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DIGEST OF INFORMAL DISCUSSION

ANNUAL STATEMENT

A. What general problems, if any, arose in preparing the annual statement on the new form?

B. Are the purposes served by the requirement to report both incurred and cash entries of sufficient importance to warrant the work required to convert from one basis to the other?

C. What problems have arisen as a result of the requirement that the net capital gain or loss of the year be split between "realized" and "unrealized"? What criteria have been adopted for arriving at the separation?

D. What effect will the continued requirement of a Security Valuation Reserve as prescribed by the National Association of Insurance Commissioners have on such matters as dividend apportionment and reserve strengthening?

MR. WILLIAM CHODORCOFF stated that the general problems in preparing the 1951 annual statement on the new form were primarily in the nature of additional work requirements. These were of two types: the nonrecurring problems and the annually recurring. Examples of the second type are the additional work in allocating expenses and taxes to insurance and investment functions, furnishing the footnotes for the expense exhibit, determining uncollected, deferred and advance premiums for ordinary, disability and additional accidental death benefits and splitting the disability claim liability between payments made and premiums waived.

In discussing section B, he pointed out that the conversions of premiums, investment income, dividends and claims from a cash to an accrual basis were necessary in preparing the gain and loss exhibit in the old statement. The new statement merely requires the trouble and expense of printing as statement exhibits what were formerly internal worksheets. While these may serve no useful purpose for the companies, they may furnish the state insurance departments a clearer picture of the changes, help them in preparing their annual reports and ultimately lead to their agreeing to have these exhibits omitted.

The instructions for preparing the Federal income tax return require that it be on a cash basis in conformity with the annual statement made to the state insurance department. As long as this instruction exists in its present form, exhibit 12 serves a useful purpose in establishing the cash basis required for tax purposes.

In regard to section C, he said the problems in splitting net capital gain or loss between realized and unrealized were precisely those anticipated by the Joint Committee on Blanks. These stem from the divergent views and strong convictions which the Committee could not reconcile. They relate to determining the criteria to be adopted in arriving at the separation. The answers depend to a large extent on whether "realized" and "unrealized" refer to the gains and losses of the year or of the period during which a security is held and, in multiple line companies, on the established basis of allocating capital gains and losses by line of business. The Prudential assumed that the terms referred to the results of the year and that realized gains or losses arose only on asset dispositions during the year. The amount of realized net gain was taken as the difference between the net consideration received and the asset value at the beginning of the year, adjusted for the current year's amortization or depreciation to date of disposition. Any gains or losses from market value adjustments of assets held at the end of the year and any changes in investment contingency reserves were treated as unrealized gains or losses.

MR. C. E. WEST, in discussing section B, also felt there was little additional work over what had been required in the past to fill out the gain and loss exhibit. Since the Provident Mutual keeps its books on a cash basis, it is helpful, from the standpoint of reconciliation, to prepare exhibit 12 before proceeding with the statement on an incurred basis.

Under section C, he stated that it might seem logical to base the realized gains or losses on disposal of assets on the actual cost of the investment (adjusted by amortization of premium or accrual of discount). However, this method would give rise to complications and anomalous situations. Therefore, the Provident Mutual determined "realized" and "unrealized" net gains by a method essentially the same as that outlined by Mr. Chodorcoff. This method may very well produce lower "realized" gains and also lower losses, but this may be an advantage considering that these "realized" gains or losses enter into the "Analysis of Operations by Lines of Business" and hence might distort the net gain from operations for any particular year.

MR. L. F. SLEZAK, in discussing section A, stated that, at the risk of oversimplifying, it might be said the only problem was to acquire a working familiarity with the requirements of the new form in time to arrange for some bits of information not previously needed. The Occidental of California encountered some minor problems. The deficiencies in the forms were the least troublesome, being overcome by inserting additional lines or columns where necessary. An example of deficient instructions or definitions is the item "Expense of investigation and settlement of policy

claims." Individual opinion may vary widely from the nominal expense of inspections, etc., to a total functional cost. His company used the amounts paid or payable for inspections, independent investigators, doctors, hospitals, etc. The instructions about handling the increase in accident and health reserves in the Summary of Operations exhibit could be clearer.

Other problems were apparently illogical changes in classification. A change in agents' debit balances is classified as surplus whereas balances charged off and recoveries are classified as expense. It would seem more logical to include all three in the same classification. The separation of the claim liability into two parts, (1) Unaccrued (reserve) and (2) Accrued (liability), gives a new meaning to the term "claims incurred" in exhibit 11, part 2.

Under section C, he reported that for many years the Occidental has made a similar separation in their internal statements without using the terms "realized" and "unrealized." Since there are no specific instructions, they followed their usual practice of charging surplus for the gain or loss from market fluctuations; in the new statement this is "unrealized" gain or loss.

MR. A. A. TOUSAW, discussing section A from the viewpoint of a Canadian company, mentioned that the Sun Life had some trouble deciding just what particular items of expense should be included in footnotes A, B, C to exhibit 5, general expenses. If other companies had a similar problem, these figures may have been reported in a variety of ways, rendering comparisons between companies of doubtful value. However, he felt that variations in the statement would apply more to figures of minor importance than to major items.

Turning to section B, he stated that his company would like to see the exhibits limited to reporting incurred figures. Certain accounts can be maintained to advantage on an incurred basis; by limiting the exhibits to reporting such figures he felt worth-while savings can be effected. Furthermore, incurred figures furnish a proper basis of comparison between companies and between years. But as long as state premium taxes are based on premiums collected and Federal income tax is levied on interest received, it will be difficult to change the relevant exhibits.

Under section C, he pointed out that the problem of dividing capital gains and losses did not cause the Canadian companies any particular trouble because of the special instructions applying to them under which columns 2 and 4 of exhibit 4 are not to be completed.

MR. L. H. McVITY, speaking on section A, also mentioned the difficulty of deciding exactly what was required in the footnotes to exhibit 5. After the figures had been prepared, instructions received for Schedule Q

filed with the New York State Insurance Department appeared to imply that the content of the footnotes should bear some relationship to similarly-captioned lines in Schedule Q. However, since there is no essential identity between the pertinent portions of the two forms, it would appear desirable, particularly for companies not operating in New York, to have more explicit instructions about completing the footnotes.

With reference to section B, he felt it was rather unfortunate that the Subcommittee of the Blanks Committee of the N.A.I.C. was unable to accept more completely the basic proposals of the Joint Committee of the L.I.A.A. and the A.L.C. The inclusion of certain exhibits which are virtually identical with pages 2, 3 and 4 of the old statement seems to involve an unnecessary amount of work; it is difficult to see what purpose is served by including many figures on both the paid and incurred basis, unless it is to preserve the continuity of statistical tables and records.

He understood that some accountants felt that the elimination of "cash" figures would permit keeping the books on an incurred basis, so that work now performed under great pressure after the close of each calendar year could be done earlier in the year. While the new form may not preclude keeping books on an incurred basis, simplifications in accounting could be made if the present hybrid basis were eliminated.

There seems to him to be no good reason for continuing the use of the captions "Ledger Assets," "Non-Ledger Assets," and "Non-Admitted Assets." He hoped that the statement can soon be completed on an "earned" and "admitted" basis. However, the Joint Committee deserves a great deal of praise in that so many of its recommendations were accepted; even with the compromises which were made, the intelligibility and usefulness of the statement have been much enhanced.

Turning to section C, he pointed out that one formula for "realized" capital gains is to use the net profit or loss on sale or maturity. This formula would result in a company never showing a realized loss from the original book value of an asset which was marked down in a previous year but which was sold in the current year at a price somewhere between the marked-down price and the original book value.

In the case of a company which disposes of an asset on which the book value is higher than the market value and for which a nonadmitted asset appeared at the end of the previous year, this formula would not result in a realized loss if the company followed the practice, just prior to the sale, of writing down the book value to its admitted value. This transaction would then be accounted for as a decrease in book value. If a company follows the practice of showing as a loss on sale the difference between the book value and market value, which would appear as a realized

loss, the fact is being ignored that distributable surplus is not changed, since the nonadmitted asset will be reduced accordingly. This and similar types of situations tend to obscure the meanings of "realized" and "unrealized."

Opinions on these matters vary. If a split between realized and unrealized items is desirable for statement purposes, which is by no means obvious, probably the only course that could have been followed was to leave their determination to the individual company.

MR. E. G. FASSEL, taking up section A, pointed out that the separation of single premiums fills a long-felt need. However, the instructions should make it plain whether dividends applied to provide paid-up additions should be included or excluded. He examined the statements of 31 companies and by inference determined that 19 included such dividends in single premiums and 12 excluded them. He agreed with the majority group; these dividends then can readily be taken out of single premiums by reference to the dividend exhibit 7.

In the 1951 statement the rate of net investment income is reported after Federal income tax by some companies and before tax by others. The new blank does not give enough information to enable the published rate to be adjusted from one basis to the other. Because of the importance of the tax, he thought that either exhibit 2 should call for the net rate both ways or else the annual statement should make it possible to convert from one rate to the other by somewhere showing the Federal income tax on the incurred basis.

He felt that the new statement was defective in the analysis of operations under supplementary contracts where their valuation has been changed to a more conservative basis than the guarantees. In the year of such change in basis there is a loss to surplus in the special line provided in the statement. Thereafter, the tabular net premium or consideration on the valuation basis will be higher than the policy proceeds or actual consideration; therefore there should be a loading loss as new settlements occur, so long as the more stringent basis is used. Some companies are handling this loading loss in what he considered the correct manner—as an element in the net gain from operations, line 37 of the surplus account. However, it appears that many companies are showing the operating gain before this loading loss, which then is put through in line 46 as an increase in reserve on account of change in valuation basis. This, he felt, was incorrect because the change in basis was made in a previous year and no change is occurring in the current year.

This condition would be remedied by two clarifications in page 6 and in the instructions:

a) In page 6, line 2, it should be made clear that "tabular net premiums or considerations" means "tabular net premiums or *tabular* considerations." The official instructions for supplementary contracts with life contingencies already call for "tabular considerations."

b) In page 6, line 3 should call for "tabular considerations," recognizing that on a different valuation basis these will differ from the actual considerations on page 5. A corresponding change is required in the official instructions. The item "income during year" should read "tabular considerations." For a company with, say, 3% guarantees and valuing interest settlements at 2½%, the 1951 instructions produce a garbled figure for the "tabular interest," which is at neither 3% nor 2½%.

The method used in the Northwestern Mutual to obtain these "tabular considerations" for such supplementary contracts not involving life contingencies may be of interest. The difficulty is on proceeds held at interest, where the valuation makes an assumption as to withdrawal rates. Their method was to find first the interest required and then the "tabular considerations" as the balancing item. For this purpose a second valuation was made at the guaranteed rate. Commencing with the second valuation figures, the required *guaranteed* interest was found by (*a*) an approximate direct formula and then by (*b*) the instruction page method, obtaining a factor as the ratio of (*b*) to (*a*). Then using the official valuation figures, they found the required valuation interest as produced by the approximate direct formula referred to, which was then adjusted by the foregoing factor as the final result.

MR. W. H. KELTON discussed four problems which pointed to desired changes in the blank. He believed that in the Summary of Operations the increase in the expenses on deferred and uncollected premiums should be included in incurred expenses, just as the increase in these premiums is included in revenue premiums. This could be accomplished by changing line 25 to read "Increase in *excess, if any*, of loading on deferred and uncollected premiums over cost of collection thereon" and by modifying the instructions to provide that increase in commissions on deferred and uncollected premiums should be included in line 21, increase in taxes in line 24 and increase in general expense of collection in line 23. The suggested revision of line 25 provides a place for any excess of the increase in loading over the increase in expenses. Commissions and taxes on deferred and uncollected premiums may be easily estimated, using average commission and premium tax rates.

He believed that from an accounting standpoint uncollected premiums and corresponding expenses belong to the revenue account of the year the premiums were due. This line of reasoning points to the inclusion of gross uncollected premiums in assets and the corresponding expenses in liabili-

ties, as was recommended by the Joint Committee in its December 1947 draft. This treatment would follow closely the form of other commercial statements and would correspond reasonably well to the written basis used for casualty and fire statements. In a multiple line company, as consistent a basis as possible for all lines of revenue premiums is desirable.

To justify similar treatment for deferred premiums, one must reason that such premiums belong to the revenue account of the year in which the corresponding policy anniversaries fell, but this is not on as solid ground as in the case of uncollected premiums, since deferred premiums are not yet due. It may be more logical to eliminate net deferred premiums from the assets and deduct them from policy reserves. This would exclude both deferred premiums and the corresponding expenses from the revenue premium and expense accounts. Another argument for this treatment is that these expenses are not incurred in the usual sense since the services for which they will be paid have not been rendered and the policyholders are not obligated to pay the premiums.

His second problem was that it would seem better to deduct depreciation from real estate income in line 5 column 1 of exhibit 3 in the same manner amortization is deducted from bond and mortgage interest.

The third problem was that the analysis of operations by line of business is not complete for a company which does not distribute its surplus fund to lines of business. The Travelers met this situation for 1951 by adding a column for surplus funds in preparing this exhibit, which column was not printed in the statement. Their columns 2–11 inclusive do not add up to the total in column 1 by the amounts entered in the surplus funds column on lines 4 and 5.

The fourth problem was that reinsurance on outstanding claims in line 5 of exhibit 11, part 1, will disagree with Schedule S for companies which enter any reinsurance for unreported claims. This can be substantial for group companies. One solution would be to change line 3 to read "Incurred but unreported (less reinsurance)" and line 5 to read "Less reinsurance on reported claims (Schedule S)." Another procedure would be to add a line to Schedule S calling for estimated reinsurance on unreported claims which would not be itemized by company.

A problem having to do with company practice is the treatment of Federal income tax. Of 39 company statements examined, 18 treated this as investment expense, 17 as insurance expense and 4 split the tax between investment and insurance expense. In his opinion, this should be an investment expense to correspond to the way the tax is assessed.

Turning to section B, he called attention to the fact that Mr. Wightman in his latest book on *Life Insurance Statements and Accounts* points

out that the requirement of cash items in exhibit 12 encourages companies to continue the present system of incomplete double entry bookkeeping. He agreed with Mr. Wightman that exhibit 12 should be eliminated so that companies may be in a better position to develop incurred expenses and taxes and liability expense and tax items directly from the ledger accounts.

Under section C, he reasoned that all capital gains and losses should eventually be carried through the Summary of Operations. Since such net gains are part of the return from investments, he did not believe it is proper accounting to relegate them to the Surplus Account. These gains could be carried to the Summary of Operations when realized and fluctuations in market values could be carried to the Surplus Account *provided* the entries at sale or maturity were such as to wipe out from the Surplus Account all previous entries on the securities involved and to register all net gains on such securities in the Summary of Operations for the current year or previous years. It would not be good accounting to enter part of the net profits on sold securities in the Surplus Account over the years and part in the Summary of Operations. He was not unduly concerned if the entries in the Summary of Operations in the year of disposition do not reflect the effects on surplus in that year due to canceling out previous entries to the Surplus Account. He believed the alternative treatment for those who think this a serious drawback is to carry all capital gains and losses, including changes in market values, to the Summary of Operations.

MR. J. A. CHRISTMAN, in discussing section D, questioned whether there was an actual requirement that the gains be split between realized and unrealized. The situation is more that complete freedom has been given to enter capital gains either in the Summary of Operations, or in the Surplus Exhibit, or part in each place. In his opinion, the only satisfactory way to separate them is on a cumulative basis, which would not fit into the framework of an annual statement reporting the operations of the year.

A review of a number of statements showed that about three-fourths of the companies used the net profit on sale or maturity as the realized gains. This implies greater uniformity than actually exists, because the definition of profit on sale is not the same for all companies.

He understood that the best modern accounting practice severely limits direct surplus account entries. Entries are made in the income account even for unusual transactions and transactions not pertaining to the operations of the year. Some people have favored direct entry in the surplus account for unrealized gains and losses because they considered it undesirable to allocate these temporary fluctuations by line of business. A more

fundamental reason, he thought, was the feeling that such fluctuations should really be disregarded entirely, that they are taken into account only because of legal requirements and that they should not be allowed to affect normal operating results. The new security valuation reserve reduces the urgency of the problem by going some way toward absorbing these fluctuations, though not so far as would the type of reserve proposed by the Joint Committee on Valuation of Assets. So long as the present requirements continue and until the maximum is reached, the companies will generally show each year a net loss from bonds and stocks amounting to the percentage contribution. It seemed to him desirable to reflect this net loss in the Summary of Operations and distribute it by lines of business.

MR. D. C. DUFFIELD felt that the concept of "realized" capital gains had no place in the statement and should not have been introduced. "Realized" has a connotation of finality which might have some meaning in a transaction by an individual investor, with whom investment was a side line, but has little meaning for an insurance company, which must, within a short time after disposing of one security, reinvest in another. The new security in turn is subject to fluctuations in market value, and, therefore, any "realized" profit is of an ephemeral nature. If companies could get away from the philosophy that securities are sold for cash, which is true only temporarily, and adopt the viewpoint that they are trading securities for other securities, he believed they would abandon the idea of making a fancied distinction between "realized" and "unrealized." Looked at in this way, profits on sale are no more "real" than "paper" profits from appreciation of securities still held.

He felt that the only manner in which "realized" gains could be allocated to maintain equity by lines of business would be in proportion to funds held at the time of purchase of *each individual security* sold. It is improbable that many companies would consider such a time-consuming task. If "realized" gains are allocated in proportion to current assets, he felt that a rapidly growing line would be unduly favored.

An examination of several 1951 statements indicates there is a considerable difference of opinion as to the meaning of "realized capital gains." He doubted that a definition satisfactory to all companies could be devised. He believed this subject would be clouded in confusion until this requirement is removed and all capital gains treated consistently.

MR. G. M. CROWLEY stated that the 1951 annual statements of 22 leading companies showed that 11 companies took gross profits less gross losses on sale or maturity as the measure of realized gains; 3 also included increases less decreases in book value; and 8 used special bases, no two of

which appeared to be exactly the same. One company took $4 millions set aside for the new security valuation reserve as an unrealized capital loss.

On the basis of their annual statements, these 22 companies had net totals of $18 millions of realized gains and $59 millions of unrealized losses, or net losses of $41 millions. Excluding the $4 millions one company set aside for the security valuation reserve, the total net loss would have been $37 millions, divided into $25 millions of realized gains and $62 millions of unrealized losses, if realized gains were taken as only gross profits less gross losses on sales, or $14 millions of realized losses and $23 millions of unrealized losses, if changes in book value were also included in realized gains. If such figures can vary so greatly because of individual company treatment, little if any weight should be given to the separation between realized and unrealized gains. Incidentally, a company need never show realized capital losses, since it can write down book values before sale.

He believed that some definite rule should be laid down for distinguishing between realized and unrealized capital gains and losses or the attempt at distinction should be quietly dropped. The second alternative appeared preferable to him for several reasons. Traditionally, net gains from insurance have not included capital gains. Although not shackled by tradition, established methods of presentation should not be changed without more compelling reasons than appear here. Secondly, the life insurance business has been, and still is, subject to considerable criticism for its use of confusing or misleading technical terms. The expressions "realized" and "unrealized" are two additional items on the list. Thirdly, it may reasonably be expected that most companies in most years will show net realized gains (using gross profits less gross losses on sales as the basis), since prudent management will usually write down investments which would result in loss if sold, while it will be chary of writing up investments. As a consequence, "net gain from operations" will, on the average, be higher than if realized gains and losses were not taken into account. This, in turn, may lead to pressure from both policyholders and field forces for higher dividends than management deems wise (or, in the case of a nonparticipating company, to the belief that the stockholders are making excessive profits).

Turning to section D, he said that the security valuation reserve appeared a highly desirable innovation in some ways, especially since life insurance companies in general were tending to operate in a wider investment area than formerly. It may be particularly helpful to companies subject to an over-all limitation on surplus who want to invest in common stocks. One effect of this new reserve should be to lessen variations in surplus and hence to reduce fluctuations in dividend scales of participating companies, a development which would be welcomed by all concerned.

Now that capital gains will be devoted for some years to increasing the security valuation reserve, they will not be available for reserve strengthening. However, since the companies will be holding these amounts as a liability, and hence not subject to limitations on surplus, the same purpose will be served. Since half the capital losses of any year are to be deducted from this reserve (if sufficient), there will be less danger of having surplus fall to an uncomfortably low figure as a result of an ambitious reserve strengthening program followed soon afterwards by a pronounced decline in asset values. Under such circumstances, there would be less need for strengthening reserve interest assumptions, since such a decline in values often goes hand-in-hand with increased yields on new investments. The new reserve should, therefore, give greater flexibility in meeting decreases in either yields or market values.

He noted that 23 leading companies had $360 millions of security reserves at the end of 1950, of which $53 millions were "above the line," $294 millions "below the line" and $13 millions in Assets Not Admitted. At the end of 1951 they held $355 millions in security reserves, of which $77 millions were "above the line" including $30 millions in the new security valuation reserves held by 17 companies (this reserve was zero for the other 6), $266 millions "below the line" and $12 millions in Assets Not Admitted.

He felt it was desirable to adopt a suggestion made by Mr. Badger that any company so desiring be allowed to re-establish as a reserve and not as a part of surplus any security reserves already set up, or to establish such reserves, provided the maximum ultimately contemplated for this reserve is not exceeded.

MR. J. L. STEARNS, continuing with section D, explained that the security valuation reserve was part of a series of proposals made by the Joint Committee on the Valuation of Assets of the A.L.C. and the L.I.A.A. These proposals had two broad objectives, each dependent upon the other, (1) to smooth out the annual valuation of securities so they would be less dependent on temporary fluctuations and (2) to provide a reserve, not to absorb market fluctuations but to be available to absorb actual realized losses on securities.

The plan adopted by the Commissioners took the idea of establishing a reserve without making any provision for stabilizing values. The industry committee looks on the Commissioners' plan as only a temporary expedient because the committee believes the contemplated reserves would be utterly inadequate to absorb fluctuations in market prices such as have occurred recently. This method of setting up reserves without giving some protection on the valuation of assets will prove burdensome to many com-

panies in many years when they may be called upon not only to set up the annual increase in reserve out of earnings but also to absorb declines in market values.

It probably is premature to discuss what effect this reserve may have on dividend apportionment and reserve strengthening because it is likely there will be changes in the Commissioners' rulings. The Commissioners do feel, however, and the industry representatives agree, that increases in values due to temporary price rises should be set aside in a special reserve and should not be available for dividends, since they represent paper profits which may or may not ever be captured.

MR. L. F. SLEZAK pointed out that all increases in the security valuation reserve are direct charges against surplus, and as such might have a negative effect on dividend declarations and delay or modify reserve strengthening programs. However, since all profits on sale are to go into the reserve until the ultimate is reached, the time required will probably be considerably less than the maximum 20 years. In the case of the Occidental of California, the 1951 reserve was 21% of the full reserve contemplated, its rapid growth being due to substantial profits on sales. In addition, it has been their practice to set up a reserve against Market Value over Book Value of ledger assets; for 1951 this reserve was equal to an additional 63% of the ultimate reserve. This indicates the possibility of their reaching the contemplated maximum reserve in a comparatively short time.

MR. E. W. MARSHALL believed that the continued requirement of a security valuation reserve would tend to affect adversely dividend apportionment and reserve strengthening, at least in companies with relatively low surplus. The building of this reserve requires that part of a company's contingency reserves against future uncertainties must be frozen as a *liability* against possible losses on only one category of assets. The remaining contingency reserves would then have to cover all other contingencies such as abnormal mortality or disability losses or losses on real estate or mortgages. Yet might not these other risks be at least as important potentially as the losses on stocks and bonds? It is difficult to see why there is more reason to create a special reserve in liabilities against one contingency than against another. He felt that it tends to weaken the life insurance fabrics to divert and freeze in liabilities part of the contingency reserves needed against future uncertainties. Who can tell from which direction heavy losses might arise? Would it not be a ridiculous situation if some company should become technically insolvent because its contingency reserves had been entirely used up by, say, extra death losses, whereas it had a large security valuation reserve frozen in liabilities?

He expected that some companies might reasonably feel it necessary to retain more in surplus plus security valuation reserve combined than they would have retained if the two items had been kept together in surplus as formerly. This extra amount retained would thus be diverted from dividend distribution or from strengthening regular reserves.

His one qualification to these comments was that life insurance companies might reasonably be allowed to include in liabilities a reserve representing the excess of market value over *cost* on those individual stocks and nonamortizable bonds on which such an excess exists. But he felt that even this is an unsatisfactory solution. The problem of fluctuations in security values should be attacked through improved methods of valuation rather than through a reserve in liabilities. It would be much better if the asset values of stocks and nonamortizable bonds of a going life insurance company were valued on a long-swing basis, such as a 7 to 10 year running average of past market values, or a modification thereof. This subject cries for solution.

MR. R. D. MURPHY, in his personal observations, pointed out that the requirement of a security valuation reserve was decided upon by the Committee on the Valuation of Securities of the N.A.I.C. rather hastily, with no detailed discussion by life companies. It is therefore appropriate that it be put under careful scrutiny. He found some philosophic difficulty in solving a problem regarding the proper valuation of assets by creating a fictitious liability. If in a company's judgment provision should be made for some indefinite contingency, whether from security losses, epidemic, war or any other cause, that provision should be made in surplus. If one wishes to think of part of surplus as designed to meet some particular contingency, one may earmark that portion; but the earmarking won't mean much if some other unforeseen contingency arises requiring use of the earmarked funds. He very strongly doubted that the security valuation reserve would ever be treated as a liability if a company's solvency were in question; its true nature as part of surplus would then have to be recognized.

He recommended that actuaries take their own company's results over the past 15 years or so and see what would have happened if this reserve had been started at various points in that period. If, for example, the process had been started just before the heavy bond refundings of 1943 to 1945, the ceiling of this reserve would probably have been reached in two years because of profits on assets. It would have been accomplished at the price of heavy inroads on surplus, unless the company had refrained from strengthening reserves or had cut dividends. This result seemed to him not only undesirable but even fantastic. The proceeds of bonds called

at a premium to be refunded at lower interest rates were being reinvested just as securely as before but at lower interest rates. The profits received did not indicate a greater likelihood of future capital losses. In fact the corporations issuing the bonds were having their obligations lessened and were in a stronger position. The important step for the companies was to strengthen policy reserves by assuming lower interest rates.

This illustration indicates, he felt, that the rules for the security valuation reserve were too arbitrary and can rob management of the free discretion necessary for a proper handling of company affairs. He hoped the whole question would be re-examined by the companies and the Commissioners. If the New York law limiting surplus—an outgrown method of measuring surplus requirements—is so confining as to suggest getting around it by creating the semblance of an additional liability, it is time to consider its revision.

MR. A. A. TOUSAW brought out that the security valuation reserve presented some problems for Canadian companies which are required to maintain on deposit with trustees in the United States assets to cover their net liabilities to United States policyholders. Because these deposits must be maintained regardless of a company's experience in the United States, it can be argued that a reserve against asset fluctuation is unnecessary for Canadian companies. However, they have not so far taken that position.

Normally a certain proportion of assets in excess of the requirements is held, but there is a tendency to limit this excess since additional work and expense is incurred on securities on deposit. Setting up the reserve presents a choice between maintaining additional excess deposits or reducing the excess by the amount of the reserve. This latter course is justified since the security valuation reserve serves the same purpose as the excess assets. Speaking generally, possibly a similar attitude toward the reserve may be adopted by some United States companies in that they may consider it of the same nature as free surplus and adjust the surplus accordingly.