CBO and HCFA Dispute Catastrophic Care Costs

by George Soules

As the Senate debates their version of the catastrophic health care bill recently passed by the House, another less-publicized confrontation has been taking place between officials at the Health Care Financing Administration (HCFA) and the Congressional Budget Office (CBO). At principal issue are estimates for a costly prescription drug benefit that likely will become part of the final bill package. The volatility of the drug provision has threatened a presidential veto, and at the Office of the Actuary at HCFA there is concern that the premium amount set by CBO is "inadequate" to fund the expanded coverage.

"It's going to be a catastrophe from the taxpayer's standpoint," said Roland E. King, chief actuary at the Office of the Actuary, HCFA. "The premium (that is supposed to pay for our estimate is ten times that of CBO's. Our estimate for the drug benefit alone is $920 (per month)." Should the premium currently set by CBO remain unchanged, King said that the Supplemental Medical Insurance (SMI) program, financed by Medicare beneficiary premiums and general revenues, will be "endangered."

Drawing from a proposal developed by Health and Human Services Secretary Otis R. Bowen, H.R. 2470 seeks to protect 31 million elderly and disabled from "catastrophic" doctor and hospital bills. Under both the House and Senate versions, the costs for this expanded coverage would be financed through increased premiums for beneficiaries under Medicare Part D. In the house bill, Medicare enrollees would pay an additional $2.60 a month beginning in 1989; the rest would be financed through an income-related premium. Although Medicare does not currently pay for outpatient prescription drugs, it is estimated that 5.5 million beneficiaries incur more than $8500 a year in out-of-pocket drug costs. The House drug benefit would pay 80% of the cost of these drugs after a beneficiary exceeds a $500 deductible.

CBO and Administration estimates for the main "catastrophic" portion of the bill are not far apart, but widely differing cost projections for the drug benefit have generated uneasiness on Capitol Hill regarding the feasibility of including such a benefit. CBO has estimated the 1990 cost of the House drug benefit at $1.6 billion; the Department of Health and Human Services puts the figure at $6 billion.

Accounting for this disparity are differing assumptions used by CBO and HCFA in arriving at the current and projected cost per capita for prescription drug use. Dan Waldo, special assistant to the director of the Office of Cost Estimates, Office of the Actuary, HCFA, said that CBO being called on the carpet for their initially "low and slow" estimates represented a "unique occurrence" in the recollection of members of his agency. CBO's first estimate of $160 (1987 cost per enrollee for prescription drug use) was based primarily on a National Health Expenditures Survey that measured drug consumption for the total population; it involved a different pattern of consumption from that of the aged and therefore, according to Waldo, could not be considered a reliable gauge of elderly drug spending.

Also considered was a study undertaken by Gordon R. Trapnell, formerly with the Office of the Actuary, HCFA, now president of the Actuarial Research Corporation. His study, independently commissioned by the Villers Foundation, a public interest group, weighed in with a $260 annual estimate, derived from a more extensive data base than CBO's. Trapnell's estimate was lower, ultimately, than HCFA's $310 figure, because it did not include data about drug use by the disabled, nor trends in cost per prescription.

After noting these results, CBO added to their data arsenal other sources, among them the 1984 Consumer Expenditure Survey (CES), a national household survey of out-of-pocket drug consumption. However, both Waldo and King of HCFA objected to CBO's strong reliance on the CES study. Waldo asserted that as a public interest group, weighed in with the Office of the Actuary HCFA, Trapnell's study was lower, ultimately, than HCFA's $310 figure, because it did not include data about drug use by the disabled, nor trends in cost per prescription.

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The Actuarial Update

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Progress Report

The Academy's 1987 Annual Meeting is nearly upon us. As we draw to the close of another year, it seems appropriate that we pause for a few moments to take stock of the many projects that the Academy has undertaken. Most of them are of an ongoing nature. Changes tend to be gradual; as needs arise, they are carefully assessed and discussed before any action is taken to address those needs.

What follows is a brief rundown of several of these significant projects.

Actuarial Standards Board (ASB). Our hope is to have the ASB fully operational by mid-1988. The Interim Actuarial Standards Board (IASB) has been our proving ground and has operated successfully for over two years.

In addition to a nine-member IASB, there are five operating committees, each representing a broad arena of actuarial practice: casualty, health, life, pension, and specialty—latter category being for those subjects that do not fall clearly into one of the other divisions. These operating committees prepare proposed standards of actuarial practice, which are passed on to the IASB for approval and exposure to the membership. During the interim period the Academy Board must also approve suggested standards before they are adopted. Once the ASB is fully operational, approval by the Academy Board will be eliminated, giving the ASB final authority for promulgation. All proposed standards will be submitted to our membership for comment. This all important exposure process is the chief means by which each of you can play a part in standards setting. I urge you to get involved, since you will be expected to conform to any final published standards. At present, three standards have been adopted, another one is out for exposure (with a comment deadline of October 13), and over a dozen more are in the pipeline.

Valuation Actuary. Steady progress has been made by all our actuarial organizations in educating actuaries and the public on the desirability, perhaps even the need, to have a valuation actuary responsible for giving advice to management or the public on the solvency of an insurance company operation. Initial opposition to this proposal has been replaced by support from many inside and outside our profession. However, there are still many important details to be worked out. The Symposium on the Valuation Actuary, which was held September 30 and October 1, furthered the debate and dialogue that is the fabric of this educational process. We look forward to the day that this general concept is fully endorsed by the National Association of Insurance Commissioners (NAIC) and the insurance community as a whole.

Continuing Education. A major undertaking of the Academy and of the other actuarial organizations is providing programs for the further education of our members. Generally, this takes the form of publications, meetings, seminars, cassette tapes, and the like. Each of the actuarial organizations has its own continuing education programs, but more and more progress is being made toward joint efforts and coordination of activities. For example, many meetings are co-sponsored by two or more actuarial organizations. As you know, we join with the Conference of Actuaries in Public Practice for the Enrolled Actuaries Meeting and with the Casualty Actuarial Society for the Casualty Loss Reserve Seminar.

The Conference of Actuaries in Public Practice is running a program that gives public recognition to its members who meet certain standards of continuing education through attendance at meetings, for example. The Academy has a similar program under consideration which, at this writing, will be exposed to members shortly for comment. Naturally, we are monitoring the activity of the Joint Board for the Enrollment of Actuaries, which has announced its intention to come forward with a program for compulsory continuing education.

Government Relations. This is another on-going major activity of the Academy. However, none of us at the leadership level, officers, or staff, believe that we are doing all that we should be doing at the state or federal level. The Executive Committee has approved the hiring of an actuary to the position of director of government relations to give more emphasis to this program. Recommendations have also been made on how we might get a better handle on what is happening at the state level. We hope to strengthen this operation as much as is currently going on. Our relationship with the NAIC is very good, and we are keeping better track of state laws affecting actuaries. The Actuarial Update, the Issues Digest, the "Government Relations Watch," and the Academy Alerts subscription service all keep our members apprised of federal and state developments and of our activities in this area.

Other. The actuarial profession in North America will celebrate 100 years of (continued on page 5)
Real Interest Rates and Pension Valuations

Anthony C. Deutsch does me an injustice in his letter in the August issue when he states that the true purpose of my article on real interest rates experienced under several pension plans was "to refute the argument that individuals can do better under various money purchase arrangements than Social Security." I plead guilty to "fervent advocacy of the Social Security system," but when I do actuarial research such as this, my underlying purpose is "to substitute facts for appearances and demonstrations for impressions."

Actually, the real purpose of my research, which was not to prove a point but rather to investigate the situation, was to see what real interest rate would be appropriate for determining the relative adequacy of the pensions developing under a Lutheran church pension plan. The discussion of real interest rates in connection with the Social Security system was merely an after-thought. I sought to obtain actual experience data for as many pension plans as possible. As to what real interest rate should be assumed in private pension valuations, I concur that 1% is probably too low, but I believe that any rate above 3% is imprudent. In developing assumptions, actuaries should look not only at past experience, but also at the current trends and likely long-range possibilities. However, they should not be near-sighted and look only at the current and the likely short-range situations. Bear in mind that, rightly or wrongly, government action (and not merely economic theory) can have a significant effect on interest rates.

Robert J. Myers
Silver Spring, Maryland

I agree considerably with Anthony Deutsch (The Actuarial Update, August 1987) that actuaries frequently tend to ignore current reality in their assessment of future events. However, he uses the words "...high real rates of return..." as an apparent justification for using somewhat higher interest rates in a pension valuation. Up until now I had assumed that the term "real interest" was an invention of the economists to justify their bad 1982-1984 predictions that the enlarged budget deficit would force interest rates up. It amazed me at the time that so many economists did not know that interest rates were under the full control of the Fed if they wished to exercise that control. At any rate, there has been no agreement as to the best specific definition of "real" in such a context. There seems to be no consensus as to the specific calculation formulas to use and no agreement as to which of a dozen types of cost-of-living series should be used.

With such an unanswerable situation, it seems to me that nominal interest rates, not real interest rates, should be used in any pension valuation. I would appreciate knowing if I am wrong. Funding a pension with real dollars and paying off in actual dollars would be most interesting.

I am opposed without limit to Deutsch's final paragraph. I have had extensive correspondence with Bob Myers in which I claimed that no current decisions should be made based upon a seventy-five-year cost estimate, even if you renamed it a seventy-five-year cost projection. Myers and I still disagree on this, but I must say that I never argued with anyone who was more objective, as I understand that term.

On the other hand, I understand Deutsch to say that Myers believes in Social Security and that prevents him from being objective whether his arguments...may or may not be right or wrong...". I have just written a new definition in my little black book: "The man who does not care whether his opponent's arguments are right or wrong and still says that they lack objectivity, may know all about prejudice, but he cannot be a good judge of objectivity."

Charles M. Larson
Whittier, California

Nerd Discrimination

The July 1987 issue of The Actuarial Update carried a cartoon entitled "A Few Moments with an Actuary." Personally, I found the cartoon offensive. It betrayed a racist insensitivity that too often remains hidden in actuarial circles. If it was meant as a joke on actuaries in general, it concerns me that...
CATASTROPHIC CARE DISPUTE (continued from page 1)

Don Muse, principal analyst for Medicare and Medicaid at CBO, scoffed at the suggestion that his agency's estimates are sacrosanct. "Our estimates are usually challenged every day," he said. He acknowledged that CBO's methodology "builds off the 1984 CES study; however, that study's limitations did not pose "that much of a problem," since he also included "homogenized" data from the 1980 National Medical Care Expenditure and National Medical Care Utilization and Expenditure Surveys, as well as the 1977 Current Medicare Survey, to arrive at CBO's $250 cost per enrollee estimate. Muse asserted that at least half of the difference between CBO's and HCFA's figures could be attributed to how the "mean and distribution" of aged drug spending was defined, with his agency taking a conservative approach.

Waldo of HCFA argued that CBO's "incorrect figure" was due to their failure to acknowledge how mean drug spending and the distribution of that spending has changed beyond what can be explained by mere inflation. "Consequently," he writes in a September 1987 issue of HCFA Review, "a correct modeling of prescription drug use must take into account trends in price, use, and distribution of that spending."

Other factors accounting for CBO's lower estimate, according to economist Muse, include the setting of reimbursements, the percentage of increased drug utilization, and the fact that, unlike other Medicare premiums, the catastrophic bill proposes an outlay rather than an incurred premium. Of CBO's and HCFA's differing interpretations of these aspects of the bill, Muse commented: "We don't think that in this new system, that two people have to do something, and get it right, for money to flow out of the federal treasury."

Reconciling the differences in this behind-the-scenes cost dispute appears unlikely as the spotlight now focuses on the Senate Finance Committee's handling of the catastrophic health care measure. "We're not going to compromise," said HCFA's King, pointing out that yet another prescription drug use study could show that the Administration's figures are too low. "In which case, we would have to raise our estimates," he said. Nevertheless, King added: "It is almost inevitable that there will be a prescription drug benefit of some kind."

In that event, and assuming that Congress does not significantly raise the premium amount, the percentage of federal revenues required to continue funding the SMI program "will go even higher" than the current 75% figure, King acknowledged. He envisions a scenario whereby the Department of Health and Human Services sets a "catastrophic" premium based on HCFA's estimate. Congress then is forced to lower that premium, resulting, ultimately, in increased government funding of SMI. "The ironic part of it," concluded King, "is that since the House bill shifts the financing of the home health benefit from Part A to Part B, the Hospital Insurance program will be better off than it would have been." Δ

ERRORS AND OMISSIONS QUEST (continued from page 4)

Tillinghast's recommendations, which were adopted by the task force, were (1) to select Marsh & McLennan of New York to pursue a group purchase program, and (2) to send out a short questionnaire to determine if there was the required economic commitment to start a risk retention group (i.e., to start our own insurance company).

Marsh & McLennan has been unable to put together a group errors and omissions insurance program for actuaries. The questionnaire results indicate that the potential insureds are simply not willing or able to make the economic commitment required to form a risk retention group.

The problem of putting together a group errors and omissions insurance program is the problem facing a risk retention group: this is a low-frequency, high-severity risk. In other words, while there are very few claims per thousand actuaries, there is the potential for very high losses and defense costs on the few claims that occur.

The joint task force estimates that there are approximately 1,000 firms, representing approximately 2,000 actuaries, that could potentially participate in this program. These are the medium- and small-sized firms. The large firms are not interested in participating.

Of these approximately 1,000 firms, about half either have coverage they are happy with or are not interested in purchasing errors and omissions insurance. This leaves about 500 firms, representing about 1,000 actuaries, which would participate in any errors and omissions insurance program.

The estimated premium for such a group is between $1.5 and $5.0 million. The desired coverage is $1 million per occurrence, with deductibles no higher than $5,000 per occurrence. It is not economically sound to have 500 policies covering 1,000 actuaries with almost $5 million exposed on each occurrence without a strong economic base. This requires participation by large reinsurers for either a group program or risk retention group. In addition, a risk retention group requires a capital base of at least $750,000 (and preferably much higher), with the amount depending on the reinsurability available.

Additional problems are that many of these firms have actuaries who are doing other than "pure" actuarial work and consultants who are not actuaries. Examples of the former are pension plan administration, data processing, expert testimony, and investment counseling. The latter include claim administration and risk management consultants. Any policy addressing errors and omissions for a firm with consulting actuaries must include coverage for these additional activities in order to be practical.

The property/ liability insurance market has recently begun to loosen up for other types of insurance. Although the joint task force expects the availability of errors and omissions insurance to increase soon, it is still working with Marsh & McLennan to put together a group program to reduce costs and stabilize availability. The change in the insurance market should increase the chance of putting such a program together. We'll keep Update readers posted.

Tiller chaired the Conference task force on errors and omissions insurance and currently chairs the joint task force.

1987 Annual Meeting Notice

The 1987 Annual Meeting of the American Academy of Actuaries will take place November 16-18 at the Hyatt Regency Hotel in San Antonio, Texas. This year's annual meeting is being held in conjunction with the annual meeting of the Casualty Actuarial Society. The Academy-sponsored portion of the program comprises a business session on Tuesday, November 17, at 8:30 in the morning, followed by a panel discussion entitled: "The CAS and the AAA: Working Together." For more details, check the annual meeting enclosure with this issue of The Update.
members of our profession are considered mindless, socially inept babblers of statistics.

Having lived for several years in Hartford, and having some relatives among the minority community in Hartford, I hardly consider their problems to be a joke or their condition to be a source of humor for the actuarial community.

I demand that you respond to these concerns.

Willard W. Witherspoon
Philadelphia, Pennsylvania

Editor's Note: The cartoon to which Witherspoon refers is by Bob Englehart, a political cartoonist on staff at The Hartford Courant. We asked Englehart to respond to the allegations of racism and a less-than-flattering portrayal of actuaries. Here is his reply.

Englehart: "My cartoon, 'A Few Moments with an Actuary,' was my comment on a news story that appeared in The Hartford Courant, reporting that the minority infant mortality rate in Hartford is among the highest in the country. And to my knowledge, this community has no creative programs to deal with what is clearly a terrible situation.

"As far as my decision to use an actuary to make my point, well, I live in an insurance capital. Actuaries are the brains and the number crunchers here. I portrayed the actuary as a nerd, because actuaries are nerds. There's nothing wrong with being a nerd. This self-hatred among nerds has got to stop! You people with bow-ties, thick glasses, and ears that stick out should be proud."

Home Run

A baseball book review in The Actuarial Update? Now I have seen everything! Yes, we actuaries (and lawyers) are a versatile lot. I will be heading to the book store just as soon as I leave the office today.

Norton W. Chellgren
Hartford, Connecticut

Errors and Omissions Insurance for Actuaries: The Quest Continues

by Margaret Wilkinson Tiller

To date, despite exhaustive investigation, a Joint Task Force on Errors and Omissions Insurance established by the actuarial profession in North America has been unsuccessful in establishing a group purchase program for errors and omissions insurance for actuaries. The joint task force has been reporting regularly to the Council of Presidents since 1985.

With the advent of the last tightening of the property-liability insurance market, which began in 1984, many insurers ceased to write errors and omissions insurance for actuaries. Other insurers decided to write errors and omissions insurance only for the actuarial firms they already insured for this coverage.

As a result of the availability problems, the Conference of Actuaries in Public Practice created a task force to investigate the possibility of putting together a group errors and omissions insurance program. As a first step, this task force sent out an extensive questionnaire to chief actuaries of consulting firms with members belonging to at least one of the organizations represented on the Council of Presidents. Tillinghast evalu-

(continued on page 6)
FROM THE PRESIDENT (continued from page 2)

growth and challenge in 1989. A gala celebration is being planned for June 12–14, 1989. Elaborate plans are already underway with many committees actively at work planning both business and social activities.

Health care is a major topic on our agenda, and we have several committees working on various aspects of the many issues involving health care. One task force, for example, is examining just what role actuaries should play in this broad field.

The Board of Directors recently appointed a task force to consider the publication of an actuarial magazine both for our profession and other publics as well. It is hoped this magazine would bring our profession and our talents to the attention of many outside the field, including business executives, lawyers, accountants, government personnel, and financial advisors, to name a few. It is likely that classified and display advertising will be included both as a service to readers and as a source of income.

There are a number of important, even vital, Academy programs (like our public information outreach activities) that are conspicuous by their absence from this editorial. I in no way intend to diminish them by their absence. The column inches I have been allowed simply do not permit a recitation of our progress in every major program area.

Finally, a “thank you” to all of you as you have made my career as an actuary a most rewarding one.

Legal Lines

by Gary D. Simms

Treasury Circular 230: Another Perspective

Most enrolled actuaries are familiar with Treasury Circular 230, a document that sets forth the rules governing practice before the Internal Revenue Service (IRS). It contains specific provisions allowing EAs, by virtue of their enrolled status, to represent clients before the IRS in pension matters. As a sidenote, the Academy is now completing a review of these provisions to ascertain whether the manifold tax revisions of recent years have created a need for amendment to the existing list of Internal Revenue Code sections under which the enrolled actuary is granted practice status.

Almost one year ago, proposed amendments to Treasury Circular 230 were promulgated by the Department of the Treasury. The preface to the document indicated concern on the part of Treasury officials as a result of an increasing volume of complaints regarding tax preparation and advice. And the liability of tax estimates reported by taxpayers. The proposal was a direct link to the so-called penalty provisions of Section 6661 of the Internal Revenue Code. That section levies a penalty against a taxpayer for “substantial understatement” of tax liability, and the penalty is imposed regardless of intent. The penalty is subject to waiver, however, on a showing of both reasonable cause and good faith by the taxpayer.

The Treasury Circular 230 proposal would mandate practitioner diligence in preventing under-reporting of tax liability. In particular, the notice of proposed rulemaking would require the practitioner to undertake, as an affirmative duty, the following (proposed Section 10.34):

1. A practitioner must advise a client fully about the addition to tax provisions of Section 6661 of the Internal Revenue Code with respect to the return if, in the exercise of due diligence, the practitioner determines that the taxpayer filing the return may be liable for an addition to tax under the section as a result of a position taken with respect to the tax treatment of any item on the return.
2. A practitioner may not advise or recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless in the exercise of due diligence the practitioner determines that the taxpayer filing the return will not be liable for an addition to tax under Section 6661 of the Internal Revenue Code as a result of the position; and
3. A practitioner may not prepare or sign a return unless in the exercise of due diligence the practitioner determines that the taxpayer filing the return will not be liable for an addition to tax under Section 6661 of the Internal Revenue Code as a result of any item on the return.

The impact of the proposal is clear. A practitioner would be subject to disciplinary action for failing to exercise “due diligence” as described in the proposed regulation, subjecting the practitioner to potential suspension from practice. If a taxpayer was found to have understated tax liability, an inference could be drawn that “due diligence” was not exercised by the practitioner.

On one hand, the Treasury Department's proposal can be viewed as an attempt to establish clearer standards against which a practitioner's actions will be measured in the computation and preparation of taxpayer returns. On the other hand, the proposed regulation would impose on the practitioner a potential liability for the accuracy of taxpayer information, made more chancy by the fact the “fault” (the imposition of the penalty) is not necessarily based on misconduct or negligence.

Further information on this matter will be reported in this column when available.

Star Gazing

At the time I graduated from the University of Iowa, actuarial science was a part of the Department of Mathematics and Astronomy. It was bound to happen. The reply to one of my job application letters came back addressed to the Department of Mathematics and Astronomy.

Dr. Byron Cosby got one of his better laughs when I showed him that one.

—Burness R. Eiler