The Actuarial Update

VOLUME 18 NUMBER 9 AMERICAN ACADEMY OF ACTUARIES SEPTEMBER 1989

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Enclosures

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Environmental Risk Forum Draws Multi-Media Coverage

FORECAST 2000

by George Soules

The disclosure that insurers in this country would not be able to fully cover the property-loss claims in the event of a major earthquake brought the news media out in force to a forum on environmental risk, July 11, in Toronto, Canada, where results of a survey of actuaries were released. The limited ability of insurers to bear the financial brunt of a full-blown natural disaster (the notion that some risks are uninsurable), known by actuaries for some time, was considered a top news story by the U.S. press. Canadian press focused on another topic addressed in the forum: insurance coverage problems related to nuclear and toxic waste cleanup.

The forum was part of Forecast 2000, a year-long program designed to highlight actuaries' role in solving the pressing social and business problems of the day.

Leading off the forum was Robert Brown, associate professor of statistics and actuarial science at the University of Waterloo and president-elect of the Canadian Institute of Actuaries. He disclosed the results of the survey of U.S. and Canadian casualty actuaries.

Out of 332 respondents, 81% said that, given current premiums and coverage, insurers would not be able to cover the cost of claims in the event of a catastrophic natural disaster such as an earthquake. According to 50%, those costs could only be borne by higher insurance premiums or increased taxes.

Fifty percent of the actuaries said that chemical wastes will be the number one health hazard in the year 2000, and a majority agreed that these hazardous wastes will be society's most costly environmental risk overall. In effect, federal, provincial, and state governments will have to bear the cost of much of the cleanup, respondents said. They noted that, thus far, "Superfund," the federally regulated cleanup effort in the United States, is doing an inadequate job. According to 64%, additional taxes will be necessary to cover the costs of such cleanups.

Finally, the courts' typically broad interpretations of what insurance contracts cover were blamed by 64% of respondents for the insurance industry's general reluctance to provide pollution coverage.

Brown said that "if public policymakers and private industry relied more heavily on the actuarial profession, they could better prepare for the costs associated with environmental risks." He also said that "as the actuarial profession enters its second century, we will become increasingly involved in assessing the costs of these risks."

Joining Brown on the panel were Martin Theriault, national coordinator,

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From the President

W. James MacGinnitie

9,000-Plus Points of Light

Tomorrow's newspapers will contain a story on a topic that has an actuarial aspect. That's a prediction that can be safely made, given the fact that today's and yesterday's, and the day before's all did, back as far as one can remember. It might be about health care cost, or toxic wastes, or AIDS, or Social Security, or California's Proposition 103. It might be about a topic that is less obviously actuarial, such as borrowing short and lending long, while insuring without risk assessment—otherwise known as the savings and loan crisis. But it's a near certainty that there will be such a story more often than not, reporting an outcome that would have been better had there been some actuarial input.

Most of us are inclined to read such stories, comment negatively to ourselves or to our colleagues, and go on about our business. But if we are truly to be a public profession, it behooves us to try to change the outcome of the next story for the better. To do so is not easy, particularly where our advice is not sought nor welcome. It requires resources, and it requires early identification of issues.

While the profession's resources for public interface involvement are limited, they are growing. The Academy has just filled a newly-created position of director of government information with an individual experienced in federal regulatory and legislative matters. He and other staff members will also increase their activity at the state level, where many actuarial issues are focused, particularly those affecting insurance companies. The Academy has launched *Contingencies*, which is aimed at both actuaries and public-policy decisionmakers. Other public relations and publicity efforts have been expanded, and together with the other actuarial organizations we have initiated a series of public policy forums.

The Academy's public interface activities depend primarily on the work of our membership, however. Issues are identified and discussed, and positions are formulated by our volunteer committees. Testimony at hearings, and other meetings with regulators, legislators, and their staff generally involve our committee chairs and members.

If we are to be effective with our limited resources, we must have the involvement of all of our members. You should be alert to opportunities for contributing the actuarial perspective to public policy debates, and bring such opportunities to the attention of our committees and staff. Your sources include your contacts with regulators and legislators, and the monitoring of litigation where an *amicus curiae* brief from the profession would be helpful. You also have contacts within other professions—law, accounting, risk management, economics—areas where actuarial expertise may be helpful. And, of course, you have contact with employers and clients, be they governmental bodies, insurers, or plan sponsors. All of these contacts are potential sources of information on new or emerging public policy issues that would benefit from actuarial analysis and input.

Whereas our number and our resources may be limited, our perspective is unique, and the public will be well served if the actuarial perspective can be effectively brought to bear on key issues. An important part of the process is the early identification of such issues, and that is where you, the membership, can make a major difference. Δ

Casualty Loss Reserve Seminar

The 1989 Casualty Loss Reserve Seminar (CLRS) will be held at the Hyatt Regency O'Hare Hotel, Chicago, Illinois, September 18–19. Cosponsored by the American Academy of Actuaries and the Casualty Actuarial Society, the CLRS provides a forum for the presentation and discussion of significant issues affecting loss reserving. This year's meeting will feature a welcoming address by Richard Rogers, deputy director of the Illinois Department of Insurance. The luncheon speaker is John J. Byrne, chairman, Fireman's Fund Corp. The registration fee is $450 (plus $50 after September 12). For information, contact Mildred Prioleau, AAA, 1720 I St., N.W. Washington, DC 20006. (202) 223-8196.

Letters to the Editor

Invited Comment on OASDI Debate

In the July 1989 issue of *The Actuarial Update*, seven actuaries debated several Social Security topics. One of the topics was whether it should be cause for concern that average income for the next seventy-five years under the OASDI program (13.02% of taxable payroll) is projected to fall short of average expenditures (13.72%) according to the 1989 Trustees Reports. This relative 5.1% shortfall is slightly more than the "close actuarial balance" standard of 5.0% that was used in prior years but awkwardly eliminated in 1989.

Admittedly it is patent transgression to eliminate a standard at the very moment it is no longer met. But all this hullabaloo diverts our attention from a larger, more threatening problem.

Social Security taxes finance *both* the OASDI and the HI programs. For these combined programs, under the alternative II-B assumptions the average income will be 15.98% of taxable payroll and the average expenditures will be 19.06%, a shortfall of 16% of expenditures. Under the alternative III assumptions, projected income will average 16.13%, expenditures will average 26.01%, and the shortfall will be 38%.

We should keep in mind that the 38% shortfall under the alternative III assumptions is an average over the next seventy-five years. Over the first twenty-five years of this period, the shortfall is only 5%. Over the second twenty-five-year period (when the baby boomers will be retiring) the shortfall is 45%. Over the third twenty-five-year period (when the children of the baby boomers will be retiring) the shortfall will be 57%. Now these shortfalls are something to worry about, especially for taxpayers who are under age 50.

Another serious problem that we should be concerned about, not even mentioned in the debate, is the Supplementary Medical Insurance (SMI) part of the program that is financed by participant contributions and general revenue. The current cost of SMI is equivalent to about 2% of taxable payroll, and is (unofficially) projected to rise, by the middle of the next century, [illegible]% of payroll under the alternative II-B assumptions and 9% under the alternative III assumptions (excluding the effects of the new catastrophic health insurance program). Yet the Trustees Report shows projected SMI costs for only three years and has the audacity to state that SMI is actuarially sound.

These are some real problems that the actuarial profession could and should be worrying about, instead of the relatively minor question of whether the OASDI program (which will account for only about 50% to 60% of the total future cost of the combined OASDI, HI, and SMI programs) is within 5.0% or 5.1% of being in actuarial balance.

A. Haeworth Robertson
Washington, D.C.

"Trust Fund" a Misnomer

I believe that Academy members should strive to call things by their proper names and not confuse the issues. In your June 1989 *Update*, there was an article by Harry Ballantyne, "The 1989 Social Security Trustees Reports."

In it, he reported that the Old-Age and Survivors Insurance Trust Fund had accumulated to $102.9 billion at year's end. A "trust fund" implies either cash in hand or else prudent investments that give confidence. How can the words "trust fund" be used when most of such moneys are spent by the Treasury? All the "Trustees" have is an I.O.U. from our government to be paid back in taxes by our children and grandchildren, when and if they can afford it.

Carl J. Strunk
Overland Park, Kansas

Editor's Response: I tend to agree with you, but I think that your complaint would better be directed to the Social Security Administration. Harry Ballantyne, afterall, did not himself coin the Social Security Administration's parlance of "trust fund" and "trustees."

Fundamental Concepts of Actuarial Science Monograph Released

by Curtis E. Huntington

In 1987, the Interim Actuarial Standards Board recognized the need to identify the common ideas underlying all areas of actuarial practice. Although each segment of the actuarial profession in North America has its own practice issues, for any actuarial standard to be effective, it must be supported by actuaries working in all areas of specialization.

With funding from an anonymous donor, the Actuarial Education and Research Fund (AERF) undertook the development of a monograph that establishes the intellectual foundations, as a necessary preliminary step in the development of standards for our profession. The AERF was formed in 1976 to "advance the knowledge of actuarial science and respond to the needs of the public for education and research in actuarial science."

The monograph, seventy-nine pages in length (including bibliography), is presented in nine chapters. Authored by Charles L. Trowbridge, the monograph identifies and delineates the fundamental intellectual concepts upon which actuarial science is based, organizing them into a cohesive whole. An introduction and seven chapters each present an idea or a cluster of related ideas that are fundamental to actuarial science. These ideas include the economics of risk, the study of random variables, the time value of money, the use of a generalized mathematical model (both for individual and collective arrangements), classification (including selection and antiselection), and the use of assumptions.

The premise of the final chapter is that actuarial standards must be based upon, and, in fact rest upon, a foundation of fundamental actuarial concepts. Actuarial principles are seen as lying between standards and foundations. The author, using a building construction analogy, likens principles to the walls and floors of a building, which rest on the foundations, but support the more specialized portions of the structure—professional standards.

The centennial edition of the monograph was released to attendees at the June 12–14 centennial celebration in Washington, DC. A revised edition, which includes an updated bibliography and corrects the few printing errors found in the first edition, was sent to all members of the American Academy of Actuaries and the Canadian Institute of Actuaries. (Academy members will receive the monograph with their September/October issue of Contingencies.)

Additional copies of the monograph are available upon request from AERF, 475 N. Martingale Rd., Suite 800, Schaumburg, Illinois 60173-2226. Please include a donation to the AERF with your request. Δ

ENVIRONMENTAL RISK FORUM
(continued from page 1)

Canadian Environmental Network; Margaret Tiller, president and actuary, Tiller Consulting Group, Inc; and Michael Tiller, environmental risk consultant and principal, Tiller Consulting Group. Gus Carlson, business editor of *The Toronto Sun* acted as moderator.

Focusing on the exposure, costs, prevention, and reduction of environmental risk, Margaret Tiller emphasized that "environmental risks are everywhere. We are a part of the ecological community and are constantly interacting with it by our very presence. Every decision we make affects the environment in some way." Determining the nature of the exposure is the first step and includes an analysis of "what can be harmed, any conditions or situations that can cause or increase the change of harm (hazards), and any active cause of loss (perils)."

She noted that the "ultimate prevention of environmental risk is avoidance," exemplified by an individual's decision to stop smoking. If this were to occur on a universal scale, the tobacco and cigarette companies would endure an immediate hardship, but "companies are amazingly resourceful at surviving, and people are similarly resourceful at finding work," she reflected. In any case, managing our environmental risk "rather than letting it manage us," is critical to our survival as a species and to our quality of life, she concluded.

Michael Tiller emphasized that "we are confused on a grand scale, between environmental problems and solutions. Our environmental problems are not hazardous dump sites, polluted air, water, and dying fish. These problems are in reality symptoms--symptoms due in part to an anemic, impoverished concept of ethical community and lousy energy policy." He recommended shifting the billions of dollars currently spent on Superfund cleanup and related litigation into energy research and training a cadre of people who could address the underlying philosophical problems.

A question-and-answer period involving media representatives from the United States and Canada, including television reporters, followed the panelists' presentations.

A spokesperson from *Probe Post*, a publication of Pollution Probe Foundation, asked whether Canada needs an office of waste minimization similar to the United States' Environmental Protection Agency. There are two ways to minimize hazardous wastes, was Michael Tiller's response, "one in the front end of the process and the other in the pipe." He said that U.S. efforts have focused on eliminating waste before it gets into the pipe, pointing out that there may be too much emphasis placed on the regulatory solution to cleanup in the United States.

In contrast, so far there has been little incentive for companies in Canada to minimize their hazardous wastes, according to Robert Brown. However, he believes that more responsibility will soon be placed on them. "There will be a strong incentive to bring in strong risk management programs, which will include waste minimization," he said.

"Cost of pollution cleanup hits home"
—The Globe and Mail

"Waste tops future risk"
—The Toronto Sun

"Hike in premiums or increased taxes to compensate future disaster victims"
—Los Angeles Herald Examiner

In consultation with actuaries, "we will see premiums that will vary depending on the risk management program that the site has in place." Brown continued: "Actuaries will have input into the risk management program, including experience rating based on an ability to minimize those wastes and control those wastes legitimately."

A reporter for *The Globe and Mail*, asked what "hard information" actuaries possessed in order to make the type of pronouncements found in the risk survey. Brown admitted that with regard to the survey questions, actuaries were "forced to think through various scenarios without a lot of hard information," and that this required some imagination. However, he said "we have the ability to model some of these probabilistic distributions, so that we don't have to have a history of earthquakes to be able to model a process that will allow us to do an evaluation of the expected costs. He said he believed "actuaries have a unique set of qualifications that allow them to take part in this process in a very legitimate fashion."

A follow-up question concerning whether there is sufficient knowledge to set pollution insurance premiums was also answered by Brown, who said that this is currently accomplished through mathematical modelling. Yet because of the many "parameters" in the process there is no continuum for pollution insurance at present. The parameters include litigation decisions and adjudications, and "the courts have taken policies that were designed with the assistance of actuaries to have very specific coverage meanings" and "have changed those meanings retrospectively and retroactively."

John Geddes from *The Financial Post* asked about the role of government in backing the insurer at a time "when there is not a clear market for insurance for a lot of types of pollution production." Brown stated that, given the response generated by the actuarial risk survey, the government, as a result of the insurers inability to cover losses in the event of a major natural catastrophe, is "the ultimate reinsurer."

Margaret Tiller was asked if she had seen any change in industrial companies' attitudes, in terms of assuming greater responsibility for environmental cleanup. She replied that "there is very slow change" and, as a practical matter, industry has been preoccupied with cleaning up the many pollution problems that occurred some time ago.

Michael Tiller gave the example of the Stringfellow site in California, which had been opened to store liquid toxic waste in the desert area east of Los Angeles. When the storage facility had started leaking, the government did go after private disposers to clean it up. The mandated cleanup has been going on for about five years. He said that in the United States at least, "some of the costs are being shifted to the owners of, or the real sources of, some of these problems."

Does the individual have a responsibility similar to the insurers for environmental pollution and cleanup? Brown stated that "we do need a complete change in societal attitudes," and that the individual should be involved in that movement. "The most important part," he noted, "is to become a part of the mosaic that will change the whole direction, and in that process industry will also set a new focus in waste management and waste minimization."Δ

CDC Says Estimate of HIV Infections May Be Lower

by Dana H. Murphy

The apparent divergence of two new estimates, respectively, on AIDS and HIV prevalence, from the General Accounting Office (GAO) and from the statistical branch of the Centers for Disease Control (CDC), underscore the tremendous difficulty in obtaining reliable numbers on the incidence of human immunodeficiency virus (HIV) infection and acquired immune deficiency syndrome (AIDS).

A new report from the GAO suggests that up to 30% more people will develop AIDS than previously has been predicted. Prior estimates of total AIDS cases by the end of 1991 had generally ranged between 195,000 to 320,000 total AIDS cases; the new GAO estimate is 300,000 to 485,000.

Now Meade Morgan of the CDC's statistical branch says that prior Public Health Service estimates of the number of individuals infected with HIV are probably too high. The U.S. Public Health Service had estimated that 1 million to 1.5 million people are infected with HIV; however Morgan, on the basis of several new studies, puts total incidence at 750,000 to 1.25 million.

Speaking at the American Statistical Association (ASA) meeting in Washington, D.C., on August 7, Morgan noted that researchers are currently attempting to get firm numbers on people infected with HIV through several data sources:

- Sentinel HIV surveys (which comprise data from the CDC, state and local health departments, and others);
- Surveys of special groups (such as blood donors to the Red Cross and military inductees);
- The National Household Prevalence Survey;
- Back extrapolation from incidence data on AIDS; and
- Deterministic and computer-simulation models that mimic the spread of the disease (these, however, are still on the drawing board).

The CDC sentinel surveillance system has been in place throughout 1988 and 1989. It is a data-collecting network undertaken by CDC, in collaboration with state and local health departments and other federal agencies, in thirty-nine major metropolitan areas, for estimating the prevalence of HIV infection by significant variables such as demographic and behavioral subgroup, and local geographic area. In each area, surveys are being conducted, according to standardized protocols, in sexually-transmitted-disease clinics, drug-treatment centers, women's health clinics, and tuberculosis clinics. In forty-four states and territories, additional studies are being done in childbearing women, by testing blood samples from newborns. Tests from the six states that have reported, to date, on infection in new mothers have shown a wide range in percent of women infected—from 0.04% in Colorado to 0.66% in New York.

Morgan pointed out that these kinds of clinic-derived data cannot be extrapolated to either the total U.S. population, or even to the population of persons attending these clinics, since the metropolitan areas were not selected using probabilistic sampling, and because of the presence of selection biases that influence attendance at public health clinics. However, these data are important for comparing rates of HIV infection in different demographic subgroups according to transmission category and geographic area.

The surveys of special groups include military recruits (2,000,000 since October 1985), Job Corps applicants (70,000 since October 1987), and designated "sentinel 20 hospitals."

James Massey of the National Center for Health Statistics described the National Household Seroprevalence Survey—a study of 50,000 U.S. adults (ages 18 to 54), data from whom will be used to derive a single national estimate of HIV prevalence. However, this study has already involved more than its share of controversy, in part because it entails questions about people's drug use and sexual habits. Massey believes that this kind of information is crucial; so, if the controversy persists, he is uncertain as to whether it is possible to conduct this sort of national survey.

In addition, a stochastic model for estimating AIDS prevalence was presented at the ASA meeting by Philip C. Cooley of the Research Triangle Institute. This model has several fundamental characteristics:

- Backward estimating procedures are used to define initial model conditions, i.e., infective and susceptible population sizes by risk group;
- Simulation experiments are conducted that estimate critical model parameters, such as the number of sexual and/or needle-sharing contacts that explain AIDS cases and deaths due to HIV-related illnesses and AIDS;
- Estimated parameters are then fixed and used to make short-term projections of the incidence of AIDS.

With this model, Cooley estimates that between 670,000 and 740,000 Americans are infected with HIV (not including hemophiliacs). Cooley stressed that AIDS should not be characterized as a national epidemic, but rather as the series of "subepidemics" at regional levels.

In a discussion that followed the formal presentations, Michael Soto of the National Research Council noted that, in a recent report, the council estimated that about 1 million Americans are infected with HIV. Still, because of the array of possible errors that enter into these estimates, Soto acknowledged that the true number of HIV-infected individuals might range from 500,000 to 2 million.

And in speaking with *The Update*, Meade Morgan stressed the uncertainty of his own new estimate of HIV prevalence. For example, he noted that a *Washington Times* report (August 8, 1989), based on his presentation, overemphasized the degree of certainty that can be attached to the newer estimate (750,000 to 1.25 million). "The official Public Health estimate of 1 to 1.5 million hasn't changed," he said. It will remain at this level until we get some consultants together in a room to look at the numbers carefully." Morgan stated that while his work (among others') indicates that the Public Health Service estimate is, in fact, too high, other research confirms its essential reliability. "As we published in the *Morbidity and Mortality Weekly Report*, 1 million remains as the lower bound."

Dana Murphy is editor of Contingencies.

Meet Academy Director of Government Information, Gary Hendricks

Gary Hendricks recently joined the Academy staff as director of government information and chief economist. Formerly chief economist and director of the office of research and economic analysis, Pension and Welfare Benefits Administration, U.S. Department of Labor, Hendricks brings eighteen years' research experience and nine years' of hands-on policy and legislative experience to the Academy's government information program. Most of his policy work has been in two areas: private pensions and taxation. He also has served as a consultant on policy and legislative strategies related to Social Security. Hendricks holds B.A. and M.A. degrees in economics from the University of Michigan. Prior to working for the Department of Labor, Hendricks was senior research associate at the Urban Institute in Washington, DC.

UPDATE: What do you consider to be the main objectives of the Academy's government information program?

HENDRICKS: I could list many objectives, but the really basic one is getting information from those who have it to those who need it. That is, from our members to policymakers.

UPDATE: If that's the case, how would you describe the Academy's role in public-policy debates—both regulatory and legislative?

HENDRICKS: In theory, our role is very simple; in fact, it is very difficult. We work hard to get the best information that the profession has to the policymakers who need that information. That's the easy part. The difficult part is establishing our credibility. In Washington, all "bearers of gifts" are looked upon suspiciously, which is not too surprising in a town where everyone's a lobbyist for something. To properly represent the profession, I believe that the Academy must scrupulously avoid being a lobbyist. It's good to win the argument, especially if you're on the side of right and justice. It's better still to be sought out for one's wise counsel because others know that you seek to inform, rather than merely to persuade.

The Academy's stock in trade always has been to get information from its members to state and federal policymakers. The job of the government information program is to make that information even more useful and even more timely. Most important, we want the right people to get it and assimilate it.

Actuaries are too few in number to be a political constituency. But as an informational constituency, actuaries have the opportunity to become equally influential.

During my tenure in Washington, I've noticed that people often say that the choice between one policy and another is merely a political decision. What they sometimes don't realize is that, with proper information, this would not be true. New information almost always narrows the range of options that reasonable people would support. Thus, the policy debate becomes more focused on the real advantages or disadvantages of particular approaches. Ideological differences become less important and, ultimately, the public interest is better served because the information was available.

UPDATE: What do you perceive to be the major obstacles to ensuring actuaries' greater role in these debates?

HENDRICKS: I can think of three obstacles at the federal level. First, we need to improve our ability to speak in ways that policymakers can easily understand. Sometimes this means making our statements longer and including more data; sometimes it means making our statements shorter. Sometimes we need to be more erudite; sometimes more folksy. At all times, we need to carefully distinguish between fact and our professional biases. It isn't that we haven't communicated well in the past; it's just that we haven't communicated well enough.

A second obstacle may be less an "obstacle" than a past omission. The actuarial community has a great deal of data that can be used to address issues that are not really actuarial ones. We should try hard to identify non-actuarial issues where our information would be useful and put forth the effort to present this information. Such efforts will not only be appreciated by the policy community, they will heighten the community's awareness of the actuarial profession as one that is willing to do public service, even when there is nothing to be gained by the profession.

A third obstacle to a greater policy role for the actuarial profession is gaining greater access to policymakers. We want to have easy access to policymakers and open, honest communication with them. I think that this is a realistic objective for our government information program. However, we also have to realize that developing working relationships with agency people and members of Congress is painstaking work. As an informational constituency, the Academy can best serve the profession if we keep the need to be good public servants foremost in our minds. This is not an easy task. It takes great self-discipline. It also takes perseverance. In Washington, good deeds are not acknowledged quickly.

AMERICAN ACADEMY OF ACTUARIES

Government Relations Watch

September 1989

FEDERAL LEGISLATION

Congress recessed 8/4 & will reconvene 9/6 with budget reconciliation & 1990 appropriations as the main orders of business.

MANDATED HEALTH BENEFITS

Bills S. 768 & H.R. 1845 introduced by Sen. Kennedy (D-MA) & Rep. Waxman (D-CA). S.768 approved by Senate Labor & Human Resources Cmte 7/12. Provisions include small business subsidy & expansion of Medicaid. Senate Finance Subcomte held hearing on 6/19 on universal access to health care. ACADEMY COMMITTEE on Health; CHAIR. Edward J. Wojcik.**ACADEMY ACTION-Comments submitted 7/6 & 7/10.**

LONG-TERM CARE

Hearing held 5/25 by Rep. Stark (D-CA) on H.R. 1325, to provide certification standards for long-term care products. Rep. Gradison (R-OH) introduced H.R. 1010, treating LTC insurance contracts as health insurance contracts. ACADEMY COMMITTEE on Health; CHAIR. Edward J. Wojcik.

HEALTH & WELFARE BENEFIT PLANS

House Ways & Means Cmte approved major changes to Section 89, in large part conforming H.R. 1864 to provisions of Senate-passed legislation (S. 5). Both bills include an affordability standard permitting up to 50% cost sharing with employees, but House bill adds a dollar limitation ($2000 for family coverage and $1000 for individual coverage) for those earning less than $20,000 annually. Both bills change current law's availability standard from 90% of non-highly compensated to 90% of all employees, & redefine part-time work as under 30 hours per week. **The Ways & Means provisions were added to its budget reconciliation package.** ACADEMY COMMITTEE on Health & Welfare Plans; CHAIR. Jeffrey P. Petertil.

AGE DISCRIMINATION

Sen. Metzenbaum (D-OH) introduced S. 54, prohibiting employers from requiring waivers of rights under Age Discrimination in Employment Act (ADEA) before they participate in early retirement incentive programs. Rep. Hawkins (D-CA) introduced House companion (H.R. 1432). Proposal approved by House Labor-Management Subcommittee on 6/13. Senate hearing held 3/16. **In reaction to recent Supreme Court decision (Betts case), Senator Heinz (R-Pa) introduced bill to clarify that ADEA applies to benefit plans.**

DISABILITY DISCRIMINATION

Senate Labor & Human Resources Cmte unanimously reported out the Americans with Disabilities Act (H.R.2273 & S.933). Bill could be interpreted to affect all employee benefit plans and the way insurers do business.

PENSIONS/REVERSIONS OF EXCESS ASSETS

Sen. Metzenbaum (D-OH) introduced S.685 on pension asset reversions 4/4, linking size of reversion to the nature of the replacement plan. Hearings held 4/11. Companion bill (H.R.1661) introduced in House & approved up by House Education & Labor Cmte on 7/13. **House Education & Labor Cmte budget reconciliation package would eliminate all reversions (effective for terminations after 7/12/89).** ACADEMY COMMITTEE on Pensions; CHAIR. Larry D. Zimpleman. ACADEMY ACTION - Statement submitted 5/3.

INSURANCE REGULATION/SOLVENCY

House Energy & Commerce Cmte Chairman Dingell (D-MI) held hearings 4/5,11,19 on Transit insolvency; witnesses questioned the states' ability to regulate reinsurance. ACADEMY COMMITTEE on Property & Liability Issues; CHAIR. Robert V. Deutsch. ACADEMY ACTION - Met with congressional staff 3/14.

INSURANCE REGULATION/McCARRAN FERGUSON

On 2/23 Rep. Florio (D-NJ) introduced Insurance Consumer Protection Act of 1989 (H.R.1093) that would amend the Risk Retention Act "to establish standards for the conduct of the business of insurance in interstate commerce." Senate Judiciary Committee held hearing on S. 719 introduced by Sen. Metzenbaum on 4/18. Bill would repeal anti-trust exemption, but allow safe harbors for certain joint activities. Rep. Brooks (D-TX) introduced H.R. 1663, similar to last year's House Judiciary Cmte compromise. ACADEMY COMMITTEE on Property & Liability Issues; CHAIR. Robert V. Deutsch. ACADEMY ACTION - Statement submitted 5/8. **Revised statement under development for anticipated hearings.**

PENSION/TECHNICAL CORRECTIONS

On 6/29 House Ways & Means Cmte approved pension technical corrections as part of budget reconciliation. Reps. Clay (D-MO) & Roukema (R-NJ) introduced H.R.2794 to make pension-related changes to recent tax laws. Education & Labor Cmte approved proposal 7/13.

PENSION/MISCELLANEOUS

Senate Labor & Human Resources & House Labor & Education Cmtes added filing fees for 5500s & termination exit fees to their budget reconciliation bills. House Education & Labor also added a joint employer/employees trustee requirement for all plans. House Ways & Means budget reconciliation bill includes general repeal of 50% interest exclusion for ESOP loans & deductions for dividends to reduce ESOP debt.

LIFE INSURANCE TAXATION

Congress is scheduled to review the life insurance industry's taxes, with a focus on stock/mutual taxes. House Ways & Means Cmte budget reconciliation proposal includes revisions to the alternative minimum tax (AMT).

SOCIAL SECURITY

Joint Economic Cmte held hearing to examine economic & budgetary implications of Social Security trust funds build-up. ACADEMY COMMITTEE on Social Insurance; CHAIR. Robert J. Myers; ACADEMY ACTION: Statement submitted 3/28 to congressional leaders & agency officials on 1988 Trustees' report.

RETIREE HEALTH BENEFITS

Rep. Chandler (R-WA) introduced legislation (H.R. 1865 & 1866) to allow pre-funding of retiree health & use of excess pension assets to fund retiree health benefits. House Ways & Means Subcmte held hearing on employer-sponsored retiree health insurance on 6/14. **Budget reconciliation bills of Senate Labor & Human Resources, House Ways & Means & House Education & Labor Cmtes all provide for transfers of excess pension assets to fund current retiree health benefits.** ACADEMY COMMITTEE on Health & Welfare Plans; CHAIR. Jeffrey P. Petertil.

FEDERAL REGULATION

TREASURY/COBRA HEALTHCARE CONTINUATION PROVISIONS

COBRA requires employers to offer continuation of coverage under group health plans to former employees, divorced or widowed spouses, & dependent children. Treasury released "non-cost" proposed regs 6/15/87 (52 FR 22716); IRS held public hearing 11/4/87. ACADEMY COMMITTEE on Health & Welfare Plans; CHAIR. Jeffrey P. Petertil. ACADEMY ACTION - Comments submitted to IRS 1/6/87.

IRS/SECTION 89

Section 89 imposed new health & welfare plan nondiscrimination rules based on benefit valuation. Proposed regs issued 3/7 include transitional rules. ACADEMY SUBCOMMITTEE on Benefit Values, CHAIR. Richard Ostuw.

IRS/INTEGRATION RULES

On 11/14, IRS issued proposed integration regulations making changes to rules required by the Tax Reform Act of 1986 for qualified pension, profit sharing, & stock bonus plans. Regs would apply to plan years beginning after 12/31/88. IRS Notice 88-131, released 12/13, provides some relief to plan sponsors on changes required by TRA86. Additional guidance provided in IRS Notice 89-70 issued 6/2. ACADEMY COMMITTEE on Pensions; CHAIR. Larry D. Zimpleman. ACADEMY comments submitted 1/17/89. Cmte testifed at public hearing on 6/29.

IRS/MINIMUM COVERAGE

On 5/17, IRS issued proposed regs on minimum coverage requirements of Section 410(b). The proposed regulations address whether group that benefits under a qualified plan meets 410(b) mini mum coverage requirements. **Public hearing scheduled for 11/20.** ACADEMY COMMITTEE on Pensions; CHAIR. Larry D. Zimpleman.

IRS/MINIMUM PARTICIPATION RULES

On 2/13 IRS issued proposed regs explaining minimum participation requirements in Section 401(a)(26) affecting qualified pension, profit sharing, & stock bonus plans. **Public hearing scheduled for 10/30.** ACADEMY COMMITTEE on Pensions; CHAIR. Larry D. Zimpleman. ACADEMY ACTION- comments submitted 4/17.

DOL/PARTICIPANT LOANS

DOL issued final 408(b)(1) participant loan regulation. Final reg includes a market interest rate requirement with no safe harbor.

PBGC/PREMIUM PACKAGE

PBGC issued final 1989 single employer premium package with revised regulations. Certification by an EA of Form 1 is not required.

NAIC ISSUES

Next meeting in Wilmington, DE 9/10-13. NAIC Life & Health Actuarial Task Force ("L&HATF") scheduled 10/5-6 in San Francisco. Items involving Academy activity:

- Valuation actuary. Special Advisory Committee on the Valuation Law submitted exposure draft. Adoption possible in December. JOINT COMMITTEE on the Valuation Actuary; CHAIR. Walter S. Rugland.
- Actuarial guidelines. L&HATF has adopted actuarial guidelines on structured settlements & substandard annuities and is also working on a revision to Guideline 4, called Guideline XXX.ACADEMY COMMITTEE on Life Insurance; CHAIR. John J. Palmer. ACADEMY ACTION - Comments submitted 5/30.
- Health valuation standards. L&HAFT adopted revised proposal. ACADEMY SUBCOMMITTEE on Liaison with NAIC (B) Committee; CHAIR. E. Paul Barnhart. ACADEMY ACTION - Statements submitted 4/15/88 & 9/12.
- Health rate guidelines. L&HATF has exposed new guidelines. Actuarial standard on health rate filings adopted by ASB 1/12. ACADEMY SUBCOMMITTEE on Liaison with NAIC (B) Committee; CHAIR. E. Paul Barnhart.
- Universal life. NAIC exposed amendments to valuation/nonforfeiture provisions of model reg. ACADEMY COMMITTEE on Life Insurance; CHAIR. John J. Palmer. ACADEMY ACTION - Reports submitted 6/12/87, 9/28/87, 3/5/88 & 6/6/88.
- Non-forfeiture values. Academy appointed Task Force on Non-Forfeiture Values charged with development of a suggested basis for revised, modernized, non-forfeiture legislation. CHAIR. Walter Miller.
- Yield index. NAIC adopted model reg on use of index. ACADEMY COMMITTEE on Life Insurance; CHAIR. John J. Palmer. ACADEMY ACTION - Report submitted 6/1/88 and discussed 10/27.
- Reinsurance reserves. NAIC appointed new working group to consider reinsurance issues. ASB adopted 7/89 standard on reinsurance transactions for life companies.
- CCRCs. NAIC Blanks (EX4) Task Force has appointed a new study group to develop a standard reporting form for CCRCs. Academy assisting in effort. ACADEMY COMMITTEE on CCRCs; CHAIR. Alwyn V. Powell.
- CCRCs. NAIC Long-term Care (B) Subgroup discussing possible model regulation for CCRCs. ACADEMY COMMITTEE on CCRCs; CHAIR. Alwyn V. Powell.
- Securitization. Emerging Issues Study Group issued report; L&HATF to develop guidelines.

ACCOUNTING ISSUES

EMPLOYERS ACCOUNTING FOR OTHER POST-EMPLOYMENT BENEFITS/FASB

FASB Exposure Draft on accounting for non-pension retirement benefits released 2/14/89. Deadline for submitting comments 8/14/89. Public hearings scheduled 10/10-12 & 11/2-3/89. ACADEMY COMMITTEE on Health & Welfare Plans; CHAIR. Jeffrey P. Petertil ACADEMY ACTION - **Will testify in Washington at 10/10 hearings. Written comments submitted 8/4.**

FINANCIAL INSTRUMENTS/FASB

FASB released Exposure Draft on disclosure involving financial instruments 12/87. Issuance of a discussion document on recognition &

measurement scheduled for 1990; discussion memorandum on liability & equity scheduled for 1990. ACADEMY CMTES. on Financial Reporting; CHAIRS. Stephen P. Lowe (Casualty) & Paul F. Kolkman (Life). ACADEMY ACTION - Statement submitted 5/13/88.

INSURANCE ACCOUNTING/FASB

FAS 97, final standard on insurance accounting, released 12/87. ASB developing proposed standard on methods & assumptions for use in stock life insurance company financial reporting. ACADEMY COMMITTEE on Life Insurance Financial Reporting; CHAIR. Paul F. Kolkman.

INTEREST METHODS/FASB

FASB appointed advisory group on time value of money. Discussion will include loss reserves, deferred taxes, etc. Discussion memorandum scheduled for 1990.

PENSION ACCOUNTING/GASB

Project on accounting standards underway. Preliminary views document released 10/27. Public hearings 3/15 & 17/89. GASB to pursue funding-oriented approach rather than FAS 87-type approach. Exposure draft expected 3rd quarter. ACADEMY COMMITTEE on Pension Accounting; CHAIR. Darrel J. Croot. ACADEMY ACTION - Statement submitted 2/14/89; testified at 3/15 public hearing.

EMPLOYERS ACCOUNTING FOR OTHER POST-EMPLOYMENT BENEFITS/GASB

Research project initiated on accounting for post-employment benefits. ACADEMY COMMITTEE on Health & Welfare Plans; CHAIR. Jeffrey P. Petertil.

INSURANCE ACCOUNTING/GASB

GASB conducting new project on risk management in reaction to liability insurance crisis. Standard is expected to be based on FAS 5. Discussion memorandum issued 9/87. On 12/6 GASB released on Exposure Draft on Accounting & Financial Reporting for Risk Financing & Related Insurance Issues. COMMITTEE on Property & Liability Financial Reporting; CHAIR. Stephen P. Lowe.

AICPA INSURANCE COMPANIES COMMITTEE AGENDA

Various projects at different stages of development. Issues are:

- transfer of risk, foreign reinsurance, & fronting; statement of position on transfer of risk in reinsurance contracts & accounting for reinsurance contracts being redrafted ACADEMY COMMITTEES on Financial Reporting; CHAIRS. Stephen P. Lowe (Casualty) & Paul F. Kolkman (Life). ACADEMY ACTION - Comments submitted 7/21/88.
- medical malpractice loss contingencies; Statement of Position 87-1 released 3/16/87. ACADEMY COMMITTEE on Property & Liability Financial Reporting; CHAIR. Stephen P. Lowe. ACADEMY ACTION - Comments submitted 10/6/88.
- property and liability audit guide expected to be issued in mid- to late - 1989. Exposure Draft released 7/87. ACADEMY COMMITTEE on Property & Liability Financial Reporting. CHAIR. Stephen P. Lowe. ACADEMY ACTION - Statement submitted 11/9/87.
- agents and brokers. Paper under development.

OTHER ACCOUNTING ISSUES

- AICPA Exposure Draft on accounting for CCRCs released 1/9/89. ACADEMY COMMITTEE on CCRCs; CHAIR. Alwyn V. Powell. ACADEMY ACTION - Comments submitted 5/31/89.
- AICPA released Exposure Draft on Audits of Providers of Health Care Services on 3/15/88. Audit & accounting guide scheduled to be issued 8/89. ACADEMY COMMITTEE on Health; CHAIR. Edward J. Wojcik. ACADEMY COMMITTEE on CCRCs; CHAIR. Alwyn V. Powell. ACADEMY ACTION - Comments submitted 5/10 & 7/5/88.

FOR ADDITIONAL INFORMATION CONTACT:

Gary D. Simms, General Counsel
Gary Hendricks, Director of Government Information
(202) 223-8196

Items in **bold-faced** type indicate new developments this month. Please order Academy statements by date of release.

UPDATE: How do you see yourself facilitating this information exchange between actuaries and state and federal government?

HENDRICKS: My job is to keep track of the legislative and regulatory pulse— to stay in immediate contact with congressional and agency staffers who are working on the bills and regulations that concern actuaries. I find out what information they need and then work with the appropriate Academy committees to get it to them in the most useful form.

The important details of most laws and regulations are decided by agency and legislative staff. It's behind-the-scenes work, and it's important, for any one who wants to influence the process, to get to key staff people early on. That's really how I can best help. I know many of these people and have sympathy for the difficulties and pressures that confront them. Having worked on legislation myself, I know all too well the frustration of not being able to get significant information in time for it to be useful.

If we are to help policy staff, we must communicate with them and live up to the commitments we make to them. The Academy's executive vice president, as the representative of the profession in Washington, must be able to make commitments that members of the Academy will stand behind. Members, in turn, must be willing to work with Capitol Hill and Executive Branch staff, even when the going is rough. In the future, I think we're going to have to work much harder to understand the problems and perspectives of the regulators. I hope I can contribute to that greater understanding.

UPDATE: How will you know when the government information program is a success?

HENDRICKS: We want to be the people in town to whom everyone wants to talk. To successfully contribute to the sound development of policy, the Academy must get important information to more policymakers in time for it to be useful. When key decisionmakers consistently recognize issues that have actuarial aspects and begin to contact the Academy for guidance, we'll know that the government information program is a success.Δ

Social Security: A Briefing Notebook

As background material for its forthcoming statement on the long-term measures of actuarial soundness for two Social Security programs--the Old-Age, Survivors, and Disability Insurance (OASDI) and Hospital Insurance (HI) programs--the Academy has prepared a briefing notebook that discusses some of the issues involved. Divided into five sections, the notebook contains the Academy's prior statement on this topic and four new papers.

In January 1987, the Academy's Committee on Social Insurance issued a report that included recommendations for the measurement of the actuarial status of the Social Security system. That report concluded that the current approach used to measure the long-range actuarial balance of the OASDI system is inappropriate if the system is to be financed on a current-cost basis. The committee also recommended the establishment of an additional criterion for the fund ratio. Finally, the committee urged publication of seventy-five-year cost projections for Supplemental Medical Insurance (SMI), another Social Security program, and the establishment of an independent board of actuaries to review the methodology of the actuarial estimates and the measures of actuarial status for the Social Security system. The committee's 1987 report constitutes the first section of the briefing notebook.

The second section of the notebook contains an issue paper by Francisco R. Bayo, deputy chief actuary of the Social Security Administration. The paper gives a brief history of methods used to measure the long-range stability of the OASDI system and proposes a modification to the test of OASDI long-range actuarial balance. The proposed modification would retain all current computations and presentations, with several exceptions. For example, it would:

1. Assign a reliability factor for each year in the seventy-five-year projection;
2. Base the actuarial balance on the present value of projected income and expenditures, expressed as a percent of projected taxable payroll; and
3. Include the trust-fund balance at the start of the valuation period as part of income.

The proposed changes would satisfy the General Accounting Office's recommendation that the trust-fund balance be taken into account in judging the financial soundness of the system. The paper provides illustrative results to show the effect on the actuarial balance and discusses the relative weight assigned to the seventy-fifth year of the projection as compared to the first year. The paper also discusses modification of the width of the tolerance band for assessing actuarial soundness. An appendix to the paper provides simple mathematical developments of the items the paper discusses.

The third section of the briefing notebook contains a paper by Richard S. Foster, Toni S. Hustead, and Steven V. McKay, which discusses why the use of a present-value concept (i.e., discounting future cash flows for interest) is misleading for large social-insurance programs like OASDI. The paper strongly argues why OASDI must be considered as part of overall government expenditures, and not merely as an isolated program.

In the fourth section, a memo from Guy King, chief actuary for the Health Care Financing Administration, proposes changes in the method of measuring the actuarial balance for the HI system. The memo discusses why the level-financing method is inappropriate for HI when it is funded on a pay-as-you-go basis and recommends a change to a method more like the average-cost method formerly used for OASDI. The paper also provides illustrative tables of how the method works for Old-Age, Survivors Insurance (OASI) projections.

The final section of the briefing notebook is a historical chronology of the funding basis for OASDI. This paper, written by Robert J. Myers, outlines the historical estimates of the future fund ratios and year of exhaustion of the trust fund and shows how these estimates have changed over the years. The paper also provides tables of the historical fund ratios that show that OASDI was financed, *as to its actual operations*, on a partial-reserve basis from its inception through the early 1960s. Thereafter, the actual financing has been on a current-cost basis. However, under 1977 and subsequent legislation, a mammoth fund is estimated to build up over the next several decades, essentially returning OASDI to a partial-reserve funding basis.

Copies of the Social Security briefing notebook are available from the Academy's Washington office.

Standards Outlook

by Christine Nickerson

The Actuarial Standards Board (ASB) held its third-quarter meeting in St. Louis, July 13–14, 1989. At the meeting, the ASB approved two new standards of practice titled, *The Treatment of Reinsurance Transactions in Life Insurance Company Financial Statements* and *Methods and Assumptions for Use in Stock Life Insurance Company Financial Statements Prepared in Accordance with GAAP*. These two standards were released as exposure drafts in January 1989 and are included in this mailing of *The Update*.

The ASB also approved, as an exposure draft, the Casualty Committee's proposed standard of practice titled, *Trending Procedures in Property/Casualty Insurance Ratemaking*. The proposed standard would provide actuaries with a basis for assessing procedures appropriate for adjusting historical data to reflect the expected value of future cost levels.

Projects currently under development by ASB operating committees are as follows:

Casualty Committee

The Casualty Committee is redrafting a proposed standard on loss reserve discounting. The ASB reviewed the committee's work on this topic at the July ASB meeting and asked the committee to consider revisions to a number of items, before the board approved its release as an exposure draft. The proposed standard would define the issues and considerations that an actuary must take into account when determining discounted property or casualty loss and/or loss adjustment expense reserves.

The committee is shifting direction somewhat in its development of a standard of practice for the valuation of insurance companies and now plans to focus more specifically on cash flow testing for property and casualty insurers.

The committee is considering the need to create a standard of practice on profit issues and is also planning to begin work on a standard relating to reinsurance.

Specialty Committee

The Specialty Committee presented a proposed exposure draft on expert-witness testimony by actuaries, at the July ASB meeting. The proposed standard would guide actuaries in giving testimony as actuarial experts in public forums, including administrative or legislative hearings and judicial or extra-judicial proceedings. The ASB reviewed the proposal and agreed that it needs further work by the committee before it can be approved for release as an exposure draft.

Health Committee

The Health Committee is beginning work on standards related to health maintenance organizations (HMOs) and health ratemaking. With regard to HMOs, the committee plans to develop a standard that will point out issues and practice areas unique to HMOs and items that actuaries should consider when dealing with these issues.

In the area of health ratemaking, the committee is reviewing the principles drafted by the Casualty Actuarial Society for casualty ratemaking and also the recently-adopted standard for documentation and disclosure in casualty ratemaking and reserving. The committee believes these principles may also have some applicability for health ratemaking and will consider their use, with some modification, in a health ratemaking standard.

Life Committee

In addition to the two standards mentioned above that were adopted at the July ASB meeting, the committee is drafting a standard on when to do cash flow testing. The committee plans to have a draft on this topic ready to present to the ASB in October.

The committee's Task Force on the Financial Implications of AIDS has begun work on a standard of practice and plans to have a preliminary draft ready by October.

The committee's Appraisal Task Force has developed a charge and has agreed to the fundamentals of a standard of practice relating to an actuarial appraisal of an insurer. The task force draws its members from both the casualty and life disciplines and also includes members drawn from the investment banking community.

Pension Committee

The Pension Committee is discussing changing the provision for numeric demonstrations contained in its exposure draft on shutdown benefits (released in April 1989) and is also considering expanding the proposal to encompass unpredictable contingent events. The committee is currently redrafting the document and expects that changes may be substantive enough to require re-exposure.

Retiree Health Care

The Retiree Health Care Committee is analyzing the Financial Accounting Standards Board (FASB) exposure draft on retiree health benefits. The committee has offered comments to the Academy's public interface committee as that committee prepares its statement, and it will begin work on an actuarial compliance guideline once the FASB standard becomes final.

Task Force on Long-Term Care

The newly-formed "Task Force on Long-Term Care" will be chaired by Bartley L. Munson. Several task force members have been recruited and the task force will hold its first meeting in September. Issues relating to private long-term care insurance are receiving regulatory attention at both the state and federal levels, and this activity underlines the need for standards of practice in this area. Δ

Corrected Compliance Guideline

With this issue of *The Actuarial Update*, you are receiving a corrected copy of the Actuarial Standards Board's *Actuarial Compliance Guideline for Statement of Financial Accounting Standards No. 88*. Please discard the earlier version, which was mailed with July's *Update*; it contained several copy-editing errors.

Modified Endowment Contracts: Form 1099 Timing Issues

By Edward L. Robbins

As life insurance marketing people are aware, the Technical and Miscellaneous Revenue Act (TAMRA) passed by Congress in 1988 adds a new section to the Internal Revenue Code (Section 7702A) that, in effect, forces a segmentation of life insurance policies into three types, for federal income tax purposes: policies that do not qualify as life insurance contracts; modified endowment contracts (MEC), which qualify as life insurance contracts but are subject to certain onerous distribution rules; and contracts that qualify as life insurance contracts but avoid the modified endowment contract "taint." One particular problem that all companies will have to face is the question, "When does a policy become a MEC?"

A contract generally becomes a MEC through either one of two events: payment of cumulative premiums in excess of a stipulated seven-pay limit; or reduction of benefits, such that the seven-pay limit is less than the cumulative premiums paid.

Each of these two events is reversible by the policyholder, but the time limits for reversing the contract differ. Excess premiums (the first event) are reversible within sixty days after the violating policy year. Alternately, benefit reduction due to nonpayment of premiums (the second event) is reversible within ninety days after the reduction. The issue here is, has the policy become a MEC at the time of the violating event, or at the point at which it has become irreversible?

If the policy is considered a MEC at the time of the violating event, it leads to potentially severe administrative reporting problems. These administrative requirements are already onerous, and to confer MEC status at the time of the violating event compounds the difficulty.

Let's look at the following example: A policy is issued in July 1988. In November 1989 a premium in excess of the seven-pay limit is paid. In December 1989, a policy loan is taken out, and it is assumed that there is income in the contract. In January, 1990, because the policy is deemed to be a MEC, the insurer would then send a Form 1099 in order to report the amount of taxable income. In July, 1990, interest compounds into new loan principal, and thus an additional (possibly taxable in part) deemed distribution has taken place.

In August, 1990—still within the sixty-day period of reversibility—the insured "sees the error of his ways" and wants to reverse MEC status by having the excess premiums returned to him with interest. Taxable income for the prior year should now be somehow reversed, most likely by amending the 1989 tax return.

Additionally, investment in the contract (basis) must be recalculated, since on a MEC the taxable income on the loan distribution is deemed to increase basis, and this must now be unwound. Also, investment in the contract must be reduced for the amount of premium returned. Further, let us assume for the moment that the loaned amount was in excess of the amount that would have been eligible to be loaned if no excess premiums had been paid. That excess loan amount must now be recast as a prior return of excess premium (plus interest) before calculation of the current excess premium return at interest. Basis must also be recalculated for this reason.

We have a similar problem on partial surrenders, with a somewhat different retroactive recalculation of basis (the excludable portion of the withdrawal decreasing basis). On a MEC there is "last in first out" treatment of partial withdrawals (income first); whereas on a non-MEC it is generally "first in first out"—except when a Section 7702(f)(7)(B) positive recapture ceiling is present.

A substantial amount of this complexity possibly could be avoided if one could take the position that the policy was not deemed to be a MEC until it became an "irreversible MEC" and the additional tax was not incurred until the year the "irreversible MEC" status occurred. In such case, as in the above example, no Form 1099 would be sent for tax-year 1989 in the case of a loan. Even in the case of a partial withdrawal that is partly taxable, the Form 1099 sent in 1989 reports less than the taxable income than it would if the policy were eventually deemed to be a MEC. So, in virtually all cases, for a policy in which premiums are eventually reversed, the company would have performed reasonable Form 1099 reporting based on the non-MEC status for 1989 and might generate another "positive," incremental Form 1099 for 1990, once the policy has become a MEC. Thus, if the policy becomes a MEC in 1990, a Form 1099 would be sent for a positive incremental amount, reportable as a 1990 event. If excess premiums are returned with interest in 1990, in most cases, the 1990 Form 1099 would also be for a positive incremental amount (including interest on the returned excess premiums).

Thus, if a reasonable interpretation could result in income reporting of potentially taxable events being expressed in successive "positive" layers—i.e., possible additional taxes assessable at later dates, rather than both "positive" and "negative" layers—we could avoid the problem of initial 1099 reporting and subsequent amended returns. Amended returns are disruptive and can be expensive. Some people will tell you that amended returns also are likely to trigger audits.

The basic problem is that it is very difficult on a reading of the Internal Revenue Code to arrive at the "positive layering" approach as the correct approach. That is unfortunate, inasmuch as it appears fundamentally illogical to require a practice which amended tax returns become common events in policyholder tax reporting. Certainly it is not in the interest of the U.S. Treasury, the life insurance industry, or the policyholder to suffer this type of environment, and the code appears to be sufficiently vague to warrant Treasury's issuing a regulation permitting the "positive layering approach."

As an alternative solution to the amended return problem, any company that wishes, at the time an excess premium is made, can obtain a signed authorization from the insured, stating that he or she wishes the policy to be a MEC, instead of accepting a return premium. One company pursuing this approach has informally indicated that, once such authorization is received from the policyholder, the company will

(continued on page 10)

Checklist of Academy Statements July 1989

TO: Senate Labor and Human Resources Committee, July 6, 1989. RE: Employer-provided health benefits. BACKGROUND: This statement comments on the proposed Basic Health Benefits for All Americans Act of 1989, S. 768.

TO: Colorado Insurance Department, July 10, 1989. RE: Proposed regulations. BACKGROUND: This statement comments on the definition of "qualified actuary" for regulating purposes.

TO: Senate Finance Committee, July 10, 1989. RE: Health coverage for the uninsured. BACKGROUND: This statement comments on health care financing and insurance.

MODIFIED ENDOWMENT CONTRACTS

(continued from page 9)

take the position that it has no obligation to return the premium if the policyholder later changes his or her mind. The date of such authorization would probably constitute the date of MEC irreversibility for companies wishing to pursue this route. The chance such companies are taking, of course, is policyholder dissatisfaction, if and when the policyholder later requests a return premium and the company refuses it.

Most companies are just beginning to wrestle with the administrative complexity that TAMRA 1988 has wrought. The above issues are a small, but important sample of those issues being discussed in the search for solutions, and an area in which a clarifying or enabling regulation from Treasury would be most welcome.

Edward Robbins is a principal at Peat Marwick Main & Co., Chicago. He would appreciate your comments.

Centennial Portrait

Albert Wurts Whitney

Albert Wurts Whitney, in a eulogist's words, "belonged to that select group of men whose intelligence, scientific integrity, perseverance and foresight created the firm foundation from which the rating structure of casualty insurance has been built."

Whitney contributed significantly to the theory of experience rating with his paper on that subject, published in the 1917–1918 *Proceedings* of the Casualty Actuarial and Statistical Society of America.

The paper outlines "the general line of reasoning" behind the development of experience rating, first conceiving of experience rating as a problem "not found in life insurance, except potentially in group insurance, and not at all in fire insurance...." Whitney states that "the problem exists only in those forms of insurance in which there is a risk-experience as distinguished from a class-experience." He then explains that "in the case of life insurance death occurs but once and in the case of fire insurance likewise the occurrence of a fire is so rare that the experience of risk is of little evidential value in itself."

His paper considers how the balance between class-experience and risk-experience will depend on (1) the exposure, (2) the hazard, (3) the degree of concentration within the class, and (4) the credibility of the manual rate, and how finding this balance is "strictly a matter for statistical treatment," as "the detailed solution of this problem depends upon the use of inverse probabilities ...." The statistical formulations then are presented in considerable detail.

In conclusion, Whitney said that he hoped "the future may see important work done along these lines and that an actuarial theory for workmen's compensation insurance rating may be developed as consistent and well-balanced as that of life insurance and going beyond it in its nicety of measurement."

Effective Casualty Loss Reserve Opinions

The Academy Committee on Property and Liability Insurance Financial Reporting is engaged in an evaluation of the effectiveness of the current casualty loss reserve opinions, with the goal being to make suggestions on how to improve their effectiveness in the future.

An important part of this evaluation is Academy members' comments. The committee would very much appreciate members' thoughts on the topic. The committee will also survey chief examiners of state insurance departments. Part of the survey asks for narrative comments about casualty loss reserve opinions. To stimulate thoughts, the survey asks the following questions:

1. How much does the department rely on the opinions?

2. Does the department view differently an opinion signed by a company employee from one signed by someone outside the company?

3. Would standardized wording for particular situations be helpful? Would it be helpful to highlight the distinction between a clean opinion, a qualified opinion, or no opinion?

4. Should the telephone number of the opinion signer be required?

5. Would an actuarial report be more helpful than a one- or two-page opinion?

6. Is the department familiar with the discipline process of the Academy?

The key question is: how can the credibility of the casualty loss reserve opinion be improved? Any and all comments would be welcome. Please direct your comments or call to Edward Ford, at William M. Mercer, 1375 East 9th Street, Suite 2600, Cleveland, OH 44114. (216) 781-7634.

A Summary of the NAIC Actuarial Guidelines

The National Association of Insurance Commissioners' (NAIC) Life and Health Actuarial (EX5) Task Force is often asked to assist state insurance department in interpreting a statute dealing with an actuarial topic. Guidance is especially important in the case of an unusual policy form or a situation that was not contemplated at the time a statute was drafted. To this end, the task force has developed certain actuarial guidelines and will continue to do so as the need arises.

The actuarial task force, in developing its interpretation or guidelines, considers the intent of the statute, the reasons for initially adopting the statute, and the current situation it is being applied to. A guideline is not a statutory revision, but merely a guide to be used in applying a statute to a specific circumstance.

By publishing interpretive guidelines for situations that are sufficiently common to all states, the task force hopes to benefit regulators in each state and promote uniformity in regulation—and thereby to benefit everyone.

The table of contents for the *Actuarial Guidelines* is being printed in this *Update* for easy reference. Please note that the full text of any one of these guidelines is available upon request from the Academy's Washington office.

ACTUARIAL GUIDELINES TABLE OF CONTENTS

Guideline No.	Description	Date Adopted by NAIC	Interpretation of	Revision of Earlier Guideline
1	Valuation of policies in which the net premium exceeds gross premium	Dec. '78	Standard Valuation Law	No
2	Valuation of active life funds held relative to group annuity contracts	Dec. '78	Standard Valuation Law	No
3	Definition of the term "maturity value" in the Standard Nonforfeiture Law for individual deferred annuities	Dec. '78	Standard Nonforfeiture Law for Individual Deferred Annuities	No
4	Minimum reserves for certain forms of term insurance	Dec. '84	Standard Valuation Law	Yes
5	Acceptable approximations for continuous functions	Dec. '79	Standard Valuation and Nonforfeiture Laws	No
6	Interpretation regarding use of single or joint life mortality tables	Dec. '79	Standard Valuation and Nonforfeiture Laws	Yes
7	Calculation of equivalent level amounts	Dec. '79	Standard Valuation and Nonforfeiture Laws	No
8	The valuation of individual single premium deferred annuities	Dec. '80	Standard Valuation Law	No
9	Form classification of individual single premium annuities for application of the Valuation and Nonforfeiture Laws	June '81	Standard Valuation Law and Standard Nonforfeiture Law for Individual Deferred Annuities	No
9A	Use of Substandard Annuity Mortality Tables in valuing impaired lives under structured settlements	June '89	Standard Valuation Law	No
9B	Clarification of methods for deferred annuities and structural settlements contracts	Dec. '88	Standard Valuation Law	No
10	Guideline for interpretation of NAIC Standard Nonforfeiture Law for individual deferred annuities	Dec. '81	Standard Nonforfeiture Law for Individual Deferred Annuities	No

(continued overleaf)

Guideline No	Description	Date Adopted by NAIC	Interpretation of	Revision of Earlier Guideline
11	Effect of an early election by an insurance company of an operative date under Section 5-C of the Standard Nonforfeiture Law for Life Insurance	Dec. '82	Standard Nonforfeiture Law	No
12	Interpretation regarding valuation and nonforfeiture interest rates	June '83	Standard Valuation Law and Standard Nonforfeiture Law for Life Insurance	No
13	Guideline concerning the commissioners' annuity reserve valuation method	March '85	Standard Valuation Law	No
14	Surveillance procedure regarding the actuarial opinion for life and health insurers	Dec. '85	Instructions for Financial Examiners	No
15	Illustrations guideline for variable life insurance model regulation	June '86	Variable Life Insurance Model Regulation	No
16	Guideline for calculation of commissioners' reserve valuation method on select mortality and/or split interest	Dec. '86	Standard Valuation Law	No
17	Guideline for calculation of commissioners' reserve valuation method reserves when death benefits are not level	Dec. '86	Standard Nonforfeiture Law	No
18	Guideline for calculation of commissioners' reserve valuation method reserves on semi-continuous, fully continuous or discounted continuous basis	Dec. '86	Standard Valuation Law	No
19	Guideline concerning 1980 commissioners' Standard Ordinary Mortality Table with 10-year select mortality factors	Dec. '86	NAIC procedure for permitting same minimum nonforfeiture standards for men and women insured under 1980 CSO and 1980 CET Mortality Tables Model Regulation	No
20	Guideline concerning joint life functions for 1980 commissioners' Standard Ordinary Mortality Table	Dec. '86	Standard Valuation Law	No
21	Guideline for calculation of CRVM reserves when (b) is greater than (a)	June '87	Standard Valuation Law	No
22	Interpretation regarding nonforfeiture values for policies with indeterminate premiums	June '87	Standard Nonforfeiture Law	No
23	Guideline concerning variable life insurance separate account investments	June '87	Variable Life Insurance Model Regulation	No
24	Guideline for variable life nonforfeiture values	June '87	Standard Nonforfeiture Law for Life Insurance and Variable Life Insurance Model Regulation	No