TRANSACTIONS OF SOCIETY OF ACTUARIES
1951 VOL. 3 NO. 7

VOL. III MEETING NO. 7

TRANSACTIONS

SEPTEMBER, 1951

ADDRESS OF THE PRESIDENT, VALENTINE HOWELL

THE ECONOMIC POWER OF THE LIFE INSURANCE COMPANIES

I HAVE a dog that has been negatively conditioned to the word "bath." "Bath" has become a very evil word to him. No matter how pleasantly you say it, he takes off and crawls under the bed.

In the same way, "power," and especially "economic power," has, in our democracy, come to be one of the worst handles you can hang onto a man or an institution. The connotation is that of a sort of superracket. We think of Hitler and Stalin, and "malefactors of great wealth."

Consequently, when Mr. A. A. Berle says that the life companies are "great institutions" with "enormous capital funds" and that a small group of their executives have power in their hands to determine the long-term interest rate, he knows very well that he is saying to us, "How would you like a bath?" and he hopes that we are going to hide under the bed.

And don't be deceived when he says that, individually, company executives are "good Joes" living a simple life on what the taxgatherer leaves them out of their salaries. That kind of thing is standard technique intended to give the impression of balanced judgment and "looking on both sides of the question." But statements like his are all the more harmful because they imply evil rather than make a direct accusation.

Now, I realize that we are actuaries, not economists. We are, however, at least observers and consultants in company policy matters. When a responsible ex-public official like Mr. Berle, in a recent speech before the Life Insurance Association, accuses our executives of being in a position to determine interest rates in the United States, it must be a matter of concern to actuaries as well as to others in the industry.

First, let me give you a brief résumé of the financial history of the past years, as seen from the inside of a life insurance company—what I might call a germ's-eye view of things.

My first recollection starts with those same gray days in 1932–1933 that Mr. Berle talks about. At that time, Ed (Paddlefoot) Duffield, then President of the Prudential, asked a young actuary and a young invest-

ment man to figure out, on the basis of the then current rates of loan and surrender of policies, how long there was going to be any Prudential. We came back with an answer. I think it was to the effect that the Prudential had an expected after-lifetime of 4 years and 37 weeks. Mr. Duffield looked at the calculation thoughtfully and sealed it up in an envelope. He put it in his safe. So far as I know, it was never afterward seen by human eye.

For some time after that, we worried rather acutely as to whether we had enough available cash to meet requirements. Perhaps this was the time when John Maynard Keynes was theorizing that, to the investor, liquidity of investments might be a more important factor than interest yields. Right then, it surely was. This was also the time when the government took control over money and credit, and hence, potential control over the long-term interest rate.

Easy money conditions continued for a period of years. We worried because we had ever-climbing cash balances and couldn't get them invested. The interest rate dropped down and down, and so did policyholders' dividends. We acquired considerable property we didn't want, and some companies found themselves in the hotel business.

Demand for money picked up with the onset of the war abroad. But as the supply of money for investment was still in excess of the demand, there was little change in interest rates. Then came our own entrance into the war, and the government's control over credit and currency became effective. Interest rates were fixed at 2½ percent for long-term bonds. This was then a rate that was fair to the investor and the taxpayer alike. The bond issues were so large that a higher rate would have had little effect in diverting them to noninflationary channels.

The companies, and particularly the large companies, bought large blocks of government bonds, and stopped worrying about their cash balances. This was patriotic of them, but there were also reasons other than patriotism. Private investments were as scarce as ever. Also, a very powerful motive was the distrust of any credit except that of the government. The directors of many of the companies approached an investment on the basis of 10 points for security to one point for yield. One large company emerged from this period with government bonds totaling nearly 60 percent of its assets.

The nation came out of the war still in a 2½ percent frame of mind. Predepression bonds, issued at higher rates of interest, were refunded in great quantities. The administration was undoubtedly prepared to support the prices of its securities in order to maintain low interest rates, but the strain on it was slight. Basic interest rates did not climb very far above a

$2\frac{1}{2}$ percent riskless basis for two or three years. So far, rounds 1, 2 and 3 had gone to the government without the necessity of raising a glove. The policyholders were beginning to show nasty bruises in the pocketbook area.

At the end of the period, however, the companies began to get out into the suburbs and the grass-root areas and ask the natives how they would like to buy a new tractor or a new house, on the cuff. Or, "How would you like to put up a new apartment house free of rent control?" Or, "Could we help you build that factory?" The answer was often "Yes." In other words, encouraged by basic needs for capital and by the sales methods of the lenders, the investment demand at last picked up. Due to this investment demand, the interest rate moved upward. The companies found themselves not only able to invest their current funds, but in a position to sell their 2 and $2\frac{1}{2}$ percent government bonds and put the money in $3\frac{1}{4}$ and $3\frac{1}{2}$ percent investments.

Now, for the first time, the administration's policy of low interest rates came into real conflict with the law of supply and demand. And now, also, approaches the time when Mr. Berle says the life companies took over control of the long-term interest rate. His assertion is dramatic, but untrue.

In 1932 the government passed legislation enabling the Federal reserve banking system to issue money based on its holdings of government securities. Take a five dollar bill out of your pocket. Ten to one, it is a Federal Reserve Note. Read what it says on the black side. It says, "The United States of America will pay to the bearer on demand five dollars." Now, isn't that silly? It *is* five dollars, isn't it? What are they going to give you in exchange for it?

Two years later, the government exercised its power to alter the ratio between the United States dollar and a given weight of gold. Since that time, the government's control over the supply of money and credit, and hence over the interest rate, has been absolute.

Why do I say, "and *hence* over the interest rate"?

Interest rates are determined, like other prices, by supply and demand. If the supply of funds for loan purposes remains constant, an increasing demand for such funds has the effect of raising the interest rate. But when the supply of money and credit can be expanded indefinitely by the government, as at present, the supply can always be made to exceed the demand for money. Then competition for available investments develops, and the interest rate starts downward.

The principal method by which the government controls the supply of money, and hence the interest rate, is through the operations of the Fed-

eral Open Market Committee. When the Federal reserve banks buy government securities in the open market, they pay for them in cash or bank credit. This payment is available to the seller for other investments. But the government bonds bought by the reserve banks also form the basis of further credits or of currency issues and this new money competes with the old to drive down the interest rate. Also, if new government issues are not marketable because the coupon rate is too low, they will be taken up by the reserve banks and still more currency or credit will result.

Thus, as long as there are government securities for the Federal reserve banks to buy, and as long as the Federal reserve banks can continue to print their own money—and at present there is no practical limit to either of these factors—the Federal government can set the interest rate at whatever figure it chooses. The administration might experiment with an interest rate of zero. This, I assume, would be equivalent to issuing legal tender money directly. I don't know that the issue of printing press money is unthinkable in the United States. Perhaps it is just a socially undesirable habit. It is like the man who brings his own poker chips to the party. Nobody seems to be hurt by it—until the time comes to settle up.

How do the life insurance companies get into the picture? In the first place they constitute large accumulations of capital. According to Mr. Berle, they are growing faster than the rest of the economy. Actually, they are not. Savings, other than life insurance, have increased at a faster rate over the past twenty years than have the assets of the life insurance companies. Also, over the same period, the big insurance companies have lagged somewhat behind the others in growth.

But without respect to size, all investors, including the heads of savings institutions and insurance companies, desire higher interest rates and are apprehensive of continued inflation. Their reactions will normally all be alike because they are all governed by the same motives. They will, therefore, do their best to persuade the administration of the wisdom of financing the present defense effort on an interest basis higher than $2\frac{1}{2}$ percent. They will point out that financial conditions today are the antithesis of those at the outset of World War II. They will point out that interest rates can be held down to $2\frac{1}{2}$ percent only by increasing the supply of money, and that such an increase under present conditions would be inflationary. They will point out that those living in whole or in part on investment incomes are the forgotten men and women, bedeviled by lower incomes and prices twice as high as those at the beginning of World War II. In a word, they will ask the administration to permit the interest rate to rise to a point somewhere between the level it is now seeking and the inflexible $2\frac{1}{2}$ percent at which it has been maintained.

But where is the compulsion on the part of the life insurance executives? Where is that "control" that Mr. Berle speaks about? Suppose, in spite of the so-called economic power of the companies, the administration had decided to maintain the $2\frac{1}{2}$ percent long-term rate through continued purchases of its $2\frac{1}{2}$ percent bonds at par. In such case the companies and other institutional investors would sell government bonds to the Federal reserve banks and invest the proceeds at more attractive rates. But the bonds coming into the reserve banks would immediately form the basis of additional funds seeking investment. These funds would inject new money into the economy in addition to the normal supply of investment funds. In the resulting competition for available investments, the long-term rate would inevitably drop to a rate based on the $2\frac{1}{2}$ percent government rate basis. Also, because of the increase in the supply of credit, an inflationary impulse would be generated.

Thus in the long run, policyholders would get less interest to offset further inflated company expenses, and the cost of insurance would be increased. In addition, the real value of insurance policies would be decreased by inflation.

Because of the ultimate harm to their policyholders and because of the inflationary danger to the nation as a whole, insurance men have urged that government support of bond prices should be withdrawn and that new financing should be on a more realistic basis. The government, convinced that the move was a wise one, has been temporarily won over. Let us hope that it doesn't have a change of heart.

I spoke of the policyholders. That is one subject conspicuously absent in Mr. Berle's discussion. He points out that whatever they do, there can be no chance for the insurance executives to acquire really big money. What then, he asks, motivates these men? What are they after? It doesn't seem to have occurred to him that the primary concern of the insurance executive is the obvious one of responsibility to the policyholders. He discusses at length the effect of a one percent increase in the interest rate. He shows that, because of this increase, the home owner will pay more for his home and the factory owner will have lower earnings from his business. But how about those 83 million obnoxious capitalists who own life insurance policies?

Company interest earnings have decreased from about 5 percent to around 3 percent over the last twenty odd years. That is a decrease of 2 percent. The day of the 5 percent interest rate may be gone forever. But even an additional one percent over present rates would mean $640 million more every year in dividends to policyholders. If the net rate went to $4\frac{1}{2}$ percent, the policyholders would be a billion dollars a year to the

good. A billion dollars a year is still a lot of money. Just for a basis of comparison, it is enough to pay the entire bill for medical care insurance coverage issued by all private carriers, including Blue Cross and Blue Shield. Actually, if earned, it would go to increase life insurance dividends and decrease the cost of life insurance.

Now, I am not pretending to judge between the relative claims of the home owner and the factory owner on the one side, and the policyholders on the other. But isn't it obvious that the first and most important consideration of insurance executives must be to provide insurance at a minimum cost? And, bearing in mind the effect of inflation on the purchasing power of life insurance, must they not be greatly concerned with the problems of inflation?

These are strong motives—so strong that Mr. Berle's concern with motivation seems to me to be absurd. The problem is not the absence of motives. It has to do with Mr. Berle's plea to the insurance executives to ignore the rights of policyholders as a class, and to make the national economy, presumably along the lines favored by Mr. Berle, their only consideration. Mr. Berle, by inference at least, suggests that the company executives should combine to help the administration in its easy money policy. I can almost hear the Attorney General pointing out that such combinations are illegal in themselves, however worthy the motive. And again I say, how about the policyholders? If a man is trustee for the savings of several million policyholders, should he be moved by completely different considerations than those that motivate him as the trustee of his wife's mother's estate?

Now I will solve the last of Mr. Berle's problems—in a way that satisfies me at any rate—and then I will have done with him. As a student of economics, he finds himself unable to classify the life insurance companies or to assign them a logical place in the economic structure. He decides that they most resemble private bureaucracies, but, he says, they constitute "an evolution of capitalism into an institution peculiar to itself." I would like to suggest to him that the top management of the life insurance companies constitutes the leadership of a "pressure group" of 83 millions of small capitalists.

This pressure group is not a very efficient institution, as these groups go. The reason is simple—the companies control no votes. Because of this and because the great majority of policyholders belong to other groups in which they have far more interest, such as union labor or the farm bloc, for example, the insurance executives have little power except over the operation of their own companies.

So far they have run their companies in a way that is good for the

policyholders and sound for the economy. But quite possibly what is good for policyholders as capitalists may not always be good for the economy as a whole. Quite possibly there is need for regulation of this as there is need for regulation of other pressure groups.

This I know—there is no need for regulation based on the theory that the life insurance companies, as capitalistic organizations, primarily must be servants of the economy, whereas the economy must adapt itself to serve the ends of other organizations banded together solely to watch over their own interests in the political arena without respect to the good of the country as a whole.

In a word, let us in the insurance business agree that we will be satisfied to be ruled by the same harsh regulations and economic controls that now apply to the cooperatives, the labor unions, the farm bloc, the American Legion, the "free silver" senators, the cattlemen, and all similar groups.

But, Mr. Berle, please don't tag us as the capitalistic wielders of "great economic power" or we won't be able to go home and face our families.