TRANSACTIONS OF SOCIETY OF ACTUARIES
1952 VOL.4 NO. 9

RESERVE STRENGTHENING

A. Are there currently reasons for changing the emphasis on reserve strengthening programs? Has there been a change in emphasis? Is the use of the new annuity tables being considered in the reserve strengthening process?

B. What methods have been adopted to emphasize the "reserve" character of undistributed surplus? Is the use of the word "surplus" in our annual statements misleading?

MR. P. E. MARTIN summarized three reasons why the emphasis on reserve strengthening has changed in the Ohio National.

First, a program involving several million dollars has been completed strengthening annuity and supplementary contract reserves, causing these blocks of business to be self-supporting and in some cases show fair book profits.

Second, the improvement in interest rate, even though of too recent origin to assure its permanence, has lessened their concern about certain closed blocks of life business, especially in view of the continuing favorable mortality trend.

Third, a primary source of reserve strengthening funds in the Ohio National has been from capital gains on liquidation of tax-free municipal bonds. The fact that such capital gains must now go to a security valuation reserve until the reserve is completely established eliminates this principal source of reserve strengthening funds at present.

Except for setting up strengthened reserves on new supplementary contracts and annuities arising throughout the year from maturing life policies, Mr. Martin's company is not contemplating further reserve strengthening in the immediate future.

It is suggested that the earmarking of funds as additional reserve for a specific purpose might be confined to those classes of items where it is likely that the funds will be needed eventually for that purpose; for example, reserve strengthening on blocks of business with excessive interest or settlement option guarantees. But funds which are really in the nature of contingency reserves afford maximum flexibility if they are held as such or included in free surplus. Of course, the method of lumping together contingency funds for several purposes as general contingency reserve or free surplus does require that management keep in mind the true nature of such funds and, with due regard to the basis used for valuation of assets and liabilities, maintain them at levels sufficient to meet contingencies which might arise.

MR. D. M. ELLIS does not believe that any major change in reserve strengthening programs is justified as yet. The recent slight increase in interest rates may have removed some of the immediate urgency. Nevertheless, an insurance reserve basis of 3% or higher can hardly be considered satisfactory with U.S. Government bonds yielding a little better than $2\frac{1}{2}\%$ and the trend, if any, again downward.

The recent studies made by Jenkins and Lew have emphasized the inadequacy of present annuity valuation mortality bases.

A study of the reserve strengthening figures reported in the Gain and Loss Exhibit in 1949 and 1951, of 27 of the leading companies, indicated on the whole that there has been little, if any, change in the emphasis on reserve strengthening.

In Canada with Dominion bonds yielding close to $3\frac{1}{2}\%$ and nearly all valuation rates strengthened to 3% or better, nothing presently need be done with regard to interest. In the Canada Life, the strengthening program is almost entirely related to annuitant mortality.

MR. J. E. HOSKINS said that in The Travelers the emphasis on reserve strengthening has shifted to annuities and to matured and unmatured life income settlements because of the continued improvement in mortality. He suggested that the *a*–1949 Table might be an adequate goal for some years to come, in view of the conservatism built into that table and of the fact that most life income settlements, and many original annuities, are of the refund type.

MR. H. W. JONES stated that the improvement in net interest earnings over the last few years has afforded considerable relief with regard to insurance reserve strengthening programs. However, it is doubtful whether the interest factor is yet a satisfactory offset to some of the future improvement being estimated for annuity mortality.

The Mutual Benefit has been concerned about the reserve basis for unmatured settlement options on older policies with regard to both interest and mortality basis. If the "interest only" options can now be eliminated from consideration because of the improvement in earnings, there will remain only the mortality element in the life income option in need of strengthening.

From 1911 until two years ago, the Mutual Benefit showed no unapportioned surplus in its statements. Instead, a Suspended Mortality Fund and a Security Fluctuation and Real Estate Depreciation Fund and more recently, when the Company entered the field, an Additional Reserve for Total and Permanent Disability Benefits were listed among the miscellaneous special reserve funds at the foot of the liability page. The formula for computing these funds was changed from time to time to meet changing circumstances, but the Company met continuous opposition from certain State Insurance Departments over this practice. Two years ago the Company gave it up as a bad job and now shows its excess funds as unassigned surplus.

MR. G. G. MYER compared the meaning of the term surplus in England and in North America. In England the Actuary makes a periodic valuation of his liabilities on a quite stringent basis. The surplus so thrown up is, therefore, surplus in a much truer sense of the word than what we regard as surplus on this side of the Atlantic.

In North America various devices have been used to try to overcome the popular sense of the word surplus. Some companies use a variety of qualifying words, phrases, or sentences. For example, one company's annual statement describes it as: "Reserve surplus: This amount has been held in reserve to reinforce the Association's security and is made up of the following: Provision for Contingencies; Shareholders' Surplus; and Surplus Unallotted." Some companies break the surplus figure up into reserves for specific purposes such as Asset Fluctuation Funds, General Investment Reserve, Fund for Excess Mortality Losses, Special Surplus Funds, and many others. These various devices all imply the necessity of reserving at least a portion of the so-called surplus to meet certain contingencies. These devices not only help educate the public as to the true nature of our surplus, but also point out to other departments of the business itself, the fact that all is not surplus which is called surplus.

On the other hand, there is little doubt that the uninitiated tend to judge a company by the size of its surplus funds both absolutely and in relation to its other liabilities. Therefore, there is a tendency to include everything in surplus that can possibly be described as such. This does not seem a bad practice, particularly if the aforementioned safeguards are used to then "reserve" this surplus for various contingencies.

MR. J. R. LARUS agreed in principle with the position of Mutual Benefit of allocating a surplus to the purpose for which it may be required. The Phoenix Mutual met, however, the same difficulties that Mutual Benefit encountered. For the last 20 years any attempt to divide surplus according to its purpose has been entirely internal, except that in later years a special fund for investment fluctuations has been set up. The recent announcement concerning such a fund seems to make it practically necessary to set it up as a reserve.

Mr. Larus is disturbed about the ultimate treatment of this compulsory investment fluctuation reserve. After it has been built up to the required level, can a company take out any loss that it may suffer, can it take out only half of the loss, or must the fund be maintained at the full amount indefinitely? If full losses can be reflected in the fund and full profits in later years used to rebuild it, a great many objections to this fund will be removed.

MR. B. F. BLAIR said that the Provident Mutual has felt for many years that the use of the word "surplus" in the annual statement could be misleading. Since 1922 they have used the terms "special reserves" or "contingency reserves" instead of "surplus" in both the convention blank and the annual report to policyowners.

Beginning with 1945 the excess of assets over liabilities ("surplus") has been carried as two items: (1) a special reserve of unrealized appreciation on bonds and stocks valued on a market basis, and (2) a contingency reserve for protection against mortality fluctuation, asset depreciation, and other contingencies. This second item has been many times as large as the first.