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THE IMPORTANCE OF BEING ERNST

by W. H. Odell

Robert Posnak, *Ernst & Ernst GAAP—Stock Life Companies*, 653 pages, Ernst & Ernst, 1974.

Many individuals working with GAAP over the years found much of value in the Memorandum *Natural Reserves and Life Insurance Accounting* published by Ernst & Ernst in August 1970. They have been eagerly awaiting a sequel — a book which they hoped would be a comprehensive, well considered, and well illustrated exposition of a complex subject. This is the book and expectations have been more than fulfilled.

This volume will be sought after by every individual connected with GAAP work as a guide, as an explanatory text, and as a book of reference. This reviewer suggests that the Introduction be required reading for all actuaries whether or not they are actively at work in GAAP. To encourage them it should be mentioned that a most pleasurable aspect of the text is a visible sense of humor which starts in the Preface and is continued throughout. The light touch of Mr. Posnak is more than welcome in a volume of 653 pages on such an involved and onerous subject.

The success of the book is due in no small part to clarity of diagnosis of problems and objectives by those who initiated and managed the project. In the introduction, it is stated "the problem giving rise to this research project is the fact that the application of generally accepted accounting principles to life insurance companies has not definitely been determined. Underlying this general problem is the problem that the nature and practices of the life insurance business are not adequately understood from the accounting point of view." This text will surely go a long way toward promoting such an understanding.

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THE 1975 TRUSTEES REPORTS

by Robert J. Myers

The Social Security Act provides that, on or before April 1 of each year, the Board of Trustees of the OASDI trust funds and the two Medicare trust funds should submit to Congress reports presenting statistical operational data, future cost estimates, other actuarial analyses, and financing recommendations. Actually, there are three reports, for OASDI, for HI, and for SMI. The Board of Trustees consists of three cabinet officers (the Secretaries of HEW, Labor, and Treasury).

Of foremost interest in the 1975 reports is the one dealing with OASDI, because the financial plight of this program has been so much in the news in recent months. The 1974 report showed a very serious long-range financing situation in that there was a lack of actuarial balance of 2.98% of taxable payroll, or a cost over-run of about 25% relative to the tax income. This year's report shows an even worse situation — namely, an actuarial deficiency of 5.32% of taxable payroll, or almost 50% of the average value of future taxes. This is certainly a far cry from the situation that prevailed before the 1972 Amendments, when the "acceptable limit" on the actuarial imbalance was 0.1% of taxable payroll, or about 1% relatively, and this limit was almost always maintained (or else prompt corrective action was taken by Congress).

The increase in the OASDI actuarial deficiency under OASDI results primarily from a change in the long-range economic assumptions. The 1974 report assumed annual rates of increase in earnings in the ultimate situation of 5% per year, as against 3% increases in the CPI. The 1975 report uses 6%/4% assumptions. Some 83% of the increase

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ACTUARIES AND ASSETS

by Irwin T. Vanderhoof

Over the past five years, an increasing number of actuaries have become concerned with the asset side of the balance sheet. Many papers on investment topics have been presented and several actuarial consulting firms have begun including investment advisory work in the services they offer to clients. Clearly, an area of actuarial responsibility exists here which so far has not been well-defined.

The following definition of the responsibilities of the actuary in investment matters has no formal endorsement by any actuarial body or company, but has been discussed with other actuaries who have offered no serious disagreement. Once stated, these responsibilities should seem obvious to everyone. All comments and criticisms are welcome, since I feel the profession must decide upon a course of action or allow this matter to escape us as has the question of adjusted earnings.

In this article, I will be referring to those responsibilities that we have automatically because we are actuaries, not those which individual actuaries may have because of non-actuarial expertise. Choice of specific investments is *not* one of these responsibilities. Some actuaries may be proficient in this area, but it is not an integral part of the material of the profession.

What is the basic responsibility of the actuary? I think it is the determination of the surplus of a fund (or the determination of the adequacy of implicit margins in the assumptions, which is inherently the same). Surplus has traditionally been the difference between the liabilities the actuaries have been concerned with and the assets they have merely accepted. This unilateral concern

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1975 Trustees Reports

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in the actuarial imbalance is due to these revised economic assumptions. The remainder arises from changed demographic assumptions (lower mortality rates in the period after the year 2000) and higher disability rates (to reflect the recent unfavorable experience and to project it somewhat into the future), although these are partially offset by an assumed higher rate of labor force participation by females.

It is most significant to note that a decoupling of the benefit structure with regard to the initial computation of benefits by a wage-indexed approach applicable to the past earnings record, as recommended by the Advisory Council on Social Security, would neutralize the effect of changing economic conditions and would eliminate from 45% to perhaps as much as 60% of the currently-estimated deficiency of 5.32% of taxable payroll, depending on exactly how decoupling is done. There would then remain a deficiency of only about 2¼% to 3% of taxable payroll on the average over the long range to be taken care of by additional financing.

The short-range picture for the OASDI system is equally bleak. The estimates in the 1975 report show that the OASI Trust Fund will be exhausted in 1983, and the DI Trust Fund in 1980, unless additional financing is provided. The Trustees recommend that such additional financing should be obtained through increases in the tax rates, in the taxable earnings base, or in both. They oppose the use of a government subsidy through general revenues (either done directly or, as the Advisory Council on Social Security recommended, indirectly by a transfer of the Hospital Insurance tax rate to OASDI and then a government subsidy to HI).

This reviewer strongly supports the Trustees in their objection to a government subsidy, but does not concur that any additional financing should come from raising the earnings base more than the automatic-adjustment provisions would do. The earnings base in reality is not a financing measure, but rather an element that determines the scope of the benefit protection. Moreover, sharp increases in the taxable earnings base provide uncalled-for benefit windfalls for current older workers, which certainly can be termed as upside-down social welfare (with acknowledgments to Jim Clare).

Moreover, the short-range situation will very likely be considerably worse than the estimates contained in the 1975 report. These estimates are based on the economic assumptions that the annual rate of increase of wages will exceed the corresponding rate for the CPI by an average of somewhat more than 3% in the 5-year period 1976-80. This is a complete reversal of what is expected in 1975, and seems most unlikely to occur. If wages do not increase this much more rapidly than prices, then the projection of the trust funds will not be nearly as favorable, and they will be exhausted much sooner than the years shown in the report.

The Medicare system was the part of the Social Security program which had financial difficulties in the late 1960s. In the early 1970s, the situation reversed, largely due to the effect of price controls, and Medicare has seemed to have no substantial financing problems. However, the peak of the iceberg of new financial problems is showing. The Hospital Insurance program (HI) now has an actuarial lack of balance of 0.16% of taxable payroll, or about 6% relatively, whereas in last year's report it had a small favorable balance (0.02% of taxable payroll). It may well be that, in the years to come, inflationary trends may be greater than the rather favorable ones assumed in the 1975 report, and new financial problems will arise.

The trust fund balance for HI is shown to increase slightly in the next few years, from $9.1 billion at the end of 1974 to $11.9 billion at the end of 1977. The favorable situation of the HI system has been due in part to the increases in the taxable earnings base in the period since 1972. These have been far larger than the increase in the general earnings level and, unlike OASDI, have not produced any additional benefit liabilities. In any event, it would appear that the HI Trust Fund is in no danger of exhaustion in the next few years, even though it may not increase as rapidly as shown in the report.

Supplementary Medical Insurance (SMI), which had been in the deepest trouble of all in mid-1970, as a result of the arbitrary, undesirable freezing of the premium rate by a lame-duck Secretary of HEW, is now in the financially strongest position. For the first time in the program's history, the assets on hand at the end of a fiscal year (June 30, 1974) exceeded the liability for benefits then incurred but unpaid and the administrative expenses thereon. Thus, even the strict standards of actuarial solvency for private health insurers were met. It is estimated that the same condition will prevail in the next two years. As of June 30, 1970, assets had been only 10% of liabilities. □

Letters

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Question

Sir:

In the present examination of the statutory valuation system, considerable attention seems to be given to reconsidering traditional approaches. The newer interpretations seem to result in increased reserves. However, there are areas of possible excesses about which there seems little comment.

One situation is the use of cash values for reserves when the cash value exceeds the statutory reserve. Could someone please let me know the statutory requirement for this?

The annual statement says that this should be so, and presumably the annual statement requirement has some backing by the NAIC. However, as far as a statutory requirement is concerned, NAIC resolutions have no validity. States cannot cede their sovereignty. So there is no statutory requirement there.

As far as actual necessity is concerned, it is noteworthy that GAAP does not require the excess reserve.

I wonder if anyone would care to comment on the apparent lack of need either statutory or actual.

John T. Gilchrist

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Erratum

The price of the second report of the SOA Committee on Cost Comparisons reviewed in the May issue of *The Actuary*, is $4.00 not $5.00. Apparently the Editor following current sales practices was trying to engineer a rebate.