, or the market value divided by the book value of assets. Of course, it's never that simple; there are always ifs, ands, and buts—and I'm not being very precise here.

The book value of assets that you used for this approach wouldn't have to be exactly the same as the pre-3855 book value; you just need any stable book value approach for this. In many blocks at Sun we've decided to retain pretty much the same book values we had before, but that's because those values can be useful for other purposes as well. For example, our sources of earnings analysis, our management of dividends on par business and credited rates on UL. But, because they are going to be maintained outside the general ledger we've got some control issues.

So, basically, for some blocks the easiest path through this is to keep the same process they have today and then make the adjustments they need to get to the right answer at the end.

Now another approach—there are two variations on this one- I call fair value of liabilities with a Q4 adjustment. The first one is to solve for a spread at Q3 when you're doing your testing, such that the fair value of the liability is equal to the present value of the liability cash flows at Q3 spot rates, plus that spread J. And then you keep the J at Q4; you do the present value of Q4 cash flows at Q4 spot rates plus that J; and that should give you the fair value liability at Q4.

Another approach is to solve for a PPM-type interest vector that basically does the same thing, but, again, then you would have to be careful because that gives you a book value answer. You would have to adjust for the change in the fair value of the bonds backing the liabilities.

A third approach which is used in a couple of annuity blocks is, first, you do your CALM testing and you determine your C3 provision. Then you know at the reporting period your liability will be your statement value: your assets basically, plus the present value of the liability cash flows, minus the present value of the asset cash flows. So that's like the old cash flow valuation method and that's a way to get you to the right answer.

The main issue is the required information in time to do the reporting, and also the materiality of the adjustments required to account for changes that happen during the quarter. I mean, all of these approaches are really approximations, so you have to be careful. If you had a material change in the asset mix, in your asset quality, in your duration of assets or the matching position of the assets and liabilities, you might have to make an adjustment. Also, if you wrote a lot of business—new business, during the quarter that went into that segment, that's changing the composition of the assets in the segment. And that's another thing that you would have to adjust for.

Ben promised I would go through taxes. Taxes are so complicated, and I try and shy away from them, but we can't. There are going to be changes to the timing differences. Actually I should start off by saying that most of the comments I'm going to be saying going forward apply only in Canada, because outside of Canada the tax basis is not changing—the tax cash flows aren't changing. So it doesn't create anywhere near the same complications as it does in Canada.

These changes will cause projected income to change, and it's almost all attributable to tax impacts, and it will cause projected income to be more volatile. And that added volatility is almost completely attributable to the tax impacts. Another caveat—I'm really only talking about the liability segments here. I've set the surplus aside; I'm looking at the assets backing the liabilities.

Now, one thing I'll mention at this point that you will hear more about, I believe this afternoon or tomorrow at the CLIFR topics, is that there will be changes to the tax timing differences going forward in 3855. So the natural question has come up, is how to do the December 31st 2006 valuation? We're on the old rules, but we know that these new rules are coming, and we know that these tax differences are changing. Are we supposed to account for those changes in future taxes in the December 31st 2006 valuation? From what I've heard from Ty Faulds and I hope this hasn't changed, the CLIFR fall letter is going to recommend no, that we do not; that the 2006 year-end liability should reflect the current financial reporting rules. You'll hear more this afternoon, I'm sure.

Ben asked me to give an example of how taxes change the income and the volatility, just for illustration. I decided to go with a really simple example, just because it's so much easier to illustrate, and this is the kind of thing I always seem to have to do myself whenever I try and figure out the implications of taxes. I start from square one and go back to a very simple example.

I started with pre-96 life insurance, which means that the tax reserve is not changing in these blocks. So, if I start with a pre-3855 balance sheet where I had an asset that was $1,000 and that was the book value equal to the tax value of that asset—and what I am implying is that my total after-tax liability with discounted deferred tax liability is also $1,000. So I've got a block that's matched. Then if you do the math the tax reserve is $1,060. The DTL—I'm using maybe old terminology; I should probably call that the future tax asset or liability - that's the undiscounted provision for taxes that's on the balance sheet—the one that the accountants figure out and set up. The sum of the statement liability—the statement liability is what ends up on the balance sheet—the sum of the statement liability that the actuaries put on the balance sheet and the DTL that the accountants put on the balance sheet is the right answer. It's $1,000.

So what's going to happen if the asset value rises to $1,150? Well, the balance sheet value of the asset goes up, but the tax value of the asset doesn't. The tax basis of the asset isn't changing. So, now the accountants are going to book a new DTL related to the asset difference, which will be $60. Your total after tax liability with discounted taxes is still equal to the asset value of $1150. I've assumed that this asset is still sufficient to discharge the obligations. Your tax reserve isn't going to change, because this is a pre-96 contract, but now your DTL is going to change and your statement liability changes to $1,110.

Now one thing worth noting here is that the total future tax provision hasn't changed. It's just that now, instead of just being one for the liability piece and nothing for the asset piece you've got a DTL related to the asset and a DTL related to the liabilities, but the sum hasn't changed. The amounts are changing, but they're changing by exactly equal and offsetting amounts.

Also, the new timing differences on assets are completely offset by changes in the timing differences on liabilities. So, in the end there's no change to the tax cash flows. The only thing that's going to come through is that the assets backing everything are now being held at fair value instead of book value. You just have to be really careful that you do the right thing. For example, if you're going to use that approach that I mentioned first, which is to calculate the book value of the liability and ratio it up by the market value of assets over book value of assets, you have to make sure that you apply that ratio to the total liability including the future tax cash flows.

Another way of looking at it is that the assets backing the total of the statement liability—and by that I mean the one that the actuary calculates—and the deferred tax liability which the accountant sets up, the assets backing the total of those are held at fair value. But you've got to be careful, because the accountants aren't going to change the DTL balance. They're not going to

make the DTL balance a market value number instead of a book value number, so the actuary has to make up that difference in the actuarial liability, to make sure the whole thing hangs together.

There are going to be some variations across companies. For example, you might back the DTL with cash. And another thing that I've seen companies do in my past life is that some use the liability with no tax to actually determine the DTL. So the way the accountants set the up the DTL actually varies across companies.

But what I would recommend, and this is what I do, is just sit down and figure out how it should work and then figure out a way to get yourself there practically. And it's not going to be perfect; every line of business that's gone through this and said well, this is how I'm going to do it—there's always a little bit of slush; there's always a little bit of change in the asset value that's not going to make it through the change in the liability value for one reason or another. There are always complications, and you just have to get to the point where that little bit that's not perfect is little enough that you're not worried about it.

OK, now this time I've gone through a post-96 example, so this is completely different because the tax reserves are changing. I started with exactly the same pre-3855 balance sheet with an asset value of $1,000 and liability of $1,000 and a tax reserve of $1,000 detail(ph: 59:28) zero. Gee, if only life were that simple it would work so nicely, so easy.

Now, if your asset value rises to $1,150—remember that tax value on the asset isn't going up, so now you've got this DTL related to the assets. Also, because your tax reserve is going up that additional $150 liability is actually tax deductible and the increase in the asset value is not taxable.

So, and this is a big assumption; assuming immediate recoverability—in other words, if you have taxable income that would allow you to realize any tax loss in your valuation, any negative tax, your total liability is actually less than what you might think it is.

Now, there's no DTL related to the liability, so the total DTL balance is changed. That's one thing to watch out for. But, basically what you're doing is you're getting a gain of that $60—it's the deductibility—the fact that the $150 increase is deductible. I used a 40% tax rate. That $60 is actually a benefit to you. It's a gain at transition.

So, again, my example is simplified, just to illustrate. I've ignored the fact that there are going to be transition rules. There are going to be transition rules. We're not going to get the benefit of this tax deduction right away, and the CLHIA has proposed spreading it over time. That proposal will probably be accepted, but we haven't heard officially whether it will be accepted, so we don't really know yet.

Now, in actual fact this wouldn't change the total future income. It's all timing. All that happens is you would get this $60 now and then it would be reversed later. But, of course, we all know timing is real; it's money. Time is money?

So, what you find if you do the math is that on your post-96 business—forgetting about the transition rules again, for now; —each reporting period the tax on the change in the fair value of the assets backing those liabilities is going to show up as a gain or loss. So, if your asset values go up you're going to show a loss of the tax on that increase in value; if your asset values go down, you're going to show a gain of the tax savings on that reduction, presuming that you can recover it. And that's because the change in the liability value is deductible while the corresponding change in the asset value is not taxable immediately. It's all timing again, and this will be complicated by changing projections in asset values, of course.

So, income is going to be more volatile, but it's only going to be because of taxes. Ok, I'm going to get off taxes now; that's enough about taxes. We're running out of time, too.

There is a lot of stuff in here that's just basically a laundry list of issues that you will run up against. I'll just go through them quickly, because I can see that we're running out of time.

First is the valuation of deposit amounts. If you've got deposit balances, like dividends on deposits or such, where you're actually paying the policyholder the credited rate or the earned rate of interest, so the credited rate is basically the earned rate— we used to just to think that the liability value for those amounts is equal to the account value. But, if the market value of the assets is

significantly higher than the account value, you should set your valuation equal to the market value of the assets. Well, minus profit spreads plus PfADs. I'm simplifying for the purpose of illustration. But it's something you should be thinking about.

MCCSR will definitely increase, just because asset values are increasing and liability values are increasing.

The one piece of the required capital that is unsure is the lapse component. That seems to be a bit of a wild card. In other words, you don't know if it's going to go up, stay the same, go down, whatever. I think our initial testing showed that, at least in Canada, it wasn't going to be a big increase; it may even be a decrease. But I've talked to other actuaries who say that their lapse component is going to go up significantly.

There's a general issue with policyholder dividends and credited rates of interest on UL-type business. We based these for years and years on book rates of return on the assets in the par account or the assets in UL, and we're not going to have the same book rates anymore. So, we have to do something.

Sources of earnings are definitely more complex whenever you use market values. What we're going to do at Sun—at least in Canada—is we're going to continue to do our source of earnings analysis on the book value basis and then add a line for the impact of the market value fluctuations. We're probably going to have lots of additional questions and disclosures.

Inter-segment trading turned out to be a problem. We do have a system in place where you can trade at market value between segments and then you have notional deferred realized gains and losses between segments that wash out at the overall company level, so they don't go into the external reports, but they're important to our internal reporting and management. But this is going to be way too difficult for AFS assets, with the complexities of the OCI, so we're actually going to prohibit inter-segment trading of AFS assets. The investment guys aren't too happy with that. They don't like it when reporting rules stop what they think should be done—the freedom that they have.

We're not going to allow hybrid segments—segments with both AFS and HFT. It's just too complicated.

We've got SOX issues. All of our SOX processes are going to have to be reviewed in case we have to change them for 3855, though this is probably minor on the actuarial side. It's probably a lot bigger for other people, but it's important to actuaries, too.

We've got the AUG-43 audit requirements coming at the same time, and what this means to me is documentation. We're going to have to be really good about documenting the approach we're taking to valuation for 3855.

Disclosures definitely are going to increase, if only to satisfy OSFI's requirements to use the fair value option.

We saw a recent analyst's report that indicated that they would want disclosure of the change in liabilities caused by change in interest rates. I think this is because investment income isn't going to be as meaningful as it was before. I mean, the investment income on the income statement is going to be the change in the market value of the assets; it's going to be going all over the place. So, I think they're catching on to this and saying, hey, can we get something from the company that lets us go back, let's us look at it in a meaningful way, to go back to the way it would have been before.

There are going to be all kinds of changes in DCAT, source of earnings, embedded value, whatever. Basically, the thing that's going to be really complicated is whenever you have to project liabilities. Whenever you have an application that demands that you project liabilities going forward, it's going to be more complicated. Are you going to do projections on book value and then make some kind of adjustments? Or, are you actually going to try to project on a market value basis. You have to think about all that.

And then there are the transition issues:

The tax, as I said, isn't finalized.

The capital—I just heard about. Glad to hear about that, because what OSFI said in their last memo was their final proposal was something we couldn't even do. So I'm really glad to hear that that's been changed.

There have been companies complaining that the deferred net gain balances are written off at the time of transition. So that's a piece of income that is never going to hit the income statement. So the assets in the past and the past accounting rules made you defer that income, and now you don't get to see it. It's never going to come up on your income statement. It's not like the value is gone. If you were only worried about value, you wouldn't be worried. But, of course, we are worried about optics and income going forward.

The treatment of deferred unrealized gains on equity is still unresolved. I'm not sure about that; it might be resolved by now. By that I mean the amortized piece of unrealized gain

For HFT assets, the change from book value to market value, the unrealized gains, are agoing to retained earnings, not income. So that would be another piece of income that would never hit the income statement. And that's not true for AFS assets, so that's another reason to use AFS assets in surplus.

That's it. (Applause)

Moderator Meckler: We have about ten minutes or so for questions and comments, so we'll open it up to the audience. Just follow the rules—please state your name clearly.

Trenton Haggard, Insurance Bureau of Canada: Just have a question for Dave and Bernard. For the P&C industry there's been a lot of focus on ROE and such over time, as the industry has such volatile cycles. Just wondering going forward, first of all what's going to be appropriate way of measuring ROE? Secondly, how useful is this calculation, or this ratio? And, thirdly, how would you bridge between ROE going forward and historical ROE?

Speaker David Thomson: A whole series of questions, and we need a stock analyst up on the panel here. But, essentially on the P&C side—I'm not sure how many people in the room are P&C people—but the likely outcome is that P&C companies will account for their investment assets as available for sale rather than held for trading. So the change in fair value would go through Other Comprehensive Income. So that will obviously significantly impact surplus, significantly impact return on equity. I think the relevance of the calculation is still going to be just as relevant. It's going to be all in the communication and interpretation of the change, but it's going to be significantly different from what it's been in the past. So it's a communication challenge more than a relevance challenge I would suspect.

Speaker Dupont: What I would add is that volatility is going to be part of the new world with fair value, anyway.. for any industry. And, also, it will force P&C companies to do a little bit more matching to be able to use the fair value option, not necessarily a real cash flow dollar for dollar matching, but at least some sort of notional matching—at least as a minimum duration matching.

Nick Bauer: Lesley said that tax is complicated, and I think that truer words have never been spoken. There are three little items that I would like to mention in connection with that.

One is that Lesley's examples were based on the situation as it will be on January 1, 2007. Neatly, all the SDOs existing at that point are sort of book value or with amortization, and the liabilities will neatly move to market value, and so on. And the pre-96 liabilities will stay at the current tax value, and so on.

What, in fact, is going to happen is that your SDOs are going to start rolling over, and every time you buy a new SDO or trade one, the new SDO becomes marked to market, because the treatment of an SDO for tax purposes depends on its treatment for accounting purposes at the point of acquisition. So, pretty soon you're going to find yourself with a portfolio in which the assets are increasingly a mix of the old treatment and the new treatment. It's going to challenge you to make sure you have good control of your tax situation.

The CLHIA did recommend as part of the recommendations to Finance that there be permitted a one-time election to move the SDOs to market by a so-called deemed disposition. The point made by CLHIA was that the companies could actually do this by the annoying and somewhat expensive expedient of shortly after January 1 actually dumping all their current SDOs, waiting 35-40 days—you know, past the watch sale period and then buying them back. CLHIA recommended that it would be

an appropriate gesture on the part of Finance to allow a one-time conversion of SDOs to market, if it was done in order to back some substantial portion or the entire liabilities moving to fair value.

The second caution I would make is that while it's very nice and neat to say assets backing liabilities should be at fair value and assets backing surplus should be at AFS, in fact you will find over time that it will be increasingly difficult to keep that neat dividing line, because assets are going to start moving from liability to surplus, or in the reverse direction. It will take pretty tight and fancy management in order to be able to keep the distinction clearly.

And the third point I would make is there seems to be a general acceptance that what should happen is that you should have fair value for assets backing liabilities and AFS for assets backing surplus. I would merely suggest that it might be useful not to discard the fair value option for the assets backing surplus immediately. Think about it and see if it might help your particular situation, because it will depend on what you want to control. Is it the dollar value of surplus? Is it income reported on surplus? Or, maybe is it MCCSR ratios? And if it is MCCSR ratios and you deploy the assets in the surplus similarly to the liabilities, you can get a fairly stable MCCSR ratio.

So, those are the three points.

Speaker Lesley Thomson: Thanks, Nick. I know I threw in a couple of caveats. My examples were over-simplified, and you added a very important one. Thank you.

On your second point about the neat dividing line, at Sun we are definitely going to keep a very neat dividing line. We have prohibited the intermingling and we're going to do that by making regular transfers of assets in and out of segments with cash, and if you need to transfer more than that you will have to sell an asset and buy another.

On the comment of using the fair value option for surplus assets, one caution there is you would have to sell that to OSFI. You would have to have a good reason—that relates to risk management. It can't just be for the ability to play with income, or something like that. But there are situations where it would make sense. For example, we have plans to set up a sub-segment of surplus in the annuity line, which will be HFT to pre-purchase assets before RRSP season for when we're making commitments, because you need a lot of assets, and the liabilities don't always come in at the same time. So, we will have the flexibility to do that there.

Speaker Dupont: I would just like to hear Dave's comments on using the fair value option for backing surplus, because companies will need to have the auditors reviewing their position or their policy. Would you, as an external auditor, approve a company using the fair value option for assets in surplus?

Speaker David Thomson: I think as Lesley has pointed out there are some hurdles to get over to justify doing that, but there is no preclusion from doing it. So, as long as those hurdles are met—and that's documented risk management strategy that, as Lesley points out, if there's a valid reason for doing it other than the income effect. So long as those hurdles are met and the appropriate documentation is put in place and that it can be audited, then it would be acceptable.

Speaker Lesley Thomson: The hurdles are OSFI's, though, just for clarification. They don't arise out of the accounting rules.

Barry Senensky: A quick question for Bernard. In the TAAM formula, Canadian branches of foreign companies are allowed to now count as capital market value gains on assets backing liabilities. We all know that that's not right and should go away, and it is implicit in the new changes. However, you mentioned a transition of two years for the required capital; you made no mention of transition for this portion of the changes, and it can be very significant for a foreign branch. Is there going to be a transition for this part of the formula, as well? If not, can you give justification for why not?

Speaker Dupont: The change was coming anyway with going to fair value, so we decided not to do the phase-in here. Also, we're trying to be more in line with actuarial requirements, so having the assets on the same valuation basis as for the liabilities I think just made sense to go ahead right away.

Barry Senensky: So, you said there will be no transition?

Speaker Dupont: No transition.

Barry Senensky: OK. Thank you.

Steve Sullivan: When we are restating the January 1st 2007 balance sheet—so, net deferred gains are out; assets, some are now at market. That will cause a sort of change in the policy liabilities that were reported at December 31st. Does that opening balance restatement also include the restated policy liabilities, or does that change go through regular income?

Speaker Lesley Thomson: That change would also go through equity, so it would be through the opening balance sheet restatement.

Steve Sullivan: Thanks.

Moderator Meckler: If there are no other questions I would like to thank our panellists again, and thank you to the audience for your attention and for your comments. This session is adjourned. (Applause).