The Actuarial Update

VOLUME 18 NUMBER 5 AMERICAN ACADEMY OF ACTUARIES MAY 1989

In this issue

Enclosures

Included in this month's issue of *The Update* are the following:

- Government Relations Watch
- In Search Of . . .
- ASB Boxscore
- Final Standard on Documentation and Disclosure in Property and Casualty Insurance Ratemaking and Loss Reserving
- Exposure Draft Concerning Risk Classification

The Washington Briefing

by George Soules

Any lingering doubt about the profession's potential for greater visibility and clout on Capitol Hill was largely dispelled at this year's Washington Briefing, held March 22 at the Grand Hyatt Hotel, Washington, D.C. In engaging fashion, three congressional staffers, an agency staff person, and a General Accounting Office (GAO) official, delivered a mix of updates, anecdotes, and advice to an attentive gathering of Academy board and committee members. The briefing preceded the annual Washington Luncheon, during which new Academy Executive Vice President James J. Murphy spoke of the Academy's new, more vigorous public policy stance.

At the morning briefing, Gary Hendricks of the Pension and Welfare Benefits Administration, Department of Labor, offered commentary on how actuaries could become better recognized on the Hill. "You really have to come in person," he said, "because you are not a political constituency—you are an informational constituency." He urged Academy committees to send in their reports early in the legislative process or risk having no influence at all. Hendricks added: "I do think the expertise in this room is so great, especially in the pension area."

Hendricks outlined three issues that will "drive future decisions" in the pension area: the redefining of liabilities for defined benefit plans, the large pool of pension assets now escaping taxation, and the budget deficit. He related that Senator Howard Metzenbaum's (D-OH) "asset reversion" bill contains a change in principle whereby employers would give employees projected benefits based on salary increases, not expected service. "That really is a fundamental shift," Hendricks stated. Another "troublesome" issue, he said, concerns the shifting of termination liabilities and the tax committees' bias against giving away benefits in the instance of overfunded plans.

Addressing the issue of pension portability, Hendricks said that while three Labor secretaries have come out in favor of it, members of Congress just now are beginning to grasp the concept of a flexible workforce and the inevitability of dealing with portability losses. "People are going to suffer real losses when they change jobs," warned Hendricks, and awareness of this may result in legislation calling for deferred vested benefits based on projected benefits, rather than frozen assets, as under current law.

Another issue discussed was the minimum funding level and how it interacts with the full-funding limitation. Hendricks said he doubted that Congress has "the stomach" to go back and make fundamental changes. Although there are thirty-seven million uninsured in this country, Hendricks forecasted that "you are not going to have mandated health benefits" in the near future.

Debate Over Long-Term Care

A "whirlwind tour" of issues confronting the Senate Finance Committee led off staff member Anne Weiss's remarks. Reducing spending for Medicare has been earmarked by Congress as a way to trim the budget deficit, she said, and the debate now involves whether doctors or hospitals will be targeted. Weiss admitted that there has been a "tremendous backlash" from the elderly over the increased costs they must bear as a result of the Medicare catastrophic legislation and, in particular, a growing concern over the expense of the prescription drug benefit.

The main focus of Weiss's remarks centered around long-term care. She pointed out the irony of the Medicaid program in that it currently represents the best available protection against the long-term care needs of our elderly. Regarding the current Medicaid system, which "forces" recipients to become impoverished in order to be eligible, Weiss said "there is a lot of ambivalence in our society over whether an individual's income should be taken to meet long-term care needs, or whether this should be a universal entitlement."

The issues of greatest contention involving long-term care bills already introduced in Congress, Weiss explained, concern eligibility rules, ability to pay,

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The Actuarial Update

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From the President-Elect

Harold J. Brownlee

In the March issue of *The Actuarial Update* Academy President Jim MacGinnitie discussed some contributing factors to the poor public image that insurers and benefit plans currently have and described two fundamentals of risk transfer mechanisms, risk classification and advance funding, which are not generally understood or appreciated. As the organization to which the actuarial profession has given responsibility for public interface, the Academy must continually seek ways to educate both the general public and the individuals who develop laws and regulations at federal and state levels.

Doing this in a constructive way is a formidable task, given the increasing number of complex issues confronting the country, the emotions that many of these issues generate, and the large amounts of money they involve. In addition, the actuarial profession is small in number—fewer than 15,000—and has, for much of its hundred years, been virtually invisible to the public.

The Academy, since the Washington office was opened in 1976, has been working to make us more visible. The Academy works in ways designed to give the profession optimal impact for each dollar of membership dues.

For example, helping courts of law to understand the principles underlying insurance and benefits issues—such as risk classification and the need for advance funding—is important to the profession. The Academy files *amicus curiae* briefs in selected cases. Three of the Academy's more recent briefs were described by Academy General Counsel Gary Simms in a March *Update* article. The Academy will continue to submit briefs in cases where the potential impact to the profession is substantial. Even though *amicus curiae* briefs rarely make page one of the newspapers, they are a vital part of the Academy's work.

Our new executive vice president, Jim Murphy, came on board the first of the year. By the time you read this, we hope to have hired a director of government relations. Jim and the director of government relations will concentrate on improving contacts with key people in Washington. There are several critical issues involving both pensions and health coverages that may come before Congress this year. In addition, if McCarran-Ferguson is to be modified or repealed, it is important that key congressional staffers and committee members be informed of the implications for insurance costs, both life, and property and casualty. The Academy's government relations effort also reaches the state level, where there are always issues involving selection of risks, rate setting and the level of reserves.

News releases, radio spots, and other items designed to reach either the general public or specialized audiences have been successfully developed by Erich Parker, the Academy's director of public relations. And this year he is helping to develop another major vehicle: *Contingencies*, the first issue of which should be in the mail to you right now. It is not only being sent to most actuaries, but also to business leaders and federal and state legislators. Dana Murphy, the editor, will continue to select articles that present issues relating to casualty insurance, life insurance, health plans, and pensions. By showing how actuarial science is applied to diverse social and economic problems, we hope to garner more recognition for the profession in the future.

Contingencies is your profession's latest attempt to get greater visibility in the outside world. Your comments on it are solicited and welcome. Send them to Dana Murphy, to Jim MacGinnitie, or to me. We hope you like the magazine, and that you will learn more about your profession as you read it. Δ

Board of Director Nominations Talleyed

The Academy Nominating Committee received a total of 110 nominations for directors of the Academy's board, reported Chairperson Preston C. Bassett. "There were very few duplicate names and no one was mentioned more than three times," he said. He was certain that, from the "many fine suggestions, . . . some will be nominated by our committee." Please note that the Academy's election will take place during the Annual Meeting in Hot Springs, Virginia, October 16–18.

New ASB Board Members Appointed

The Actuarial Standards Board (ASB) announces the appointment of two new board members, Willard A. Hartman and P. Adger Williams, who replace Edwin F. Boynton and Thomas E. Murrin. The ASB consists of nine members, each of whom is appointed for a three-year term. Terms of membership are staggered, so that one-third of the members are appointed annually. No individual may serve more than two consecutive terms.


Hartman


Williams

Letters to the Editor

Retirees' Publications Fee

The Academy may be able to prove me wrong about this, but I believe that hardly any retired member would be willing to pay $40.00 to receive your magazine and other items mentioned in your recent yellow paper. [An Academy dues waiver notice on publications]

I think the old $25.00 price was all the traffic could be expected to bear, and the Academy may turn out to lose money by its $15.00 hike.

Furthermore, speaking as one who was actively involved in the days when the Society of Actuaries and the Academy originally decided what attitude to take toward keeping in touch with their retirees, I can assert that a fee calculation based on cost accounting (which presumably is how you reached the $40.00 amount) did not used to be considered the determinant. We thought that retired members had done their stint for the institution; it seemed to us that a nominal charge, just to make sure that we weren't continuing to flood members with unwanted mail, would be sufficient.

What I hope the Academy will seriously consider is moving *The Actuarial Update* into the gratis category and then charge whatever it pleases for the *Enrolled Actuaries Report*, exposure drafts, and statements.

E.J. Moorhead
Bermuda Run, North Carolina

Editor's response: I am on record as being opposed to the high combined level of fees being charged by the various organizations. I suppose there are two ways of interpreting your wanting to receive The Update *gratis. Either you don't think it's worth anything at all, or you think it's too valuable to go without. I prefer to think you meant the latter.*

Ad Hominem Attack?

Charles B.H. Watson's editorial in the December *Update* refers to the *Manhart* decision: "when a confused band of actuarial brethren tried to solve a public policy question by an abolition of the laws of statistics. . . ." I have several problems with his comments.

First, Mr. Watson seems to feel that statistical "laws" are the only rational basis for public policy decisions. I believe *interpretation* is more important than the underlying figures. Statistics certainly have a bearing in the discussion, which is exactly how the drinking age was raised to age twenty-one. Did the statistics fail to support a raise to twenty-two, or did judgment get in the way of statistics? Similarly, a legislator could look at auto accident figures for young men and raise the male driving age to twenty-five. I don't think that would be acceptable public policy, though.

Mr. Watson goes on to say that we need "unity" to deal with the discrimination issues that he mentions. Actually, he seems to want unanimity. I believe unanimity, if achieved by a stifling of discussion and/or dissension, would serve us very poorly. As much as I believe the actuarial profession should offer its opinions on relevant public issues, I also believe the "loyal opposition" among us is entitled to be heard. If it's an issue for the public to decide, then those of us who might disagree with the actuarial majority still have a right to press our case before the public at large.

Finally, and of most concern, the tone of Watson's comment disturbs me. A good many good actuaries supported *Manhart*, and they were both rational and cogent in their arguments. Calling them "confused" merely because you disagree with them is out of place in a professional journal, particularly coming from the editor. I hope as actuaries we can conduct our public discussion without resorting to *ad hominem* attacks.

John W. Atteridg
San Francisco, California

P.S. Mr. Watson's reference to actuarial "brethren" is exactly the sort of sexism that gives credence to charges of discrimination. There are men *and women* on both sides of *Manhart*, so it seems inappropriate to use a collective male noun to refer to the decision's supporters.

Editor's response: Clearly, there has been a failure of communication between me and Mr. Atteridg. I have no objection to the proposition that public policy can mandate the use of sex-neutral mortality rates, regardless of what the probabilities might indicate. This is a reasonable position, and one that I tend to support.

The problem was that the Manhart group rested their case not on this, but on a purported theory of mortality that I (and a "good many good actuaries") saw as truly confused and erroneous—one that, if accepted, would tend to erode the foundation of our profession. This was, and is, a very serious matter, and I do not see criticism of their approach as an "ad hominem" attack.

Speaking of sexist language, I chose to use "band of brethren" as a somewhat sarcastic but (I hoped) distinguished turn of phrase, consistent with the tone of the editorial. I'm sorry, but I just can't think of a suitable feminine or asexual counterpart to "brethren"—a failing, no doubt, of our language or my imagination—but no reason to abjur using an elegant word.

Finally, I cannot agree that I advocated a "stifling" unanimity. Far more dangerous is any implied proposal that The Update *should exclude controversial editorials.*

subsequently encouraged legitimate business executives to come forward with proposals to address these problems; however, in some instances even well-intentioned insurance officials have admitted to not employing actuaries at their firms. "The message," Chesson concluded, "is that we're trying to get more work for you. We have good relations with your people in town so far, and as we move along we hope for more input."

Taxing Stock and Mutual Companies

A comparison of the taxation methods of stock and mutual companies was the focus of remarks from Natwar Gandhi, group director for tax policy at GAO. He began by explaining that, between 1984 and 1986, the life insurance industry incurred more than $11 billion in federal income taxes. Of this total, mutual companies accounted for 48% and stock companies 52%. "Whether the mutual companies paid too high or too low hinges on the controversial issue of measuring mutual company income," said Gandhi.

According to GAO, while taxes incurred exceeded revenue estimates for the period 1984–86, mutual companies incurred less than 55% of the tax bill and therefore did not pay a "proper share" of the bill. Using a definition of income contained in Section 809, Gandhi reported that the split in taxes roughly parallels the split in income. "Yet we have several concerns about Section 809," he stated.

Gandhi argued that the Section 809 mechanism is "inequitable" since it taxes mutual companies more heavily during years of poor earnings and more lightly when that experience is strong. The mechanism also imposes a "regressive" tax burden on a company-by-company basis, Gandhi noted. For 1986, the proportions were 87% for low-earnings companies and 39% for high-earnings firms.

An additional problem with Section 809 is that a company's taxes depend disproportionately on the behavior and performance of the larger mutual companies. Gandhi raised the issue of whether mutuals' taxable income should be based on how stock companies performed, and whether this may result in excessive taxation of mutuals.

He stated that GAO is currently studying a number of alternative methods for assessing the taxable income of a mutual company. One suggestion would allow mutuals to deduct policyholder dividends in determining taxable income. The second would "impute a rate of return," said Gandhi, "on equity to mutual companies on the basis of experience—not from stock companies as Section 809 does, but from outside the life insurance industry," through the use of a tax-free bond index.

The third alternative would target a proportion of policyholder dividends to be included in taxable income, which could be based on the the underlying principle of Section 809 or on a rate from outside the insurance industry. Of all the options, this one appears to have the "fewest difficulties" and the greatest flexibility, according to Gandhi.

The report should be ready by early next year, said Gandhi, and he encouraged those in attendance to make their concerns known before the final recommendations are in place. "At GAO we bend over backwards to make sure that we hear from the industry . . . from independent actuaries, experts in the area. We receive their comments and go back to the drawing board and see if we made any mistake. When the report comes out, it becomes a kind of social document." Δ

Murphy Addresses Washington Insiders

Before a large audience composed of actuaries, congressional and regulatory staff, insurance and benefits consultants, and the press, the featured Washington Luncheon speaker, new Academy Executive Vice President James J. Murphy, revealed some of the current activities and future focus of the profession in the public policy sphere.

"We are pushing back the horizons of actuarial practice," said Murphy, "expanding our role, moving into completely new terrain—like long-term investment analysis, continuing care retirement communities, and environmental risk."

Murphy elaborated on the Academy's recent initiatives on Capitol Hill. "Among the biggest issues facing the 101st Congress are those in the health area," he said. "These issues include health care for the estimated thirty-seven million uninsured, long-term care for the elderly, and employer-provided health benefits."

Murphy disclosed that a previous warning issued by the Academy concerning the expense of the Medicare catastrophic prescription drug benefit has recently been borne out by Health Care Financing Administration estimates of the benefit's likely cost. He also reported that the Academy-devised method for valuing accident and health plans under Section 89 requirements offered to the Internal Revenue Service "is currently in wide use."

Recent efforts to repeal Section 89 requirements have elicited reaction from some members of Congress to the effect that, should the law be repealed, a tax on employee benefits might emerge. Taxation of employee benefits would be one means of trimming the federal budget deficit. "The threat that taxing employee benefits poses to the availability of health coverage for employees," said Murphy, was the subject of a recent letter to Congress from the Academy and insurance, employer, business, and labor groups.

Emphasizing the profession's increasingly pro-active stance in public policy and regulatory matters, Murphy revealed that a monitoring of the property-casualty industry's insolvency problems was currently underway. "In the investigation of the Transit Insurance Company insolvency case," said Murphy, "the Academy recently met with Capitol Hill staff to discuss the complex process of loss reserving. While there is no insurance insolvency crisis yet, it is important to develop a record of information that can be used to avoid one."

Among emerging actuarial specialties, Murphy cited the Academy's efforts in assisting states to improve the financial regulation of continuing care retirement communities. The Academy is "writing model legislation that would provide guidance for improved and consistent financial oversight," he stated.

Murphy also spoke of the profession's involvement in the formulation of a national retirement income policy. "The Academy has developed a definitive statement on creating a national retirement income policy," he said, adding that the statement addresses reasonable funding standards for private pension plans, individual retirement savings, and flexibility in plan design, among other elements. Δ

Checklist of Academy Statements— March 1989

TO: Various members of Congress and trustees of the Social Security and Medicare trust funds, March 28. RE: 1988 Annual Reports of the Board of Trustees of the Federal Old-Age, Survivors, and Disability Insurance Trust Funds. BACKGROUND: This statement comments on and makes recommendations regarding the 1988 annual report.

Centennial Portrait

James Douglas Craig

In October 1929, James Douglas Craig remarked, "Our own business as well as the part we are acting in it should be reviewed at relatively short intervals in order that our vision be clear, our aim true, and our purpose definite . . . " Addressing a joint conference of the Actuarial Society of America and the American Institute of Actuaries that year as Society president, he raised the inveterate, leading question: "What are some of the aspects of our work that might be worthy of consideration," with respect to "the problems of the day?"

A seminal event of his day—"attracting attention throughout the daily press"—was that American life insurance companies, after eighty-five years, had written one hundred billion dollars of insurance. Craig commented, "It has been stated that such an amount of insurance in force might warrant our being called a far-sighted, money-wise and prudent people." He continued, "there has been misplaced energy and consequent waste in life insurance, as in many other fields," however. (The prime example he gave was "wastes in our banks.") Yet, " . . . while there has been waste in life insurance concurrent with waste in other lines, at the same time there has been more insurance progress on this continent than has been achieved by any other country. . . ."

Mr. Craig surmised one reason for the industry's success:

> Toward the close of the first era, conditions changed so that moderation and cooperation became more the accepted custom. The spirit of cooperation developed so that the practices and conditions in one company became more and more the common property of the insurance world at large. . . . There are many examples of important changes in general company practice and in insurance laws which have been initiated or developed by these two actuarial bodies. The willingness and ability to subordinate local interests for the improvement of business as a whole have been recognized as characteristic of the members of the profession. The actuary's knowledge of the scientific foundation of the business tends toward a broad viewpoint and naturally brings [the actuary] into position to assume an increasingly important part in the executive management of companies. . . . Many illustrations could be given of actuaries who have so developed that they are holding positions in practically every field of the insurance business—investment, administration, and sales.

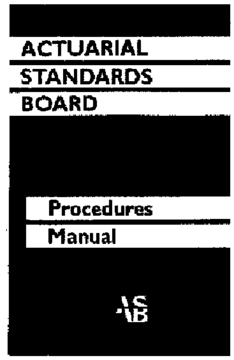
Continuing, Mr. Craig pointed to the actuary's natural role in the newly burgeoning pension area:

> Outside of the insurance business there is another field almost virgin. Corporations of all types in industry are turning to insurance principles to solve some of their problems, such as personnel relations programs, an outstanding example of which is the problem of industrial pensions. The employer is beginning to consider these as matters of business, rather than as matters of charity or relief. He is looking for guidance and advice and the actuary is the logical one to give it to him.

As the son of an actuary and also the father of one, James Douglas Craig had a unique view of the profession. A generation before, his father, James McIntosh Craig, once a president of the Actuarial Society of America himself, had helped to forge what by 1929 was the actuarial profession's historic role in the development of the U.S. life insurance industry. And James Douglas Craig's propensity for looking ahead to new, emergent roles for the actuary, may reflect a partiality for the next generation and with it his son's, Douglas S. Craig's, prospects.

Reference: Transactions *of the Actuarial Society of America, 1929. Volume 30, pp. 341–345. Photographs that appear in this column are courtesy of the Society of Actuaries.*

ASB Procedures Manual



The Actuarial Standards Board (ASB) has published a procedures manual. The manual outlines committee appointment procedures, the process for standards development, the exposure process, the adoption procedure for standards, minority opinions, and public hearings. Copies of the *ASB Procedures Manual* are available from the Academy's Washington office.

Seminar on the Valuation Actuary

Fifty state insurance regulators—department actuaries, examiners, and other department personnel—attended a seminar on the valuation actuary, March 2 and 3, 1989. This was the first such seminar prepared entirely for regulators. The Academy's Committee on Life Insurance developed the agenda and arranged the program. Items covered in the seminar included the development of the valuation actuary concept, definitions of terms, underlying concepts explained by examples, the role of the valuation actuary within the insurance company structure, guidelines for valuation actuaries, rules and regulations currently in force, and how state regulators can and should use valuation actuaries' reports.

Speaking at the seminar were Ted Becker, Texas State Board of Insurance; Joseph Buff, Tillinghast; Robert Callahan, State of New York Insurance Department; Donna Claire, The Equitable Life Assurance Society; Larry Gorski, Illinois Department of Insurance; Frank Irish, John Hancock Mutual Life Insurance Company; and Gregory Jacobs, Milliman and Robertson. Both the participants and the speakers found the seminar to be a valuable source of information and a good opportunity to exchange ideas.

WASHINGTON BRIEFING
(continued from page 1)

Senate Finance Committee staffer, Ann Weiss.

functional status, respite care, and the kinds of long-term care services to be covered. She said most of the elderly favor "community-based" care; however, it is unclear to what degree the setting has a bearing on quality of care.

How to pay for long-term care is ultimately the biggest issue, said Weiss, declaring that "we are not going to be charging older Americans any substantial amount for long-term care in the near future." Of the various financing options being considered, increasing the Medicare payroll tax "is not a very helpful solution," she said. Nor is an increase in estate taxes very highly regarded, as it is considered a "disincentive" for working Americans. Moreover, "a general tax increase is not in the cards, and you can read my lips on that one," she said. Weiss predicted that the Congress will be moving "in an incremental way to encourage private coverage and private insurance for long-term care."

Attention Employee Benefits

Announcing at the outset his high regard for "the level of expertise in this room," William "Mac" McKenney, legislative director for Representative Rod Chandler (R-WA), went on to say that "when most members of Congress come to work in the morning, pensions and benefits isn't the first thing they ask about." Difficulties in getting pension issues heard include "getting the people's attention," overcoming an "institutional skepticism" towards incentives currently in the tax codes regarding benefits, and capturing the ears of plan sponsors. "You probably share in that frustration," said McKenney.

A report issued in February of this year, "Estimates of Federal Tax Expenditures for Fiscal Years 1990–94," suggests that the 1991 revenue loss from excluding pensions and pension contributions from taxable earnings is $51.4 billion. "In the absence of the tax reform act," said McKenney, "I don't think a $51.4 billion tax loss is excessive when you consider the burden that could be placed on the private sector when the baby boom arrives, if we don't have adequate protection for retirement."

McKenney also cited a report from the Congressional Research Service, "Retirement Income for an Aging Population," which criticized the fact that a $50 billion revenue loss associated with qualified pension plans does not equally benefit all citizens. He went on to say that universal salary reduction arrangements, as supported by Chandler, are not compatible with non-discrimination rules. "It's damned if you do, damned if you don't," McKenney said. The report also suggests that the way defined benefit plans calculate deferred annuities could be changed in order to "front-load" the accrued benefits. However, according to Congressional Budget Office estimates, this would increase plan costs by 20%–25%.

Congressman Chandler has proposed legislation that would make it easier for plan sponsors to fund retiree health accounts under Section 401(h), McKenney

"Mac" McKenney, legislative director for Representative Rod Chandler.

explained. This would be accomplished by waiving the subordination requirement if contributions don't exceed a certain cap. Other provisions of the bill would allow plan sponsors to transfer excess pension assets, beyond 125% of current liability, to Section 401(h) accounts. "If it is necessary to terminate the plan," said McKenney, "that could be done by plan amendment." He disclosed that Chandler believes the government will eventually shut down reversions, and accordingly, Chandler's bill would place a prohibitive excise tax on asset reversions in addition to repealing the 150% full-funding limitation.

Before finishing, McKenney urged the audience to have their employers meet with congressmen in their local district offices to argue for specific benefits proposals. "Try to explain what this problem means to your employees' interests," he suggested, adding, "If this is as important to you as I think it is, then it's a very prudent use of your CEO's or CFO's time."

Property-Casualty Scams

Although the savings and loan crisis continues to overshadow insurance insolvency woes, Jack Chesson, counsel for the House Subcommittee on Oversight and Investigations, said his subcommittee is looking for "a system of checks and balances" to prevent a similar debacle from occurring in the insurance industry. The subcommittee, headed by Representative John Dingle (D-MI), views this area of investigation as a "people" rather than a technical problem, Chesson noted. He characterized the individuals responsible for bankrupting Mission, Integrity, and the Transit insurance companies as "incompetent—but more colorful than that."

In uncovering the "cash management system" and non-existent reserving methods that led to the downfall of Mission and other companies, Chesson remarked that "along the way we discovered actuaries." Inquiring as to whether these troubled companies employed actuaries usually produced a negative response. Although Mission's audit firm, Coopers & Lybrand, had an actuary who wrote a report on the company, "it was quickly submarined," said Chesson.

In interrogating Mission's representative, the subcommittee discovered that he was responsible for applying a formula whereby, in the first year of this long-tail casualty business, the company took 50% of a sub-standard premium and declined the balance every year for five years until the IBNR (incurred but not reported) was zero. The result: "humongous jumps in losses year to year," up to $1.2 billion, Chesson said. "It was slavish adherence to an imbecile formula." Before the losses hit Mission, he and another top manager bailed out. Soon thereafter they succeeded in using the same formula to bankrupt the Integrity Insurance Company of New Jersey. The subcommittee also looked into the bankruptcy of the Transit Insurance Company of Los Angeles and discovered that it too, had adhered to a bogus formula, this time perpetrated by two accountants.

Chesson said the subcommittee has