

Turning risk into reward*

Gearing up for a new world order in financial reporting, risk management, and capital management

Table of contents

The heart of the matter	02
On the verge of a revolution in financial reporting and capital management	

An in-depth discussion	04
New directions in financial reporting, risk management, and capital management	

Potential changes to insurance contracts	05
Toward convergence	07
Aligning finance, risk and capital management	09
The competitive impact of Solvency II	11
The potential effects of Solvency II in the U.S.	15
The complexities of IFRS Phase II	16
Accounting for universal life under a new financial reporting model	17
Questions to consider when implementing an IFRS framework	18
Exploring premium questions	20

What this means for your business	23
The way forward	

The heart of the matter

On the verge of a revolution in financial reporting and capital management

On the verge of a revolution in financial reporting and capital management

Many analysts, investors, and other observers view financial reporting within the insurance industry as baffling, opaque, and ineffective at providing information about the underlying financial condition of a given business. In an industry on the brink of its biggest financial reporting shake-up in a generation, these long-held perceptions are certain to change as risk becomes a more important consideration in decision-making and disclosure. While this change presents sizable implementation challenges, it also potentially provides insurance businesses an opportunity to move to a better informed more economic footing.

The long-term nature of many insurance contracts, along with the timing mismatch between collecting premiums and paying related benefits and claims, has created considerable debate over measuring and reporting results. The earliest measures were based on solvency approaches that sought to do little more than determine whether the entity had access to sufficient assets to meet its unpaid obligations. The evolution of generally accepted accounting principles (GAAP) stimulated interest in developing performance-related information. More recently, insurers, regulators, and standard setters have turned their attention to measuring shareholder, or intrinsic value. As these developments gather steam, the insurance industry is on the verge of a financial reporting and capital management revolution that potentially could affect the reserving, pricing, and product design of many popular US products, including universal life contracts.

An in-depth discussion

New directions in financial reporting, risk management and capital management

Potential changes to insurance contracts

The front line in this revolution is outside the United States. When revisions to the International Accounting Standards Board's (IASB) International Financial Reporting Standards for insurance contracts (IFRS Phase II) are agreed to, they will replace IFRS 4 interim arrangements. More than 100 countries already have or are in the process of adopting IFRS as their primary basis of accounting, including members of the European Union (for consolidated accounts), Canada, Japan, and India.

In May 2007, the IASB issued a discussion paper, *Preliminary Views on Insurance Contracts*, which advocates a “current exit value” approach to the measurement of insurance contracts (see the box below for basis of evaluation). The market-consistent approach advocated in the discussion paper is broadly in line with recent developments in prudential regulation, including the UK’s Individual Capital Adequacy Standards (ICAS) and the anticipated EU Solvency II. As such, it forms part of the accelerating convergence toward an economic framework for evaluating solvency, reporting earnings, and measuring performance.

Building blocks

The IASB discussion paper proposes that an issuer's rights and obligations under an insurance contract should be measured on a discounted cash flow basis using three building blocks:

1. Explicit, unbiased, market-consistent, probability-weighted, and current estimates of the contractual cash flows;
2. Current market discount rates that adjust the estimated future cash flows for the time value of money; and,
3. Explicit and unbiased estimates of the margins that market participants require for bearing risk and providing other services.

The discussion paper examines each of these building blocks and how adoption of the IASB's preliminary views may affect the reserving, pricing, and product design of many popular US products, such as universal life contracts.

Toward convergence

In the United States, the Financial Accounting Standards Board (FASB) issued an "Invitation to Comment," which incorporates the discussion paper. The FASB wanted to know if its stakeholders would support a joint project with the IASB to overhaul accounting for insurance contracts, and expects to make a final decision about such a project before the end of 2008. As it works toward a decision, the FASB also may consider its own future as it weighs in on the importance of the IASB insurance contracts project.

The asset and liability requirements included in the draft framework for Solvency II, published by the European Commission in July 2007 (updated in February 2008), are in many respects conceptually consistent with the current IASB proposals. Under Solvency II, insurance assets and liabilities would be measured using economic principles, with the resulting capital requirements based directly on risk-based measures. Although Solvency II would at present apply only to European Union insurers, many other jurisdictions are monitoring its developments to assess the competitive impacts and determine what elements might be more widely applied.

Among others, the International Association of Insurance Supervisors (IAIS) is closely watching these developments. In addition, insurance regulators in the United States are considering adopting standards that link solvency requirements with the level of liabilities (called C3P2 standards). They also are considering principles-based policyholder liability valuation standards for life and health insurance, which use projected contractual cash flows instead of conservative assumptions and arcane Commissioners net premium valuation bases.

At the same time, insurers—notably in Europe and Asia—have increased their use of embedded values as a supplementary reporting basis for long-term life insurance business. Embedded values calculate projected cash flows that are distributed to shareholders in a way that is consistent with how similar cash flows are traded on the open market. Embedded values do not include future sales.

The Chief Financial Officer Forum, which brings together leading European insurers, launched its Market Consistent Embedded Values (MCEV) Principles in June 2008. From year-end 2009, member companies will be encouraged to use MCEV as a metric to identify, assess, quantify, and monitor risks. Some companies already use MCEV to make decisions regarding pricing and overall capital allocation. The MCEV principles could strongly influence IFRS Phase II and Solvency II, while allowing companies to road-test a market-consistent approach. Although the uncertainty regarding the applicability of such models to non-life business must be resolved, all three measures ultimately could converge and thereby eliminate the need for supplementary embedded value reporting or disclosure.

Since 2007, International Financial Reporting Standard 7, Financial Instruments—Disclosures (IFRS 7) has required insurers to disclose information about risk management and economic sensitivity to market and other risks, including relevant changes in market indices and the claims environment. Under IFRS 7, companies can disclose internal risk management metrics, such as economic capital or MCEV. Economic capital metrics are fairly common in investor presentations and annual reports, but IFRS 7 is the first standard to require the disclosure of risk metrics in financial statements.

Until recently, the US insurance industry observed most of these international developments from afar. Now, in the wake of moves by the Securities and Exchange Commission and FASB, bodies such as the Group of North American Insurance Enterprises are keeping close tabs on international developments. Of particular note, the SEC recently removed the requirement for foreign private issuers (FPIs) to reconcile their IFRS-based accounts to US GAAP. As a result, most FPIs stopped reporting US GAAP information. To level the playing field, many industry observers think that US companies may soon be allowed, under certain criteria, to use IFRS as their primary accounting standard. In September of this year, the SEC proposed a roadmap for the potential use of IFRS by U.S. issuers. The proposal includes early adoption of IFRS as early as 2009 with potential mandatory adoption by 2014.

Aligning finance, risk and capital management

The convergence of financial reporting and prudential regulation will bring external reporting closer than ever to the internal metrics that companies use to manage their businesses, in particular the embedded value principles used in Europe. As a result, internal reporting needs to be upgraded so that risks presented through the eyes of management are accurate and can be reliably disseminated externally.

Insurers could use the investment in data, systems, and human resources as an opportunity to enhance the speed, quality, and usefulness of their management reporting. A harmonized economic approach to management and stakeholder reporting also could strengthen market confidence by enabling insurers to convey a single view of the businesses that more closely reflects internal operations. The move to this economic approach will create opportunities to align finance, risk, and capital management and develop consistent metrics for strategic evaluation that result in a common language of risk and reward. Operationally, risk and finance can work together to develop consistent reporting, control, modeling, transactional, and data elements (see box below). There also may be further opportunities to leverage predictive analytics for external reporting purposes, such as stress testing risk and reward scenarios used as part of the budgeting and planning process.

However, although greater alignment of these systems can be helpful, we believe full integration would be a mistake as it would obscure the fundamental differences and complementary roles essential to the effective operation of the business. These include distinct areas of expertise: financial management in areas such as tax planning, raising capital, and financial engineering; actuarial in areas such as pricing, reserving, and reinsurance; and risk management in areas such as process improvement and the enforcement of limits and controls.

Steps toward operational alignment

From training to data standardization, closer alignment between risk and finance can help insurers meet the demands of a convergent environment and develop a more incisive economic basis for management. Practical steps to achieve this include:

- **Alignment of the risk and finance functions:** Risk and finance traditionally have had different skill-sets, perspectives, and analytical approaches. Moving away from "black box" analytical outputs to a more mutually intelligible and compatible set of common metrics could help break down silos and foster greater cooperation in business planning and strategic evaluation. Training also could help to lay the foundation for a common understanding—finance teams need to be able to understand risk terms and issues, and risk teams should be familiar with accounting requirements.
- **Create common data warehouses:** Although prudential and financial data requirements may differ, there is sufficient common ground for companies to consider establishing data warehouses or shared service centers to source and reconcile information. Additionally, data from diverse areas within the organization need to be consistent. Risk and economic capital analytical systems also need to be appropriately controlled and comply with an auditable standard.
- **Development of performance evaluation and compensation systems based on risk-adjusted metrics:** In the future, different departments will share skill-sets and assumptions. Measurement of how well a company succeeds in managing risks and attaining targets will be based on the same economic values. Companies may want to develop performance evaluation and compensation systems based on these uniform metrics.
- **Establishment of cross-functional risk and finance governance structures:** The move to Solvency II and IFRS Phase II will require the rationalization of oversight and development of cross-functional accountability that extends to the company's highest level—the board of directors. Where risk and finance functions report to different executives and committees of the board, the creation of jointly accountable structures is likely desirable.

The competitive impact of Solvency II

Although Solvency II in its current form will apply only in the European Union, US insurers are encouraged to pay attention to the factors underlying its developments, particularly their potential competitive impact.

Solvency II seeks to map insurers' regulatory capital requirements against their individual risk profile. This will encourage, if not actually require, companies to enhance risk management, upgrade information systems, and embed risk awareness more closely into the governance, strategy, and business operations. Although it presents a significant implementation challenge, moving to Solvency II could help develop a more informed and forward-looking economic basis for decision-making.

The foundation of the new regime consists of three pillars that are conceptually comparable to Basel II:

1. Quantitative requirements
2. Governance and risk management requirements
3. Disclosure and transparency requirements

Assets and liabilities will be valued on a market-consistent basis, conceptually in line with the latest proposals for IFRS Phase II. The standard solvency capital requirement (SCR) will be based on a 99.5 percent confidence level of remaining solvent within the next 12 months (equivalent to being able to absorb a 1-in-200-year event). The SCR evaluation—broadly equated to a BBB rating—should include all material financial and non-financial risks facing the company. Companies then can determine the amount of capital appropriate to a true economic level and calibrate to the target level to meet their desired rating.

In keeping with Basel II's underlying advanced approach, it is likely that many larger companies will take advantage of the option to use an internal model to calculate their SCR, subject to supervisory approval. For most companies this is expected to result in a lower regulatory capital requirement. Last year's quantitative impact study for Solvency II (QIS 3) found that non-life companies entering SCRs based on their own models achieved on average a 25 percent reduction in SCR over the standard formula. For life companies the comparable reduction was 15 percent¹. Larger groups also can take advantage of lower compliance costs and more flexible capital arrangements by opting for group supervision under Solvency II.

Many industry stakeholders have argued that there has been a disparity between true economic capital and the capital required by traditional regulatory frameworks. In particular, regulatory capital often has been derived from formulas intended to cover a wide range of companies and risk profiles. Because these factor-based calculations do not reflect the specific risks associated with and the effectiveness of the management of individual insurers, they have resulted in capital levels that may exceed what is appropriate for many companies. This results in an additional cost (or "capital drag") because companies are compelled to hold more capital than their risk portfolio otherwise would require on a purely economic basis.

By using their own models, companies can incorporate their portfolios' diversity and diversification with their own experience into a unique but credible capital assessment. They then can apply solvency requirements that are more appropriate to their risks, as well as reduce the disparity between regulatory requirements and the true economic capital they believe they must hold to support their risks. In contrast to Solvency II, US capital requirements are typically based on standard formulas or include calculations based on prescribed assumptions that may be significantly different from the assumption of a 1-in-200-year event.

¹ 'Solvency II – QIS 3 Report,' published by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) on 21.11.07

There are limited provisions to reduce capital based on risk mitigation or diversification between products or marketplaces. Where these risk mitigation provisions exist, their application may be subject to approval by various state regulators. This results in limited and inconsistent application and may impose a significantly larger capital drag than would be expected under the harmonized Solvency II.

The companies most likely to benefit from lower capital charges under Solvency II are larger, diversified insurance groups with effective risk management. Their smaller, less-sophisticated mono-line counterparts may find their capital requirements increase on a relative scale. As a result, European companies may face mounting pressure to restructure—shuffling existing groups, moving to a branch structure, or exiting high risk or discontinued lines that may absorb too much capital—to obtain benefits from Solvency II.

Capital drag affects the pricing and profitability of insurance products. For example, if a company prices a product to achieve a 15 percent return on economic capital and earn 5 percent on any capital in excess of economic capital, then a solvency regime that requires only 100 percent of economic capital would realize this 15 percent return, while provisions requiring 110 percent of economic capital would result in a 14.1 percent return on invested capital. If a company subject to US regulations and a company subject to Solvency II were to offer a life insurance product with identical assumptions and features, then the return on investment for the US-regulated company would be lower or the company would have to charge a higher price to realize the same return. This would be solely due to the costs associated with holding a higher-than-necessary amount of capital.

Companies naturally will seek ways to take advantage of less onerous capital regimes. For years, they also have been entering into financial treaties or agreements in order to avoid or defer high liability or tax requirements; this has been the primary factor behind the growth of the reinsurance sector in Bermuda, Luxembourg, the Cayman Islands, Ireland, South Carolina, and Vermont. However, certain costs, including

the expense of establishing and maintaining subsidiary companies, fees paid to other entities, charges associated with the treaties themselves, and possible lack of transparency, have accompanied relocation to these markets. In addition, the level of available credit is another constraint with respect to liabilities. Many treaties or agreements are accompanied by a letter of credit or surplus note equal to the liability credit. The availability of credit can be limited in jurisdictions with more favorable regulatory arrangements, which, coupled with the recent credit crunch, have increased costs and slowed transactions.

Despite the costs, letters of credit, surplus notes, and other arrangements are increasingly used in situations in which additional expenses are more than offset by the savings associated with removal of unnecessarily high liability or capital requirements. If insurers that sell products in the United States efficiently transfer risk and capital requirements to a subsidiary operating under Solvency II requirements, then they may be able to reduce excess capital requirements and increase overall profitability and return on equity.

The potential effects of Solvency II in the U.S.

Developments in the pipeline in the United States may help some insurers to reduce the costs of more onerous domestic capital requirements, but they may not be sufficient to offset the advantages European insurers may realize under Solvency II. If, as anticipated, Solvency II leads to markedly lower capital charges for some companies than those applicable in the United States, then the Europeans will hold a significant competitive advantage.

Effective and forward-thinking US reform could eliminate these disparities. Although this may seem unlikely to many in the industry, there are encouraging signs: Recent developments, such as the Variable Annuity Commissioners Annuity Reserve Valuation Method (VA CARVM) and NAIC participation in Solvency II discussions indicate that US regulators are interested in certain aspects of Solvency II. In addition, the concept of a federal insurance company charter—something which US Treasury Secretary Henry Paulson supports—once again is a topic of serious discussion.

The combination of external competitive pressures, internal pressures for financial reform, and insurers' increased discipline in assessing and measuring risks indicates that the industry's and regulators' risk management focus is evolving toward more flexible and less onerous capital requirements. Successful Solvency II implementation may be enough to push US regulators to seriously consider an approach with comparable advantages.

The complexities of IFRS Phase II

The IASB is keen to ensure that the eventual IFRS Phase II standard adheres to its overall framework for financial reporting and is consistent with the standards for other industries. The IASB also wants the eventual standard to account for the substance of a contract as opposed to its form, which the IASB interprets to mean focusing on the rights and obligations created by the contract. These parameters mean that the discussion paper has had to break new ground by addressing issues that existing accounting practice has not had to confront. The result is a single model based entirely on estimated future cash flows for all types of insurance contracts.

The following paragraphs describe how some of the potential complexities resulting from the discussion paper, which focuses on future cash flow measurement, might affect universal life contracts commonly sold in the United States. Current US GAAP for such policies establishes a liability based on accumulated past cash flows. The complexities arise from trying to determine which future cash flows should be recognized in accounting measurements under the IFRS model.

Accounting for universal life under a new financial reporting model

Universal life policies are contracts with terms that are generally not fixed with respect to premium amounts, mortality and expense assessments, or benefits accruing to the contract holder. These products continue to be among the most popular individual life products for consumers in the United States because of their flexible terms. However, the flexibility in both insurers' and policyholders' options has created additional stress on the discussion paper model. In particular, the evaluation of which cash flows meet the IASB's definitions of rights and obligations, and subsequently should be recognized as assets and liabilities under the IASB framework, is one of the most complex and difficult issues in developing an accounting model for insurance contracts.

Typical universal life cash flows include premium payments received from the policyholder and benefit payments triggered by a withdrawal or insurance event. In many contracts, the amount of premiums to be paid on a periodic basis is at the policyholders' discretion. The benefits ultimately paid by the insurer reflect the balance of net accumulated premiums received, less deductions for mortality and expense assessments, with additions for interest credited to the account. The assessments and interest credited are determined by the insurer at its discretion within contractual maximums and minimums. If the net accumulated balance goes to zero, the policy typically will lapse, and the coverage will be lost.

The difficulty in defining the proper accounting model is determining which future premiums and future benefits payments are rights and obligations under the insurance contract and, thus, require recognition on the balance sheet. Some observers believe that expected future premiums and benefits could be viewed as the result of an established business relationship started at the inception of the contract. However, other observers believe that they may not be recognized under the discussion paper model until later.

Questions to consider when implementing an IFRS framework

To consider the question of the obligations of the insurer first, the rough definition of a liability in the IFRS framework is the ability, created by a past event, for someone or something outside of an insurer's control to take something of value from it. In this case, if the policyholder elects to withdraw or dies, the insurer must pay a claim or death benefit. However, the amount to be paid depends on decisions (some within the insurer's control and some not) made before that date by both the insurer and policyholder. A number of implementation questions arise:

- Do the future cash flows that currently bind the insurer (current obligations outside of insurer's control) include only those benefits based on the company acting in its most advantageous contractual manner, such as maximum mortality and expense charges and minimum crediting rates?
- If so, should the measurement of those cash flows assume what the policyholder would hypothetically do if that insurer behaved in that way or should expected lives of contracts be used even though such insurer behavior is not expected?
- Should "most advantageous manner" be looked at more broadly, such that it may be more profitable for the insurer to behave in a manner that maintains the policyholder's good favor and encourages the policyholder not to withdraw (accounting theorists call this economic compulsion)?
- What if the policyholder has the ability to increase benefits by paying a larger premium without the insurer being able to check the current health of the policyholder? In that case, how much accumulated premium should the insurer assume in calculating the benefit?
- Does the insurer assume that unhealthy policyholders will maximize this option to purchase additional insurance?

These questions illustrate the complex implementation challenges of developing an accounting model that fits the IFRS framework and is consistent with other similar transactions. One such analogous transaction that people turn to in evaluating these questions is a common stock dividend, which also creates an obligation. There are certainly expectations and economic compulsions to pay future dividends if that has been the company's past practice, but the IFRS framework would say that a dividend is not an obligation until the board of directors declares the current period's dividend. As a result, no liabilities would be recognized relating to probable future dividend declarations. Most insurance company's internal projection models and financial statement users' models project cash outflows using a best estimate of what companies and policyholders would be likely to do. The IASB, in an effort to bridge the gap between the framework and users' needs, is debating whether economic compulsion rather than contractual minimums represents the best measure of an obligation.

Exploring premium questions

Similar issues exist with premiums. The definition of an asset under the framework typically would prohibit recognition of a cash flow the other party did not have to pay if it did not want to. In the preliminary conclusions of the IASB discussion paper, universal life premiums from policyholders are not regarded as being different from any other insurance contract premiums. Accordingly, it would be consistent with the accounting treatment of those products to consider the future cash inflows of universal life products as future premium payments from the policyholder. The issue is that policyholders would not have to pay any more premiums. In some cases, the policy would lapse if the policyholder did not pay them; in other cases, the benefits would change. In all cases, the policyholder could not be forced to pay future premiums. The IASB's preliminary conclusions are that the obligation should be reduced by the future premiums that must be paid in order for the policyholder to receive the benefit. However, the IFRS framework does not have room for an obligation to become negative or, in other words, become an asset without having to run through the separate asset definition.

Why is the inclusion of these future premiums in excess of future obligations so important? Insurers pay money every day to distribution networks or secondary market sellers (reinsurance or business combinations) to enter into universal life policies. This indicates that something of value is created when entering into a universal life contract. As the preliminary model is based on measuring future cash flows, transaction monies spent on distribution or other third parties will be expensed immediately. If the preliminary model assumes avoidance of a day one loss on entering into an expected profitable contract, then at least some portion of the future premiums in excess of the future cash outflows should be recognized to offset these expenses.

The discussion paper introduces a test to recognize future cash flows called "guaranteed insurability." Essentially, the discussion paper tries to determine which future cash flows are based on a customer relationship that is not generally recognized as an asset under IFRS, and which future cash flows are contractual and can be recognized as assets immediately. The test says that the accounting model can recognize as assets those future premiums that policyholders must pay to maintain insurance coverage at a price that is contractually constrained without the insurer reconfirming the policyholder's risk profile. This is not only a mouthful to say but it is also difficult to implement, even for simple contracts. And, in some IASB members' views, this test is contrary to the basic IFRS framework.

The flexibility of universal life adds to the complexity of guaranteed insurability concept. The amount of premium a policyholder must pay to keep the policy death benefit in force depends on the accumulated account balance which, in turn, is dependent on assessments and credits for which the insurer has discretion within contractually established ranges. Because the assessments and credits have contractual ranges, they are contractually constraining to a degree. Few policies allow the insurer to change the assessments or crediting rates for an individual policyholder based on current knowledge of the health of the policyholder.

Therefore, it is reasonable to conclude the insurer should recognize certain potential future premiums in the financial statements using the IASB criteria. All the questions regarding the obligation come into play here as well. Should the measurement use contractual minimums and maximums for charges and rates? If so, should the assumptions be based on the insurance company maximizing the premiums the policyholder must pay or the policyholder minimizing the premiums they could pay? In addition, the assumptions for calculating these

future premiums and whether they are consistent with the assumptions used to calculate the obligation portion of the measurement also come into question. This argument can be made because both rights and obligations will be added together to become the financial statement measure of the insurance contract.

The FASB eventually abandoned its deliberations of universal life accounting and created its SFAS 97 accounting model. This model was not based on future cash flows and therefore was unlike other insurance accounting methods that were based on the present value of future benefits less the present value of future premiums. Instead, the SFAS 97 model is based on the view that the only fixed item in the present obligation is the amount that has accrued to the benefit of the policyholder to date, i.e., the accumulated account balance. This break from the existing models has made US GAAP more complicated to apply and more difficult for financial statement users to understand because companies sell different types of policies that fall into different accounting models. To deal with the day-one loss caused by acquisition costs, the FASB allowed for the deferral of these costs with amortization over the life of the contracts. IFRS tries to steer clear of this mechanism for avoiding a day-one loss because it is not a measurement based solely on future cash flows.

At a recent meeting, an IASB staff member mentioned that the issue of the boundaries of a contract is one of the two major stumbling blocks in completing the project. The other potential stumbling block is the recognition of day-one gains. The IASB and the insurance industry continue to explore alternatives to the guaranteed insurability and constructive obligation concepts. The goal is to bridge the need for users to have less complex accounting that reflects the economics of insurance transactions with the equally relevant concepts of consistency across industries and transactions.

What this means for your business

The way forward

The prevalent perception is that the insurance industry is slow to change. However, there is a growing consensus that the industry is on the verge of a financial reporting and capital management revolution. Regardless of the opinions one has held, there is no doubt that the industry is about to undergo significant changes in both the basis of its financial reporting and in the way solvency is measured. Forward-looking management should develop strategies to take advantage of the opportunities created by the global convergence of reporting and risk measurement to an economic-based approach. Management also must assess the competitive challenges and risks, such as those the discussion paper and Solvency II raises.

Better alignment of financial reporting, capital management, and risk management will result in the simplification of the reporting, control, modeling, transactional, and data elements used in the risk and finance functions. The potential benefits to insurance companies include:

- Enhanced efficiency through shared services and data warehousing;
- Improved business processes for strategy, planning, and valuation;
- Increased opportunity to develop robust financial plans and projections; and,
- Reduced direct and indirect costs and the elimination of inefficiencies and duplication.

Most importantly, insurance companies will benefit from a coherent and consistent view of the business through the development of the risk and finance functions. Management will be able to better define its appetite for earnings volatility as it considers the ranges of upside and downside outcomes. And as management considers the potential outcomes, it will be able to make faster, more informed decisions based on the common data used by the aligned functions.

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