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Editor's Note: The following two contributions are a continuation of a series of articles which began in the October issue of The Actuary on the subject, "Accountants and Adjusted Earnings."

Accountants and

MUTUAL COMPANIES

by Paul H. Knies

Mutual life companies have only recently been included in the adjusted earnings developments. Presumably, the accountants feel that the matching of expenditures (especially acquisition costs) with revenue has relevance for mutuals as well as for stock companies. Until this development, criticism of mutual life-insurance company reports has been negligible. It is not surprising that there is some difference of opinion among actuaries and accountants as to how to solve a heretofore nonexistent problem.

A Natural Premium Approach

Non-participating premiums can be analyzed into two segments: a natural premium based on *realistic assumptions* as to mortality, interest, expenses and withdrawal rates; and a premium for expected profit. The natural reserve is then developed from the natural premium.

However, in a mutual company the gross premium scale is designed with policyholder equity in mind. If each and every class of policy is to be self-supporting, the premium scale should be designed to be adequate under reasonable *floor assumptions*, that is the most unfavorable assumptions which might reasonably be anticipated to prevail over an extended period of time.

When this test is satisfied, each premium may be regarded as adequate, with a return to each class of policyholder (in the form of dividends) of any excess of the premium charged over the actual cost experienced. This concept of self-supporting classes prevails, of course, throughout the life of the class and not just at issue.

A "natural mutual premium" might be described as the premium generated by reasonable floor assumptions. While we may expect basic agreement on the use of reasonable floor assumptions in mutual company premiums, we would expect some disagreement as to the precise reasonable floor. In any event, the natural mutual premium would appear to be equal to the gross premium, since there is no justification for profit.

Next, the natural mutual reserve might be calculated by considering the natural mutual premium together with realistic assumptions as to investment income, expenses, and payments to policyholders (including dividends). Alternatively, the natural mutual reserve might be calculated by considering the natural mutual premium and the reasonable floor assumptions of income and outgo. The two approaches will produce essentially the same natural mutual reserve.

A Direct Approach

The actuary might by-pass the natural mutual premium and attempt to directly determine the natural mutual reserve in the aggregate. At this point he might well consider why surplus is needed in a mutual company. Perhaps surplus would be considered as the amount required to protect against contingencies which might or might not arise over the life of a current inforce, but which must be anticipated over the life of the company. Another approach might consider surplus to be a general reserve for contingencies which was accumulated over the years from all policy classes, and which is retained for the benefit of continuing and future policyholders of the company.

On the other hand, consideration of surplus might be by-passed in favor of considering the total fund which a company deems necessary to have on hand to meet all future obligations to current policyholders. When policies terminate, these approaches would frequently provide for the release of surplus or funds to policyholders, in accordance with the manner in which the amounts were contributed.

Having considered the need for surplus, an actuary could return to the task of defining natural mutual reserve. He might choose the amount contributed by current policyholders, or by current and past policyholders, or the portion of contributed amounts which are expected to be expended or returned in the form of payments to policyholders (again including dividends).

A Balance Sheet Approach

Apart from techniques for matching expenditures with income, an actuary could approach the problem from the point of view of the balance sheet of the annual report of insurance companies. The balance sheet is expected to divide total funds into three parts: one part dealing with policyholders, a second part dealing with others who are creditors, and a third dealing with proprietors. If the second part is known, we might boil the problem down to a division, in accordance with generally accepted accounting principles, of the remaining funds as between policyholders and proprietors.

Noting that a mutual company cannot hold any more or less than the amount that it deems advisable in light of its obligations to policyholders and that in a mutual company there are no proprietors, an actuary might come to the conclusion that there is really no reason to divide the fund. However, if the funds are subdivided between reserves and surplus, or otherwise, the income statement can readily follow the fund subdivision.

To What End?

Given that the objective sought by adjusting earnings of stock companies is to provide the investing public with a more meaningful measure of earnings, what objectives might be served by adjusting the earnings of mutual companies? More useful reports to supervisory authorities? To management? To policyholders?

The supervisory authorities have determined that the statutory report best suits their purpose, which is the protection of the insuring public. Management can obtain analyses of earnings without external pressure. In the absence of other objectives, we are left with the questionable hypothesis that the interests of policyholders would be better served by adjusted earnings.

While there are some superficial ownership aspects for policyholders of mutual companies, their basic interest is

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Mutual Companies

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that of a purchaser of insurance. The interest of present and future policyholders is in the financial statement for the *insuring* public not the *investing* public. The statement form devised by regulatory authorities also serves to inform the insuring public, including policyholders of both mutual and stock companies—whether their policies be participating or non-participating.

Perhaps at this point an actuary might wish to consider two major statutory requirements that have been questioned as not in accordance with generally accepted accounting principles: statutory reserves are too conservative, and acquisition costs should not be charged against income when incurred.

Reserve Questions

Are the reserves in a mutual company too conservative? In answering this question, an actuary would only consider the interests of the insuring public, since there is no investing public for mutual companies. Clearly the supervisory authorities should not consider the "legal reserve" to be too conservative for the insuring public if they feel that the reserve system has resulted in the industry being relatively free of insolvencies. It seems that the interest of the policyholder is the same as that of the supervisory authorities, and that is the ability of the company to carry out its lifetime guarantees.

Another question which might be raised is whether or not it is too conservative to hold reserves at least as large as surrender values plus settlement expenses. Even if the answer is yes for stock companies in reports for the *investing* public, an actuary would want to consider whether or not it would be proper to show in a report to policyholders a liability to policyholders that did not cover their own surrender values.

Acquisition Cost Questions

Clearly, the value of a life company share might well depend on the amortization of acquisition costs and the probability of receiving future premiums payable by policyholders. On the other hand, the interest of policyholders is in *distributable* earnings, which have nothing to do with future premiums. While the amortization of acquisition costs has a material bearing on the financial position of a stock company for an investor, it might well confuse the financial position for a policyholder. The policyholder is looking for assurances that the company can carry out its policy obligations. A surplus that is increased by unamortized acquisition costs could be misleading to the insuring public.

Possible Conclusions

It would seem that the main interests of the insuring public—the ability of a company to carry out its guarantees, and the pricing of the insurance product—are also the main interests of the supervisory authorities, who have prescribed the form of the statutory statement.

An actuary might then conclude that the form of statement that best suits the supervisory authorities would best suit the insuring public. Indeed, some representatives of mutual companies have expressed the opinion that the end result should be the acceptance of the statutory statement by the accountants as being in accordance with generally accepted accounting principles for mutual companies. There are accountants, however, who feel that this is unacceptable, because there is no provision for matching of expenditures with revenue.

If the statutory statement is to be adjusted for mutual companies and for the participating business of stock companies, it would logically result in regarding most, perhaps all, of the surplus of such business as funds which should be recognized under generally accepted accounting principles as additional liabilities held for the benefit of policyholders and beneficiaries, over the above funds held as statutory reserves. □

Wisconsin Code

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one chapter at a time. These drafts have been released to insurance companies, trade associations, and other interested persons and organizations for review and comment, and hearings were held by the Committee before the drafts were submitted to the Legislature as bills for introduction. Six chapters covering areas of relatively minor importance to life insurance have already been enacted by the Legislature, one in 1967 and five in 1969.

Drafts of chapters now being released contain provisions of substantially more importance to life insurance. Particularly important is Chapter 623, entitled *Accounting, Valuations and Reserves,* a first draft of which was released in July.

The covering memorandum released with Chapter 623 states that, for this chapter and for the chapters on Investments and Insurance Contracts, the various sections of the statutes have been written in general terms with authority delegated to the Commissioner to prescribe detailed provisions by means of rules and regulations. This practice will probably provoke different reactions from different persons, actuaries included. Lawyers, for example, may raise questions as to constitutionality. The ultimate regulatory effect of the practice would obviously depend to a significant degree on the details of the regulations promulgated by the Commissioner. In some areas, particularly those affecting valuation and nonforfeiture requirements, the proposed practice differs sharply from the pattern recommended by the National Association of Insurance Commissioners and now in effect in Wisconsin and in nearly all other states.

In addition to the general covering memorandum on Chapter 623, the release includes comments on the different sections of the chapter, and in an appendix are suggested rules recommended to the Commissioner for promulgation to implement the statutory provisions. There are also comments on the rules and suggestions as to how they might be modified at a later date to achieve the improvements the drafters believe to be desirable. One reason advanced for the desirability of the flexible approach of general statutory provisions with details to be prescribed by regulations, is that it is better adapted to the development of new ideas and new products such as variable life insurance.

The provisions of the more important sections of the draft of Chapter 623 relating to life insurance will now be briefly described. The chapter covers all lines of insurance, but some sections state specific requirements for life insurance.

Standards for Accounting Rules. In prescribing accounting rules the Commissioner is directed to "consider recommendations made by the National Association of Insurance Commissioners, customary accounting practices, both in the insurance industry and outside it,

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