



**FSM Social Security Administration  
Calendar Year 2004 Annual Report**



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## Letter from the Chairman

This report covers calendar year 2004, the 18th fiscal year of operation of Social Security as an independent program under the Federated States of Micronesia.

The trust continued to achieve a positive return on invested assets during 2004 following the positive return of 2003. During 2004 the fund realized total investment income of \$2,403,942, a 6.43% return. Also during 2004 Social Security received \$12,275,901 in contributions, paid \$923,670 in net administrative expenses and disbursed \$11,321,238 in benefit payments and refunds of contributions.

Benefit payments increased by 4.4% in 2004 compared to 2003 and this is proof that Social Security continues to provide financial support to more and more retirees as well as those who have become disabled and can no longer earn a living and the survivors of deceased covered workers. For many, this support is their most significant source of income. It is important to note the increase in benefit payments was accompanied by a 7.7% increase in the amount of contributions collected.

Efforts continued toward a totalization agreement that would allow someone who has worked in the FSM, Palau, and the Marshall Islands and has earned credited service under the social security systems in these countries to combine his or her credited service and covered earnings in order to determine entitlement to and the amount of social security benefits in each country. The totalization agreement was signed by the Presidents of the FSM, Palau and the Marshall Islands during the Presidential Summit which was held in Palau during July of 2005.

Recently a 20-year projection of system assets and accrued liabilities was performed. While this study concluded that Social Security should be able to pay promised benefits for the next 20 years, it also highlighted the need to strengthen funding of existing and future benefits and that future benefit increases should be accompanied with strategies to pay for these increases.

The 20-year projection of system assets and accrued liabilities, ongoing measures to insure proper collection of contributions, and close monitoring of the performance of system assets are indications of the continued focus of the Board to ensure that Social Security remains able to meet its benefit commitments in the near and extended future. As was cautioned in last year's report, the positive returns of 2003 and 2004 should not yet be seen as an ongoing trend and should not be used to justify any immediate increases in current or future benefits.

Finally I would like to thank the members of the Board of Trustees, the Administration, and everyone else whose efforts enable the Social Security System to provide income security to the citizens of the Federated States of Micronesia.

Sincerely,

Signed

Charles L. Chieng  
Chairman  
Board of Trustees

## Board of Trustees

The Board of Trustees is the governing body of the Federated States of Micronesia Social Security System. Members are nominated by the President, confirmed by the Congress and serve three-year terms.

Nominations to the Board take into account the need to have adequate geographical representation and to have representatives from public and private sector employers and employees. The Social Security Administrator is an ex officio member of the board.

### Board Member

### Terms

*Yap State*  
Charles L. Chieng  
  
Chairman



5/26/89 to 5/26/92  
6/5/92 to 6/5/95  
5/13/96 to 5/13/99  
5/26/99 to 5/26/02  
11/5/02 to 11/4/05

*Pohnpei State*  
Jack Yakana  
  
Vice-Chariman



10/10/02 to 10/9/05  
10/10/05 to 10/9/08

*Kosrae State*  
Nena Ned



3/19/97 to 3/18/00  
3/19/00 to 3/19/03  
9/4/03 to 9/3/06

*Chuuk State*  
Bernes Reselap



2/11/00 to 2/11/03  
3/14/03 to 3/14/06

*FSM National Government*  
Nahoy G. Selifis



10/10/02 to 10/9/05  
10/10/05 to 10/9/08

*Administrator*  
Alexander R. Narruhn



7/1/00 to 6/30/02  
7/1/02 to 6/30/05  
7/1/05 to 6/30/08

I submit this Annual Report of the Federated States of Micronesia Social Security System (FSMSSS) covering the period January 1, 2004 to December 31, 2004, the 2004 fiscal year, for the review of all interested parties.

As management of the FSMSSS, the Administration, is responsible for the accuracy of the data presented in this report. We believe that this data is accurate in all material aspects and is reported in such a manner as to accurately represent the financial condition of the FSMSSS operations.

In 2004, the Administrators of the social security systems of the Federated States of Micronesia, The Republic of Palau, and The Republic of the Marshall Islands met in Palau in order to negotiate the terms of a totalization agreement that would allow someone who has worked in and earned credited service under the social security systems in these countries to combine his or her credited service in order to determine entitlement to and the amount of social security benefits. This agreement was signed by the Presidents of each of the participating countries in July of 2005 and the President of the FSM has submitted a resolution to the FSM Congress to ratify the agreement during their September 2005 session.

A project to upgrade the database software used by the social security systems in the FSM, Palau, and the Marshall Islands to Foxpro 9 which was funded by Technical Assistance Grant No. PAL-98 began in 2004. Conversion and implementation of this project in the FSM was completed in August of 2005.

### **Board Meetings**

The Board of Trustees held three regular meetings and one special board meeting in 2004.

A special Board meeting was held in Honolulu, Hawaii on February 11 and 12. This meeting was called to perform the annual portfolio review, which coincided with a joint investment seminar hosted by the National Government and attended by the State and National Governments and the Social Security Administration.

During this meeting the Board interviewed various investment managers for the fund's small cap and Treasury Inflation Protected Securities (TIPS) investments. These new classes of investments were added to the fund's portfolio as the result of an asset liability study that was conducted by Merrill Lynch in order to diversify the portfolio with the intent to increase returns without greatly increasing the risk. As a result of these interviews, the Board hired Provident Investment Counsel to manage the Treasury Inflation Protected Securities as recommended by Merrill Lynch, our investment consultant.

The first regular Board meeting was held in Pohnpei on June 3. During this meeting the Board approved a recruitment policy that requires a panel of three people interview candidates for key positions and also for branch manager positions. The Board also approved a policy to streamline the processing of documents and forms. Additionally the Board established a fee schedule for processing social security applications, allotments, changes of address, social security cards, and employer identification cards. These fees are in addition to the administrative costs associated with providing these services and became effective September 1, 2004.

The Board later considered an appeal from a member who had requested a determination regarding eligibility for benefits, reviewed the financial report for the first quarter of 2004, and discussed the possibility of decentralizing the administration of the Prior Service Benefits Trust Fund due to the

## Administrator's Report

fltering of the program. The Board expressed its desire to separately administer the Prior Service program for beneficiaries who are FSM citizens with the goal of reducing administrative costs. Previously the Board had received letters from the states of Kosrae, Chuuk and Pohnpei stating their agreement with the Board's proposed action.

The second regular Board meeting was held in Chuuk on August 9 through 11. On August 9, the Board held a forum open to the public to give the people of Chuuk an opportunity to voice any questions or concerns that they had regarding Social Security.

On August 10 the Board visited the Governor of Chuuk, Ansito Walter. During this meeting, among other topics, the Board and Governor Walter discussed the possibility of decentralizing the Prior Service Benefits Trust Fund.

One of the issues concerning the Board was that fact some members are missing quarters of coverage in their wage histories. The Board concluded that this problem can be attributed to the Chuuk State Government's debt to FSM Social Security, which amounted to \$634,872 on August 10, 2004.

The Administration made it clear that it is considering taking legal action against the municipal governments of Chuuk because of the contribution delinquency and as a response Governor Walter asked the Board to reconsider and perhaps waive penalties and interest. The Board informed the governor that the purpose of the legal action would be for the lack of payments, which has led to some employees not being fully insured and therefore not being qualified for benefits. The Board further reported to the Governor that the accountability of collections since the 3rd Quarter of 1998 has to be reviewed because most of the employees of the municipal governments have only 2 quarters credited in each year.

The Board later met with Chuuk State Legislature Speaker Joe Suka and again discussed the situation facing the municipal governments. Speaker Suka said he would look into the matter and do what he can and revealed that the Chuuk State Legislature is willing to appropriate money to solve the problem but stated that he needs to be informed of the matter by the Executive Branch and that so far he had only heard from the FSM Social Security Administration.

Before concluding the meeting the Board approved the Totalization Agreement that was drafted by the Social Security Administrators of the FSM, Palau, and Marshall Islands. Following approval by the Board, the Agreement would then require approval by the President of the FSM.

And finally, the Board reviewed financial reports prepared by the FSM Social Security Administration.

The third and final regular Board meeting was held in Pohnpei on October 19 through 21.

On October 19 the Board held a public forum at the conference room in the Sea Breeze Hotel. This meeting was attended by no less than fifty interested citizens. This forum followed the one previously held in Chuuk and the Board plans to hold one in each of the states at least once a year. The purpose of the forum was to give citizens a chance to voice any questions or concerns they had about Social Security directly to the Board and the FSM Social Security Administration.

One topic of particular confusion was the area of benefits paid to customarily adopted children. The Board clarified that Social Security does pay benefits to children who have been customarily adopted



but that there has to be clear evidence proving that the child was economically dependent on the wage earner at the time of death. Such documents may include insurance documents, permanent school records, etc.

Many attendees complained about the way benefits are currently being paid by the Prior Service Benefits Trust Fund. The Board pointed out that the Prior Service program is currently having difficulties in paying benefits due to the lack of funding from the U.S and this trend will continue if there is no long-term funding solution. The Board also informed the audience of the Totalization Agreement and mentioned that they have approved the Agreement and that it now must be approved by the Presidents of the FSM, Palau, and the Marshall Islands.

The Board was quite pleased with the level of attendance and the outcome of this forum and encourages the public to participate in future meetings of this type.

In the afternoon of October 19 the Board met with members of the Pohnpei State Legislature. The meeting had been arranged by the Board to allow the Legislature to voice any questions that they might have about Social Security and was also seen as an opportunity for the Board to ask the leadership of Pohnpei to support the Prior Service Benefits Trust Fund Administration in its efforts to lobby the United States for additional funding.

The Board also discussed the financial report prepared by the FSM Social Security Administration and the ongoing issue of collecting delinquent taxes and met with Patrick M. McFadden, the representative from Merrill Lynch, who assured the Board that the current market slump will not continue forever. Mr. McFadden said that the recent conditions plaguing the market that have kept earnings flat will eventually dissipate and that the market will eventually recover.

### **Funding Status**

The Administration continues its efforts to ensure that collected contributions and investment income are sufficient to pay current benefits, meet administrative expenses, and reduce the unfunded accrued liability. The long term goal of the Administration is for the FSMSSS to accumulate assets sufficient to guarantee that future benefit obligations will always be met.

In order to assess the ability of the FSMSSS to continue to pay benefits when due the Administration recently commissioned a 20-year projection of system assets and accrued liability. While the study did not indicate that the unfunded accrued liability will be eliminated in 20 years it did predict that the funded ratio will improve over the study period and that the Administration should be able to pay benefits when due for the next 20 years. This study also estimates that the funded ratio will increase from 16% as measured with the January 1, 2004 actuarial valuation to 27% in 20 years. A funded ratio of 100% would indicate that fund assets were great enough to cover the value of all benefits already earned so this means that the study indicates that assets should be sufficient to cover 27% of the benefits earned in 20 years. A copy of this study is included as part of this report.

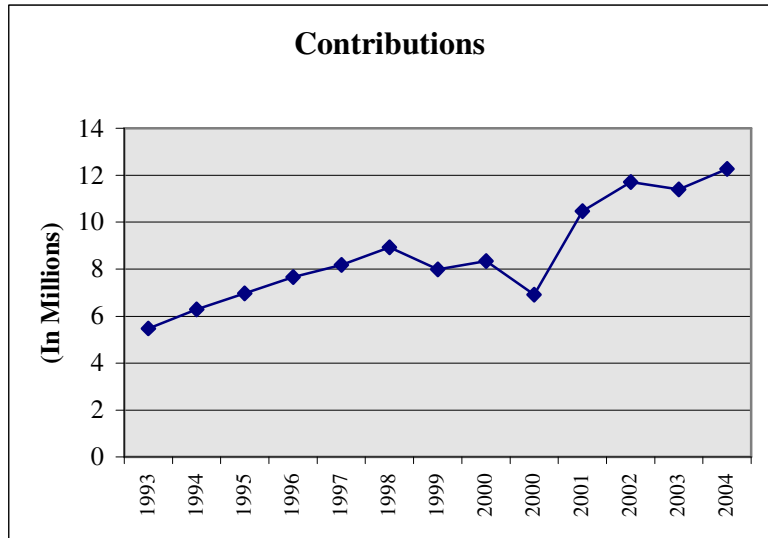
Law No. 12-76 which increased the maximum taxable wage base from \$3,000 to \$5,000 per quarter became effective the fourth quarter of fiscal year 2003, and its total impact was finally realized in 2004. The amount of contributions collected during 2004 increased by 7.7% over 2003 collections and most of this increase can be attributed to the increase in the taxable wage base.

## **Administrator's Report**

The following graphs illustrate current and historic levels of contributions received as well as benefit payments and administrative expenses paid. The graphs also track the overall historic value of the assets and realized past investment performance.

## Contributions

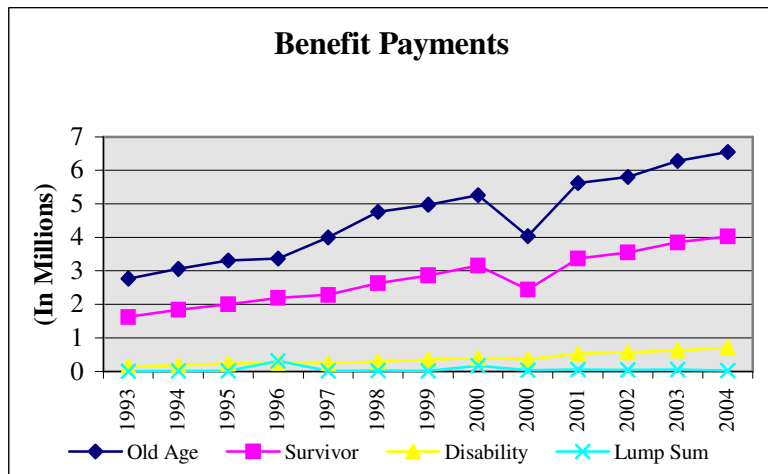
Contributions collected during fiscal year 2004 totaled \$12,275,901. The administration continues to pursue an aggressive campaign of audits of public and private sector employers to assure compliance with the Social Security Act.



## Benefit Payments

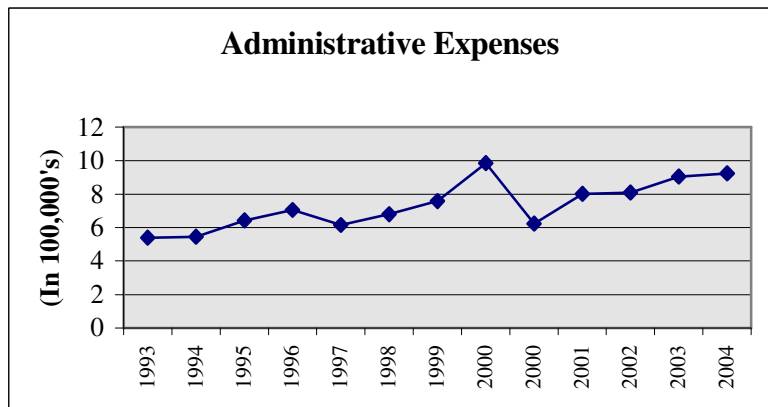
A total of \$11,320,348 was disbursed in benefit payments during fiscal year 2004 the total of which was offset by \$10,541 of prior year credits. In addition \$11,430 was disbursed as refunds of contributions. The following benefits were paid during fiscal year 2004:

Type	Amount
Old Age	\$ 6,550,765
Survivor	\$ 4,025,827
Disability	\$ 710,668
Lump Sum	\$ 33,088



## Administrative Expenses

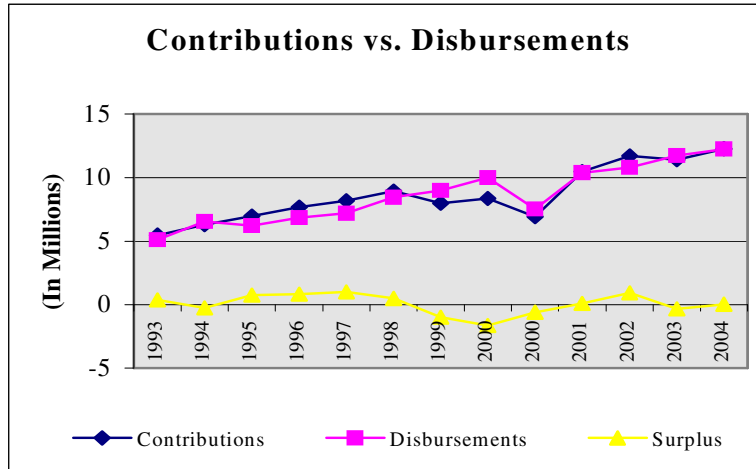
Net administrative expenses of \$923,670 were paid during fiscal year 2004. This represents a 2.2% increase from the prior year.



# Administrator's Report

## Contributions and Disbursements

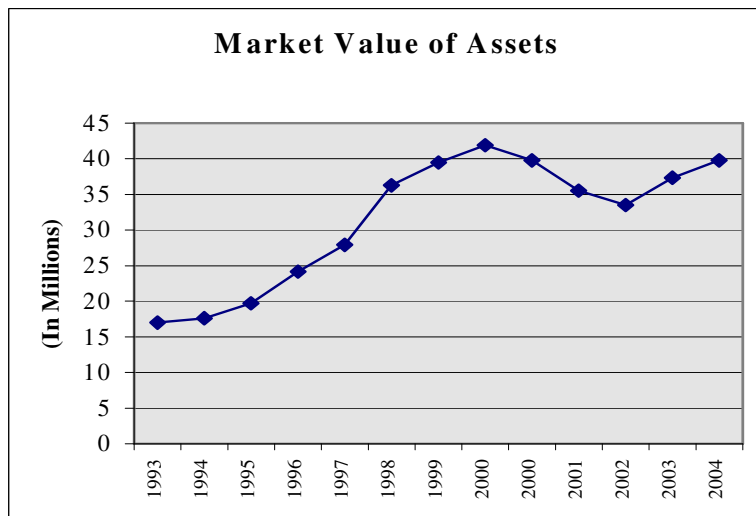
During fiscal year 2004, contributions exceeded disbursements by \$30,993. For this comparison, disbursements consist of payments to beneficiaries and payments for administrative expenses.



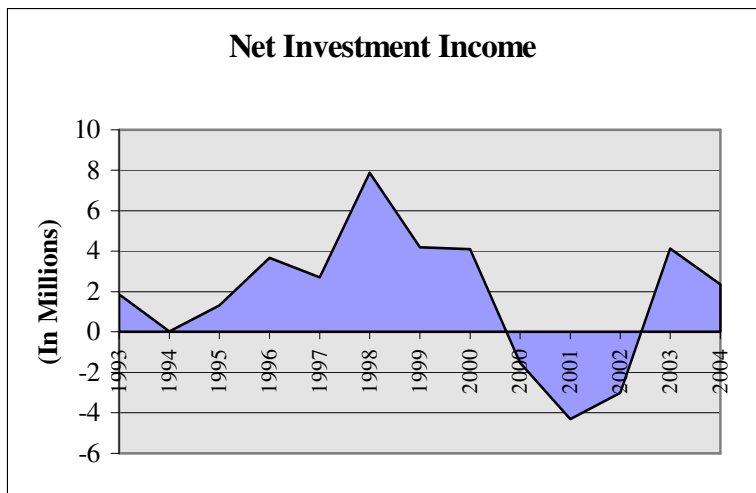
## Investments

The Administration retains Merrill Lynch as its investment advisor, Atlanta Sosnoff Capital Corporation, Missouri Valley Partners, and Provident Investment Counsel as money managers and Pacific Century Trust as custodial trustee.

FSMSSA does not own any time deposits at the local banks. They are maintained in our general savings account and miscellaneous accounts with Bank of FSM. They are also maintained in miscellaneous accounts, benefit checking account, payroll checking account and operation checking account with Bank of Guam.



Social Security's assets totaled \$39,781,837 at the end of fiscal year 2004, a \$2,434,935 increase from the prior year. The fund experienced a net increase in the fair value of investments of \$2,351,940.



## Professional Service Providers

### Actuary

Pacific Actuarial Services, LLC  
3213 West Wheeler Street  
Suite 382  
Seattle, WA 98199

### Investment Advisor

Merrill Lynch  
Pauahi Tower Penthouse  
1001 Bishop Street  
Honolulu, HI 96813

### Money Managers

Atlanta Sosnoff Capital Corporation  
101 Park Avenue  
New York, NY 10178

Missouri Valley Partners  
P.O. Box 16901  
135 N. Meramec, Suite 500  
St. Louis, MO 63105

Provident Investment Counsel  
300 North Lake Avenue  
Pasadena, CA 91101

### Auditors

Deloitte & Touche LLP  
361 South Marine Drive  
Tamuning, Guam 96913-3911

### Custodial Trustee

Pacific Century Trust  
P.O. Box 3170  
Honolulu, HI 96802

### Legal Counsel

Federated States of  
Micronesia Attorney General

Michael Sipos  
P.O. Box 2069  
Kolonia, Pohnpei FM 96941

Saimon and Associates  
P.O. Box 1450  
Kolonia, Pohnpei, FM 96941

# **Administrator's Report**

## **System Legislation**

During 2004 the 13th Congress considered a bill that would allow the Administration to waive interest penalties assessed against employers who are late in remitting contributions. This bill was not passed and has been submitted again to the 14th Congress for their consideration.

## **Prior Service Benefits Trust Fund**

The Prior Service Benefits Trust Fund (PSBTF) is a supplemental retirement, disability and survivors' plan established pursuant to Section 105(m) of U.S Public Law 99-239. It was established to continue to provide benefits to those who worked for the U.S. Navy Administration or the Government of the Trust Territory of the Pacific Islands for at least 5 years prior to July 1, 1968.

The Administration continues to assist in processing claims for the PSBTF under a contractual agreement. All claim determinations and benefit payments are made by the Prior Service Benefits Trust Fund Administration in Saipan. The Vice-Chairman of the FSMSSS Board of Trustees is also a member of the PSBTF Board.

In 1987 the United States Congress provided \$8 million for initial capitalization of the PSBTF. Pursuant to U.S. Public Law 99-239, future funding would be provided if warranted based on the results of actuarial valuations.

In the past five years there have been four appropriations used to pay benefits, the most recent coming from the United States Department of the Interior for \$1.5 million. These appropriations are used to reimburse beneficiaries for payments that were missed in the past due to insufficient funds, pay current benefit payments, and to cover administrative expenses. The Prior Service Benefits Trust Fund Administration continues to lobby the United States for additional required ongoing funding.

The Prior Service Benefits Trust Fund Board of Trustees has begun a process that will allocate the liability and responsibility for benefit payments between the countries whose citizens receive Prior Service benefits. After separation, which is expected to be completed in early 2006, the administration for Prior Service benefits will be performed by the Administration of the social security systems in the FSM, the Marshall Islands, the Republic of Palau, and the Retirement Fund in the Commonwealth of the Northern Mariana Islands.

## **Conclusion**

The Administration remains vigilant in its efforts to ensure that all contributions due the FSMSSS are collected and also to verify eligibility for benefit payments to all current beneficiaries.

Beginning in the fourth quarter of 2003, PL 12-76 increased the quarterly taxable wage base from \$3,000 to \$5,000 and this was largely responsible for the 7.7% increase in contributions collected during 2004 over 2003 collections. Following the 12.55% return on assets in 2003, the FSMSSS realized total investment income of \$2,403,942 during 2004 which represented a 6.43% return for the year.

Although the 20-year projection of assets and accrued liability indicates that the funded status is expected to improve in the next 20 years, it is important to keep in mind that this study assumes that the current benefit and contribution structure will be maintained with no changes whatsoever for the next 20

years. With this in mind, in order to not reduce the funded status, it is critical that any future benefit increases are accompanied with a concrete means to pay for them. Additional funding either from the National Government or through increased payroll taxes may also be needed in order to improve the funded ratio from the predicted level of 27% in 20 years as shown in the study.

Pursuant to Section 707 of Title 53, actuarial valuations are to be performed on a regular basis and recently valuations have been performed every two years. Since the most recent valuation was performed as of January 1, 2004, no valuation was performed during 2005, with the next valuation scheduled for January 1, 2006. Regular valuations provide a current comparison of the accrued liability to the market value of assets which determines the funded status. As required by law an actuarial study must be performed to determine the affect of any proposed major changes to the System so regularly updated valuations also provide a current basis for estimating the effect of any future proposed changes to the FSMSSS.

Looking at the increase in contributions collected and the two consecutive years of positive returns on trust assets one may be tempted to say that these two encouraging factors justify and support an increase in the existing level of benefits. Unfortunately such is not actually the case. The current level of contributions and trust earnings are required to support the existing benefit level and as mentioned above, the Administration strongly suggests that any future benefit increases be accompanied with a means to pay for the additional benefits.

### **Acknowledgements**

I sincerely appreciate the untiring efforts of the Administration staff whose hard work has made Social Security the financial safety net that it is for so many citizens of Micronesia. I would also like to thank the Board of Trustees for their judicious and prudent direction of Social Security and their support of the efforts of the Administration. And finally I would like to thank everyone else who put together the information presented in this report.

This report is intended to be a complete and succinct summary of the FSMSSS as a basis for making management decisions, responsible management of the assets contributed by the members and their employers and as a preliminary means of evaluating the effects of legislation pertaining to the system. This report will be submitted to the President and Congress of the Federated States of Micronesia as well as other interested parties.

### **Signed**

Alexander R. Narruhn  
Administrator

## INDEPENDENT AUDITORS' REPORT

Board of Directors  
FSM Social Security Administration:

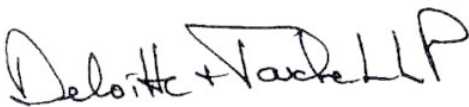
We have audited the accompanying statement of net assets of the Federated States of Micronesia Social Security Administration (FSMSSA), a component unit of the FSM National Government, as of December 31, 2004 and 2003, and the related statements of changes in net assets for the years then ended. These financial statements are the responsibility of FSMSSA's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Governmental Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstance, but not for the purpose of expressing an opinion on the effectiveness of FSMSSA's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the FSMSSA as of December 31, 2003 and 2004, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2-6 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This information is the responsibility of FSMSSA's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 8, 2005, on our consideration of FSMSSA's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.



June 8, 2005



**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Management's Discussion and Analysis  
Year Ended December 31, 2004

Program Description

The FSMSSA is one of the successor systems from the former Trust Territory Social Security System that closed down its operation on March 31, 1988. The FSMSSA began its full operation on January 1, 1988 and is administered by a six-member Board of Trustees. Five members of the Board are nominated by the President and confirmed by the Congress of the FSM while the FSMSSA Administrator serves as an ex-officio member. The FSM Social Security Administration Board of Trustees is comprised of the following individuals:

Charles L. Chieng	Chairman of the Board, representing Yap State;
Lt. Governor Jack E. Yakana	Vice-Chairman, representing the Pohnpei State;
Nahoy G. Selifis	Member representing the National Government;
Bernes O. Reselap	Member from the State of Chuuk;
Nena Ned	Member from the State of Kosrae; and
Alexander R. Narruhn	Administrator serves as the ex-officio member.

The Federated States of Micronesia Social Security Board of Trustees are nominated by the President and confirmed by the Congress of the FSM to operate the Social Security Program authorized under the FSM Code title 53. Their nominations to the Board should take into account the need to have adequate geographical representation and to have representatives from public and private sector employers and employees. The members of the Board serve a 3-year term, and they shall provide for its own organization and procedure. Should there be any vacancies on the Board, it shall be filled for the unexpired term only. Where a vacancy is 1 year or less, it shall be filled by appointment by the President; otherwise vacancies shall be filled by nomination by the President and confirmation by the Congress. The Social Security Administrator serves an ex-officio member of the Board. Members of the Board who are not State or National Government employees shall be paid at the rate of \$30 per day and necessary travel expenses when actually attending meetings of the Board.

The FSMSSA was established by the Federated States of Micronesia Public Law 2-74 enacted February 2, 1983 to provide retirement, disability and survivor benefits for the citizens of the Federated States of Micronesia.

The FSM Social Security system is financed by employer/employee contributions at a rate of 6% each, or a combined tax rate of 12% paid to the system every quarter. State and national governments and all private employers incorporated or doing business in the FSM are subject to social security tax. At present, the maximum taxable wages per employee for each quarter is \$5,000, which was effectuated in the 4<sup>th</sup> quarter of 2003.

Management Perspective

The management of the FSMSSA is responsible for the accuracy of the data. We believe that the information enclosed is accurate in all material aspects and is reported in such a manner as to accurately represent the financial condition of the FSMSSA operations. Net assets at the end of calendar year 2004 increased by \$2,434,935. This increase is primarily attributable to the positive returns of 6.8% on our investment portfolio or \$2,351,940. The rest came from the excess of contributions collected and miscellaneous receipts after payments of benefits and administrative expenses. Total revenue for CY 2004 was \$14,679,843 while benefits, administrative expenses and other disbursements were \$12,244,907.

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Management's Discussion and Analysis  
Year Ended December 31, 2004

***Significant Events – 2004***

- Extending our public forums on all four States to include Board of Trustees;
- Celebrated the social security week and 36<sup>th</sup> anniversary with a visit to government offices and conducted open forum with the employees. Promotional items were distributed to instill public awareness of what the Program has to offer;
- Continue to enhance employees' knowledge particularly in Accounting and Auditing through participation in the APIPA Conference held in Majuro, Marshall Islands;
- Joint Proposal to DOI with Palau SSA and Marshall SSA for computerization upgrade to Visual FoxPro, approved and authorized for \$215,000 grants. FSMSSA has received its share of the grant specifically allocated for computer system hardware. \$18,024 worth of computer hardware were purchased this year; and the upgrading of our FoxPro Software is nearly completed – will be implemented in FSMSSA sometime in August 2005;
- Continue the efforts to finalize the totalization agreement with Palau SSA and Marshall SSA;
- Establish annual conference between all Administrators from MRI, ROP, and FSMSSA to compare and contrast regarding a better operation of the program.

Statements of Net Assets

	<u>2004</u>	<u>2003</u>
Cash and equivalents	\$ 1,789,785	\$ 2,171,221
Investments	35,855,045	33,318,406
Other current assets	2,156,189	1,859,674
Fixed assets, net	<u>91,221</u>	<u>80,527</u>
Total assets	\$ <u>39,892,240</u>	\$ <u>37,429,828</u>
Liabilities	\$ <u>110,403</u>	\$ <u>82,926</u>
Net assets:		
Held in trust for retirement, disability and survivors' benefits	<u>39,781,837</u>	<u>37,346,902</u>
Total liabilities and net assets	\$ <u>39,892,240</u>	\$ <u>37,429,828</u>

Statements of Changes in Net Assets

	<u>2004</u>	<u>2003</u>
Total revenues	\$ 14,679,843	\$ 15,585,287
Expenses	<u>12,244,908</u>	<u>11,769,979</u>
Change in net assets	2,434,935	3,815,308
Net assets at beginning of year	<u>37,346,902</u>	<u>33,531,594</u>
Net assets at end of year	\$ <u>39,781,837</u>	\$ <u>37,346,902</u>

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Management's Discussion and Analysis  
Year Ended December 31, 2004

Contributions

Contributions collected during fiscal year 2004 totaled \$12,275,901, a 7.7% increase over CY 2003. The administration continues to pursue an aggressive campaign of audits of public and private sector employers to ensure compliance with the Social Security Act.

Benefit Payments

A total of \$11,320,348 was disbursed in benefit payments during fiscal year 2004 which are offset by \$10,541 of prior year credits. The following benefits were paid during fiscal year 2004:

<u>Type</u>	<u>2004</u>	<u>2003</u>
Old Age	\$6,550,765	\$6,290,710
Survivor	\$4,025,827	\$3,859,375
Disability	\$ 710,668	\$ 635,004
Lump Sum	\$ 33,088	\$ 60,941

Administrative Expenses & Fixed Assets Purchases

Net administrative expenses of \$886,492 and fixed assets of \$29,848 were paid during fiscal year 2004. This was 6.2% less than the approved budget of \$977,245 and 24.3% less than the \$1,210,000 ceiling imposed by the Social Security Act, but represented a 1.4% increase from 2003 administrative expenses. Among the highest expenses paid this year were Actuarial Services of \$26,000 and Professional Services of \$81,015. These two items combined increased by 46% compared to last year and account for 12% of the total administrative costs this year. Other expense items in CY2004 were relatively stable compared to CY2003.

Investments

Fiscal year 2004 saw another gain in our investment portfolio with a net investment income of \$2,351,940. However, this year's net gain was 41% lower compared to 2003, which registered a net gain of \$3,982,671.

Net investment gain for the year ended December 31, 2004, comprises the following:

Interest and dividends-investments	\$ 901,714
Realized gains on sale	1,925,027
Unrealized gains	3,748,234
Realized losses on sale	(214,276)
Unrealized Losses	(3,769,275)
Investment fees	<u>(239,484)</u>
Net investment gain	<u>\$ 2,351,940</u>

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Management's Discussion and Analysis  
Year Ended December 31, 2004

Our professional service providers for our investment portfolio consist of the following:

Investment Advisor

Merrill Lynch  
Pauahi Tower Penthouse  
1001 Bishop Street  
Honolulu, HI 96813

Custodial Trustee

Pacific Century Trust  
P.O. Box 3170  
Honolulu, HI 96802

Money Managers (Fixed Income)

Provident Investment Counsel  
300 North Lake Avenue  
Pasadena, CA 91101

Money Manager (Equity)

Atlanta Sosnoff Capital Cor  
101 Park Avenue  
New York, NY 10178

Money Manager (Small Cap US Stock)

Missouri Valley Partners  
135 N. Meramec, Suite 500  
St. Louis, MO 63105

Treasury Inflation Protected Securities

Provident Investment Counsel  
300 North Lake Avenue  
Pasadena, CA 91101

Conclusion

During the calendar years 2003 and 2004, the program's net assets increased by \$3,815,308 and \$2,434,935, respectively. With intensified efforts in our audit and collection of delinquent accounts, close monitoring of our investment portfolio to ensure it's higher returns, and watching and keeping administrative costs down, we are hoping to maintain a yearly positive bottom line in the years to come.

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Statement of Net Assets  
December 31, 2004 and 2003

	2004	2003
<u>ASSETS</u>		
Cash and equivalents	\$ 1,789,785	\$ 2,171,221
Investments, at fair value	35,855,045	33,318,406
General receivables	1,979,938	1,712,396
Accrued interest receivable	167,605	138,278
Advances	5,941	7,500
Prepaid expenses	2,705	1,500
Fixed assets, net	91,221	80,527
Total assets	\$ 39,892,240	\$ 37,429,828
<u>LIABILITIES</u>		
Accounts payable - general	\$ 76,807	\$ 11,643
Taxes/personnel benefits payable	20,666	50,464
Accrued PCT monthly fees	12,930	20,819
Total liabilities	110,403	82,926
Contingencies		
<u>NET ASSETS</u>		
Held in trust for retirement, disability and survivors' benefits	39,781,837	37,346,902
Total liabilities and net assets	\$ 39,892,240	\$ 37,429,828

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Statement of Changes in Net Assets  
Year Ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Additions:		
Contributions	\$ <u>12,275,901</u>	\$ <u>11,398,884</u>
Investment income:		
Net increase in the fair value of investments	2,351,940	3,982,671
Interest income	-	138,278
Miscellaneous income	<u>52,002</u>	<u>65,454</u>
Total investment income	<u>2,403,942</u>	<u>4,186,403</u>
Total additions	<u>14,679,843</u>	<u>15,585,287</u>
Deductions:		
Benefit payments	11,309,808	10,835,214
Refund contributions	11,430	30,634
Administrative expenses, net	<u>923,670</u>	<u>904,131</u>
Total deductions	12,244,908	11,769,979
Change in net assets	2,434,935	3,815,308
Net assets at beginning of year	<u>37,346,902</u>	<u>33,531,594</u>
Net assets at end of year	<u>\$ <u>39,781,837</u></u>	<u>\$ <u>37,346,902</u></u>

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Notes to Financial Statements  
December 31, 2004 and 2003

(1) Summary of Significant Accounting Policies

A. Basis of Accounting

The Federated States of Micronesia (FSM) Social Security Administration (the Administration) is accounted for as a Fiduciary Fund Type – Private Purpose Trust Fund and is a component unit of the FSM National Government.

For the year ended December 31, 2003, the Administration adopted GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments* (GASB 34) as amended by GASB Statement No.s 37 and 38 and applied those standards on a retroactive basis. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that FSM Social Security Administration resources be classified, for accounting and reporting purposes, as held in trust for retirement disability and survivors' benefits.

B. Future Liabilities and Contributions

No recognition is given to the present value of the liabilities of prospective benefit payments or the present value of future contributions required from employees or employers.

C. Cash and Equivalents

For the purposes of the statement of net assets, cash and equivalents is defined as cash on hand, in bank checking and savings accounts, time certificates of deposit with initial maturities of ninety days or less and funds held by Pacific Century Trust, the trustee, in an automated cash management fund.

Cash and equivalents as of December 31, 2004 and 2003, are comprised of the following:

	<u>2004</u>	<u>2003</u>
Petty cash	\$ 1,400	\$ 1,400
Cash in bank – operations	17,953	855
Cash in bank - payroll	1,158	1,250
Cash in bank - benefits 3	(265,383)	(254,843)
Cash in bank - benefits 4	-	(3,384)
Savings accounts	1,126,558	1,320,496
Pacific Century Trust – automated cash management fund	<u>908,099</u>	<u>1,105,447</u>
	<u>\$ 1,789,785</u>	<u>\$ 2,171,221</u>

Of the cash and equivalents, \$300,000 is subject to coverage by the Federal Deposit Insurance Corp. (FDIC) as of December 31, 2004 and 2003. The remaining balance is uninsured. The Administration does not require collateralization of its deposits. Therefore, amounts exceeding FDIC insurable limitations are characterized as uncollateralized.

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Notes to Financial Statements  
December 31, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

D. Investments

Investments in securities are stated at fair value.

Generally, the FSM Social Security Administration can invest in bonds and other evidence of indebtedness of the FSM or U.S.; or of any State of the FSM and U.S.; in bonds, debentures, notes and other evidence of indebtedness issued or assumed by FSM or U.S. institutions; and in preferred or common stock of any corporation created or existing under the laws of the FSM or under the laws of the U.S., or any state, territory, or commonwealth.

Investments as of December 31, 2004 and 2003, comprise the following:

	<u>2004</u>	<u>2003</u>
Common stock	\$ 21,755,629	\$ 19,688,918
U.S. government obligations	225,252	308,760
U.S Treasury obligations	5,606,425	697,908
Government agency obligations	6,137,557	9,349,686
Corporate bonds, preferred stock and mutual funds	<u>2,130,182</u>	<u>3,273,134</u>
	\$ <u>35,855,045</u>	\$ <u>33,318,406</u>

Net investment gain for the years ended December 31, 2004 and 2003, comprises the following:

	<u>2004</u>	<u>2003</u>
Interest and dividends-investments	\$ 901,714	\$ 660,917
Realized gains on sale	1,925,027	1,299,038
Unrealized gains	3,748,234	4,377,976
Realized losses on sale	(214,276)	(715,493)
Unrealized losses	(3,769,275)	(1,421,567)
Investment fees	<u>(239,484)</u>	<u>(218,200)</u>
Net investment gain	\$ <u>2,351,940</u>	\$ <u>3,982,671</u>

D. Investments

Governmental Accounting Standards Board (GASB) Statement No. 3 requires government entities to categorize investments in the following categories to give an indication of the level of risk assumed by the entity.

Category 1 - Insured or registered, or securities held by the Administration or its agent in the Administration's name.

Category 2 - Uninsured and unregistered, or securities held by a party other than the Administration or its agent, in the Administration's name.

Category 3 - Uninsured and unregistered, securities held by a party other than the Administration and not in the Administration's name.



**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Notes to Financial Statements  
December 31, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

D. Investments, Continued

The Administration's demand deposits are non-categorized investments in accordance with Governmental Accounting Standards Board (GASB) Statement No. 3. All other investments held by the Administration have been classified as category 1 investments in accordance with GASB No. 3 as all investments are held in the name of the FSM Social Security Administration by Pacific Century Trust, the trustee.

E. Fixed Assets

The cost of fixed assets, if greater than \$250, is capitalized at the time of acquisition. Depreciation is provided using the straight-line basis over the estimated useful lives of the respective assets.

Fixed assets as of December 31, 2004 and 2003, are as follows:

	Estimated Useful Lives	January 1, 2004	Additions	Retirements	December 31, 2004
Motor vehicles	5 years	\$ 103,054	\$ 9,634	\$ -	\$ 112,688
Computer equipment	5 years	115,633	32,860	(4,035)	144,458
Furniture	5 years	114,192	5,378	(9,035)	110,535
Office equipment	5 years	<u>3,059</u>	<u>-</u>	<u>(410)</u>	<u>2,649</u>
		335,938	47,872	(13,480)	370,330
Less accumulated depreciation and amortization		<u>(255,411)</u>	<u>(36,430)</u>	<u>12,732</u>	<u>(279,109)</u>
		\$ <u>80,527</u>	\$ <u>11,442</u>	\$ <u>(748)</u>	\$ <u>91,221</u>
	Estimated Useful Lives	January 1, 2003	Additions	Retirements	December 31, 2003
Motor vehicles	5 years	\$ 85,466	\$ 17,588	\$ -	\$ 103,054
Computer equipment	5 years	109,657	5,976	-	115,633
Furniture	5 years	106,674	9,497	(1,979)	114,192
Office equipment	5 years	<u>3,058</u>	<u>1</u>	<u>-</u>	<u>3,059</u>
		304,855	33,062	(1,979)	335,938
Less accumulated depreciation and amortization		<u>(214,604)</u>	<u>(40,807)</u>	<u>-</u>	<u>(255,411)</u>
		\$ <u>90,251</u>	\$ <u>(7,745)</u>	\$ <u>(1,979)</u>	\$ <u>80,527</u>

F. Contributions

Contributions to the Fund are governed by the Federated States of Micronesia Social Security Act of 1983 which imposes a tax on the quarterly income of every employee not currently subject to the United States Social Security Administration or any other recognized social security system. There is imposed on the income of every applicable employee a tax equal to six percent of wages received.

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Notes to Financial Statements  
December 31, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

F. Contributions, Continued

Maximum quarterly taxable wages are currently \$5,000. Every employer is required to contribute an amount equal to that contributed by employees.

Contributions as of December 31, 2004 and 2003, comprise of the following:

	<u>2004</u>	<u>2003</u>
Government employment	\$ 5,931,863	\$ 5,960,268
Private employment	5,896,019	5,284,263
SS Tax contributions	254,882	-
Penalties and interest	<u>193,137</u>	<u>154,353</u>
	\$ <u>12,275,901</u>	\$ <u>11,398,884</u>

G. Benefit Obligations

Retirement benefits are paid to every person who is a fully insured individual as defined by the Federated States of Micronesia Social Security Act, has attained sixty years of age, and has filed an application for old age insurance benefits. Benefits are also paid to surviving spouses of deceased workers, subject to eligibility requirements, as long as they do not remarry or work. Eligible children who are not married or are not working may also receive benefits until age eighteen (18) or up to age twenty-two (22) if in school.

Eligible children who become disabled before age twenty-two (22) will continue to receive benefits for the duration of disability. Disability benefits are paid to qualified workers for the duration of the disability or until retirement or death at which time retirement or survivor benefits become available.

Benefits are paid monthly and are computed upon an annual basis of 16.5% of the first \$10,000 of cumulative covered earnings, plus 3.0% of the next \$30,000, and 2.0% of any earnings in excess of \$40,000. The minimum benefit payment is \$50 per month.

Benefit payments as of December 31, 2004 and 2003, are comprised of the following:

	<u>2004</u>	<u>2003</u>
Retirement pension	\$ 6,540,224	\$ 6,279,893
Survivor pension	4,025,827	3,859,376
Disability pension	710,668	635,004
Lump sum pension	<u>33,089</u>	<u>60,941</u>
	\$ <u>11,309,808</u>	\$ <u>10,835,214</u>

**FEDERATED STATES OF MICRONESIA  
SOCIAL SECURITY ADMINISTRATION**

Notes to Financial Statements  
December 31, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

H. Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require management to make estimates and assumptions that affect the reported amounts of net assets and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

I. New Accounting Standards

For fiscal year 2005, the Administration will be implementing GASB Statement No. 40, *Deposit and Investment Risk Disclosures* (an Amendment of GASB Statement No. 3) and GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. The Administration has not evaluated the financial statement impact of GASB Statement No 42.

K. Risk Management

The Administration is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Administration has elected to purchase automobile insurance from independent third parties for the risks of loss to which it is exposed. The Administration is substantially self-insured for all other risks. Settled claims have not exceeded commercial coverage in any of the past three years.

(2) Establishment of the Social Security Administration

The Social Security Administration of the Federated States of Micronesia National Government was established by Public Law 2-74, passed on February 8, 1983, and began operations on October 1, 1987, for the purpose of providing retirement, disability and death benefits to qualified individuals and their survivors. The Administration is administered under the authority of a six-member board, five of whom are appointed by the President of the Federated States of Micronesia. The Administrator, who is selected by the board, serves as an ex-officio member.

(3) Net Assets Held in Trust

Net assets are held in trust to comply with the Social Security Act of 1983. All net assets of the Administration are to be used for retirement, disability and survivors' benefits.

(4) Contingencies

The Administration is aware of liabilities of the fund related to retroactive benefit payments for wages not posted to the system due to an unmatched social security number or name provided by the employer, as well as a liability related to overpayment of contributions. Management is unable to determine a reasonable estimate of the abovementioned liabilities at this time; however management is of the opinion that the amount is not material to the financial statements taken as a whole.

**FEDERATED STATES OF MICRONESIA**  
**SOCIAL SECURITY ADMINISTRATION**

Notes to Financial Statements  
December 31, 2004 and 2003

(4) Contingencies, Continued

In October 2004, the FSM Social Security Administration obtained an actuarial valuation of the Retirement Fund as of January 1, 2004. The valuation reported actuarial accrued liabilities for the Retirement Fund of \$240,247,000. As of January 1, 2004, the FSM Social Security Administration recorded a total fund equity of \$37,347,000 in the Retirement Fund, as funds available to fund future benefit obligations; these figures resulted in an accrued unfunded liability of \$202,900,000. The report indicates that the Administration should not increase future or current benefits until a long-term trend of decreasing the unfunded accrued liability is realized.

(5) Contributions Receivable

The Administration is of the opinion that there are outstanding contributions due to the fund; however, a reasonable estimate of this amount cannot be made due primarily to noncompliance by employers.

(6) Prior Service Claims

Under the terms of the Prior Service Claim Adjudication Service Agreement between the Prior Service Trust Fund Administration and the Social Security Administration of the Federated States of Micronesia, the FSM Social Security Administration is to provide for the processing of benefit claims and to assist in the monitoring of continuing eligibility under the Prior Service Program. The Prior Service Trust Fund Administration will reimburse the Social Security Administrator \$8,000 per annum plus an amount equal to 8% of the total amount of automated and manual benefit payments.



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**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE AND OTHER MATTERS BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

The Board of Directors  
FSM Social Security Administration:

We have audited the financial statements of the FSM Social Security Administration, as of and for the year ended December 31, 2004, and have issued our report thereon dated June 8, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered FSM Social Security Administration's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the FSM Social Security Administration's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

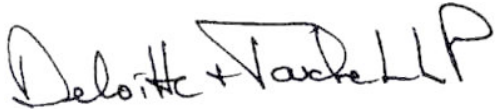
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the FSM Social Security Administration's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Member of  
Deloitte Touch Tohmatsu

This report is intended for the information of the Board of Trustees and management of FSM Social Security Administration, federal awarding agencies, pass-through entities, the cognizant audit and other federal agencies, and is not intended to be, and should not be, used by anyone other than those specified parties.

A handwritten signature in black ink that reads "Deloitte + Tatchell LLP". The signature is written in a cursive, stylized font.

June 8, 2005

# 20-Year Projection of System Assets and Accrued Liabilities

## FOREWORD

This report contains the results of a 20-year projection of the unfunded accrued liability. The projected unfunded accrued liability is calculated as the projected accrued liability less the projected market value of trust assets.

In order to arrive at estimated future values of trust assets it was necessary to project the return on invested assets as well as benefit payments to beneficiaries, administrative expenses, and contributions collected from members and employers. The assumptions specific to this study are described in detail in Section V.

The purpose of this report is to:

- Compare the projected accrued liability to the projected market value of trust assets in order to estimate the future funded status which is represented by the projected unfunded accrued liability as well as the projected funded ratio.
- Estimate when, if ever, in the next 20 years that benefit payments plus administrative expenses will exceed contributions collected plus trust investment returns.
- Provide suggestions for consideration intended to improve the future funded status.

Respectfully Submitted,

*Pacific Actuarial Services LLC*

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## 20-Year Projection of System Assets and Accrued Liabilities

### EXECUTIVE SUMMARY

Based on the assumptions made in this study regarding the future return on trust assets, the growth in the population of workers covered by the Social Security System, future benefit payments, and administrative expenses, the Administration is not expected to “run out of money” within the 20-year span of this study which begins with the 2004 fiscal year.

This study indicates that, under the current provisions of the Social Security Administration, the unfunded accrued liability will not be eliminated within the next 20 years, but will rather continue to grow, as will payments to beneficiaries. However it also appears that the overall level of trust assets will continue to increase as will the amount of contributions collected.

The study also indicates that the funded ratio will increase over time from 16% on January 1, 2004 to 27% in 20 years. The funded ratio is an indication of how well funded the Administration is at any point in time with respect to benefits already earned. A funded ratio of 100% would indicate that the Administration’s liability for benefits already earned was fully funded by current trust assets. A funded ratio of 25% would indicate that current trust assets were only great enough to cover 25% of the benefits already earned. The greater the funded ratio, the better funded the Administration is with respect to benefits already earned.

During fiscal year 2003 payments to beneficiaries and administrative expenses (total disbursements) exceeded contributions collected by \$371,000. This study projects that this trend will be reversed in fiscal year 2015, when contributions are projected to exceed total disbursements. This is expected to occur because administrative expenses are projected to increase at a slower rate than are payments to beneficiaries. This study also predicts that each year during the 20-year span of this study contributions collected plus investment income will continue to exceed total disbursements.

It is important to realize that any projection of assets and liabilities 20 years into the future is extremely sensitive to the assumptions made regarding future returns on trust assets, the growth of the population covered by the Social Security System and the growth of worker salaries, future contributions collected, and the dollar amount of future benefits paid to beneficiaries and administrative expenses. A complete summary of assumptions specific to this study is included in Section V.



# 20-Year Projection of System Assets and Accrued Liabilities

## STUDY RESULTS

### A. Introduction

This section contains the results of the study. The results are classified in subsections B through D below.

B. Projection of Contributions, Assets, Unfunded Accrued Liability, and Funded Ratio

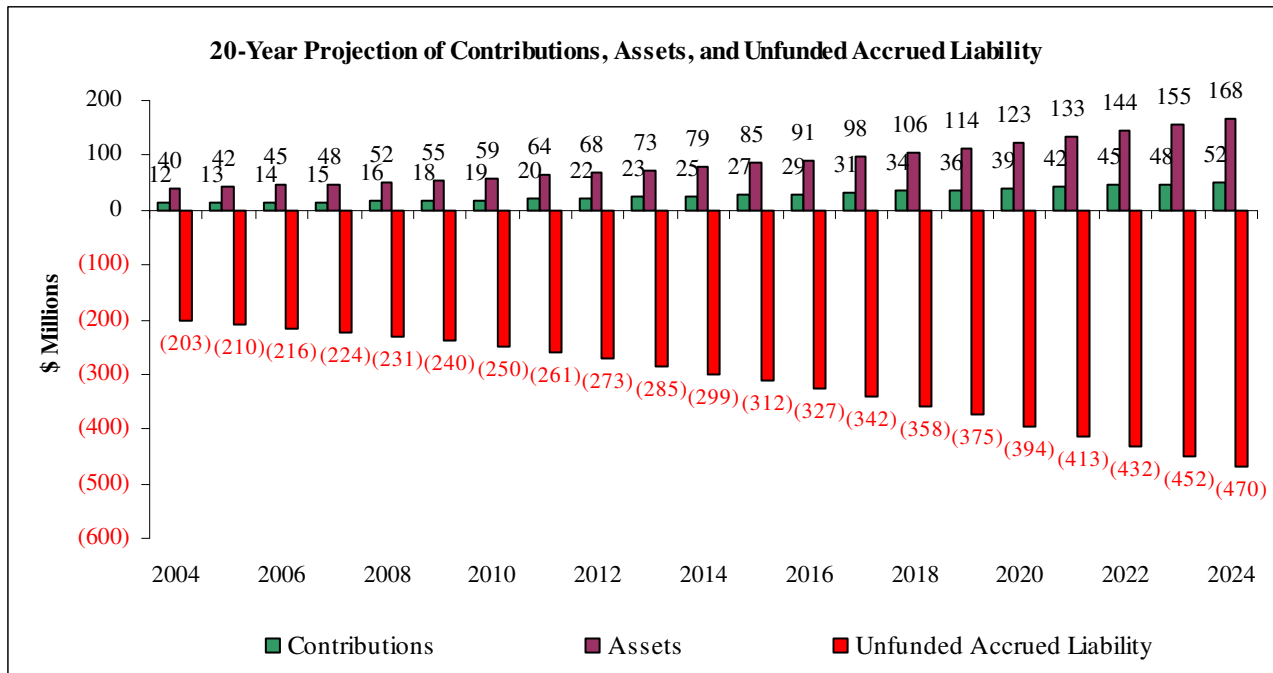
C. Projected Contributions Compared to  
Projected Benefit Payments plus Administrative Expenses

D. Projected Contributions plus Investment Income Compared to  
Projected Benefit Payments plus Administrative Expenses

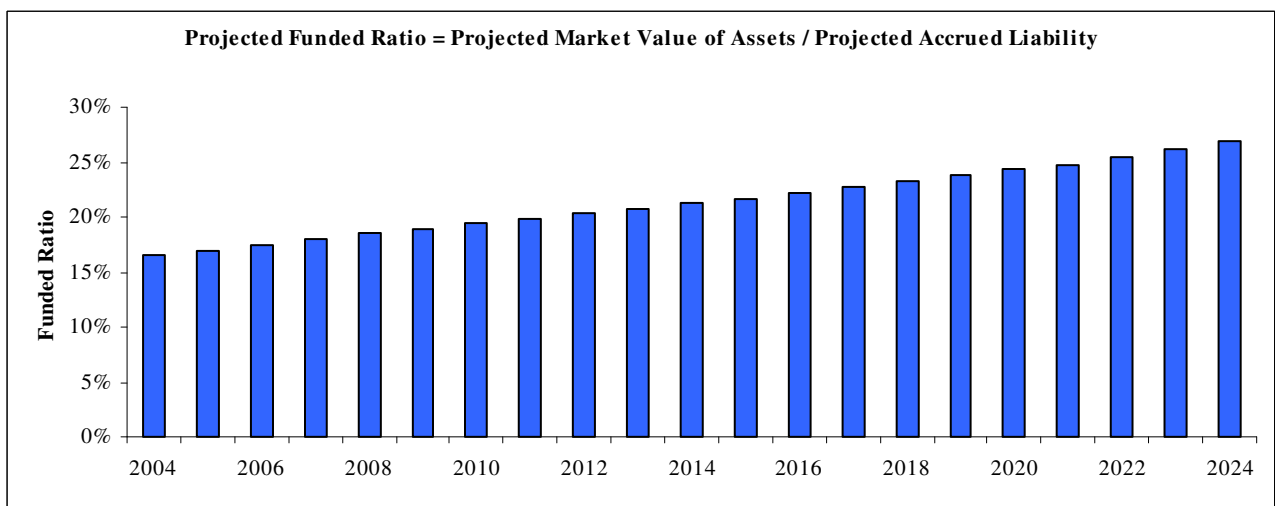
## 20-Year Projection of System Assets and Accrued Liabilities

### B. Projection of Contributions, Assets, Unfunded Accrued Liability, and Funded Ratio

As mentioned in the Executive Summary, this study does not predict the ruin of the Administration within the next 20 years. Although the unfunded accrued liability will increase over time, contributions collected will also increase such that within approximately 10 years it is estimated that contributions collected will exceed benefits paid to beneficiaries plus administrative expenses each year. The level of assets is projected to continue to increase for the next 20 years.



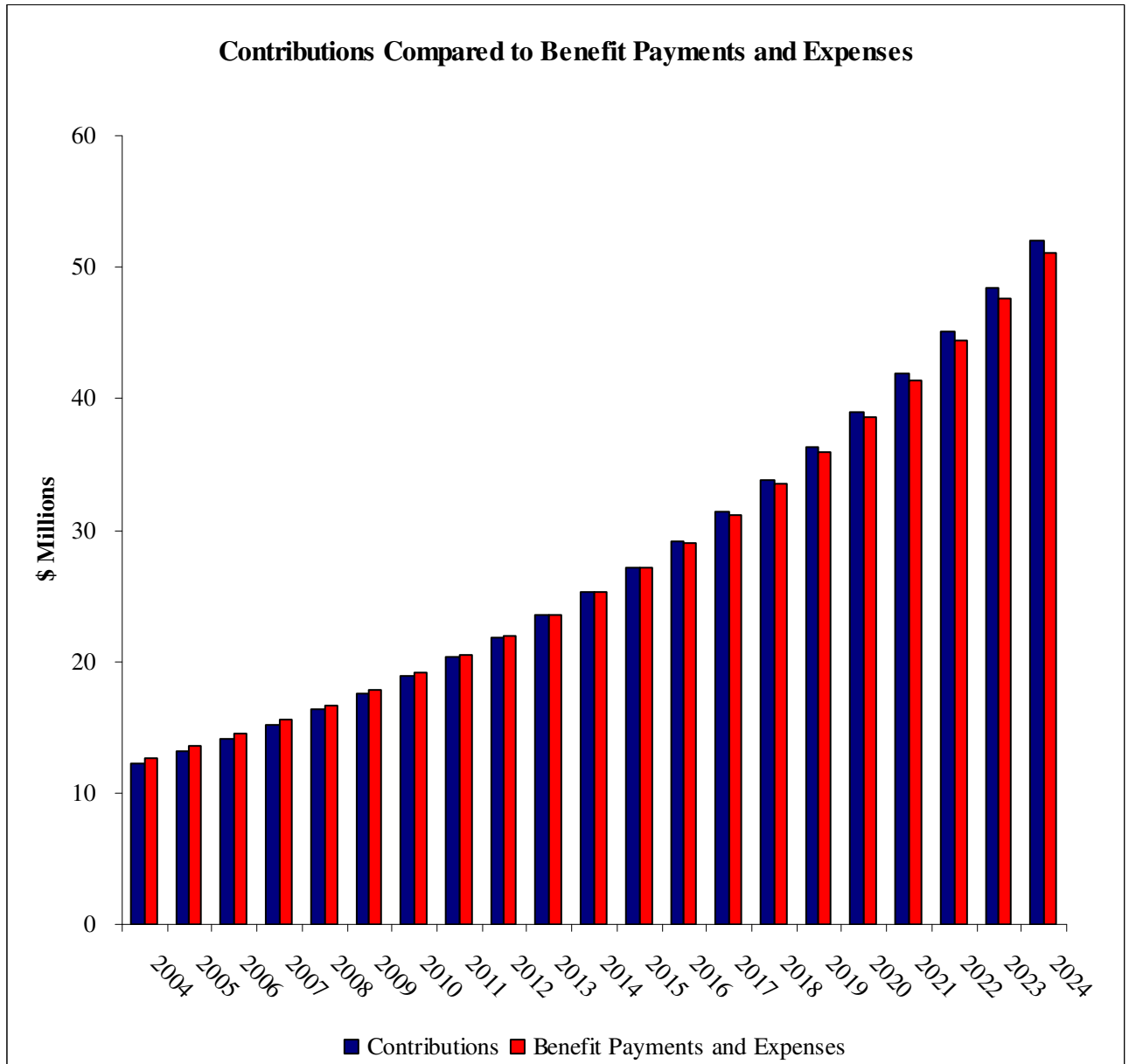
This study also estimates that the funded ratio will increase from 16% on January 1, 2004 to 27% in 20 years. The funded ratio indicates what percent of the accrued liability is covered by the market value of assets.



## 20-Year Projection of System Assets and Accrued Liabilities

### C. Projected Contributions Compared to Projected Benefit Payments plus Administrative Expenses

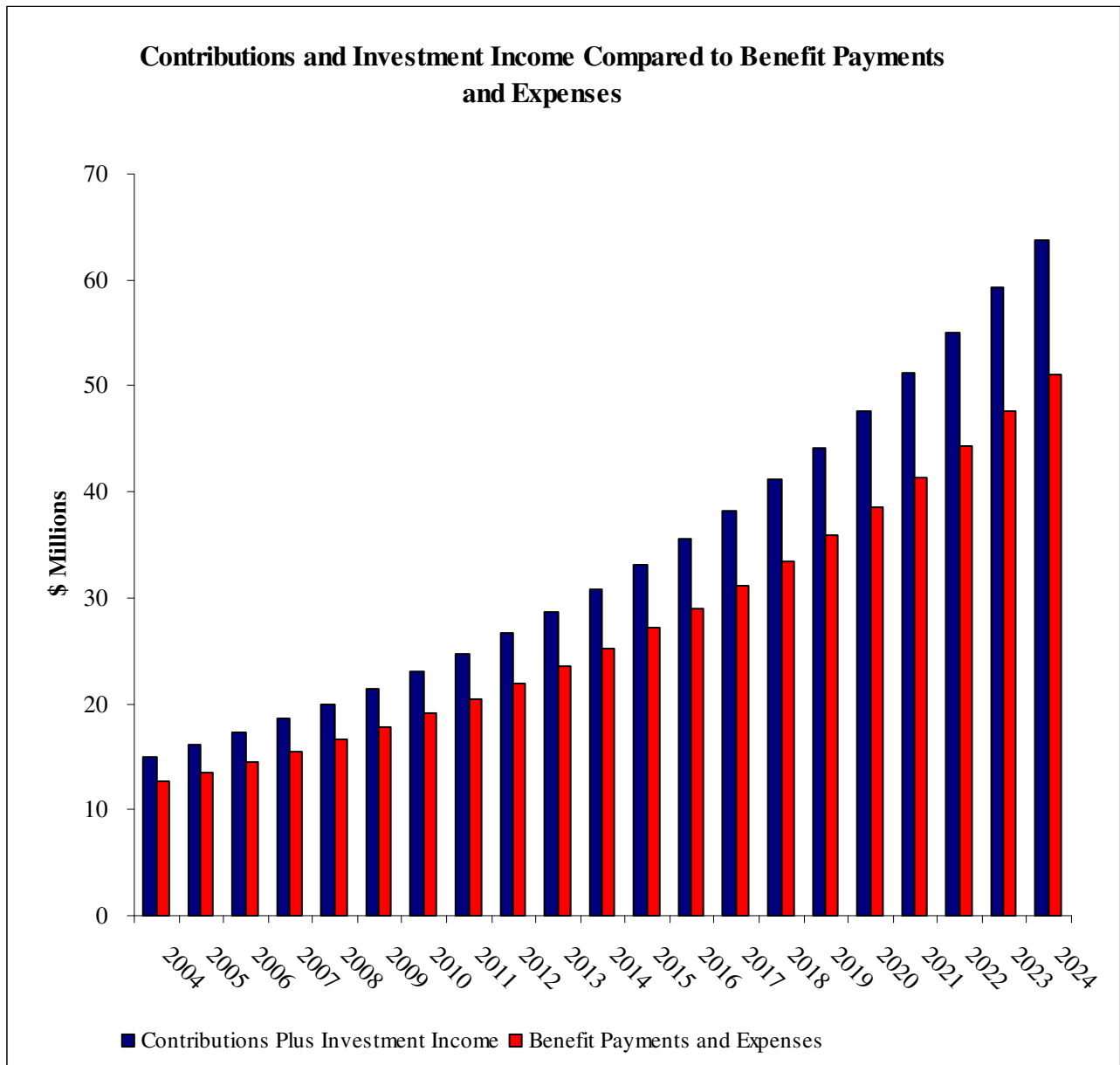
The following graph compares the projected amount of contributions collected to the projected benefit payments plus expenses paid each year for the next 20 years. It indicates that in 10 years more will be collected each year in contributions than will be paid out in benefits and expenses.



## 20-Year Projection of System Assets and Accrued Liabilities

### D. Projected Contributions plus Investment Income Compared to Projected Benefit Payments plus Administrative Expenses

The following graph compares the projected amount of contributions collected plus the projected investment income received to the projected benefit payments plus administrative expenses paid each year for the next 20 years. It indicates that for the next 20 years more will be received in contributions and investment income in than will be paid out each year in benefits and expenses.



## 20-Year Projection of System Assets and Accrued Liabilities

### CONCLUSIONS AND RECOMMENDATIONS

This study applies actuarially sound principals to project and estimate the level of future contributions, benefit payments, administrative expenses, and accrued liability in order to estimate the future funded status. The projected return on invested assets, 7.5% per year, is based on the 8 ¾ year average return on trust assets determined as of December 31, 2003 (which was 7.21%).

Although the main conclusions of this study are that the funded ratio will continue to increase and the Administration will be able to pay benefits for the next 20 years, the actual funded status and ability to meet future benefit obligations for the next 20 years will depend on the actual return on invested assets, the future number of workers covered by Social Security, and the benefit structure in place then.

While this study predicts that the Administration will be better funded in 20 years than it is now, the funded ratio is still only expected to increase to 27% which means that in 20 years, trust assets are expected to only be great enough to cover 27% of the benefits earned at that point. With this in mind, the Administration, the Board, and Congress might want to consider taking steps now in order to improve the future financial health of Social Security.

Accordingly, the benefit formula could be revised to reduce the level of benefits earned by large wage earners. Currently a worker earns a monthly benefit equal to 16.5% his first \$10,000 of cumulative covered earnings, plus 3% of the next 30,000 of cumulative covered earnings, plus 2% of cumulative covered earnings in excess of \$40,000. It may be worth considering adding another tier of benefits that applies to cumulative covered earnings in excess of \$40,000. Under the following benefit structure only wage earners with more than \$302,500 in cumulative covered earnings would receive a benefit that is less than what they would currently receive. Both this and the current benefit structure produce a basic benefit of \$650/month for \$302,500 of cumulative covered earnings.

16.5% of the first \$10,000 of cumulative covered earnings, plus  
3.0% of the next \$30,000 of cumulative covered earnings, plus  
2.0% of the next \$262,500 of cumulative covered earnings, plus  
1.0% of total cumulative covered earnings in excess of \$302,500.

For example, currently someone who retires with \$500,000 in cumulative covered earnings would receive a monthly benefit of \$979 and under the revised benefit structure above he would receive \$815 per month.

The breakpoint of \$302,500 and the fourth tier benefit level of 1% are only suggestions and were chosen so that those who would currently earn a basic benefit of \$650/month or less would be unaffected. The actual new breakpoint and benefit level would need to be chosen after consideration and study in order to meet the future funding goals set by the Board.

## 20-Year Projection of System Assets and Accrued Liabilities

Regularly scheduled increases in the wage base would further reduce the future unfunded accrued liability. Because the basic benefit is a function of cumulative covered earnings, this would be especially effective if it were combined with an additional benefit tier as mentioned above. The wage base could be increased by some small amount each year into the future or it may be desirable to schedule increases every few years up to a maximum amount. For example the wage base could be increased to \$6,000 per quarter in 2010, then \$7,000 in 2015, and so on, increasing \$1,000 every five years until the wage base finally reaches \$10,000 per quarter in 25 years.

It may also be worth considering increasing the retirement age for unreduced retirement benefits to age 65 and then reduce benefits by 2/3% for each month before age 65 that benefit payments begin. This would mean that someone who retired at age 60 would receive a benefit that is 60% of the benefit that he had earned at age 60 but would receive if he waited to retire at age 65. This would effectively introduce the concept of a reduced early retirement benefit to Social Security. In order to encourage workers who choose to retire before age 65 to remain in the work force and pay into Social Security the earnings test could be eliminated (either indefinitely until age 65) or the level of earnings at which the earnings test applies could be increased for these workers. Benefits would be recalculated at the end of each fiscal year that the early retiree works and has covered earnings using the same benefit formula and early retirement factors that applied on the day that he began receiving benefits. The 2/3% per month reduction factor was chosen to illustrate the concept of a reduced early retirement benefit only and the actual reduction factor would need to be chosen after consideration and study in order to meet the future funding goals set by the Board.

It has come to our attention that customary adoption continues to be an issue regarding survivor benefits paid to dependent children. We understand that because there is no reliable way for the Administration to verify which children have actually been customarily adopted and which ones have not, it is possible that survivor benefits may be paid to children who claim to have been customarily adopted but in fact were not. Without knowing the dollar amount of benefits paid each year to dependent children who claim to have been customarily adopted it is impossible to accurately estimate the amount of payments that may be improperly paid each year. However, if the dollar amount of these benefits is great enough, it may be necessary to limit or even curtail benefit payments to dependent children other than to the deceased worker's natural born children and those children whom he or she had legally adopted and for which proper documentation of the adoption exists.

And finally, we understand that currently the Administration is allowed to negotiate the amount of penalties but not interest applied to contributions from employers that are past due. While it is important to make sure that measures are in place to strongly encourage prompt and timely remittance of contributions it is also important to realize that from time-to-time there may be legitimate reasons for which the Administration would want to have the ability to negotiate the amount of interest collected as well as penalties from a past due employer. One such case would be if the accumulated interest and penalties are so great that collecting the entire amount due, including the total amount of interest and penalties would cause the overdue business to cease operations. In this case it very well may be in the public interest for the Administration to reduce the interest as well as the penalties in order to collect the contributions that are due and to allow the employer to remain in business. However, this ability to negotiate should be used very sparingly and there should be limitations regarding how often exceptions regarding interest and penalties could apply to any one business and perhaps even how often exceptions could apply to the business owner or owners.

## 20-Year Projection of System Assets and Accrued Liabilities

### EXPLANATION OF ASSUMPTIONS SPECIFIC TO THIS STUDY

It is important to realize that any projection of assets and liabilities 20 years into the future is extremely sensitive to the assumptions made regarding future returns on trust assets, the growth of the population covered by the Social Security System, the growth of worker salaries, future contributions collected, and the dollar amount of future benefits paid to beneficiaries and administrative expenses.

Based on the current 8  $\frac{3}{4}$  year average return on trust assets determined as of December 31, 2003 (which was 7.21%), and in line with the assumed rate of return in past actuarial valuations, this study assumes that the trust will realize an average net investment return of 7.5% each year into the future.

The estimation of the future accrued liability also depends on the overall state of the economy as well as the rate of future population growth. Based on population growth estimates in the FSM from 1980 to 2000, the projection of the accrued liability in this study assumes that the number of workers covered by the Social Security System grows by an average of 2% each year into the future. Also consistent with past actuarial valuations, this study assumes that salaries will increase at an average rate of 4.5% each year into the future.

Contributions (both worker and employer paid) are assumed to increase at an average rate of 7.5% each year into the future. This estimated increase is based on the actual average increase in contributions collected for the past five fiscal years ending with fiscal year 2004 and also takes into account the fact that the quarterly taxable wage base was recently increased from \$3,000 to \$5,000.

This study assumes that the total dollar amount of benefits paid to beneficiaries will increase by an average of 7.5% each year into the future. This estimated increase is based on the historical growth in benefit payments from fiscal year 1996 through 2003 as well as the fact that the quarterly taxable wage base was recently increased from \$3,000 to \$5,000, and because a worker's benefit is based on the cumulative amount of his wages up to the wage base, this increase in the wage base will contribute to an increase in overall future benefit payments.

Historical growth in contributions and payments to beneficiaries already take into account past actual population growth and increases in salaries. Accordingly no further adjustments were made to the assumed growth in contributions and payments.

And finally, administrative expenses are assumed to increase at an average rate of 2.5% each year into the future and this is consistent with the average increase in administrative expenses from fiscal year 1996 through 2003.

Other than these specific assumptions used for this study, all other assumptions and the actuarial method used to estimate the future accrued liability are the same as those used in the January 1, 2004 actuarial valuation. Also, this study assumes that the provisions of the Social Security Administration, including the taxable wage base and the formula used to determine the benefits paid to beneficiaries is unchanged from the provisions current as of the date of this study.

## 20-Year Projection of System Assets and Accrued Liabilities

### ACTUARIAL ASSUMPTIONS, AND SUMMARY OF KEY SYSTEM FEATURES

#### A. Actuarial Assumptions

*Please see Section V. for special assumptions specific to this study.*

Actuarial Cost

Method: Individual Entry Age Method, Level Percent of Pay

Investment Income: 7.5% per year

Expenses: 0.75% of Covered Wages

Salary Increase: 4.5% per year

Mortality: 1984 Unisex Pension Mortality Table for participants not yet in receipt of benefits. The same mortality table for retirees and beneficiaries in receipt of benefits except that they are considered to be two years older than they actually are.

Disabled

Mortality: PBGC Mortality Table for Disabled Persons receiving Social Security

Retirement Age: Age 60 if eligible, otherwise when eligible but not later than age 70  
Active workers who are older than 60 are assumed to retire at the end of the next fiscal year if they earned 4 quarters of coverage during the fiscal year that just ended.

Pre-retirement

Spouse Benefit: 80% of the workers are assumed to be married and males are assumed to be 3 years older than their spouses.

Surviving male spouses are assumed to remarry 2 years after death of the worker and surviving female spouses are assumed to remarry 6 years after death of the worker.



## 20-Year Projection of System Assets and Accrued Liabilities

Representative percentages of those who receive a pre-retirement spouse benefit who remarry are shown in the following table.

Age	Male Spouse Remarry within 2 years		Female Spouse Remarry within 6 years	
	Remarry	Does not Remarry	Remarry	Does not Remarry
20	39.22%	60.78%	76.71%	23.29%
30	32.35%	67.65%	48.92%	51.08%
40	20.70%	79.30%	26.80%	73.20%
50	14.44%	85.56%	9.75%	90.25%
60	7.40%	92.60%	2.52%	97.48%

Surviving spouse benefits continue if the spouse is employed but the benefits are subject to the earnings test.

### Pre-retirement

**Children's Benefit:** Married workers are assumed to have 3 children and each child is assumed to be age 13 at the time of death of the worker.

### Post Retirement

**Survivor's Benefit:** 80% of active workers are assumed to be married when they retire. Males are assumed to be 3 years older than their spouses. It is assumed that 10% of male spouses and 60% of female spouses have Old Age Benefits smaller than the survivor's benefit.

### Disability:

Rates are from the 2003 US Social Security Trustees Report Intermediate Assumptions.

### Turnover:

None for citizens of the Federated States of Micronesia.

5% of citizens of countries other than the Federated States of Micronesia are assumed to leave each year, except for that 80% are assumed to leave in their third year of employment. It is also assumed that 80% of workers who are not citizens of the Federated States of Micronesia leave when they retire.

## 20-Year Projection of System Assets and Accrued Liabilities

### Earnings Applied

To the Earnings Test: Retirees: 80% of what the retiree was earning prior to retirement

Surviving Spouses of Active Workers: 75% of what the worker was earning prior to death.

Surviving Spouses of Inactive Workers: Quarterly earnings of twice the quarterly benefit plus \$300.

Children: None

Disabled: None

### Workers included

In the Valuation:

Workers who have covered quarters in at least one of the last three years, are not currently indicated in the data files supplied by the administration as actively receiving a benefit or closed with no future benefits payable and who are age 21 or older are assumed to continue working and earn 4 quarters of coverage until they become disabled, die, or retire. Workers who have not earned any quarters of coverage during the last two years are assumed to stay out of the work force. Salary used as a basis to project future salaries is the greater of the salary earned during the last three years. If this salary is based on less than four quarters of coverage, it is converted to an annual salary.

## 20-Year Projection of System Assets and Accrued Liabilities

### B. Summary of Key Features

#### Applicable Laws

Public Law 2-74, as amended by Public Laws 5-120, 6-111, 7-118, 7-119,7-120, 9-56, 12-51, and 12-76.

#### Workers and Employer's Contributions

Workers, self-employed workers and employers each pay 6% of earnings up to a maximum of \$5,000 of earnings per quarter.

Self-employed with employees - remuneration shall be deemed to be twice the amount paid to the highest paid employee reported by the self-employed person in quarter, up to \$5,000 taxable per quarter.

Self-employed with no employee - Remuneration is deemed to be 2.5% of the gross revenue of the business for the previous calendar year subject to \$5,000 taxable per quarter.

#### Coverage

All employees employed by an employer incorporated or doing business in the Federated States of Micronesia are covered unless both the employer and employee are currently subject to another recognized social security system.

#### Eligibility for and Computation of Benefits is based on the following definitions:

Quarters of Coverage: A calendar quarter in which contributions were made for at least \$50 of earnings.

Currently Insured: Credited with at least 8 quarters of coverage during the most recent previous 13 calendar quarters.

Fully Insured: Credited with at least one quarter of coverage for each year since the later of attainment of age 21 or June 30, 1968 and having not less than 12 quarters of coverage.

Maximum Covered Earnings: Earnings up to a maximum of \$5,000 each quarter.

Minimum Benefit: \$50 per month.

## 20-Year Projection of System Assets and Accrued Liabilities

### Basic Benefit

A worker's Basic Benefit is calculated as 1/12 of:

1. 16.5% of the first \$10,000 of total Maximum Covered Earnings for which contributions have been made, plus
2. 3.0% of the next \$30,000 of total Maximum Covered Earnings for which contributions have been made, plus
3. 2.0% of total Maximum Covered Earnings in excess of \$40,000 for which contributions have been made.

### Old Age Insurance Benefit

Eligibility: Age 60 and Fully Insured

Amount: Greater of the Basic Benefit and the Minimum Benefit, subject to the earnings test.

### Disability Insurance Benefit

Eligibility: Disabled for three months and Fully Insured at time of disability

Amount: Unreduced Basic Benefit earned at time of disability. Sum of disability benefit and workers compensation benefit may not exceed 80% of the highest covered compensation earned in the year of disability and the prior five years. The benefit ceases should the worker recover from the disability.

### Surviving Spouse Benefit

Eligibility: Worker must have been Fully Insured at time of death.

Amount: 60% of the Basic Benefit earned at the time of death, subject to the earnings test. Paid until the earlier of the date the spouse remarries or dies. This benefit is reduced by any Old Age Insurance Benefit that the spouse may be entitled to based on his or her own earnings history.

### Surviving Child Benefit

Eligibility: Worker must have been Fully or Currently Insured at time of death.

Amount: 15% of the Basic Benefit for each dependent child under the age of 18 or 22 if a student. The benefit ceases if the child marries or is adopted by a close relative.

## 20-Year Projection of System Assets and Accrued Liabilities

The minimum total Survivor benefit is \$50 per month and is subject to the Earnings Test.

The sum of all survivors' benefits cannot exceed 100% of the Basic Benefit earned at the time of death.

### Lump Sum Death Benefit

Eligibility: After the death of any covered worker and rights to all survivors benefits have ceased.

Amount: Four percent of total Maximum Covered Earnings for which contributions have been paid, less the value of any benefits already paid.

### Lump Sum Benefit (other than death)

Eligibility: Age 60 and not fully insured, native born citizen of the Federated States of Micronesia or resident for at least 10 years and must have lived in the Federated States of Micronesia for at least one year immediately preceding death.

Amount: Four percent of total Maximum Covered Earnings for which contributions have been paid.

### Earnings Test

Benefits are reduced by \$1 for every \$2 of earnings in excess of \$300 received each quarter.

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