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INTEREST RATE AND INVESTMENTS

A. To what extent have the current levels of government bond and other security prices retarded reinvestment at higher yields because of the losses on sale involved in such transactions? Is the program of voluntary credit restraint similarly restraining improvements in yield from existing portfolios?
B. Has the absence of stable statement valuation criteria for preferred and common stocks deterred companies from expanding their holdings in this form of investment? What changes in investment policy have occurred or are being considered as a result of the change in the New York Insurance Code permitting limited investment in common stocks?
C. To what extent is investment policy influenced by the tax position of various types of investment when owned by life insurance companies as compared with ownership by others?
D. What effects have higher investment yields and credit restrictions had upon the movement in policy loans and policy funds on deposit?
E. What steps can be taken to stimulate the current flow of cash to the companies in order to assist in curbing inflation and to permit greater advantage to be taken of available investment opportunities?
F. Will a continuance of the present investment situation lead to revisions of interest assumptions for new contracts, and if so, how should such revisions be coupled with adequate provision for future changes in (1) administrative expenses and (2) annuity and settlement option mortality?

MR. D. N. WARTERS said that after the Federal Reserve Board withdrew its pegged support of government bonds on March 9, 1951, the prices of all bonds fell and the spread between the prices of high and low grade bonds increased, so that a switch from high to medium grade bonds appeared attractive to many investors from the price standpoint. However, the absence of substantial support from the Federal Reserve Board has left the government market very thin and in all sections of the market only small volumes can be sold at the quoted prices. In addition, the lower prices of new bond offerings have been offset largely by disappointing call provisions which would make refunding probable if yields dropped as little as $\frac{1}{4}$ of 1%. Thus many of the new issues do not offer any great compensation for the capital loss arising from the sale of seasoned bonds.

As large companies can take only limited advantage of price changes because of the thin market, the allowable reduction in surplus from capital losses is not the limiting factor it may be for smaller companies. Many larger companies have felt it wiser to use the limited funds that can be raised in meeting mortgage and loan commitments which were relatively heavy on March 9, 1951.

He explained that on today's market the sale of high grades often means a capital loss on the books. Reinvestment in lower grades usually increases current yields at the expense of an increase in future capital loss. Reinvestment in the same grade is one way of trading present book surplus for an increase in the yield basis at which the bonds are scheduled.

He felt that the voluntary credit restraint program is affecting company yields because a fair volume of attractive investments are being refused and the demand for approved investments is increased.

With reference to section B, he believed that life insurance companies should be allowed to hold a reasonable volume of common stocks as a hedge against inflation, to provide equity funds for American industry and to increase yields in order to meet trust company competition for pensions and the competition of investment trusts, etc., in the sale of individual policies. Possible fluctuation in statement values and its effect on surplus has limited the volume of stock investments. The change in the New York code will help companies domiciled in other states to obtain similar legislative changes.

Referring to section C, he said that, generally, tax-free municipal bonds are out of line pricewise for life insurance companies, as they are relatively more attractive to individuals and other corporations because of differences in rate of tax. "Sale and lease back" investments at low gross yields are now less attractive to insurance companies because of recent changes in the income tax law. Stocks of issuing corporations paying income tax may be attractive investments for some corporations because they are allowed to deduct 85% of the income from them in figuring income tax, but the tax saving is not as great for life companies.

MR. R. E. SLATER said that following the offer of an exchange from Victory bonds to nonmarketable $2\frac{3}{4}$'s, there had been heavy selling of government bonds, until the price fell to approximately 97. While the incurred losses may have been the major reason why the companies then discontinued selling, he felt that some companies had reached a level of government bond holdings below which they did not care to go. There has also been a feeling that the government may have to restore pegs at higher levels in order to continue deficit financing.

He believed that very few loans were made by the John Hancock prior to the voluntary credit restraint program which would have been prevented by the present restrictions. All questionable loans in which his company has been interested since the program was instituted have received official approval, and he believed that the program has been of little significance to life insurance companies.

With reference to section B, he cited the case of a New York fire insurance company which had stocks with a market value of $90 million in 1929 that had fallen to $19 million by March 19, 1933. By July 3, 1933, they had a value of $32 million but nineteen days later they had declined to $27 million. He referred to the experience of one large Canadian life company during the same period as another example of the serious effect, not only on surplus, but on the reputation and, possibly, the soundness of life insurance companies, when they invest a substantial portion of their assets in common stocks.

Although it is recognized that the year-end market value of stocks does not, in many instances, give an accurate indication of their intrinsic value, no other acceptable basis for valuing stock has so far been worked out. Some have suggested a five-year average of market values, others more elaborate formulas based on earnings, book values, net working capital, and other factors. If some satisfactory method can be achieved the life companies would show greater interest in common stock investments. The restrictions on the investment in common stocks in the New York Insurance Law have probably been a greater deterrent than the absence of stable statement valuations. He referred to the practice of some companies in setting up a "Reserve for Fluctuation in Security Values" as one way of avoiding severe fluctuations in the surplus account.

The change in the New York Law has so far had little effect on the investment practices of most of the larger New York companies, and some of this lack of interest was attributed to the large volume of advance commitments running into 1952. Companies domiciled outside New York are continuing to buy common stocks, although the purchases of some of these companies may have been stimulated by the desire to acquire some blue chip stocks before they find themselves in competition with the New York companies. Some of these companies which were operating in New York State had always felt free to invest to a limited extent in common stocks, and the recent liberalization of the New York Statutes has expanded the limit to which they had felt it prudent to go if they were to avoid any questions concerning their right to sell insurance in New York State.

MR. W. F. POORMAN said that some attractive but ineligible investments had been offered to the Central Life following the voluntary credit restraint program and he believed that the withdrawal of credit for such issues was largely responsible for the high yields offered. In this sense these attractive offerings may be somewhat illusory.

He referred to the experience of the latter portion of 1948 when a drop in prices made it possible to purchase high grade bonds at a $3\frac{1}{4}\%$ rate but that most of these were refunded at $2\frac{3}{4}\%$ within 12 months. He considered it advisable to purchase outstanding low coupon discount bonds despite the lower yield as compared with new offerings of higher coupon bonds affording more liberal yields, as protection against the refunding hazard.

With reference to section B he said that according to a study made in 1948, the total nonamortizable securities owned by life companies constituted nearly 70% of their total capital and surplus funds. Sharp market fluctuation which may or may not be directly related to intrinsic worth can therefore have considerable significance. He referred to the current report of the Joint Committee of the A.L.C. and L.I.A.A. on Valuation of Assets recommending a valuation formula for preferred stocks not in default, and the establishment of Fluctuation Reserves.

In discussing section C, he said that with life insurance company income taxes geared to investment income, and the decision of the United States tax authorities to consider the total lease payment as taxable income in the year received, the purchase-and-lease-back type of investment will be less attractive to life companies. As an illustration he showed that the net return on a 15-year lease plan and a tax rate of 6½% may be .58% lower than that of a corresponding conventional loan, both calculated at a gross rate of 3¼%. This he believed necessitated higher rental charges, particularly if there is a relatively short basic term, a large proportion of nondepreciable land value in the original purchase price, and a low rate of allowable depreciation on the building and improvements.

MR. M. A. LINTON believed that the voluntary credit restraint program has indirectly affected life companies' yields because without it some issues not now offered to them would have been submitted.

He referred to the effect of the prospective 6½% life company income tax rate in raising, relatively by ¼% plus or minus, the net yield from stocks as against a comparable bond return—the reason being that in effect only 15% of the income from stocks becomes taxable income. Preferred stocks provide a major avenue of investment in the stock field, and this factor becomes increasingly important as the income tax rate on net investment income increases.

MR. W. C. McCARTER, in discussing section D, reviewed the policy loan experience of the Northwestern Mutual and concluded that credit restrictions have had little if any effect on the rate of policy loan borrowing, no significant changes having occurred in the ratios of either new loans or total loans to policy reserves. Higher yields obtainable on new investments have not produced noticeable changes in the proportion of eligible policy proceeds left with the Company under the interest option. The rate at which existing proceeds on deposit are being withdrawn increased slightly from 2.83% for the last half of 1950 to 3.48% during the first half of 1951.

MR. E. M. McCONNEY, in discussing section E, said that increased income, decreased disbursements or a quicker turnover of assets will increase the normal cash flow to the companies.

To increase income we can sell more or higher priced insurance and encourage prepayment of premiums. We should consider expanding the field force, improve its training, and pay more attention to planning and market analysis. Increased advertising he believed would be of doubtful immediate value. The sale of higher priced plans will not prove permanent unless they fit the applicant's insurance needs.

He saw little opportunity for decreasing disbursements because the majority were policy claims, and inflationary trends gave little hope for decreasing expenses. Claim proceeds being left on deposit were already high and many such contracts guaranteed high rates of interest.

A quicker turnover in assets is hard to accomplish. He suggested that policyholders be encouraged to repay policy loans and that mortgagors be encouraged to prepay principal even on their amortized loans.

Personal disposable income in excess of personal consumption is now at an all time high, and we must get the agents to bring it in.

MR. E. J. MOORHEAD advocated a plan for instalment repayment of policy loans which had been suggested to him by a management consultant as an effective way to increase the flow of cash income.

He also thought that we might reconsider our rules for single premiums, prepayments and investment plans. Many of these rules were brought into effect at a time when some of us may have been fighting off people who wanted to transfer their investment problems to us. Because that kind of money is not really competing for goods and services in the consumer market, such measures would not help to combat inflation.

MR. W. A. JENKINS, in discussing section F, stated that the probable future investment situation, rather than the current investment situation, is the important factor in determining the interest assumptions for premium rates of new contracts. Actuaries also realize that the whole premium rate is the important thing and not any constituent part. He referred to the increase in Moody's index of corporate bond yields which increased from 2.88% to 3.21% from March 1 to June 28, but which had declined to 3.08% by September 20, as an indication that adoption now of interest assumptions based on changes in the investment situation since March would be premature. He believed that the increase last Spring resulted in part from a temporary cash shortage due to advance commitments. Any change in interest assumption, he stated, should wait till we have a better indication that higher yield rates will continue for more than a few weeks or months.

If higher interest rates do become more definitely established, he would expect reductions in nonparticipating rates, but believed that the $2\frac{1}{4}\%$ and $2\frac{1}{2}\%$ assumptions for participating contracts would remain.

He suggested great caution in considering an increase in interest assumptions for annuities and settlement options because of the deficiency of most mortality bases now in use. If there is any mortality margin at all, it is less than that in our life insurance tables. A realistic appraisal of all factors is required. He suggested the same interest assumption as for life insurance contracts, the Annuity Table for 1949 (or other current table) with projection, current expense rates, and a substantial safety margin for increased expenses in the future plus the possibility that one or other of the assumptions will prove insufficient over a considerable period of years.

Regardless of changes in interest rates, he believed that a careful appraisal of future expense and mortality assumptions is required at all times for annuity and settlement option rates. For many, many years there have been these two unfavorable trends, both very gradual, rather irregular, but persistent: (1) a slow erosion in the purchasing power of the dollar and (2) a gradual lengthening of life. The rate of inflation over many years has been of the order of 2% or $2\frac{1}{2}\%$ per year.

MR. F. D. KINEKE said that there had been a change in the investment situation since the program for the meeting was prepared, but based his comments on the improvement in the net rate of interest earned over the past few years. If the improvement continues, he thought a reconsideration, if not a revision, of the interest assumptions for new contracts would be warranted.

Current premium rates were set in 1947 following a 15-year drop in earned interest from over 5% to less than 3%. Companies were therefore making extremely low interest assumptions at that time in determining minimum safe rates. Notwithstanding large holdings of very low yielding government bonds, the net rate earned by the companies generally did not fall below $2\frac{3}{4}\%$. If the interest assumptions for the test rates or experience premiums in 1947 were $2\frac{1}{2}\%$ or less, they should now be re-examined.

The expense assumptions, however, should also be reconsidered to make provision for future expenses at a higher level. He suggested assuming a further increase in expenses equal to the increase that has taken place during the past 5 or 10 years. He thought it quite possible that the higher expense assumptions will be found to offset the higher interest assumption, and might indicate that present rates are still satisfactory. He suggested that it would be reassuring to make the calculation.