FSLIC: Governmental Insurance Gone Awry
by A. Frank Thompson

The savings and loan or "S&L crisis" erupted into public view last summer when, after a General Accounting Office audit, the Federal Savings and Loan Insurance Corporation (FSLIC) was declared financially insolvent. The FSLIC is the insurance organization created by the federal government in 1934 through the National Housing Act to provide coverage on deposits at savings and loan associations (S&Ls).

The public considers the FSLIC a deposit insurer, whereas the FSLIC is managed more as a government guarantee fund. FSLIC managers have never embraced actuarial principles of premium calculation, reserve development, underwriting, or claim settlement in administering the depository fund. However, regardless of whether the FSLIC is viewed as an insurer or a government guarantee fund, the current funding difficulties facing the FSLIC require the underwriting, claim settlement, and premium techniques used by private insurers. Published reports indicate that the FSLIC may have $100 billion in unreserved losses and may be losing about $1 billion per month on insolvent S&Ls, which cannot be closed due to lack of FSLIC funds. Failure to employ insurance-related methods may ultimately lead to larger losses than the $100 billion already estimated.

Over the last six months, the estimates of FSLIC losses have escalated because of the lack of a consistent and reliable method for assessing the costs attributable to failed S&Ls. Present estimates appear to be based on the amount by which current liabilities exceed tangible assets (i.e., the negative tangible net worth). A major portion of the assets in the failed S&Ls consists of mortgage participations and direct investments with questionable values. The numbers used to calculate FSLIC losses on closed S&Ls come from the Quarterly Thrift Report, compiled from data provided by each operating S&L every quarter. The data on tangible assets for insolvent, but still operating, S&Ls are provided by the managers of the insolvent institutions. These figures are neither given uniformly for all failed S&Ls nor credible from the standpoint of being independently produced. Without an outside party calculating the value of the S&L assets and liabilities on an actuarial basis, the current estimation procedure may be subject to wide fluctuation over time.

The FSLIC appears to have gotten into this crisis because of its failure to recognize and underwrite depository risks. Beginning in 1980, and continuing to the last session of Congress, banks and S&Ls (continued on page 4)
From a Guest
President

Howard M. Phillips

A Letter to a Son on His Way to Becoming a Pension Actuary

Last fall, I deposited my son at a well-known midwestern university to begin his four-year college experience. I spent a good deal of time with him before he left, discussing career goals. Well, I received a letter from my son after his first few weeks at school, and in that letter he told me that, after thinking about all of our discussions and examining all that is offered to him at the university, he has decided to become a pension actuary. With your permission, I would like to share with you a portion of the letter I mailed to my son in response to his announcement.

Dear Gary:

Your mother and I are very pleased to learn that you are happily settled in and have enjoyed your first few weeks of college. I was also pleased to learn that you have come to a decision with respect to a career goal. However, I unhappily must tell you that you may have made a poor choice.

Let me share with you some of the reasons why you may need to rethink that decision. Although I enthusiastically embraced my career decision twenty-eight years ago, in many respects being a pension actuary is just not fun any more. As you know, I have always approached my work as an effort to provide efficient, accurate, and timely service to my clients. That objective has been stymied by outside interference.

You know that I am vehement with regard to the "keep it simple" philosophy. Imagine my frustration with the following example of an actuary's working life. You have learned enough about actuarial mathematics from me to know that a good deal of my profession is based on interest rates. You also know that an enrolled actuary I am legally authorized to do things for clients that involve selecting interest rates. What you do not know is that today the law has grown to be so complex that I must be involved in selecting and using several different interest rates, each with a different meaning, each with a different application, and each totally misunderstood by my clients. So whereas ten years ago one in my profession would talk about an "interest rate," today that same individual must be thoroughly familiar with a valuation interest rate, an actuarial equivalence rate, a PBGC interest rate, a Section 415 rate, a participant loan rate, a FASB rate, and a federal midterm rate.

There are probably infinite examples demonstrating how Congress has made my colleagues' lives and mine miserable. Recently, two senators drafted a resolution to charge a 60% excise tax on certain distributions made from pension plans, an increase from 10%. Although the resolution may go nowhere, such a resolution is confiscatory and Draconian, and it demonstrates clearly how some of our representatives in Congress just do not understand the private pension system.

However, back in 1980, a presidential commission on pension policy was formed and did some good work, coming up with a number of sound recommendations with respect to a national retirement income policy. So, I admit to you that I cannot be totally negative with respect to your career decision. If I were ready to give up the career of a pension actuary, I would not have accepted the president's position with the American Society of Pension Actuaries for 1989. I do have some genuinely positive feelings about the near-term future of our profession. In addition to the national retirement income policy that still has to be finalized, sheer demographics make me optimistic.

The seventy-five million "baby boomers," who represent one-third of the workforce in body count, and almost half of the workforce in total income, are beginning to understand what they have to do in order to secure their retirement years. I intend to spend a good deal of time during 1989 educating them! With retirement ages on the decline and life expectancy on the increase, we had better make sure that the "three-legged stool" is solidly in place when boomers reach that retirement age. In the 1960s more than 85% of those between the ages
of fifty-five and sixty-four were working; today that figure is less than 70%, and the Department of Labor projects that it will hit 50% shortly after A.D. 2000. The boomers have several problems—the Social Security leg may be fiscally drained by more people over the age of sixty-five than under, and by the use of the Social Security surplus by the government to reduce its deficits, as well as by higher medical bills as the boomers age. And having been brought up in an inflationary time, baby boomers are not personal savers, but rather big spenders and big credit users.

With our help, the boomers will begin to understand and pay more attention to how the government treats the private pension system. They will begin to become a political force and begin to ask a lot of questions, like—"Why, Mr. Congressman, do you continue to vote in a way that discourages private employers from establishing private pension plans?—If the goal is to reduce the deficit, why not reduce the waste in government rather than programs that provide both for capital formation in America as well as tax dollars when those assets return to the tax system later?"

If as professionals we can help people secure their future retirement income through a national retirement income policy, then I am thrilled with your choice of profession, and I will always be there to help you.

Love,

Dad

I shared this letter to my son with colleagues attending the American Society of Pension Actuaries (ASPA) Annual Conference last October. It now seems appropriate to share it with Academy members. I would ask you to join me in 1989 in finalizing a national retirement income policy; in creating heavy public relations involvement with baby boomers; and in strengthening the voice of the actuarial profession through a unification of the actuarial bodies in North America.

Howard M. Phillips is president of the American Society of Pension Actuaries (ASPA) for 1989. He is a MSPA, EA, and FSA as well as a member of the Academy. Mr. Phillips was invited to represent ASPA's actuaries as a new member of the Council of Presidents at the COP's December 1988 meeting.

Letters to the Editor

"Spell Check" Status

Actuaries really are well-known outside of actuarial circles, despite the hoary cartoon from The New Yorker. (See below.) Our profession is well-known throughout the business world.

I recently purchased an IBM Wheelwriter 10, Series II, which has a spell check containing some 50,000 words. This clever spell-check gadget functions such that, if it does not have a word in its vocabulary, it beeps when that word is typed. I am pleased to report that the machine quietly goes about its work when the words "actuary," "actuaries," and "actuarial" are typed. The same is true for "economist," "mathematician," and "statistician," but, strangely enough, not for "demographer" or "demography."

In the political area, the machine willingly accepts "Democrat," "Republican," "Socialist," and "Communist," but not "Libertarian." One word that is widely used in the Social Security area is "de-liberalization," although it is not contained in any printed dictionary that I have seen. However, the machine is completely up-to-date in this respect and fails to beep for this word. I wonder if my experience with typewriters that spell is similar to other people's?

Robert J. Myers
Silver Spring, Maryland

1988 OASDI Estimates Still a Sore Subject

The debate about whether the actuarial estimates for the Social Security program have been subject to political pressure has gone on too long already. However, Ed Hustead's letter in the January 1989 Update cannot go unanswered. As was the case with his article in July (continued on page 7)
What If ... The Federal Reserve Could Guarantee a Set Inflation Rate?

For the past two years, prices have been rising at a rate of about 4% per year. This rate is higher than it was for any year between the Korean and Vietnam wars. It is higher than the current inflation rates in Japan and West Germany.

According to Herbert Stein, former chairman of the President's Council of Economic Advisors, we should not accept this 4% rate as a given, with a sigh of collective resignation. Granted, others have argued that, if every financial exchange simply accommodated the 4% inflation rate as a given, for most practical purposes, the rate would be equivalent to zero. However, Stein contends that, although financiers may be able to incorporate a 4% increase adeptly, each year, into their contracts and fiscal plans, the general populace could only be dismayed at the unending upward drift in the costs of goods and services. As monetary policy is the prime instrument for decreasing inflation, policymakers who believe the 4% rate is unacceptable should make lowering the inflation rate the Federal Reserve's foremost objective.

Several questions come to mind in pondering this last proposal. Might actuaries, involved as they are in long-term forecasting, prefer that the Federal Reserve manage the money supply to "guarantee" one level of inflation, rather than make strenuous efforts to lower inflation? Would policies aimed at lowering the inflation rate possibly distort various other measures of the economy? How might interest rates be affected, for example?

Please send your response to What If ... ?, in care of the Academy, for possible publication in Contingencies.

FSLIC (continued from page 1)

were permitted to enter new lines of business via deregulation. Whereas S&Ls were traditionally barred from making high-risk investments, with deregulation they were allowed to and often did. Under the FSLIC, S&Ls were allowed to speculate on land acquisition, direct investment, and mortgage participations, without assessing the risks and potential future losses from such activities. Finally in 1986, when losses from such activities were sending the FSLIC into insolvency, the Federal Home Loan Bank Board enacted strict regulation.

At a time when the barriers of the Glass-Steagall Act are being lifted at the request of the banking industry, the financial consequences of unregulated banking activities could not be clearer than in the case of the FSLIC. After nine years of deregulation, both the FSLIC and the Federal Deposit Insurance Corporation (FDIC) are busy bailing out insolvent institutions and trying to figure where to transfer these costs. Before permitting bank institutions to sell insurance or investment securities, the underwriting costs to the FSLIC and the FDIC should have been determined.

Current bailout proposals for resolving the FSLIC's financial insolvency may prove inadequate because of the soft numbers used to create them. In addition, the lack of a uniform claim costing procedure makes it difficult to prioritize which S&Ls should be resolved by liquidation or merger. Because the FSLIC lacked a uniform claim costing procedure, it has on occasion assessed an S&L as financially "healthy" and allowed it to operate, only to discover months later that the supposedly viable S&L had losses exceeding those of some thrifts the FSLIC had closed earlier.

Further, the estimated losses currently being used have never been calculated as present value future claim costs. Some proposals, such as a fee on deposits or increases in premiums for banks and S&Ls, do not appear to address this issue. These proposed measures may generate a $4 to $7 billion cash flow to cover FSLIC claims; however, these limited funds are insufficient to immediately close down all the failed S&Ls. During the ten or twelve years it takes to raise the funds needed to reduce the 500-plus failed thrifts down to a manageable size, the embedded losses will continue to mount. Any type of cash-flow solution, such as using Treasury Bond financing, increases in deposit premiums, or user fees on mortgages or deposits is likely to lead to larger resolution costs in the future.

Unfortunately, private insurers and pension plans may not be able to take a detached view of the FSLIC insurance crisis. The FSLIC's financing requirements with respect to insolvent institutions increase daily, and sources of funds will have to be found to pay for S&L losses. Currently proposed cash-flow solutions to the S&L crisis have the political advantage of funding these losses apart from the federal government's budget. However, such solutions may prove to be deficient over the years, while insolvent S&Ls remain open awaiting sufficient funds for their resolution. Economists who initially advocated deregulation of the banking industry, now point to insurance companies and pension funds as part of the financial sector along with banks and S&Ls. If economists now tend to think of the financial services industry as a whole—a view that is perhaps implicit in some of the government's proposed solutions as well—then it is possible that insurance and pension products could be taxed to meet the billion-dollar losses in the S&L industry without a public outcry.

As a safeguard against such taxation (insurance policyholders' and pensioners' inequitable sharing of the S&L industry's losses), the public should be made aware of the significant difference between depository institutions (banks and S&Ls) and contractual savings organizations (life and casualty insurers and pension funds). The FSLIC's lack of attention to underwriting, claim settlement, and premium development has contributed to the tremendous losses now facing the federal government. Actuaries have the expertise to help the government frame another, reasonable solution to this financial disaster. However, insurers who are financially sound (and sound because actuaries have attended to the right considerations) should not be asked to pay for the management abuses of the S&L industry.

Thompson is associate professor of finance, insurance, and actuarial science at the University of Cincinnati. He served as an actuarial and financial consultant to the federal government in 1986-87 and 1980-81.

Correction to 1988 Loss Reserve Opinion Survey

The State of Hawaii statute requiring an actuary or other loss reserve specialist to provide an opinion on the 1988 Fire and Casualty Blank was incorrectly cited in the January 1989 Actuarial Update survey. Last summer, Hawaii recodified its insurance laws and the statute's citation was changed. The revised statute is 431:3-301.
Savings & Loan Problem Cuts Across the USA

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<tr>
<th>State</th>
<th>Savings &amp; loans total insolvent</th>
<th>Assets (millions)</th>
<th>Net worth (millions)</th>
<th>Net worth as % of assets</th>
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<td>11 3</td>
<td>1,135.9</td>
<td>80.4</td>
<td>7.08%</td>
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</table>

Source: Federal Home Loan Bank Board, USA Today research

How the Table Was Compiled

USA TODAY researchers obtained third-quarter (September 30, 1988) data from the Federal Home Loan Bank Board and calculated (using generally accepted accounting principles) the total assets; net worth; and net worth as a percentage of assets for the insolvent and solvent banks together in each state. By combining the 433 insolvent and 2,600 solvent banks' financials, the total negative effect of the insolvencies is not given relief. What is illustrated best is the overall health or sickness of the thrift industry in a given state. As a point of information, when we contacted the Federal Home Loan Bank Board to corroborate these figures, we were given a very different picture. The bank board lists the number of insolvent thrifts at the end of the third-quarter as 196 and the total assets (of these insolvents alone) as $54,208,000,000. The board obtains its figures on the basis of RAP, "regulatory accounting practices," which liberally allow the postponed reporting of losses in a way that GAAP (generally accepted accounting principles) do not. USA TODAY's figures are what result when generally accepted accounting principles are applied to the Federal Home Loan Bank Board's data.

Attention: Enrolled Actuaries

If you passed the EA-2 examination in 1977 or 1978, there is something you should be aware of. Under the old Fellowship examination system a candidate could not receive credit for both EA-2 and another Part 7 examination. However, in the Flexible Examination System, you can receive credit for all of these examinations. This being so, there are probably a number of enrolled actuaries who are close to Fellowship. It may be that only one twenty-credit course is needed for some.

For further information, please call Education and Examination Ombudsperson Patricia Holmberg at the Society of Actuaries, (312) 706-3527.
Centennial Portrait

David Parks Fackler

David Parks Fackler "was the one who proposed the meeting of actuaries that resulted in the formation of the Actuarial Society of America." On September 30, 1891, about three years after the founding of the society, Mr. Fackler addressed North American actuaries assembled in Toronto, Canada, as the society's second president:

The warm invitation of our Canadian members has brought us together here, several hundred miles west of what might be styled the centre of actuarial population, but though some of our more southern members have been kept away by the distance, and others by having to attend the Convention of State Insurance Commissioners, which unfortunately meets this day in St. Louis, we have, nevertheless, a good number present here, in the middle of our third year . . . . Before our organization there had been several attempts to form an Actuarial Society on this continent. The first effort, some twenty years ago, resulted in only one meeting, after that there were two or more attempts that did not even go as far as that, for most of us saw that circumstances were not favorable to the formation of such a society as we wished. The trouble was there were too many persons with the title of Actuary, and some of them in prominent positions who had few or no professional qualifications as such. A society could not well be formed without them, but giving them full membership and possibly office in such a society, would be tantamount to dispensing with all requirements in the way of qualification. Gradually, however, the increasing complexity of actuarial calculations compelled the companies to give the rank and title of Actuary only to those who were properly qualified, and when this proper condition of affairs was attained the natural instinct of co-operation caused us to come together into this Society as an essential factor of our professional life. Now that we are on a firm footing let us hope that our Society may not only continue a means of benefiting and elevating the whole business of life insurance.

Mr. Fackler spent most of his career with The Mutual Life Insurance Company of New York, as had Charles Gill and Sheppard Homans. (See previous months' centennial portraits.) Mr. Homans, a member of the Actuarial Society of America himself, attended the Toronto meeting and would have heard Mr. Fackler's address.

Reference: Transactions of the Actuarial Society of America, 1891–92, Volume 2, pp. 224–232. Again, our thanks to Donna Richardson at the Society of Actuaries library for her skillful research assistance.

Checklist of Academy Statements

February 1989

TO: Governmental Accounting Standards Board, February 14, 1989. RE: Accounting for pensions.

BACKGROUND: These comments were submitted to GASB on Preliminary Views on Governmental Employers' Accounting for Pensions.


BACKGROUND: This letter discusses the standard actuary confirmation letters to be used by accountants in conjunction with audits of public employee retirement systems.

Two Actuaries Assist Railroad Commission

The Commission on Railroad Retirement Reform held its first meeting February 10, in Miami, Florida. The commission, established by the Omnibus Budget Reconciliation Act of 1987, is required to submit a report on the railroad retirement system’s financing to the President and the Congress, on or before October 1, 1990.

Among the seven commission members are Robert J. Myers and John G. Ireland, both members of the Academy. Mr. Myers, one of three public members on the commission, was appointed by the Speaker of the House, March 2, 1988. From 1947 to 1970, Mr. Myers was chief actuary for the Social Security Administration. He is currently an actuarial consultant to Congress. Mr. Ireland, a public member also, was appointed by the U.S. Comptroller General, June 23, 1988. Mr. Ireland is currently chairman of William M. Mercer, Inc., of New York.

At the February 10 meeting, Mr. Myers was elected commission chairperson. The committee now plans to hold monthly meetings in order to complete its statutory requirement of reporting to the President and the Congress by October, 1990.
LETTERS TO THE EDITOR
(continued from page 3)

1988, much of the information presented as factual is incorrect.
We maintain that political manipulation has not occurred. The changes that were made in developing the estimates in the 1988 OASDI Trustees Report were appropriate. Basically, those changes involved revision of assumptions on which reasonable people can differ, without believing that they know the only true answer, and correction of the methodology.
The major change in methodology that was made in 1988 was to substitute the "level-financing" method of determining actuarial balance for the "average-cost" method of determining actuarial balance that had been used since 1973. The level-financing method properly recognized the time value of money, which is essential in preparing actuarial estimates for a program that is advance funded to a considerable extent; the average-cost method does not. The average-cost method was satisfactory when the program was financed on a pay-as-you-go basis, as was intended after the 1972 legislation. It was simple for non-actuaries to understand and did not introduce significant distortions. With changes in the financing of Social Security, as a result of legislation in 1977 and 1983, returning to the level-financing method was overdue and, at long last, occurred in 1988.

Ed Hustead's description of a recent action by the Trustees is also inaccurate. The Trustees tentatively agreed in April 1988 to drop the concept of "close actuarial balance" for the 1989 report. Whether they will follow through with that decision remains to be seen, but information regarding the actuarial balance itself will most certainly be shown. Those who want to compute the 5% threshold previously required for close actuarial balance will be able to do so.

Guy King's views on how the Trustees manipulated the 1988 reports are interesting but not conclusive. [See November 1988 Update.] As protection against manipulation, the law required actuarial certification of the reports by the chief actuaries of the Social Security Administration and the Health Care Financing Administration. Guy King had the opportunity to express his views in that statement, which the Trustees publish as part of their report. Moreover, the Board of Trustees includes two members of the public, one Democrat and one Republican, who provide further protection against manipulation.

Still, the bottom line is that the Board of Trustees has the statutory responsibility for reporting to the Congress on the program's financial condition. Actuaries provide staff support, much as they do for insurance companies and for sponsors of pension plans, but they are not "in charge," nor should they be. The Trustees and their staffs, who are not completely without knowledge about many of the elements on which the assumptions are based, participate appropriately in the development process. The government actuaries should have—and always have had—great involvement in the development of the assumptions, as well as complete control of the methodology involved in preparing the estimates.

The "audit" to which Ed Hustead refers was a limited review of the method of calculating the Social Security program's liabilities, for purposes of the Social Security Administration's annual report to Congress, which must be distinguished from the annual report of the Board of Trustees. SSA's report uses the Trustees' assumptions from the previous year, but the Inspector General (of HHS, not SSA) sought an independent review of the methodology of the calculations. The request was reasonable and legitimate. The assumptions, however, were already set and had been published; they were not in question. In any event, SSA has no authority to substitute its judgment for that of the Trustees, and the public is not well-served by having to interpret many sets of numbers, each based on different assumptions.

We support the proposal to have an independent board of actuaries to advise on and to review the Trustees Reports. However, this will not "remove the official valuation of the Social Security system from the political process," assuming that the public even shares that goal, or that it is a proper one. The setting of actuarial assumptions is not a completely precise matter. A variety of assumptions can be reasonable, and no board of actuaries, no matter how well-constituted, can have a monopoly on the truth. Sufficient safeguards against unwarranted politicization of the process already exist in the statutory requirements for public members on the Board of Trustees and for the chief actuaries to certify, assuming they agree, that "the assumptions and cost estimates used are reasonable."

Robert J. Myers
Silver Spring, Maryland
Bruce D. Schobel
Louisville, Kentucky

AERF Practitioner's Award
The Actuarial Education and Research Fund (AERF) announces the second annual practitioner's award for research done by nonacademic actuaries in 1988. The award was established to encourage the publication of research performed in the workplace.

For rules and requirements regarding any submission, contact Mark G. Doherty, AERF research director, at (312) 706-3500. Submissions should be received by the AERF no later than June 1, 1989. The AERF plans to publish submitted papers in the Actuarial Research Clearinghouse (ARCH). The top prize is $1,000; honorable mention prizes of $500 may also be awarded. Practitioner's Award winners will be announced October 1, 1989.

Notice to Consulting Actuaries Practicing in Connecticut
A recent ruling by the State of Connecticut Department of Revenue Services specifically exempts some actuarial services from sales and use tax in that state. (See Bulletin No. 41, January 19, 1989, for the language of the ruling.) The new tax exemption ruling applies to consulting services generally, although actuarial services are mentioned in particular.

The bulletin gives examples of both taxable and nontaxable services. For example, actuarial valuations for pension plans and actuarial calculations for insurance companies are exempt from sales tax under the ruling. Whereas consultations about pension plan design and the development of financial models for forecasting are taxable.

Actuarial firms will be required to break down total charges to clients in Connecticut in terms of taxable and nontaxable services under the new ruling.
Copies of the bulletin are available from the Academy's Washington office.
ACTUARIES HELP WITH LONG-TERM CARE

MANY AMERICANS BELIEVE THAT MEDICARE WILL TAKE CARE OF THEM IF THEY BECOME CHRONICALLY ILL OR DISABLED IN OLD AGE. THESE PEOPLE ARE SADLY MISTAKEN. MEDICARE IS AVAILABLE TO PAY FOR SHORT HOSPITAL STAYS, BUT FOR SEVEN MILLION OLDER AMERICANS WHO REQUIRE PROLONGED ASSISTANCE IN THEIR DAILY LIVING, MEDICARE WON'T HELP. ALTHOUGH THE FEDERAL MEDICAID PROGRAM IS AVAILABLE, ONE HAS TO BE VERY POOR TO QUALIFY FOR THESE BENEFITS. AS THE CONGRESS LOOKS FOR A BETTER WAY TO INSURE OUR COUNTRY'S HEALTH NEEDS, PRIVATE INSURANCE COMPANIES ARE STEPPING FORWARD WITH LONG-TERM CARE POLICIES OF THEIR OWN. HELPING THEM ASSESS THE COST OF PROVIDING THIS PROTECTION TO THE ELDERLY ARE PROFESSIONALS CALLED ACTUARIES. ALSO KNOWN AS "SOCIAL MATHEMATICIANS," ACTUARIES FORECAST THE FINANCIAL EFFECT THAT LIFE EVENTS SUCH AS BIRTH, DEATH, MARRIAGE, SICKNESS, ACCIDENT, AND FIRE HAVE ON INSURANCE AND EMPLOYEE BENEFITS. ACCORDING TO THE AMERICAN ACADEMY OF ACTUARIES, THERE ARE OVER 13,000 PRACTICING ACTUARIES IN THE UNITED STATES TODAY.

This radio news-script was released to over 3,000 radio stations nationwide in January. It is part of the Academy's Long-Term Care publicity campaign.