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GENERAL

A. During recent months a number of companies have made extensive changes in premium rates.
   1. In what way have interest, mortality and expense assumptions been varied?
   2. Do the changed assumptions point in the direction of new patterns of premium rates?

B. In the new annual statement form a diversity of practice has developed in the treatment of federal income tax.
   1. What are the relative merits of the different methods of treatment in the light of the present legislation and its prospective course?
   2. Should a greater measure of uniformity of treatment be sought on one of the present bases or on some different basis designed to portray adequately the effect of this important operating factor?

C. If regulations pertaining to the classification and allocation of income and expenses of life insurance companies are promulgated by state supervisory officials, what values would such a procedure have for:
   1. insurance supervisory officials, policyholders, and the public in measuring the efficiency of the various companies licensed to do business in a state;
   2. insurance supervisory officials in ascertaining compliance with the requirement that no insurer shall issue any life insurance or annuity contract or contract of Group Accident, Group Health, or Group Accident and Health insurance which shall not appear to be self-supporting;
   3. state supervisory officials in obtaining suitable cost allocation information necessary to carry out their responsibility to protect the interests of policyholders?

MR. W. D. MacKINNON mentioned that the Equitable Life of Iowa had made a change in premium rates effective May 1, 1952, applicable to both participating and nonparticipating business. No basic changes in assumptions as to interest and mortality were made in the participating rates. His company adopted a $2,500 minimum for participating policies because they felt that they were issuing too many $1,000 contracts and had not been too successful in reducing the number of such contracts by educational measures. The anticipated improvement in average size policy more than offset increased expense assumptions and made it possible to decrease the loading margin. The new gross premiums were based on the same CSO $2\frac{1}{4}\%$ net premiums that had been used before and were loaded with a constant plus a percentage varying with age. Since reserves and nonforfeiture values were based on the CSO Table at $2\frac{1}{2}\%$ interest, use of the $2\frac{1}{4}\%$ net premium resulted in an additional loading of the excess of such premium over the $2\frac{1}{2}\%$ net premium. This brought out a scale of gross premiums somewhat lower than that formerly in effect, with greater reductions at the younger and older ages and very little change at the middle ages.

In order to meet the market for small policies, his company decided to reduce the minimum nonparticipating policy from the former $2,000 to $1,000 under the new program. This necessitated an increase in the expense loading because of the anticipated decrease in average size policy. The increase in expense was offset by some mortality margins based on a current investigation of the company's experience. Nonparticipating premiums were finally based on the following assumptions:

Interest: 2.75%—same as before.
Mortality: The company's own experience to which was added a 5 year select period. (Mortality in the former rates was based on 1931–40 Select Experience.)
Expenses: First year and renewal overhead based on a reduced average size policy with percentage loading for commissions and taxes.
Lapse Rates: Linton's "A" rates.

The above assumptions were used for "without profit" premiums and a loading was added to arrive at the final premium scale. The new rates showed a modest increase at the younger ages and a substantial decrease at the older ages where the improvement in mortality more than offset the increase in expenses. Results of the new program have been gratifying in three respects:

(1) Anticipated objections to the $2,500 participating minimum have not materialized and the program has been enthusiastically accepted by the field force.
(2) The average size participating policy has increased about 25%.
(3) There has been a slight decrease in proportion of nonparticipating business, although total production is substantially ahead of last year.

The fact that a considerable volume of small policies has not been transferred to the nonparticipating branch indicates that the field forces have probably been successful in upgrading some prospects to purchase larger amounts and that they are probably concentrating on those prospects who can afford larger policies. He believed this was a move in the right direction for a company writing only Ordinary business, inasmuch as contracts were still available for the small purchaser.

MR. J. E. HOSKINS stated that the Standard Nonforfeiture Law makes it difficult for cash values to be based on any other table than the CSO, although in nonparticipating insurance such values would ideally be based on the table used in premium assumptions. If the death rates in the latter table differ from those in the CSO by approximately a constant multiple of the reciprocal of the expectancy, as was the case with the 1930–1940 Table, the CSO values are likely to be satisfactory. However, natural reserves at the older ages are smaller on recent tables than they would be if based on CSO mortality, because the extension of mortality improvement into those ages has resulted in relatively greater differences from the CSO at those ages. Hence, values based on CSO with the same interest rate used in premium assumptions are too high and require an extra loading above the premium that could be used if no surrenders were expected. He suggested that a cash value formula, based on the CSO Table with a higher interest rate than that in the premium assumptions, might fit closer to natural reserves.

Another effect of mortality improvement is the fact that settlement options and maturity values based on the 1937 Standard Annuity Table, even with substantial setback, are generally inadequate for current issues and a loading is needed to provide a proper reserve when such options mature. If the recent apparent trend of the interest rate is felt to justify a more liberal interest assumption in premiums, there is added reason for either reducing cash values or inserting a loading to support the existing scale of values.

MR. M. R. CUETO, discussing section B 1, said that a review of the 1951 annual statements of the first twenty-five United States companies by assets showed that fourteen companies treated the federal income tax as a charge against investment income and eleven treated it as an insurance expense. Nine of the fourteen companies had changed their methods as compared with the previous year. The difference in treatment of this tax depends upon whether a company feels that it is directly chargeable to investment income because it is based on such income or whether the tax is in the nature of a franchise tax which may be treated as an insurance expense. He said that treating federal income taxes as a charge against investment income has the effect of reducing the net interest rate in line 8, Exhibit 2, of the annual statement. He noted that some companies added another line to Exhibit 2 in order to show the net interest rate both before and after federal income taxes.

He explained that the 1951 federal income tax formula imposed a tax up to $6\frac{1}{2}\%$ on net investment income without deduction for interest required to maintain reserves but with a special tax credit for those companies failing to earn 105% of their reserve interest requirements. The rate of tax differs from that for other corporations in order to allow for interest requirements on reserves. This formula was originally adopted for one year pending further study and the so-called Stamm Joint House-Senate Committee was directed to study this subject with a view to determining an appropriate permanent tax basis. No report has yet been made by the Stamm Committee and the 1951 tax formula has been extended to cover the business year of 1952 despite some objection by the Treasury Department whose representatives advocated an increased rate of taxation.

He stated that both the Stamm Committee and the Treasury Department are carrying forward their studies with the result that the insurance industry may be faced with a new proposal in 1953. He emphasized that the Secretary of the Treasury had urged in 1950 that life insurance companies be taxed on their total income in accordance with normal corporation tax procedure. He referred to a statement of Mr. Stamm to the press that the chief point his Committee wanted to determine was whether the tax should be based on net investment income or whether other types of income such as underwriting and capital gains should be used as yardsticks instead of, or in addition to, investment income. It is a matter for conjecture what the prospective course of federal tax legislation will be in view of the results of the national election. He believed that if the industry takes the position that federal income taxes should be based on net investment income with suitable allowance for interest required to maintain reserves, its position would be materially strengthened if the companies treated such taxes as a charge against investment income in their annual statements.

With reference to section B 2, he stated that the 1952 annual statement blank will require a company to show separately the estimated amount reserved for federal income taxes and the total amount of federal taxes paid, the latter subdivided between insurance and investment expenses. Supervisory authorities will therefore be in a better position to identify this item and to note the method of treatment of such taxes. Insurance companies are still free to treat this tax entirely as an investment expense or an insurance expense or to divide it between these two classes of expense. He felt that the treatment of federal income tax should be determined by a company's over-all policy rather than by arbitrary uniformity, although the supervisory authorities would undoubtedly prefer to secure uniformity of practice.

MR. J. R. TRIMBLE stated that we have always had this variation in treatment of income tax and that it has not arisen because of the new blank. The Mutual Benefit has always thought that it was reasonable to view federal income taxes in the way of franchise taxes and will continue to do so unless prevented by supervisory authorities. Twelve of twenty-five leading companies, whose statements he assembled for 1951, treated such tax as an insurance expense. A point of considerable concern in this connection is the effect on the net rate of interest. The difference between the two rates of interest according to the varying treatment of this expense item was 17 points for the Mutual Benefit in 1951 and 15 points for the group of 25 companies. This shows the danger of comparing interest rates in Exhibit 2 of the annual statement. A related subject is the depreciation of real estate properties where only 8 of the 25 companies passed *all* such depreciation through the interest account in Exhibit 2 and at least one passed it all through the capital account in Exhibit 4. A tabulation of rate of interest for the group of 25 companies under 5 different headings developed the following:

1. Statement Rate: 2.95%.
2. Statement Rate modified to include no depreciation and no federal taxes as investment expense: 3.10%.
3. Statement Rate modified to include no depreciation but *all* federal taxes as investment expense: 2.95%.
4. Statement Rate modified to include *all* depreciation and no federal taxes as investment expense: 3.03%.
5. Statement Rate modified to include all depreciation and all federal taxes as investment expense: 2.88%.

He felt there should be some merit in a greater measure of uniform treatment and that possibly the N.A.I.C. might prescribe that.

MR. N. M. HUGHES was strongly of the opinion that, while no coercion should be applied in order to obtain standardization of treatment, the interests of the industry will be best served by uniform treatment of the income tax. He pointed out (1) that the tax is computed as a percentage of net investment income and (2) that industry representatives have for many years asserted emphatically before Congressional committees that a life insurance company has no true income other than excess interest. It seemed to him that the onus of overcoming the arguments of incidence and legislative theory lay on those who argue that the tax should be regarded as a franchise tax and therefore chargeable as an insurance rather than an investment expense.

MR. H. F. ROOD thought that the change-over from insurance expenses to investment expenses has resulted from the tremendous increase in the amount of tax. He felt that this was a charge against doing business which should properly be treated as insurance expense. However, in allocating expenses for premium or dividend purposes, it is now much easier to handle this tax as an investment expense related directly to interest income, thus decreasing the net yield. His company is continuing to show federal income tax as an insurance expense in the annual statement but is treating it as an investment expense in internal accounting.

MR. W. M. ANDERSON felt that the life insurance business was moving into the position of most commercial corporations in recent years in the sense that it faces an income tax impact which has significant effect upon operations. Corporation taxation is generally levied on profits and is regarded nominally as a tax on profits. Tax economists, on the other hand, regard the tax as having its primary impact upon product price, with only a secondary impact upon profits and a tertiary one upon wage levels. A great many corporations are therefore inclined to bring out corporation income taxation in their statements in such a way that it may be regarded as a tax which falls, in some not precisely defined way, upon various phases of business operation.

He thought by analogy that, since the federal income tax in the life insurance business was a corporation tax because it is levied under the same legislation, it should be regarded as a tax of significant magnitude which falls upon various phases of operation. If that point of view be taken, the federal income tax, if not all taxation, should be stated in the statement in such a way that the reader can recognize that there is a large taxation impact but that the exact points of impact cannot be defined, even though the tax law may appear to define impact by the way the tax is calculated. These thoughts led him to the conclusion that it may be preferable to leave the tax on the disbursement side of the statement rather than deducting it from the revenue side in the form of a reduction in interest earnings, because it then becomes possible to bring the tax load out explicitly in published statements and to indicate that it is a strain which the company as a whole must bear regardless of the way in which the tax may be calculated.

The discussion on section C centered around the following reasons for uniformity in classification and allocation of income and expenses given by the Superintendent of the State of New York on Page 20 of his Preliminary Report to the 1952 Legislature:

1. There is an absence of suitable comparative information with regard to the operating expenses of life insurance companies. This information is necessary in order to enable insurance supervisory officers, policyholders, and the public to measure the efficiency of the various companies licensed to do business in this State.
2. The Insurance Law (Section 213, paragraph 11, and Section 221, paragraph 6) imposes certain responsibilities on the Superintendent of Insurance to ascertain compliance with the requirement that no insurer shall issue any life

insurance or annuity contract, or contract of group accident, group health or group accident and health insurance which shall not appear to be self-supporting.

3. Under present conditions the Superintendent of Insurance is without statutory authority to prescribe reasonable methods by which to obtain suitable cost allocation information necessary to carry out his responsibility to protect the interests of policyholders.

MR. A. L. MAYERSON of the New York State Insurance Department believed it was obvious that an important document such as our annual statement should be completed on the same basis by all companies and that adequate and uniform expense data are no less important to company management than to state supervisory officials. He felt that no executive can be certain that he is managing his company properly and economically unless he has accurate data as to expense rates and that he should also know how his company compares with others of similar size.

One of the professed aims of the new form of annual statement was to obtain sufficient standardization so that expense items in the statement would be meaningful and so that intercompany comparisons could be made. The new statement falls far short of completely attaining this purpose because instructions as to what expenses should be reported in each line of Exhibit 5 are quite fragmentary. His studies indicated that there was considerable variation in methods of assigning expenses to classifications and that lines A, B and C of Exhibit 5 were not fully understood by some companies. It is not possible to determine from the annual statement the amount of each class of expense chargeable to such lines as Group Insurance, annuities, disability and double indemnity because all general expenses are combined in the Gain and Loss Exhibit. There is also disagreement as to what items are properly includable as investment expense. Most companies capitalize commissions on securities and expenses paid in connection with real estate, but a few companies charge some or all of these items as investment expenses in the year in which they are incurred.

He said that Exhibits 5 and 6 and the Gain and Loss Exhibit need some clarification and more uniformity in reporting. The Policy Exhibit leaves something to be desired, especially with reference to treatment of group insurance issued during the year, which he suspected sometimes includes amounts other than new business under new contracts. The line between Group credit insurance and credit insurance issued on individual policies is not clearly drawn. Wholesale Insurance is sometimes included with Ordinary and sometimes with Group.

He stated that first year and renewal expense rates were important for measuring efficiency of companies, although not the only such measure, but one cannot obtain such rates from the annual statement. His studies indicated considerable variation in methods of assessing expenses between first year and renewal, some companies using very complex and accurate methods while others were quite arbitrary. Ratios of first year to renewal expense rates per thousand vary between companies from 3 to 1 to 20 to 1. He thought that an accurate split between first year and renewal expenses would provide a reasonably good basis for intercompany comparisons of expense rates and might help provide some measure of efficiency of operation. Without a proper allocation of expenses to the various lines of business and between first year and renewal, it is almost impossible to properly determine whether a policy is self-supporting on reasonable assumptions as to morbidity or mortality, interest and expense, as required by the New York Insurance Law.

State supervisory officials, in order to carry out their responsibility to protect the interest of policyholders, must be concerned with cost allocation in many other areas, such as:

(1) The provision of the New York Law that no first year dividend may be paid unless it was actually earned on reasonable assumptions as to expenses, mortality, interest and lapses.
(2) Sub-lines such as disability and double indemnity, where considerable difference of opinion as to expense allocation results in some companies showing large gains from these lines, while other companies whose claim experience does not differ greatly show much smaller gains. Supervisory officials must depend upon the Gain and Loss Exhibit when considering whether earnings on a particular sub-line warrant a dividend or whether a negative dividend factor is proper.
(3) Expense limits for Section 213 with which the Department has had difficulties because without good functional unit costs it is very difficult to draw limits which will follow the actual incidence of expense.

He mentioned the expense classification and allocation questionnaires which the New York Insurance Department has sent to all companies authorized to do business in that State and stated that these are necessary to obtain factual data for the implementation of a program of uniform reporting and allocation. Tabulation of the results of the classification questionnaire is a monumental undertaking due to the diversity of methods used by some companies. The results should provide some valuable information not hitherto available. It will probably be necessary at a future date to obtain additional information regarding allocation of expenses to annuities, disability, double indemnity, Group Life, Group Accident and Health, and between first year and renewal. After all these data are available it should be much easier to determine the kind of regulations necessary and their scope.

MR. M. E. DAVIS referred to the desire of the New York Superintendent for a statute giving him authority to promulgate regulations intended to achieve uniformity in reporting and allocating income and expenses. He stated that a committee of company representatives was appointed to study that subject, but has yet made no report. The committee felt that (1) this topic and its implications were of such great importance that thorough consideration was warranted, (2) it would be a mistake to oppose this effort to get more regulation merely because there was already so much, and (3) it would also be clearly inappropriate to reason that there should be such a thing for the life insurance business because there already is for casualty business.

There is a big difference between the two lines of business in that casualty expenses form a much larger part of the premiums than is the case in the life insurance business, a much greater proportion of casualty expenses must be allocated by judgment and the State Department is party to fixing the rates for casualty business. Under these conditions there could easily result a situation where one set of companies assigns expenses only to the A classification of coverage and another set only to the B classification. Under such a situation company experience would produce premiums too high for both classifications. Thus there may be some sense to uniformity in casualty expense allocation, which is merely term business and does not present complications inherent in the long-range nature of the life insurance business.

His committee had been invited by the New York Department to act as advisers in obtaining the information the Department felt it needed in consideration of the subject. Two questionnaires have been sent out, the first pertaining to the line in the annual statement on which each item of expense is reported and the other dealing with the distribution of each item between investment and insurance expenses and to major lines of business. Further questionnaires may be needed to obtain the type of information the Department feels is needed, such as subdivision into life, disability, double indemnity, annuities, first year and renewal. At the start of this work the Department also wanted more detailed information as to how such things as time studies were made, how extensive they were, who supervised them, etc.

The committee felt that the subject breaks itself naturally into two entirely different subjects: (1) Where in the annual statement do you put certain items? (2) How do you distribute those items by branch of business? Mr. Davis thought that the New York Superintendent had a good point so far as the first subject was concerned. A good deal more uniformity could well be achieved than we now have. We need no statute for that, since instructions for the annual statement blank can be expanded to include other items and thereby achieve such uniformity as is practical. He hoped that any such instructions would never go to the ridiculous extent of trying to cover every single item, since it is much more efficient to combine small items with other more important items. Some companies might combine a certain small item with one particular larger item and other companies might combine the same small item with some other larger item. How such small items finally get into the annual statement makes no difference to anybody.

He stated that uniformity in allocations is an entirely different subject. Such uniformity would not give an efficiency index for different companies. There would still be differences in plan distributions, average size of policies and frequency of premium payments. Uniformity in allocation would merely be a pseudo basis for comparing efficiency which would do much more harm than good. Uniformity in allocations is certainly not needed to test the self-sufficiency of a premium which depends more on mortality and interest than on expense. Improving mortality and changing interest rates greatly outweigh any changes in premiums which might be caused by a change in method of allocating expenses. Every premium which is issued has some margin in it. If a company is issuing a loss leader, one does not need all those details to tell it. All one has to do is compare one plan with some others.

He did not think it was in the best interest of policyholders to change the pattern of cost from that determined by bad judgment of the management of a company under x conditions to some other basis merely to achieve uniformity. It is solely the function of management to determine which of several logical and plausible methods of distributing an item of expense is most appropriate for a particular company even though this results in a different pattern of cost than in some other company which uses a different method.

First year commissions are graded by plan in all companies but the extent of gradation varies tremendously and has a serious effect on the cost pattern. Some companies pay renewal commissions in four years, others in 15. That affects the pattern of cost substantially, so why get fussy about some item of expense just to achieve uniformity? The concept that the life insurance business ought to be run by some test of precision is completely contrary to the concept of that business. We work on broad general averages. In preparing dividend scales, we do not use the precise mortality experience of the year, which fluctuates tremendously from year to year, nor do we use the precise interest rate. We use a broad average expense rate of recent years. Why should we then strive to put companies in a strait jacket in order to force a precision of uniformity?

However, he thought that if a case should ever exist, where a company is making a clearly inappropriate allocation of expense for some special reason, which does not merely represent a difference of opinion between someone in the insurance department and company management, the Superintendent probably should have authority to step in and stop it.

MR. E. G. FASSEL mentioned that cost accounting is an important activity in industry at large and that some persons appeared to reason that because a manufacturer with 1,000 employees has a well-developed system of cost accounting, a life insurance company with 1,000 home office employees must be deficient if it does not have a similar system. Such an opinion is a complete misunderstanding of the situation. The manufacturer must have cost accounting to determine the prices for his products which are ordinarily made in a variety of sizes, qualities, materials, etc. Competition will concentrate on weak points in the price scale and may expose the manufacturer to loss and even failure.

The cost accountant in a nut and bolt company must consider all the various sizes, styles, and other distinctions of nuts and bolts and relate to them the costs of materials, labor, plant, equipment, handling, commissions, correspondence, bookkeeping, management, etc. Probably 95% of such cost is in shop cost and commissions and only 5% in office cost. With meticulous assessment of the 95% shop and commission cost, the cost accountant is entitled to be satisfied with his work even though the 5% office cost may be handled on some arbitrary basis.

Insurance mortality and investment funding are the life insurance counterpart of shop cost. Life insurance has not lagged but has long been a leader in cost accounting. The question of pricing over the range of premiums and ages has been attended to by actuaries for at least two centuries. That is what actuarial science is about. Let us never say that life insurance is deficient in cost accounting. The life insurance home office expense is the counterpart of only the nut and bolt company's office expense and is a very minor element which can be apportioned only by some general rule which is a matter of judgment. It is a misconception that the home office is a subject for cost accounting.

The nut and bolt cost accountant enjoys some finality in his basis because he is dealing with a finished product for which the costs have become fixed. The life insurance basis has to be assumed because the cost can only be known as mortality and interest experiences emerge. Hence, even more tolerance is permissible in assessing the general expense because crudeness in the 5% area is overshadowed by large swings in the interest and mortality experiences of the 95% area.

He questioned the idea that one purpose of the annual statements to the state insurance departments is to enable comparisons to be made between companies but he agreed that such statements are furnished to enable supervisory authorities to ascertain company compliance with law and to judge as to company solvency and performance of contracts. He believed that such intercompany comparisons as become possible are an incidental by-product and not a reason for the statements. Companies and their agents, with an eye to competition, will make all possible comparisons from the statements but that is an area in which the companies should be left to their own resources. It was not clear to him how any other company's statement has any bearing on the statement of a particular company under review by the supervisory authority.

MR. R. G. STAGG pointed out that his remarks were derived from experience with several companies, and from recent years' experience with the Joint Committee on Blanks. He did not recall anything in the last thirty years which has aroused so much quiet but righteous indignation as this proposal to bring about, by statutory means, uniformity of classification and allocation of accounts. The case for these requirements rests on the three above referred to premises of the New York Superintendent's report. He thought these premises were basically unrealistic, if not unsound, the results which the superintendent anticipates were unattainable, and the resulting labor and expense burdens would be pretty close to unconscionable.

He expressed the opinion that the desired information would not enable anyone to measure the relative efficiency of any two companies. This would require studies of mortality, investment return, average sized policy, and much other information not readily available in the annual statement, although it can be obtained on examination. He questioned the propriety of a state authority assuming the function of determining the relative efficiency of life insurance companies operating in his state, even if it were possible to do so. It is utterly impossible for the public to do this because these comparisons are intelligible only to those experienced in the life insurance business. Such an attempt would be about as effective as the determination of the relative quality of the cooking of two chefs by examining the quantities of only one ingredient which each puts into his cooking.

The responsibility of ascertaining compliance with the requirement for self-supporting policy forms depends upon elaborate analysis and much information which is not available in the annual report. Uniformity of classification and allocation of expense would help very little, if any.

He believed that differences in expense allocation are quite proper if based on proper concepts of management. The Superintendent should and does have authority to do something about anything which is wrong or unsound or any attempt to conceal or misrepresent. He can insist on a full statement of methods and can criticize them in his reports. He is in a position to make a change in the statement of a company which he believes is making wrongful claims or to call for supplementary analyses which would help support his claim of concealment or misrepresentation. Information regarding methods of classification or allocation should be available on examination and, to a reasonable extent, in the annual report, and all desired publicity should be forthcoming. Compulsion is an entirely different matter. There should still be room for management to make decisions.

Mr. Stagg did not understand the meaning of the New York Superintendent's language to the effect that "the only aim is to require that expenses would ultimately be classified within the framework of a company-wide plan." Any present interpretation would not bind future superintendents to the same interpretation. If enough latitude were permitted in our broad and complex business, no uniformity would be attained and the Superintendent would be a very unhappy man.

It was his understanding that accounting authorities generally agree that uniform accounting is undesirable and unwise in all fields. Flexibility and adaptability are more needed in our business than, for example, in the railroad business where uniformity has been far from an unqualified success. If we assume honesty of purpose on the part of management—and nobody would question the state's authority to attempt to bring that about—allocation is simply one of the tools of efficient management.

The purpose of allocation may differ from company to company and he believed he could speak with some experience in that respect. Companies have radically different varieties of business in force, management problems, policies and basic needs. One company may primarily need allocation by line of business while that may be unimportant in a single line company where the basic allocation may be first year and renewal. Participating and nonparticipating business may also require basically different approaches. He knew from experience that any attempt to reach the same answer from these differing points of view would fail. Yet, neither approach is fundamentally wrong.

Inequities may result in dividends, cash values, etc., if any excessive degree of uniformity is arbitrarily imposed. He mentioned three examples of differences in allocation which arise solely from contract provisions and which vary naturally from company to company: (1) the treatment of returned annuity considerations which involves the premium tax problem, (2) the treatment of income and disbursements under company retirement plans of which it would be difficult to find any two alike, and (3) the question of unearned premium reserve versus claim reserve on sickness and accident business. He hoped that action would not result from the present proposal in such a way as to require companies to keep one set of books for sound management and another simply because supervision demands it. This would be expensive and unwise from the point of view of both public relations and the public attitude toward life insurance. He questioned whether this might not easily be an entering wedge by governmental supervisory officials, in spite of protestations to the contrary, to the taking over of the prerogative of management with respect to fixing premium rates. A completely uniform classification and allocation system ignores the principle of sound management and would have little or no value in state supervision. It would impose strait jackets on management which would be inconsistent with statutory requirements, tax laws and policy provisions. It is difficult even with complete freedom to give proper effect to all these in dealing with management's problems.

If any greater uniformity of treatment than we now have is prescribed, it is certainly to be hoped that the democratic approach will be used and that the machinery of the National Association of Insurance Commissioners will be used so that all companies and all insurance departments will have a chance to be heard on this very vexatious question.

He stated furthermore that the life insurance business has been properly accused of being too hidebound and too tied to tradition but it has still done a certain amount of experimentation in compensation methods and other matters. He was convinced that any excessive uniformity, which might result from the Superintendent's proposal, would tend to stultify our attempts to experiment. He suspected that a great many of the current problems in the railroad business have stemmed from the so-called uniform accounting system which has been inflicted on it.

MR. J. M. MILLER referred to the above-quoted reasons of the New York Superintendent for advocating legislation requiring uniformity in classification and allocation of expenses. Uniform accounting is part of the structure of several important industries, such as railroads and public utilities because they are virtual monopolies and their rates are subject to governmental regulation. It is also required of fire insurance companies. Since 1922 the New York Law has required regulation of fire and casualty rates and in 1946 legislation was passed enabling the New York Insurance Department to promulgate regulations requiring uniform accounting from such companies. New York Regulation 30, for fire and casualty companies, came into effect January 1, 1949.

He said that life insurance companies are neither monopolies nor are they subject to rate regulations. The rates of fire and casualty companies are standardized and geared to individual states or even to sections within the state; but the rates of life insurance companies, including their accident and health business, are competitive and on a country-wide basis. The Superintendent may disapprove an accident and health policy "if the benefits provided therein are unreasonable in relation to the premium charged"; but this requirement is not intended to be a "rate regulatory bill in the same sense that these words are used in the All-Industry-Commissioners Fire and Casualty and Surety Rate Regulatory Bill or in New York's rating law." (Report on regulation of mail order accident and health insurance submitted to annual meeting of the N.A.I.C., June 1949, page 38.) The industry understood that this was to be in the nature of a "policing" statute.

He pointed out that there is a distinct difference between uniform classification and uniform allocation of expenses. There does not seem to be much doubt that supervising authorities should have a right to require uniform classification to enable them to carry out regulatory responsibilities. Annual statement instructions require uniform classification of expenses and spell out in detail the kind of expense to be included and excluded. It would thus appear that authorities already have sufficient power to obtain uniform classification although it might strengthen their position if enabling legislation were passed giving them specific power.

Uniform classification can be defined with a high degree of accuracy but there is much that is not precise in expense allocation. Many areas depend greatly upon individual judgment, and expense allocation is still in the developmental stage in many companies. A great deal of thinking is necessary before there can be general agreement on standards and principles. Expense allocation can be only an approximation at best. There might be little fundamental objection to uniform allocation of expenses if the requirements were confined to broad, general principles such as "just and reasonable," and if companies were left free to work out the details and to experiment and improve their methods.

He could not see what value uniform allocation of expenses would have in measuring efficiency of various companies. Differences in results between companies might reflect mainly differences in practices and size rather than differences in efficiency. Some companies offer more services to policyholders and agents than others. Some centralize most activities in the home office while others have many of these same activities performed in branch offices or agencies for convenience of policyholders. It is not clear how the Superintendent can determine from uniform expense statistics, without supplementary data, whether a life insurance contract or a group accident and health contract is self-supporting. Life insurance companies offer the public a large variety of policy forms and plans, some standard and some substandard. Participating contracts can be presumed to be self-supporting because premium rates are customarily established to be greater than the anticipated cost of insurance. Supervisory authorities could presumably request information to indicate to their satisfaction that a contract is self-supporting. He stated that it is primarily to the interest of policyholders that life insurance companies be unquestionably solvent and unqualifiedly able to perform the promises made in contract provisions. Performance over the past several decades of companies licensed in New York is proof that the supervisory authorities have done an excellent job of protecting the public interest. It is also to the interest of policyholders that equity be maintained between different lines of business and that one line be not subsidized at the expense of another line.

The question of allocating expenses in life insurance companies is vastly different from casualty companies where operations with respect to underwriting, policy forms, premium rates, etc., lend themselves to a high degree of standardization and uniformity. In the life insurance business we can no more afford to have allocation of expenses placed in a strait jacket of uniformity than we can have such operations as underwriting, premium rates, etc., made to conform to a rigid pattern. Legislation precisely defining one of our functions might lead to legislation requiring uniformity in other phases of our business. It would seem that this matter of expense allocation should be handled, in the same way as other phases of our business, by statements of broad, general principles set out in the statutes, and by the policing of these principles by supervisory officials through periodical examinations.

MR. R. D. MURPHY wished particularly to second the comments of Mr. Davis and Mr. Stagg. He thought the implication of the New York Superintendent's statements in his last preliminary report caused a good deal of alarm in the minds of many of us. He felt that life insurance has developed partly with the aid of state supervision, rather than with the extent of such supervision, and partly because state supervision has confined itself to supervision rather than getting into the direct field of management. Implications of the Superintendent's statements raise doubt as to whether the New York Department is following the traditional theory of the division of functions between supervision and management. Mr. Murphy certainly preferred to see any question of this kind handled through a composite of discussions and views through the N.A.I.C. rather than by legislation in one particular state. Unless we have uniformity of treatment and views by various states, we are certainly going to have very peculiar results from an effort toward uniformity in this matter of classification and allocation of expenses.

He believed the Superintendent had drawn a wrong implication from various statements made in the L.O.M.A. because many of those statements were really directed at the necessity for a company to study its own expenses very carefully in the interest of intelligent management. That is something very different from enforced uniformity of allocation. There is no question but what companies should study their own classifications and allocations, but the ability of the companies to develop has been an ability to develop in very different ways. Many life companies have organized under the branch office managerial system. In some companies certain functions are paid for by commissions to general agents while in other companies those same functions may be paid for by branch office salaries. Quite a job would be involved in arriving at an intelligent allocation which could be applied to differently organized companies and to large and small companies.

He was sure that we all sympathized with permitting companies sufficient freedom to handle their own problems intelligently. The thought that insurance officials, policyholders, and the public may be able to measure relative efficiency of various companies is a very startling one which could lead to a great amount of misrepresentation. It seemed to him that such a thought reflected a very narrow point of view of the public interest in insurance business. The implication is that there would be some simple index or indexes by which this thing could be judged. Each company would be very anxious to stand well in this so-called efficiency rating. One company in a desire for large average-sized policies may have confined its operations to certain urban centers, and may have restricted its solicitation largely to people in the upper income brackers. The efficiency rating of such a company might be fine but it would be made up of a very restricted service to the public. Another company may have developed from a public service point of view a wide organization in rural areas where average-sized policies are small. Its efficiency rating would be low. Should it then give up serving the rural communities and let them go without insurance service?

Many companies issue nonmedical insurance expecting that savings in medical expense will be substantially offset by increased mortality. They get an expense saving, an improvement in efficiency rating, and a worse mortality. How is the public going to judge the results of such operations? One group annuity company may confine its business largely to very large groups resulting in a low expense rate. Another such company may deal largely in small groups resulting in a poor efficiency rating. Are there to be implications against the company which does the small group annuity business because its relative expenses are higher? It startled him to think that there might be temptation for anybody to bring up some sort of indexes from uniform allocation and thereby have a very narrow point of view as to the laudable or adverse character of a company's operation from an efficiency viewpoint.

He agreed that the question of self-supporting rates would not be materially affected by classification and allocation of expense. He emphasized that rates must be self-supporting on the basis of the individual company's operation and not through some general average resulting from uniform allocation. He reiterated the fear that such a statute might result in great temptation to future Superintendents to invade the field of management and hurt rather than help the public interest.

MR. E. W. MARSHALL was convinced, from long and sometimes unhappy familiarity with problems of life insurance expense comparisons, that regulations for classifying and allocating income and expenses would not make it possible either to measure reliably the relative efficiency of companies or to determine, without extensive mortality and other actuarial studies, whether any contract appears likely to be self-supporting. He further believed that specific regulations for allocating expenses between lines of business were against the best interests of policyholders.

He admitted that there is need for more uniformity between companies in deciding in which disbursement item certain expenses fall. The federal income tax should not be treated as investment expense in some companies and insurance expense in others. There may be unnecessary diversity of practice in classifying agency expenses but some of these diversities reflect the difference between general agency and branch office systems. These differ radically in the nature and incidence of their expenses and could not possibly be put into a strait jacket of uniform accounting without violating the truth.

He said that company executives have frequently endeavored to compare their expense rates with those of other companies, but he had never seen such a study which gave a reliable measure of the relative efficiency of companies and he did not believe the most elaborate regulations would do so. Companies are so different in important characteristics that any rigid comparisons would be utterly misleading. Some of the wide variations which would cause such comparisons to be practically worthless are: premium levels; participating or nonparticipating business; average size of policy; varying proportions of term insurance and old and new insurance; different trends in the new business level; size of company; medical and nonmedical practices; relative persistency; general agency or branch office system; commission scales; degree of reinsurance; extent of special services rendered policyholders.

He did not believe that reliable comparisons of relative efficiency could be obtained, because unlike conditions among companies make such comparisons misleading. He did not consider it the proper function of any state insurance department or the commissioners, generally, to make such comparisons. Efficiency is a matter for company managements to consider and to strive to improve and for competition between companies to stimulate. This is the American way and he believed it was working well.

He could not see any connection between expense accounting regulations and the ability of supervisory officials to determine when a contract was self-supporting. Expense under life insurance contracts is secondary to premiums, mortality, interest and reserves. Extensive evidence involving all elements is necessary to determine whether a given contract is self-supporting. To create an elaborate system to supply such evidence would not be justified.

He thought we must recognize and fully support the fundamental responsibility of state supervisory officials to promote and protect the interests of policyholders. We should be willing to cooperate to the utmost to correct any real abuses arising from improper expense allocation. There should be explicit instructions for defining classification of expenses, but he felt that there would be inevitable danger to the interest of policyholders if methods were imposed by regulation for allocating expenses between lines of business. He felt sure that any rigid formula could not succeed in this purpose because companies differ so widely. Anyone who has tried to make intercompany cost comparisons knows that the results are bound to be unreliable and unsatisfactory. The outcome would simply be more and more regulations, attempting to correct earlier regulations, which would pile up unnecessary expenses with adverse effect on the cost of insurance.

The life insurance business had made remarkable progress in developing contracts and methods to give the broadest insurance coverage to the public. Laws and supervision have followed rather than preceded this development. Flexibility rather than rigidity of governmental control has prevailed. It is vitally important that this flexibility be not endangered by law or regulation.

It is quite reasonable for supervisory authorities to seek greater uniformity of classification and a reasonable allocation of expenses by line. Classification can be imposed by more detailed instructions. The methods and formulas used by a company to allocate expenses by line, however, must be hand-tailored to conditions in the individual company. Companies might occasionally be asked to give supervisory officials descriptions of their expense allocation methods so that officials could determine whether they are reasonable; but governmental regulations in this field are against the interest of policyholders and should certainly not be made. He believed the life insurance companies were ready and eager to cooperate with state officials in achieving a reasonable solution of the important problems so well stated by Mr. Mayerson, but his concern is that these problems be approached and solved in a way which will avoid the drawbacks he mentioned.

MR. N. M. HUGHES believed that the companies have no choice but to challenge the whole concept of measuring efficiency by any other standards than those used in the past, namely, the benefits given in return for the premiums charged. If any concession were made toward allowing comparison of expense factors as criteria of efficiency, the next step might well be the prescription of even tighter control over investments and the selection of risks. Certain supervisory authorities have developed the notion that they must not only regulate the general conduct of insurance companies but must also inject themselves into company management and have a voice in the determination and execution of company policy. He believed that the problems of company solvency and honest implementation of company contracts were a sufficient tax on the abilities and energies of these officials.

He noted inconsistency between the Superintendent's statement that he was without authority to prescribe reasonable methods to obtain suitable information with regard to expense allocation and the fact that he has found that companies have loaded the expenses of one branch of business on another. He wondered how this had been detected in the absence of any reasonable means of determining proper allocation of expenses. He also wondered how it was possible for a company, for any extended length of time, to make over-allocations of expenses to Branch A in order to give a competitive advantage to Branch B without pricing Branch A entirely out of competition.

Many of the Superintendent's quotations from company sources are meaningless when cited out of context and there is no evidence that the Superintendent's advisers have made more than a perfunctory study of the serious and complex problems involved in functional cost analyses. The fundamental fallacy in any plan for uniform allocation of expense is that no method can possibly be devised by one company for any one year which can be used without extensive modification for another company operating in the same field or even for the same company in another year. There are significant differences between companies in the way management responsibilities are divided, in company history, in the rate and stage of progress in which a company finds itself.

The final and absolute criterion for judging a company is the benefits granted for the premiums charged, including in benefits all the intangibles that go into the servicing of insurance contracts, as well as death benefits, dividends, nonforfeiture values, settlement options, etc. It seems remarkable that this criterion, though accepted in every other field of financial and commercial endeavor, cannot be relied on by our supervisory officials. Lack of a uniform standard of expense measurement, like the absence of a uniform mortality standard, in no way implies that company management is without the tools to determine the soundness of its own policies. The fact that papers are written by company people on ways and means of sharpening those tools shows clearly the interest in and attention given to the matter by management. It is both unreasonable and presumptuous for persons outside management to imply otherwise.

MR. D. J. LYONS mentioned the fact that statutes and regulations have a way of growing. Section 213 has grown until it is now a monstrosity. It is very difficult to get such things off the books once they are there. He thought it very dangerous to make one system for allocating expenses applicable to all companies. Nobody has yet been able to do it perfectly for one company. It would do more harm than good to freeze an unsound system into law. Too many of us give lip service to democracy and freedom but sit by and let our problems be turned over to bureaucrats. It is quite proper for a fascist state to issue regulations because they want uniformity. That is not the American way and that is not the way we will make greatest progress. We must try to solve our own problems and must beware of passing them on to the state.

MR. MORRIS PIKE pointed out that part of our stock in trade is the stamp of confidence and approval placed upon our activities by public supervisory authorities and that any additional legislation which is necessary to carry out existing duties should not be denied. State legislatures and various segments of the public turn to the insurance department for information, advice and complaint. He felt that we all recognized the importance of proper classification and grouping of income and expense items and agreed that proper allocations by line are necessary. We might differ as to the bases of these allocations and we would differ more widely as to the interpretations and use to be made of the results. Messrs. Gelles and Pedoe have cautioned against blindly following expense figures which were intended for one purpose into an area for which they were not intended, and have also referred to the need for considering the results derived from mortality and interest as well as the expense of operation.

He stated that premiums, less dividends, less cash values, have long been accepted as an indication of operating results. It does not follow that one company is operating more efficiently than another merely because expense rates and premium rates differ. Account must also be taken of services rendered. Each company may be providing its policyholders with what they want and pay for, such as the collection of premiums at the home instead of by mail. Life insurance has thrived under a system of state supervision which has permitted individual companies to make their own rates subject to legislation which has prohibited unfair discrimination. Companies have generally drawn upon intercompany experience for their mortality base but have utilized their own individual cost figures for their expense base. He assumed it was not the intention of the New York Department to substitute a uniform intercompany expense factor for individual company expense, nor to subject premium rates to arbitrary performance standards, nor to extend its supervision over premium rates beyond its present sphere. He accordingly hoped that a solution could be reached which would enable the New York Superintendent to perform his duties and also enable the companies to continue to furnish the public with the insurance services it needs, consistent with sound business practices.

MR. R. C. GUEST heartily endorsed the views so ably expressed by previous speakers. He referred to the South-Eastern Underwriters Association case and the state statutes which were hurriedly enacted to preserve state supervision which had been so valuable in the United States. He had felt reasonably assured of a permanent continuance of understanding, cooperative state supervision instead of Federal supervision superimposed upon state supervision. He mentioned the strong feeling between various states as to their peculiar prerogatives and the extent to which these prerogatives are encroached upon by some extraterritorial statutes, such as exist in New York. He knew of one state with a long history of sound and understanding supervision from the viewpoint of the public, wherein mentioning in argument that New York's leadership should be followed is the equivalent of waving a red flag at a bull. He thought that feeling existed quite extensively in other states.

He wished to endorse the theme that anything in the way of further regulation toward uniform accounting should originate from very long and careful deliberation jointly by the N.A.I.C. and the industry in order to come up with something which would be practical and helpful but not hindering. He said that the spectacular affair of the C.I.O. challenging the constitutionality and applicability of the New York Expense Limitation Law showed the effect of too broad and detailed extraterritorial control of the insurance business.

MR. R. L. BERGSTRESSER, speaking as a representative of a small company, stated that this problem did not impinge on all companies in the same way just because they all used the same kind of annual statement. He was rather appalled at the idea that a regulation appropriate for one of the giant companies should apply uniformly in its applications to small companies as well. The question of elaborate procedures, which may add to the cost of business already in force, may have a very strong bearing on a stock company and he was very glad to see that great interest had also been taken by representatives of mutual companies.