SOCIETY OF ACTUARIES

Social Insurance &
Public Finance Section

ISSUE 3 | JANUARY 2011

IN THE PUBLIC INTEREST

ASSESSING THE FINANCIAL PERFORMANCE **OF PENSION PRIVATIZATION IN EMERGING EUROPE**

*By Nikola Altiparmakov**

Demographic aging due to lower fertility and prolonged life-expectancy is adversely affecting national Pay-As-You-Go (PAYG) pension systems worldwide: including countries that have experienced a baby-boom such as the United States, countries that have a one-child policy such as China and countries that have neither, such as India. The implicit rate of return in PAYG pension systems equals the growth rate of covered wages, which can be approximated by the GDP growth rate for all practical purposes. On the other hand, the rate of return on fully-funded pension systems is the yield realized on an invested portfolio of assets. Inspired by high observed returns on capital in most developed western economies in the latter half of the 20th century (the so called equity-premium puzzle), some economists have been advocating for partial privatization of public PAYG pension systems in the form of privately fully-funded, mandatory individual accounts.

Political and economic considerations make the introduction of a PAYG pension system appealing in times of high fertility, since both young and old generations benefit from this action. This was the case in the early 20th century when most countries introduced public PAYG pension systems. However, trying to terminate PAYG pension systems seems almost impossible from a political and economic point of view—since old generations are bound to be the losing side in this turn of events. Nonetheless, this iconoclastic move of partially terminating public PAYG systems and partially replacing them with fully-funded private mandatory individual retirement accounts (IRA) has been undertaken in some Latin American countries during the ’80s and ’90s. With strong technical support from the World Bank, many emerging European countries have also partially

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IN THE PUBLIC INTEREST

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LETTER FROM THE EDITOR

By Bill Cutlip

Welcome to another edition of the newsletter of the fastest-growing Section in the Society. The subject matter evolves with daily changes in society keeping the membership on its toes.

This was brought home when I was reviewing the articles for this edition. The news in them is current, and, in fact, so current that Florian Leger had to prepare a timely revision to his original article on the French Pension System. The original article had good background on possible changes to the system and how that will affect retirement for Frenchmen. Suddenly, over the past two days of editing for publication (Oct. 26–27, 2010) both houses voted approval for the changes, so Florian agreed to an update.

You'll also note that this issue of the newsletter should make Charles McLeod happy. He sent a comment on *In the Public Interest*'s first issue, stating it was weighted to articles from the United States. Well, Charles, we have three main articles this month: one from Canada on drugs, another on European pension privitization, and a third on the French pension program. Thanks for your suggestion. Social insurance and public finance (SIPF) is truly a global issue! So much is happening in the world which impacts actuaries. SIPF may not include a specific area of practice for you, but the results of government and social financial actions certainly affect your personal, if not professional, life.

We also have opportunities to help friends, the public and legislators. Our skills in understanding and measuring risks can put new perspective on questions. We may not be able to supply all the answers, but at least we can raise questions for others to ask and perspectives which will cause people to ask questions.

Read the SIPF newsletters and updated topics on the website as they become available. They will help you keep abreast of issues and where to find answers.

Bill Cutlip
FSA, MAAA, FAC, CLU, ChFC, CPCU
Editor for this Issue

privatized their PAYG pension systems near the beginning of the millennium. In this article, we will use the term "emerging Europe" to refer to former communist countries which are transitioning to market economies and striving to become, or have already become, EU Member States. These countries include: Albania, Bosnia & Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia and Slovenia.

When comparing the performance of PAYG and fully-funded pension systems, one has to take into account the risk-premium and transition-cost factors. Namely, one has to compensate for the risk factor when comparing defined-benefit PAYG pension systems with defined-contribution IRA systems.

Furthermore, since PAYG systems have been in place for many decades, partial pension system privatization involves transition costs, due to accrued PAYG liabilities to older generations.

Based on early empirical data on the performance on newly established mandatory IRA systems, we will try to assess whether:

* partial pension system privatization is proving to be a feasible venture from the financial risk-return perspective;
* the new mixed PAYG-IRA pension systems are more efficient than existing PAYG systems; and
* any efficiency gains can be expected to benefit future generations after accounting for transition costs of partial pension system privatization.

RISK FACTORS

Partial pension system privatization and moving from a PAYG to a mixed PAYG-IRA system increases the risks associated with the national pension system. First of all, this action exposes contributors to investment risks and inherent volatility associated with returns to capital (equity).

Secondly, there are also numerous operational risks. In emerging Europe, (inflation-indexed) annuity markets are basically non-existent, which prevents contributors from hedging the longevity risk when withdrawing IRA savings at retirement—which defeats the main purpose of retirement saving. Operating costs associated with IRA systems are very high. Data from the 2007 – 2008 period reveals that the (non-weighted) average contribution fee in emerging Europe equalled 4.3 percent, while the (non-weighted) annual asset management fee totalled 1 percent. This produces an equivalent single fee on accumulated savings of 23 percent. On top of this, one should also add an annuity-purchase fee (if, or when, efficient annuity markets develop in emerging Europe), which typically ranges from 5 percent to 10 percent in developed European economies. Hence, the equivalent single fee may amount to 30 percent of accumulated savings, that leaves only about 70 percent of total retirement saving resources for contributors. This costly fee structure should be sharply contrasted with PAYG operating fees, which are less than 1 percent of contributions in all emerging European countries.

Thirdly, there are political risks of running any national pension system, but one might expect mixed PAYG-IRA to be less susceptible to political interference. However, evidence from emerging Europe points to the contrary. Namely, private pension management companies in some countries (most notably Croatia and Slovakia) have been exhibiting political influences to protect their immediate profit interests, possibly at the expense of national pension system efficiency. Moreover, the ability of the politicians to influence private mandatory IRA pension funds was most obvious during the recent global economic crises, as governments in Latvia, Lithuania, Estonia and Romania unilaterally decided to temporarily reduce contribution rates to private pension funds (and divert those funds into the state budget) in order to reduce budget deficits.

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A further risk relates to the state of development of well functioning capital markets. The case for partial pension privatization is based on equity performance in developed western economies, where capital markets have been functioning for several centuries. But, emerging European countries have only recently started transitioning toward free-market economies. Thus, capital markets in these countries are underdeveloped—equity markets feature only a few truly liquid stocks, bond markets are underdeveloped and corporate governance is not up to western standards. It is anyone's guess when, if ever, capital markets in emerging Europe will develop to performance levels comparable to benchmark capital markets of developed economies.

With respect to capital markets' performance in developed economies, one very important risk has to be stressed—the risk of a changing economic environment and the reversal of financial conditions that existed in the latter half of the 20th century when equity returns recorded extraordinarily high growth. It is very risky to assume that economic and financial conditions from the end of the 20th century will prevail throughout the 21st century. After all, this phenomenon has been named the equity premium puzzle—suggesting that the current science of economics is not able to unambiguously explain why high equity returns have been observed. Economic science is also not able to explain whether the equity premium trend is sustainable in the foreseeable future, or whether it can be expected to shrink in the coming decades. Furthermore, there is abundant statistical evidence that demographic trends influence asset returns. Thus, forthcoming demographic aging could be expected to adversely affect not only PAYG systems, but also fully-funded pension systems as well—by reducing high rates of return on capital observed in the past.

Table 1 – IRA performance in emerging Europe from inception to 2007

Country	Inception Date	IRA Returns	GDP Growth	Difference
Hungary	Jan 1998	2.6%	4.0%	-1.4%
Poland	Jan 1999	8.2%	4.1%	4.1%
Latvia	July 2001	-2.4%	9.1%	-11.5%
Bulgaria	Apr 2002	4.3%	5.9%	-1.6%
Croatia	May 2002	4.5%	4.8%	-0.3%
Estonia	July 2002	3.4%	8.2%	-4.8%
Lithuania	June 2004	2.3%	8.3%	-6.0%
Slovakia	Apr 2005	1.1%	8.7%	-7.7%
Macedonia	Feb 2006	2.7%	4.9%	-2.2%

Source: Author's calculations

EMPIRICAL PERFORMANCE

Near the beginning of the millennium, many emerging European countries partially privatized their pension systems, by deciding to reduce PAYG contributions by one-quarter to one-third and divert those resources to newly established private defined-contribution pension funds in the form of IRA. Table 1 presents the data on initial empirical performance, until the end of 2007. IRA returns are measured by tracking unit values of individual accounts over time, adjusted for inflation. Realized returns thus represent real gross returns net of annual asset management fees, but gross of any contribution and exit fees. Performance is measured until the end of 2007, so that we do not introduce a (potentially unfair) downward bias with respect to IRA performance, due to the 2008 global financial crisis.

The data in Table 1 reveal a very troubling discovery—with the exception of Poland, private pension funds in basically all emerging European countries realized returns below GDP growth, which means that IRA returns were below the PAYG implicit rate of return! Although the relevant time period is not very long in the long-term pension reform context, the fact that the PAYG implicit rate of return outperformed IRA returns in basically all emerging European countries is striking. Needless to say, the 2008 global financial crisis even further deteriorated the disappointing IRA performance, as IRA returns plummeted significantly more severely than GDP decline during the 2008 – 2009 period.

We can observe from Table 1 that Poland is the only emerging European country in which IRA returns outperformed the implicit PAYG rate of return, and by a significant margin. In order to explore further this apparent success we need to look at the composition of IRA portfolio assets. We can observe from Table 2 that government bonds dominate portfolios of mandatory private pension funds, amounting to about 60 percent of total investment assets in many emerging European countries. Baltic countries, characterized by most liberal provisions with respect to investments abroad, represent a notable exception and government securities average about 30 percent of portfolios in these countries.

Domestic government securities have been dominating pension funds' portfolios in Poland since the inception of the mandatory IRA system in 1999. They accounted for 59.9 percent of assets at the end of 2007, with fixed-interest government bonds representing the major asset category—51 percent of the total pension funds' assets. Thus, it becomes obvious that high observed returns in the Polish IRA system are due to very attractive interest rates offered by government securities. But, in the context of partial pension system privatization and replacing a part of the existing PAYG system with a private IRA system, holding government bonds in investment portfolios effectively amounts to PAYG financing—whereby contributors are replaced with taxpayers. Furthermore, if partial pension system privatization is undertaken in order to diversify sources of retirement income and replace the sole PAYG system with a mixed PAYG-IRA system, one might argue whether IRA pension funds should be completely forbidden to invest in domestic government bonds. As explained, the investment in domestic government bonds effectively reduces funded IRA to PAYG financing. But, this kind of "investment asset" will always yield lower returns to society than traditional PAYG due to management fees charged by pension funds. Thus, this "investment asset" is first-order-dominated by the traditional PAYG component and should not be included in the optimal retirement portfolio for the society. Thus, we can conclude that contributors in the Polish IRA system have little to be excited about, since higher returns in their individual retirement accounts are being financed with their tax money.

CONCLUDING REMARKS

Early empirical evidence from emerging Europe indicates disappointing financial performance of mandatory private IRA systems. From the risk perspective, newly established mixed PAYG-IRA national pension systems are more risky compared to traditional PAYG systems due to inherent investment risk and significant operational risks. From the returns perspective, realized IRA returns were below the implicit PAYG rate of return.

Although one decade is a short period in the context of pension reforms, disappointing experiences from emerging Europe provide

Table 2 – IRA asset portfolios, end-2007 data

Country	% GDP	Govt Bonds	Equity	Bank Deposits	Other
Hungary	7.8%	58.5%	32.8%	0.9%	7.9%
Poland	11.9%	59.9%	34.9%	2.9%	2.3%
Latvia	1.6%	33.4%	24.3%	42.1%	0.2%
Bulgaria	2.1%	18.5%	28.3%	16.2%	37.0%
Croatia	6.7%	63.6%	26.7%	2.2%	7.4%
Estonia	4.5%	31.0%	40.0%	8.0%	21.0%
Lithuania	1.7%	29.6%	39.3%	17.5%	13.6%
Slovakia	2.8%	49.6%	15.1%	30.5%	4.8%
Macedonia	0.9%	59.9%	21.6%	18.5%	0.0%

Source: Author's calculations

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strong empirical support to many conceptual concerns raised throughout the years regarding the partial pension system privatization in the form of mandatory IRA. No doubt, much future research will be focused on identifying the reasons why mandatory IRA systems failed to meet their expectations. This article surveyed a few major problem areas, including high operational costs and unrealistic expectations regarding capital markets' performance in emerging countries.

Lastly, there is the issue of the outstanding transition cost associated with partially replacing a PAYG system with IRA. The transition cost is very substantial in emerging Europe and is forecast to continue nearly half a century in most countries, due to basically universal coverage of pre-existing PAYG pension systems. Although it was hoped that superior financial performance of mixed PAYG-IRA systems would eventually make it worthwhile for societies to underwrite this transition cost, the early empirical evidence casts serious doubts and raises the question—might the reforming countries be investing their national resources in a financially unfeasible venture?

This text has been written based on the article "A macro-financial analysis of pension system reforms in emerging Europe: The performance of individual accounts and policy lessons for Serbia," International Social Security Review, Volume 63, Issue 2.

SOME THOUGHTS ON THE FRENCH PENSION REFORM

By Florian Léger*

One cannot discuss the French pension system without going back to 1983 when President Mitterrand generalized the possibility to retire at 60, which was a great social advance for many. It became a symbol that no government dared to touch, until this year. The mid ’80s also coincide with the first years of the deficits in the social security system in general and the pension system in particular. Funnily, the first study pointing out the future deficit of the pension systems was prepared in the mid ’80s by Dominique Strauss-Kahn, the current Managing Director of the International Monetary Fund (IMF). A report ordered by Prime Minister Rocard in 1989 also pointed out the ageing of the population and the necessity to reform the system.

The first reform came during the summer of 1993, in the form of a unilateral decree from the Government (there was no discussion with the employers’ and employees’ representatives). It moved from wage to price indexation, progressively increased from 37.5 to 40 years—the required number of years to get a full pension—and progressively based the calculation of the pension benefits on the salaries of the 25 best years (instead of 10). In aggregate these reforms resulted in a decrease in pension levels today, estimated to be about 20 percent.

In 2003, a further major reform was passed, this time after lengthy discussions between the government and the social partners (employers and employees), the support of one trade union, and a series of strikes. The 2003 reform aligned the parameters for civil servants who had not been affected by the 1993 reform, and further increased the number of years required to get a full pension to 41 years. In addition, it also opened the possibility for those with lengthy careers (more than 40 years) to retire before the age of 60. That possibility has been largely used at a cost far above what was estimated.

Just after the presidential election in 2007, another reform, mainly concerning special schemes which still had not been reformed, was voted on. France has a very fragmented pension system with still today more than 30 different compulsory public pension schemes. The main one is the National Old-Age Insurance Fund (CNAV) for employees in the private sector. Besides it, there are pension schemes for farmers, self-employed (several schemes for different categories of self-employed), civil servants, employees of the public companies (railways, metro, Electricité and Gaz de France, Opera, Bank of France, etc., have their own schemes), employees of local authorities, public hospital workers, etc. Some are considered to be first pillar systems, others include both first and second pillars (often with different provisions for both pillars) and some schemes are only second pillar, like the General Association for Pension Institutions for Managerial Staff and the Employees’ Complementary Retirement Schemes Association (AGIRC-ARRCO) which is the compulsory second pillar scheme for employees in the private sector.

France has a very fragmented pension system with still today more than 30 different compulsory public pension schemes.

SOCIAL SECURITY AND PENSIONS IN FRANCE, FROM DEFICITS TO DEFICITS

France’s public pension system can be categorized as very strong as it provides for more than 85 percent of the income sources of older people (the highest share in OECD countries after Hungary). The poverty rate among the elderly is lower than the OECD average (8 percent against 13.3 percent) and is equivalent

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to that of the general population, meaning that the French pension system meets its objective of poverty alleviation. The gross replacement rate varies between 58 percent and 65 percent and the net replacement rate varies between 71 percent and 80 percent depending on the income, but is declining as a result of the past reforms. In addition, life expectancy at birth in France is one of the highest in the world, with 78 years for males and 85 for females. These pension levels can only be provided through high expenditure. In 2007, France spent 13 percent of its GDP on public pension, the second highest among the 27 member states of the European Union (EU).

As a result, the social security system in general and the pension branch in particular has been confronted with deficits for several decades already, with only a few years of surpluses. In the mid '90s when the deficit was particularly high following the 1993 economic crises, the government decided to create a fund (the CADES) responsible for amortizing the social debt of the country. This fund, financed by a special contribution based almost entirely on income from work and capital was supposed to run until 2008 when the deficit would have been entirely covered. Unfortunately, following the continuation of the deficits in the late '90s and early 2000s, the existence of the CADES has already been extended on several occasions. Up to now, this is about EUR 140 billion that the CADES has had to refinance and its existence is expected to continue until at least 2025.

In addition to the CADES (which does not refinance only pensions, but all other branches), based on the example of the United States and Canada, the Government created in 1999 a Reserve Pension Fund (Fonds de Réserve pour les retraites, FRR) that aimed at easing the pension deficit due to aging after 2020. The idea was to have some prefunding, but it was not clear from the beginning if the FRR was supposed to be a sustainable fund or just a smoothing fund with its assets depleted over a period of time. It quickly became apparent that only the second solution would be possible as the funds transferred to the FRR (from privatization and others) were far from what was once expected (but still amounted to EUR 33 billion in June 2010). In 2009, during an ISSA Technical Seminar on Pensions held in Paris, the Chairman of the Supervisory Board of the FRR, Mr. Raoul Briet, said that compared to the mountain of debt, the FRR was a small sandbox.

THE 2010 REFORM

Obviously, the financial and economic crises of 2008 – 2009 changed things. From an already significant deficit of EUR 5.6 billion in 2008, the deficit for the first pillar of the main pension schemes alone grew to EUR 7.2 billion in 2009, and is expected to be EUR 8.6 billion in 2010. The total deficit of the public pension system in France is estimated by the government to be about EUR 30 billion, but half of it comes from the Civil Servant schemes that are financed directly from the government budget.

As part of the 2003 reform, a review of the situation was planned for 2010, based on the work of the "Pensions Advisory Council" (Conseil d'orientation des retraites, COR) created in 2000, which is a permanent body that brings together members of Parliament, representatives of the social partners, experts, and representatives of the State. Its main purposes are to monitor the French retirement system and to put forward recommendations.

The COR did its homework and based on new projections until 2050, the Government submitted a draft bill to the parliament in June this year with the aim to restore the financial balance of the pension schemes by 2018. The reform was approved by the lower chamber of parliament on Sept. 15, 2010. The upper house discussed it in October of 2010 and a vote for a common text was held on Oct. 26, 2010. It is expected that the President will promulgate the law in mid-November.

The main changes are summarized below:
- The statutory retirement age is to be raised from 60 to 62 by 2018 at a rate of four months per year beginning July 1, 2011.
- The minimum age for payment of a full pension without reference to career span is cur-

rently 65. Starting on July 1, 2016, this age limit will be raised at the same rate as the statutory retirement age until it reaches the age of 67 in 2023. The new retirement age will also apply to civil servants. The age of retirement will also be raised by two years for those subject to a different age limit.

- The "extended careers" scheme which enables those who started work very young to retire before the age of 60 will be amended in line with the reforms.
- Beneficiaries suffering from health problems as a result of occupational exposure to hardship will still be entitled to retire on a full pension at age 60. It is expected up to 10 percent of a cohort could qualify.
- Several new sources of funding have been identified: high income earners will contribute through a one point increase in the top income tax bracket, also taxes on stock options and executive pension top-ups will increase significantly; capital income will also be targeted, with an increase in capital gains tax on gains from the disposal of securities and real estate and on dividends and interest. At the corporate level, the method of calculation of tax relief on employers' contributions and tax on company dividends will change.
- The employee share of the contribution rate for civil servants will gradually be aligned with the private sector, rising from 7.85 to 10.55 percent by 2020.

THE ROLE OF ACTUARIES

The role of actuaries in the French social security system is rather limited. This comes from the weird fact that when Social Security was created in France in 1945, it was believed that actuaries were not strictly necessary as they would be for Social Insurance. That being said, there were some famous actuaries working in the Ministry for Social Security like Francis Netter, but very few in the schemes themselves.

From the 2010 Yearbook of the French Institute of actuaries, only two actuaries work at the National Old-Age Insurance Fund (CNAV) and one of them has actually retired (CNAV is the biggest pension scheme in France accounting for 15 million salaried workers from the private sector and 11 million beneficiaries (old-age and survivors) and pays EUR 100 billion a year of benefits). There are five working at the General Association for Pension Institutions for Managerial Staff and the Employees' Complementary Retirement Schemes Association (AGIRC-ARRCO), one at the Insurance Scheme for the Self-employed (RSI), none at the Central Fund of Social Agricultural Mutual Benefit Societies (MSA), none at the Complementary Retirement Pensions Institutions for Unestablished State Employees and Employees of Pubic Administrations (IRCANTEC). However, some of the first pillar schemes (mainly the small ones) ask private consulting actuaries to undertake their actuarial valuations.

Financial projections of the pension system are called long-term projections, there is no use of the word actuarial. Actuaries are mentioned when describing how financial projections are made abroad.

The French Institute of Actuaries is heavily trying to have a voice in the debate but much still has to be done in that respect.

CONCLUSION

Opinion polls have indicated that the French people massively supported the strikes against the reform but that they have unhappily renounced the right to retire at 60 years of age. Sadly, strikes in France resemble "déjà vu" and like any tradition, a reform without a strike cannot be named so. It is even thought that President Sarkozy did in that respect support the strikes, but his government did not change much of the plans as an answer to them.

Nevertheless, it can already be said that this pension reform will not be the last reform. Without making any projection about the future majority (presidential and legislative election will take place in 2012) the reform covers the deficits until 2018. But as one can expect life expectancy to continue to increase (among other factors influencing the financial situation of pension schemes), more will have to be done.

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DRUGS FOR THE PEOPLE: AT WHAT COST?

By Doug Andrews

But drugs are costly and the amount spent on drugs has been rising.

2010 will mark a change in the trajectory of ever-increasing amounts of dollars being spent on prescription drugs in Canada. Health care delivery is a provincial, not a federal, responsibility in Canada. Consequently, there are some variations in coverage by province. Generalizing, most Canadians who are age 65 or older have most prescription drugs paid for by their provincial (government) health plan, subject to certain deductibles and exclusions. Working Canadians under age 65 and their dependents are frequently covered by an employer's supplementary medical plan that covers the cost of most prescription drugs, often subject to a deductible or co-payment. Poorer Canadians may receive assistance in paying for their prescription drugs through social assistance. Most insurance plans encourage or require substitution of a generic drug when available. Over 90 percent of Canadians have some level of private or public coverage of prescription drugs.

But drugs are costly and the amount spent on drugs has been rising. The Canadian Institute for Health Information reports that drug expenditures rose every year between 1985 and 2008, with an average annual growth rate of 10.5 percent, more than the average annual growth rate of health expenditures and significantly more than the rate of GDP growth. Total drug expenditures amounted to approximately $30 billion in 2009.

Canada is experiencing population aging and its large baby-boom cohort is just about to begin to reach age 65, which may add additional cost pressures to both provincial and employer funded health plans. New and costly drugs continue to be developed. Moreover, with an insufficient supply of doctors (less than two per 1,000 population), there is the potential for an increase in drug prescribing as a method of saving time in serving the public, especially given the small size of Canada's population and the vastness of its geography.

With effect from July 1, 2010, Ontario, Canada's most populous province, took a dramatic step to control rising drug costs in the provincial insurance program and these actions will be gradually introduced to the private sector. The province announced a limit on the price that it would pay for generic substitutes of 25 percent of the price of the original brand-name drug and elimination of professional allowances paid by manufacturers to pharmacies. With respect to private sector plans, the generic price was limited to 50 percent of the brand-name price, decreasing to 35 percent of the brand-name price on April 1, 2011 and to 25 percent of the brand-name price on April 1, 2012. Professional allowances were capped at 50 percent immediately, with further reduction to zero by April 1, 2013. The reaction from pharmacies given the significant impact on revenue has been to focus efforts on private drug plans through changes in dispensing fees, mark-ups, new professional services and preferred pharmacy networks.

Interestingly, the prescription drug manufacturers appear prepared to accept such a limit. The strong reaction came from some of the province's major pharmacies. Shoppers Drug Mart, a large Canadian pharmacy chain, launched an information campaign stating that the government's proposed measures might lead it to have to limit its hours of operation and services.

While Canadians were waiting to see which party would back down in this battle of heavyweights—the Ontario government and the pharmacy chain—the provincial governments upped the ante. At a meeting of the provincial health ministers in 2010, all provinces agreed in principle to follow Ontario's lead and to adopt an approach to limit the price paid for generics. At press time, only two other provinces had made announcements and their limits were not as extreme as Ontario's. However, an agreement in principle to take action to reduce drug costs is a significant development. By acting together, the provinces desire to leverage buying power and mitigate drug cost inflation trends. The net impact to the public, employers and plan members remains, in question.

Canadians have a long history of paying higher prices for generic drugs, paying 30 percent more than the OECD average for prescription drugs on the current pricing policies. In a 2008 report, the Competition Bureau of Canada reported that Canadian taxpayers, consumers and business could be saving $800 million per year rising to more than $1 billion per year if there were changes to the ways private plans and governments pay for generics. Among the report's recommendations were approaches used in the United States such as using preferred pharmacy networks, mail-order pharmacies, and providing patients with incentives to seek lower prices.

A less market-friendly approach was recommended in a study released in September 2010, by Marc-Andre Gagnon, a university professor, assisted by Guillaume Hebert, a researcher, published by the Canadian Centre for Policy Alternatives, namely that Canada should adopt a universal drug plan. The study examines the cost of a universal drug plan, considering four different approaches to industrial policies with respect to drugs. It calculates that the aggregate expenditures on drugs would be reduced by adopting a universal drug plan, regardless of the industrial policy considered.

Whether Canada will adopt a universal drug plan remains to be seen. Each province differs considerably in the drugs covered and cost shared by plan members. The economic and political implications and thus political will pose challenges in a universal approach being instituted. However, the Canada Pension Plan agreement provides an example that could be followed or modified (pensions are also a provincial responsibility).

What can Americans learn from these Canadian actions? First, inflation in drug expenditures is a global issue. Second, pooling of buying power by governments, employers and health providers in the United States is being adapted and adopted by other countries such as Canada. Third, regulatory levers on pricing and healthcare delivery, while greatly debated, can create savings for both the public and private sector. I know that "single payer" raises red flags, but de-politicizing this issue may be an important step in controlling and reducing costs. Michael Porter's industry competition model describes how strong suppliers can affect prices. In the drug market, drug manufacturers and pharmacies are very powerful. But as Porter points out, strong buyers can also affect prices. Some insurers may have such market power, but governments, when they take coordinated action, certainly do. One step in containing health care expenditures is containing drug costs. There are lessons to be learned from the recent bold initiatives in Canada.

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SUMMARY OF THE 2010 ANNUAL REPORTS SOCIAL SECURITY AND MEDICARE BOARDS OF TRUSTEES REVIEW AND COMMENTS BY AN INDEPENDENT ACTUARY

By Fred Kilbourne

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The Boards are to be thanked for summarizing, in readable prose, the hundreds of pages of often-technical material in the full Reports. They are also to be thanked for including and illustrating the caveats expressed so eloquently by the Medicare Chief Actuary in his Statement of Actuarial Opinion in the Medicare Report. Unfortunately, and no doubt due to the fact that the Boards are devoid of public trustees, and consist solely of partisan political appointees, they must also be reproved for the misinformation and disinformation in their Message to the Public, and for their contribution to public ignorance about Social Security and Medicare financing.

The first substantive paragraph of the Message to the Public section of the Summary bears witness to the complaint above. The paragraph is little more than a puff piece for this year's health care legislation, the Affordable Care Act (ACA). From, "The (financial) outlook for Medicare has improved substantially because of (ACA) program changes," to, "The ACA is also expected to substantially reduce costs for the Medicare (SMI) program," the message is clear that the cost impacts of ACA are expected to be highly favorable. But, expected by whom? Not by the Trustees themselves, as the reader of the remainder of the Summary learns.

The Message goes on to caution the reader that "Much of the projected improvement in Medicare finances" is predicated on "productivity growth" (a euphemism for provider cuts) that is at odds with historical experience. It continues to say that "If health care efficiency cannot be substantially improved through productivity gains or other means, then over time the statutory Medicare payment rates would become inadequate … in which case actual long-range costs (might) be larger than those projected under current law." The Message concludes with the non sequitur statement that "The ACA makes significant progress toward making Medicare financially viable."

The bad news about Medicare financing is largely tucked away in the balance of the Summary, apart from the Message to the Public. There we learn that "It is important to note that the substantially improved results for HI … depend in part on the long-range feasibility of the lower increases in Medicare payment rates … (which) adjustments would probably not be viable indefinitely into the future … (resulting in) actual future costs for Medicare (that) are likely to exceed those shown by the current-law (ACA) projections in this year's report." We also learn "that (SMI) costs are almost certainly understated as a result of incorporating substantial reductions in physician fees … (that are) required under current law, but that are very unlikely to occur." In other words, stay on Message, don't be confused by the facts.

SIPF PROGRESS UPDATE

By Bob Shapiro, Chairperson

Your Social Insurance and Public Finance Section continues to make great progress. Both our membership and our active volunteers continue to grow. With many critical areas in social insurance and public finance crying for actuarial attention, we need all of you to help in (1) identifying and refining SIPF projects that respond to the marketplace need and provide critical input quickly, and (2) assuring these projects are shaped, managed and distributed effectively. Please send the SIPF Section your ideas and particular interest areas … a note to any of the SIPF council members will work.

We held our second annual face-to-face section council meeting on Sunday, Oct. 17, 2010 at the SOA annual meeting in New York City. We thanked Ardian Gill for his help in organizing our first section newsletter and assisting on the second. While Ardian's term on the SIPF council has been completed, Ardian continues to provide valuable input and support to our activities. We also thanked Doug Andrews who has been indispensable in putting together the second and third newsletters and enabling the transition to the editor for this issue, Bill Cutlip.

We also welcomed Tia Goss Sawhney as the newest member of the SIPF section council. Tia will provide great value in our health care pursuits and will take on responsibility for coordination with the Health Section. Finally, SIPF council member, Fred Kilbourne, has agreed to co-chair the section for the next year. Fred's help will enable us to handle the increasing volume of SIPF activity in a timely, effective manner.

At the Oct. 17, 2010 SIPF council meeting we discussed a number of active SIPF projects, as well as additional opportunities that have been identified. Major projects either completed or in process over the past six months include:

1. The section's first webinar, which attracted an estimated 1,070+ attendees, was organized and moderated by Warren Luckner on Oct. 14, 2010. The subject was "What Every Actuary Can Learn About Public Pension Plans." The webinar panelists included Mita Drazilov, Cindy Rynne, Gordon Latter and Dave Sandberg. As a webinar participant, I would highly recommend purchasing the recording to anyone looking to get up-to-date on public pension plans.

2. We had 10 submissions to our SIPF-relevant bibliography write-up contest. The bibliographies will be peer reviewed and the winners announced by the time you are reading this newsletter.

3. We have developed a process to enable "key issue briefs" to be prepared and disseminated in a timely and effective basis. More information on this activity will be forthcoming in the near future.

4. The section is seeking ways in which it can better support the needs of government actuaries. Dwight Bartlett gave a report on the section's objectives and activities to the Mid-Atlantic Actuarial Club meeting in Baltimore

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As of Oct. 18, 2010, SIPF had more than 600 members.

on Oct. 7, 2010. The Mid-Atlantic Actuarial Club is the actuarial club "home" for many of the government actuaries in the Baltimore/Washington, D.C. area. Dwight's input will help us to refine our ability to support the great work these actuaries are doing.

5. The SIPF section continues to tighten its coordination with other SOA sections, as well as other actuarial professional bodies and other professional organizations. For example, SIPF hopes to strengthen the "actuarial voice" within the National Association Academy of Social Insurance (NASI).

6. SIPF held two sessions at the annual SOA meeting. The first, entitled "U.S. Healthcare Reform—Footing the Bill," was moderated by Mark Litow and included panelists Joe Antos of the American Enterprise Institute and Jack Burke of Milliman, Inc. The second, "Public Finance—How Actuaries Should Consider Helping," was moderated by Jeremy Gold and included panelists Emily Kessler, Bob North and Michel Rochette. Both sessions were well attended, informative and involved healthy discussions with the audience.

As of Oct. 18, 2010, SIPF had more than 600 members. We believe that all actuaries have professional, personal and business reasons for being a part of what we are doing. Please reach out to your actuarial associates (as well as non-actuaries who have interest in this area) and let them know about SIPF. We have put together a "general presentation PowerPoint" describing the SIPF Section's genesis, mission and objectives that you can feel free to modify and use for others at your local actuarial clubs or elsewhere. The presentation PowerPoint will be placed on the SIPF website.

Future plans for SIPF include: (1) better supporting actuaries working for government entities; (2) providing timely actuarial education and other support on Medicare, Social Security and public pension plans; and (3) continuing to increase our effectiveness in enhancing and engaging SIPF membership.

The SIPF Section Council would like to thank all of you section members for the guidance and support you have provided in our first 18 months of existence. We hope we are fulfilling the promise you saw when you joined the section.

SOCIETY OF ACTUARIES
Social Insurance &
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IN THE PUBLIC INTEREST

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