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# STATEMENT BY COMMISSIONER SUMNER T. PIKE

before

THE NEW YORK JOINT LEGISLATIVE COMMITTEE
FOR REVISION OF INSURANCE LAW

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STATEMENT BY COMMISSIONER SUMNER T. PIKE

BEFORE THE NEW YORK JOINT LEGISLATIVE COMMITTEE

FOR REVISION OF INSURANCE LAW

I

INTRODUCTION

I appreciate the opportunity to present to this Committee my views on the question of whether the New York Insurance Law should be amended to permit investment in common stocks by life insurance companies organized under the laws of the State of New York. I wish to make it clear at the outset that the views expressed here are my own. Although a Commissioner of the S. E. C., I do not speak in the official capacity of a Commissioner here today. I speak as an individual who has had four years of experience as an investment expert for a group of fire insurance companies in New York, and a further decade of experience in an investment institution. I speak also on the basis of experience and information gathered while I have been a member of the TNEC and a Commissioner of the S.E.C. I wish to make it plain, however, that I am not speaking on behalf of the Securities and Exchange Commission. Although the members of the S.E.C. are vitally concerned with the problems raised by the subject-matter of this hearing, they are not participants in these hearings.

This is not the first public occasion upon which I have given my views concerning common stock investments by life insurance companies. On February 28, 1941 in a statement on life insurance before the TNEC, I said:

> "A liberalization of investment laws to permit life insurance companies to invest a relatively small percentage of their funds in common stocks would stimulate healthier financial structures and have a wholesome effect on the economy. Accordingly it is suggested that the respective states give serious consideration to liberalizing in this direction their laws governing life insurance investments."

This proposal for liberalizing state laws governing life insurance investments was not a recommendation for federal regulation of life insurance companies nor was it a proposal for any kind of federal regulation through the back door. It was merely a recommendation for the consideration of the various states.

It is fitting that the State of New York, which is the home of many life insurance companies, including four of the five largest, is considering liberalization of its insurance law to permit common stock investment. The present provisions of the New York Insurance Law do not permit investment by a life insurance company in the common stock of any company. The New York Insurance Law allows investment in government obligations, secured corporate bonds, real estate mortgages and certain kinds of preferred stocks. The preferred stocks on the so-called legal list for insurance companies are restricted to such preferreds as have certain earnings records behind them. In addition, there is a provision that not more than 10% of the preferred stock issue of any single company may be purchased by a life insurance company and that not more than 2% of the total assets of the life insurance company may be invested in preferred stocks.

## II

## LEGAL RESTRICTIONS ON INVESTMENT

Legal lists prescribed by state laws limit the scope of permissible investments by trustees of other people's money so as to increase the margin of safety in investment and correspondingly decrease the margin of error in investment. The legal list is no more than a preliminary qualifier for securities. If the security meets the tests prescribed by the legal list it

becomes an eligible investment. A trustee, however, is under no legal compulsion to invest in an eligible security merely because it is on the list.

Of course, the legal list is no more than a rough rule of thumb. The legal list is no guarantor of investment safety. It is no magic wand which converts selected securities into gilt-edged ones. There are plenty of tinsel securities which qualify on legal lists. In short, the legal list is not a safety list.

The legal list does not absolve the trustee from liability for any selected investment made from among the eligible securities. The trustee must still exercise the ordinary care and prudent judgment that a person in his position should exercise. The truth is, however, that too many trustees tend to think and act as if the legal list was their absolution. The legal list tends to become a featherbed for the trustee who is under a duty to invest his beneficiary's funds. The featherbed investment practices of trustees, as well as the laws that have codified them, are now running into serious difficulty by virtue of the changing economic and financial conditions.

Life insurance companies should be regarded as trustees of the funds invested by policyholders and stockholders and their officers and directors should be held to strict trustee standards. Enforcement of the trustee standards should be strengthened, particularly if the legal list is expanded to include common stocks. And I believe that the powers of state insurance departments should be implemented to enable them to exercise general supervision over investments.

Legal lists have never remained static. They have been changed to follow the changing economy and financial conditions. Unfortunately, they are in some cases historical accidents rather than modern lists adopted to modern needs. Today, however, most legal lists have undergone liberalizing changes until they stand on the verge of new frontiers of investment—common stocks. some states - e.g., Massachusetts, New Jersey, Connecticut and Pennsylvania - have long since permitted life insurance companies to invest in common stocks. Some states, including New York, have not.

## III

## THE INVESTMENT PROBLEM OF THE LIFE INSURANCE COMPANY

The first question to be asked is: why should we at this time broaden the New York Insurance Law to permit investments by life insurance companies in common stocks? The investment programs of the life insurance companies are designed to meet their contractual commitments to their policyholders. The investment problems that confront life insurance company managements therefore have a vital significance to millions of policyholders. Understanding of the current investment problems of life insurance companies involves consideration of: (1) the dilemma of the life insurance company which is faced with the problem of a huge influx of funds which must be invested in a limited, narrowing supply of available securities with declining yields; and (2) the broader economic and financial considerations which flow from the position of the life insurance company in our economic life.

1. The life insurance company sells policies. The policies carry guarantees of payment by the company to the beneficiaries. The premiums received by the insurance company on the policies are invested to enable the company to meet the payments guaranteed by the policies. The

company's income on its investments must keep pace with its guarantees on policies. When the insurance company's income on investments fails to meet its requirements to maintain reserves for guarantees on policies, there is a real danger sign.

Most of our large life insurance companies are approaching that danger sign. They sell more and more insurance policies. They receive more and more money to invest. They must put this money to work. They must obtain a return on investment sufficient to maintain a larger and larger reserve which will enable them to meet the additional guarantees on the increasing amount of policies outstanding. The problem of putting funds to work at a satisfactory interest rate has become more acute. Anxious to maintain their investments in high-grade bonds, the life insurance companies have found a contracting area of investment for their funds, at a rate of interest more and more unsatisfactory in the light of their policy guarantees.

I want to present before you the current investment and capital market situation in a more graphic way. For purposes of presentation I shall use figures regarding the forty-nine largest legal reserve life insurance companies, which together hold more than ninety per cent of the assets of all legal reserve life insurance companies. The assets of these companies increased in only eight years from less than 19 billions in 1932 to more than 28 billions in 1940. Their portfolio holdings of real estate, mortgages and railroad bonds declined to about 10 billions during this period. This decline reflects the drop in urban construction, the wave of mortgage foreclosures and moratoria, and the difficulties in the farm belt and in the railroad industry. During the same period their holdings of federal government, state and municipal securities increased from about one billion to

more than 7 billions. Holdings of utility and industrial bonds meanwhile increased from less than 2-1/2 billions to more than 5-1/2 billions.

Thus, the present portfolios of the large insurance companies indicate the following pattern. Large amounts of federal, state and municipal bonds have been purchased although their yield is comparatively low and generally insufficient to maintain the level of policy reserves required by law. A large part of these purchases is attributable to the inability of the insurance companies to obtain other high-grade bonds with a satisfactory yield. The life insurance companies have hesitated to increase railroad bond holdings under present circumstances. The mortgage field has dried up considerably as the depression wrought havoc with mortgage investments and as the government, to prevent widespread chaos, stepped into the field. Interest on farm and urban mortgages has been reduced. Mounting cash balances are beginning to appear. In summary, therefore, it is apparent from an examination of life insurance company portfolios that the available investment outlet for additional insurance funds has pretty well narrowed down to government bonds and corporate bonds of utilities and industrials.

The supply of high-grade corporate bonds in which life insurance companies invest — so-called "bank quality bonds" -- has been decreasing rapidly. "Bank quality bonds" are generally deemed to be those rated among the first four grades by a majority of the rating agencies. Since 1931 there has been an enormous shrinkage of bank quality bonds from over 25-1/2 billion dollars to no more than 14-3/4 billions in 1940. To this figure probably some three billions might be added, representing bond issues omitted from

rating because not publicly distributed and therefore lacking in market interest. Thus the total outstanding amount of bank quality corporate bonds is now no more than two-thirds of what it was back in 1932. And it is almost 14 billion dollars less than the total amount of assets of the largest life insurance companies. In other words, for each dollar of such insurance assets to be invested there is only about 50 cents face amount of "bank quality bonds" in existence today. Of the 14-3/4 billions of corporate bonds, nearly 9 billions were utility and industrial issues. About 5-1/2 billions of these utility and industrial bonds were already held in 1940 by the leading life insurance companies.

The large life insurance companies ordinarily do not buy bonds which sell above their call price. Life insurance companies buy for comparatively long investment and bonds selling above call price are likely to be called soon and thereby deprive the buyers of their continued investment. Moreover, subsequent reinvestment after redemption has recently had to be made under much less favorable circumstances. In addition, if the bonds are called soon after purchase, the net income on bonds selling above call price is apt to be less than is required for insurance company investment. For these reasons, as utility and industrial bonds of bank quality rose above their call prices, they also rose beyond the investment area of life insurance companies. Meanwhile, the pressure of institutional investments on issues which were still selling below their call prices was intensified, causing them in turn to rise. Of the 8-3/4 billions utility (excluding railroads) and industrial bank-quality bonds rated in May, 1941, about

5-1/2 billion were bid at or above call prices. Another half billion was currently non-callable and bid at substantial premiums above par. That left less than 2-3/4 billions of utility and industrial bonds bid below call prices. By August, 1941, just three months later, utility (excluding railroads) and industrial bank-quality bonds bid below their call prices had been reduced to about 1-3/4 billions. As a matter of investment practice, however, the large life insurance companies seem to limit most of their purchases to corporate bonds of the first three grades. In August, 1941, utility (excluding railroads) and industrial bonds of the first three grades selling below their call prices had been reduced to less than one billion. Meanwhile the trend for these bonds to sell above call price is continuing at a fast pace. This tends to cause the rest of the bonds bid below call prices to be held on to for dear life by the present holders. The market turnover in high-grade bonds therefore tends to freeze and thereby deprives life insurance companies of opportunities even to buy bonds bid below call price.

The area of investment by life insurance companies in high-grade corporate bonds today is, of course, even more limited than the one billion figure indicates. Of this amount, a substantial part is already owned by investing institutions and not in the available market supply. Moreover, a number of the security issues comprising this amount are bid so close to the call price that any substantial buying would probably bring them up to the call price and further constrict the supply of high-grade bonds available to the insurance companies.

Furthermore, bank loans have in many instances replaced bond financing, and thereby decreased the supply of bonds. During the last few years

particularly there has been a considerable increase in long term loans at low money rates by banks. Of increasing importance too has been the resort to internal financing by many of our large corporations. Earnings and reserves are being plowed back into many corporations, frequently making resort to external financing unnecessary.

This leaves the life insurance company pretty much dependent upon refundings of corporate bonds for investment outlets in this field. We have been experiencing for some time now a tremendous wave of refundings. Companies with outstanding issues of 5% and 6% high-grade bonds have refunded these issues at lower interest rates so that they could effect substantial yearly interest savings and postpone maturity dates. For the period 1934-1940 nearly three-fourths of the new issues of corporate bonds were for refunding purposes. It is estimated that about 12 billions of corporate refundings took place between January 1935 and June 1941, equivalent to about one third of all corporate bonds outstanding at the end of 1934.

Life insurance companies were hard hit by these refundings. Huge blocks of bonds in which they had invested at comfortable yields were retired at the very time when they needed greater outlets for the investment of their funds. Naturally, they bought the new lower yield bonds because these bonds appeared to be all that were available under legal lists and their investment practices and because they simply had to have income to maintain their policy reserves. Thus the extensive refundings of corporate debt during the past several years has taken away from the insurance companies the high interest-bearing bonds which they previously held. Ironically enough, it was among other things, their own pressing demand for additional high-grade bonds which tended to raise prices and lower yields on these securities.

Funds pressing for investment by the life insurance companies are increasing at the rate of about 1-1/4 billion dollars a year. And it must be remembered that the banks and other institutional fiduciaries are also interested in the same class of investments. The great demand for high-grade bonds created by the institutional investors helped create the great seller's market for such bonds that we have been experiencing. At the same time, the supply has actually been decreasing until the available supply of high-grade utility (excluding railroads) and industrial bonds had decreased to about 1 billion in August, 1941, less than the annual amount of funds that must be invested by insurance companies. The result has been that bank quality corporate bonds have acquired a scarcity value, reflected in extraordinarily high prices and low yields.

Interest rates on bank quality bonds have dropped so that the total average return on the bulk of long term financing now hovers nearer to the 3 than to the 4% level. No one can predict how many more refundings are in the offing. But it may be that the trend has, with some exceptions, pretty well run its course. If there is a decrease in refundings, there will be an even greater scarcity of high-grade corporate bonds for life insurance company investment.

The T.N.E.C. study of legal reserve life insurance companies (T.N.E.C. Monograph 28) pointed to the fall of interest rates which had taken place in recent years, and indicated that the life insurance companies had been brought face to face with a serious investment and operating problem -- the problem of earning enough interest to meet policy guarantees. In 1938 the acuteness of this problem was apparent from the fact that on the average the 26 larger

life insurance companies had 31.19% of their ledger assets, or a total of over 7-1/4 billions, earning less than the rate of interest necessary to maintain policy reserves. The trend indicated by the figures for 1938 has been accentuated since then.

Present yields on securities eligible for life insurance company investment have been estimated as follows:

U. S. Government Bonds - 1.8 to 2.5%
Municipal Bonds - 2.0 to 2.4%
Corporate Industrial Bonds,
First Three Grades - 2.74 to 3.21%

The overall estimated yield necessary to meet policy guarantees is from about 2.8 to 3.5%.

I should like to introduce for the record four charts, marked Exhibit A, covering the Metropolitan Life Insurance Company, New York Life Insurance Company, Equitable Life Assurance Society of the United States and Mutual Life Insurance Company of New York which show that in two of these four large life insurance companies organized under the laws of the state of New York, the income on investments has dipped close to the interest requirements necessary to maintain policy reserves. The line signifying investment income continues to flatten out or drop over a period of years; the line signifying interest requirements necessary to maintain policy reserves continues to rise due to the unabated inflow of funds upon which returns are guaranteed. If the present trend continues, and I see little evidence of its abatement, these two lines will soon cross. When they do, one of the vital margins of safety for the policyholders will have disappeared.

While I am discussing the investment problem of the life insurance company I want to digress for a moment and attempt to clear up some loose

thinking concerning two outgrowths of this problem. I refer to the growth of private placements and competitive bidding for security issues. The growing concentration of high-grade bonds in the portfolios of life insurance companies, banks and other large institutional investors has tended not only to cause undue concentration of security holdings, but has also shoved the small individual and institutional investors out of the high-grade bond field. I believe that this concentration, should it continue unabated, carries with it dangers and evils to our social, economic and financial system. Some persons have attributed this situation to the growth of private placements. Private placements, that is, the direct placement of security issues with the life insurance company by the issuers, have been the outgrowth of the underlying problem of supply and demand which I have already described. Private placements are an effect and not a cause. The life insurance company has certain advantages over the investment banker which cause it to be successful in competition for security issues. But it is the pressure upon the life insurance company to invest, and the limitation of the market supply of high-grade corporate bonds, that has forced the growth of private placements of high-grade corporate bonds.

Some persons are now attributing the evils of concentration of high-grade security holdings in large institutional investors to the system of competitive bidding for security issues. I believe that these persons are fooling themselves. Competitive bidding for security issues in the utility and industrial field is of recent date and is not yet widespread. The concentration of high-grade bonds in the portfolios of a few large institutional investors has gone on for many years. Once again I point to the fact that

it is the underlying investment problem of the life insurance company and the limited market supply of high-grade corporate bonds which has caused this. Those who point to private placements and competitive bidding as the reasons for the loss of business by the investment banker and the growing dominance by the life insurance company in the purchase of security issues, are in effect pointing out a few bubbles being emitted by a caldron of boiling liquid.

2. Thus far I have been discussing the problem from the rather strict point of view of the life insurance company's investment needs. These investment problems are created by the necessity of protecting the policyholders, depositors and beneficiaries of the life insurance company. There are, nonetheless, other matters of profound significance to be considered. The modern life insurance company is a colossus which bestrides our financial markets and economy. The life insurance business is not a problem entirely unto itself. Legislators must consider the welfare of our financial and economic system in examining the investment laws relating to life insurance companies.

In this connection, there is a serious question whether the great emphasis upon bond investment may not be contributing to the maintenance and creation of over-bonded capital structures in our utilities and industries. In their capacity as large savings institutions, the life insurance companies are directing into bonds an increasing amount of capital which might otherwise be invested in common stocks. The bond demand of our large institutional investors has helped foster the large number of refundings by utilities and industries in recent years. Refundings, despite their

immediate benefits to the utility or industrial enterprise, may forebode a dire future for the company with an excessive debt structure perpetuated by refunding. Should depression set in and earnings fall off, the weight of fixed charges in an over-bonded company may precipitate bankruptcy. In fact, it often has. Many utilities and industries should be using this period of good earnings to scale off excess debt and put on some equity fact. It should help these companies survive the lean years which may come again and help avert widespread bankruptcies which disrupt the economic structure. Yet the largest investors on today's market, the custodians of great portions of the public's savings, are not permitted to buy equity securities and thereby help put shock-absorbers on the American economy.

Many insurance executives have not yet been willing to recognize that their investment programs may be creating for themselves a vicious downward spiral of safety. The pressing demand for high-grade bonds tends to result in utility and industrial corporations issuing bonds instead of stocks until, in some instances, their capital structures become excessively heavy with bonds. High bond indebtedness ices the toboggan slide during a period of depression. The railroad bankruptcies are red flags planted on over-bonded capital structures. Thus, the constant demand by the life insurance companies for an endless new supply of bonds may in the long run undermine the very security which the life insurance company seeks through its investments. For as bonded indebtedness of a corporation increases beyond a ratio consistent with a sound capital structure, the safety of each bond correspondingly decreases.

It has been well said by C. W. Kellogg, president of the Edison Electric

Institute, that "common stock money is the one . . . necessary foundation that makes the whole structure stand up." If the foundations of the corporate capital structure are shaky, the entire super-structure of bonds may come tumbling down. To repeat, excessive pressure for bond investment may tend to create capital structures in utilities and industries which are not conservative, and ultimately contribute to bankruptcy and its attendant evils. In this era of rapid change which calls for corporate flexibility, too much corporate debt is especially dangerous to the investor and the economy as a whole. Still the life insurance companies cling to the traditional practice of seeking riskless investments in bonds. Their bonds may be lulling them into a false sense of security.

I believe that encouragement of additional equity security financing at this stage, despite the strong urge to take advantage of low interest rates, will help to forestall future trouble, particularly when the defense period is over. The post-war era should find our industry strong enough to make the adjustments necessary to convert itself from a war economy into a peace economy. Equity money is flexible; debt money is rigid. Sound capital structures supported by adequate amounts of common stock should help to facilitate and insure proper adjustment. The life insurance companies can help build for post-war economic defense by buying sound equity securities. By helping avert a deep post-war depression, the life insurance companies will be investing in their own safety and security.

As you can see, there are serious problems facing the life insurance companies and our capital markets and economy generally. The problem of opening up the field of common stocks to life insurance companies is only one aspect of these larger problems. But it presents very real and immediate issues.

## IV

## COMMON STOCK INVESTMENTS

I believe that life insurance companies have been long enough in bondage to bonds. The sources of their interest income are drying up. They must face the plain stubborn fact that new areas of investment must be tapped if present contracts with policyholders are to be satisfied. The investment problem of the life insurance company calls for something other than the stubbornness of the closed mind. It calls for boldness and imagination, for careful and thorough study of the problems and for intelligent action.

I have no illusions about common stock investment by life insurance companies. It will not afford a total answer to the crushing problem of increasing size and diminishing income now upon the life insurance companies. I am no medicine man. I don't offer the suggestion for liberalizing the New York Insurance Law to permit common stock investment as a cure-all. I suggest it as a step towards alleviation of the life insurance company investment problem, the capital market situation, and some of the economic problems of the nation.

Other steps will be necessary. Life insurance companies may have to lower their guarantees on new policies. They have in some instances been writing contracts in effect guaranteeing rates of interest in excess of those which they are currently able to earn. Higher premium rates on new policies may be appropriate. But even then, there is a serious question whether this is enough. Limitations of size of life insurance companies continues to be suggested. And in the long run, it may be necessary to seek remedies even more fundamental.

Being, in effect, a trustee of other people's money, the life insurance company is properly a conservative investor. Conservatism in investment, however, cannot be pigeonholed conveniently into classes of securities. Yet some persons seem to regard bonds as safe investment and stocks as speculative. Too many bonds have been unsafe and too many stocks have been safe to permit such generalization. Still common stocks continue to be labelled indiscriminately as speculative interests. In this way there has arisen a confusion of the evil of excessive speculation with plain, ordinary investment in common stocks. Speculation in stocks is not synonymous with investment in stocks. It is true that the Congress and the S.E.C. have condemned the purchase and sale of stocks for purely gambling purposes. This criticism was directed at excessive speculation on national securities exchanges in which artificial devices were used to raise or depress market prices. It has nothing to do with legitimate common stock investment and should not be confused with it.

Safety of investment is a relative and not an absolute term. Safety of investment, as we speak of it, really means investment in securities with a minimum risk of capital loss and a maximum assurance of income return. There is no securities investment that is absolutely safe. This is borne out by the past investment experience of life insurance companies which, by virtue of their soured bond and mortgage holdings, are represented today on over 60 bondholders' protective committees, and have, through foreclosures of defaulted mortgages, become the largest farm and urban real estate holders in the country. Prudent investment in securities depends upon careful scrutiny of individual security issues, the issuing

company, the capital structure of the issuer, the earnings record of the issuer over a period of years, the ability of the issuer's management, the pertinent technological conditions, etc. - all this in light of the needs of the particular investor. Whether there is likely to be more or less risk of capital loss and assurance of earnings should depend upon the results of individual expert examinations, and not upon the general brand of security. Prudent investment may dictate purchase of the common stock of one company as a safer and more conservative investment than the bonds of another company. Labels are frequently misleading. There are high-grade common stocks which are not far from the conservative investment equivalent of high-grade bonds.

I subscribe to the proposition that the real security behind investment lies in the continuing earning power of the enterprise, not the liquidation or reorganization value of the property owned by the enterprise. Upon bankruptcy liquidation or reorganization, it is true that the senior bondholder stands in line ahead of the stockholder pursuant to the priority principles laid down by the United States Supreme Court. Yet the bondholder's rights to priority in bankruptcy liquidation or reorganization are, I believe, too fraught with the uncertainty of bankruptcy adjustments to constitute real security to the bondholder. The insurance company, of course, does not invest to extract liquidation or reorganization value. It invests to protect its principal and for steady return. The earnings record and reasonably foreseeable earning power of a corporation are therefore prime considerations to life insurance companies,

just as they are to other investors. On an earnings basis, bonds do not assure better performance than stocks. The paper assurance of security found in the words of a bond is meaningless in the absence of the brute fact of corporate earnings. Although bondholders have a prior claim to corporate earnings, this may mean little in a healthy, going enterprise whose earnings are more than sufficient to pay fixed charges and dividends. The truth is, of course, that some common stocks in companies with a well-balanced capital structure are so close to the earnings source that they are, in effect, not far different from bonds in respect of dependability of earnings. Generally speaking, therefore, emphasis upon corporate earnings as a basis for conservative investment seems both sensible and proper.

Investment analysts generally speak of liquidity, yield and safety in connection with consideration of investments. Liquidity of investments, as an important investment factor for life insurance companies, is largely mythical. Essentially long-term investors, the life insurance companies have many security holdings without established markets. Moreover, current income has exceeded current disbursements of life insurance companies for each year since 1890, thereby tending to render the liquidity factor of secondary importance.

A present comparison of yields on leading common stocks with yields on high-grade bonds is favorable to stocks. I have already cited some of the estimated current yields on bonds. They range from 1.8% on U.S. Government Bonds to 3.21% on third grade corporate industrial bonds. Leading common stocks are selling on a yield basis on present prices

from about 5 to 8%. Moody's Stock Yields Index, based on 200 common stocks, reveals that the lowest annual yield in the period 1929-1940 was 3.5% in 1936 and the highest annual average yield was 7.4% in 1932. Of course, the purchase price of the security is a factor determinative of yield. Any comparison of security yields must take this factor into consideration. In other words, there is a time to buy stocks and a time to buy bonds.

Investment safety may mean any one of a number of things. I have already used the term in what I believe to be its practical and realistic sense. Some analysts, however, prefer to give it a more technical meaning - defining investment safety as the probability of receipt of principal at some future time. This definition lends itself to one answer - high grade bonds are probably, on the whole, "safer" in this respect than stocks. But this definition is scarcely realistic in its application to stocks. Return of principal of common stocks is dependent upon the sale of the stock to another person. And, of course, there is no applicable maturity date to stocks. For reasons that I have previously discussed, greater emphasis upon earnings seems to me to be in accordance with sound investment practice for life insurance companies. Without sacrificing safety, the portfolios of life insurance companies can be broadened to include seasoned common stocks.

There is, of course, a greater fluctuation of price and return in connection with investments in common stocks than is generally true with respect to investments in bonds. However, history indicates that there are both valleys and peaks in market prices in common stocks. If an investor is able to hold on during the period of descending market prices, there is much less chance that he will suffer material

capital loss. The life insurance company which is primarily interested in long-term investment can hold common stocks for sufficiently long periods to avoid losses which might occur if it were necessary to sell while the stocks were still at depressed prices. Of course, the market prices on common stocks held by life insurance companies cannot be entirely ignored. On the contrary, investment in common stocks by life insurance companies would entail constant and alert scrutiny of the markets. It might result in revision of investment portfolios at shorter intervals than is true today. It is not an easy job. But it is a job that the modern life insurance company, with proper management, should be capable of doing. In fact, it is a job that the insurance company holds itself out as capable of doing when it accepts the public's money. Fluctuations in dividend returns can be steadied over a period of years by spreading yields of high dividend years over the low dividend years.

Since various types of investments react differently to the changing phases of the economic cycle, diversification of portfolio is desirable and essential for the large life insurance companies. Common stocks in life insurance company portfolios will permit greater diversification, and, during the immediate situation, may afford some hedge against inflation. A life insurance company, no less than other institutional investors, should not have a static investment policy. As the markets and general economy change, and as its own needs change, the life insurance company should vary its investment policy according to its needs. A group of common stocks will provide added diversification and enable a more dynamic investment policy.

I have been speaking in general terms. I want to get down to particulars.

1. I submit for the record a study of selected common stocks, marked Exhibit B. This study contains data regarding the price and dividend records of selected industrial and utility common stocks over a 15 year period from 1925 to 1940. These stocks show long uninterrupted dividend records, some fluctuation of prices but appreciation of capital value over a long period of years, and comparatively good average yields. There are not many high-grade bonds with better performance records. I do not submit this data to prove that common stocks are better investments than bonds. I offer it to prove something which should really need no proof - that there are many high-grade common stocks which rate as well, if not better, than many high-grade bonds as safe, conservative investments. In this connection, the New York Stock Exchange has recently published a study of selected common stocks which bears out the same point.

2. I submit for the record studies of selected common stocks of electric and gas utility operating companies covering a 25-year period, 1915 to 1940, marked Exhibit C. These studies show individual common stock earnings and dividends per share of thirty-eight electric utility companies having assets of over six billion dollars, more than one-third of the assets of the electric utility industry. These companies and their stocks were not selected as a matter of hindsight but include all of the electric utility operating companies with bonds outstanding, rated in the first two grades, for which figures were available. The figures reflect unusual constancy and stability of earnings and dividends in these companies extending over a long period of years. Even

where there was substantial variation in earnings and dividends of particular companies, the investor could have achieved stability of income by spreading a small part of the higher dividends over the years in which dividends fell below average. Tabulations are also contained in these studies which show average investment yields on several of these common stocks, assuming that purchases were made at different points in the time series and held for investment from that time through 1940. These average yields proved to be relatively high over long periods of time.

In connection with these studies, I wish to point to the unusual investment opportunities in this field. The enforcement of Section 11 of the Public Utility Holding Company Act by the S.E.C. is bringing about integration and simplification of the electric and gas utility holding company systems. In this process, many excellent operating utility companies are going to be cut loose from holding company moorings. This means that common stocks of operating utilities heretofore held by holding companies will be sold publicly on the markets or will eventually be traded on the markets after exchanges with senior security holders in the holding companies have been effected. Heretofore, due to holding company policies, there has been a relatively small number of utility common stocks available on the market. Thus, a great new field of high-grade equity stocks is opening up.

The data that I have submitted on electric and gas utilities bears out the excellent investment opportunities afforded by some of these

common stocks. It is the considered opinion of the investment banking firm of Lazard Freres and Co. in a recent publication entitled "A Case for Electric Utility Company Equities", that weighing all factors, and barring certain contingencies, selected common stocks of electric operating companies "justify confidence . . . not primarily for any speculative appeal but for their attractiveness as to yield and as stable income - producing investments." The S.E.C. is exerting every effort to correct some of the lop-sided capital structures and unsound financial practices of these operating companies so that they will be healthy, independent utilities. As the capital structures and financial policies of these operating companies are straightened out in accordance with principles of sound finance, common stocks in these companies should prove to be more attractive than ever. It is well to keep in mind, however, that ownership of 10% or more of the voting securities of any electric or gas utility will prima facie cause the owner to be considered a holding company subject to regulation under the Holding Company Act. Ownership of 5% of the voting securities in any electric or gas utility will render the owner an affiliate subject to limited regulation under the Holding Company Act. It would probably be the better part of wisdom for life insurance companies to limit their purchases of utility common stocks with these factors in mind.

3. The experience of other investing institutions in common stocks affords valuable comparative data. Many fire insurance companies have had considerable experience in common stock investment. Since Mr. Dwight C. Rose, who is particularly expert in this field, is scheduled to appear

before this Committee, I prefer to leave with him discussion of the fire insurance company experience. In addition, I believe that the investment experience in common stocks by some of our endowment and educational institutions, although not strictly comparable, is interesting.

*Carnegie Corporation of New York*

Carnegie Corporation of New York, a foundation with approximately $150,000,000 in assets, had a problem similar to the life insurance companies, which it met by investing a portion of its assets in common stocks. This foundation was established by Andrew Carnegie for philanthropic purposes and under the terms of the gift, the Corporation has the responsibility of maintaining the principal of the institution. As announced by the Corporation in its Annual Report for 1933, the Corporation purchased common stocks for the first time in 1933 "to meet changing conditions by a corresponding change in the proportion of total capital placed in different types of investment." As of September 30, 1933, the Corporation had invested $5,000,000 in common stocks, increasing this to $25,000,000 by 1936 and $28,000,000 by 1940. The Corporation's investment experience is revealed in Exhibit D which I offer for the record.

The Corporation's policy is expressed in its report for 1937 wherein it is said: "Furthermore, the investments of the Corporation are themselves in a highly liquid condition. It should be added that although the policy maintained by the Finance Committee has been one of prudence, it has not been one of timidity . . . while these (common) stocks have uniformly been selected on the basis of the equities involved rather than the yield expected, this yield has proved to be most satisfactory. Indeed without it

the rate of income for the year, expressed in terms of the rate of return from the cost of all investments at the close of the year, would stand at about 3-1/2 percent instead of about 4 percent as at present."

That the policy of the Corporation has been successful is attested by the fact that its average income on common stocks for the years 1934 to 1940 has been 4.45% in addition to which the Corporation had realized profits of $2,500,000 less unrealized depreciation of $382,000 as of September 30, 1940.

The Corporation's policy with respect to common stock investment is expressed in its 1940 report as follows: "The investment in common stocks is limited by resolution of the Board to a maximum of $35,000,000 at cost, not more than 5% of this amount to be in the common stock of any one company and not more than 1% of the issued common stock of any one company to be included."

*Endowed Universities*

In a study made by the American Council on Education entitled "What is Happening to College and University Investments and Income?" by Mr. J. Harvey Cain, a trend similar to that in the Carnegie Corporation was found. In eight universities with endowments of more than $15,000,000 common stocks had increased from 9.2% of assets in 1926 to 29.3% of assets in 1940. The reason for this is probably best expressed in a letter from the investment officer of a large college:

"We have gradually increased our percentage of investments in common stocks, feeling that perhaps the difference in yield between this type of investment and the highest grade bonds is too wide at the present time. An equally obvious fact is that our percentage of bonds has

continued to decline, due to our policy of not replacing called bonds with high-grade, low-coupon, long-term issues. The increase in our income rate during the past year was due principally to larger dividends from common stocks."

Prior to 1936 Stanford University was prohibited from investing in stocks. After witnessing a decline in its rate of income, The Board of Trustees of the University petitioned a California state court, seeking a judicial determination of its power to invest the endowment funds of the University, particularly with respect to the investment of such funds in debentures and shares of stocks in corporations. The university's power was confirmed by the court. Thereafter, it invested in common and preferred stocks and as of August 31, 1939 had 10.5% and 10.2% of its assets in preferred stocks and common stocks, respectively.

## V

## SOME ARGUMENTS AGAINST COMMON STOCK INVESTMENT

Thus far, I have discussed the investment problem of the life insurance company, some of its broader effects on our economy, and some of the considerations, experience and data which favor liberalizing the New York Insurance Law to permit life insurance companies to invest in common stocks. Now I want to consider some of the principal arguments which have been advanced against common stock investment by life insurance companies.

1. A good deal has been said about the report of the New York legislative committee to investigate life insurance companies in the early 1900's. That Committee, often called the Armstrong Committee, recommended in its report in 1906 that the New York Insurance Law should be amended so as to prohibit life insurance companies from investing in common stock. The New York

State legislature adopted this recommendation and made it law. It still is law. The Armstrong Committee report has since been cited again and again for the proposition that life insurance companies should not be permitted to invest in common stock. Upon study of the Armstrong Committee report, I am not convinced that it stands irrevocably committed to the proposition for which it has been cited. At the time of the Armstrong Committee investigation the laws of the State of New York permitted investment by life insurance companies in stocks. Several of them owned common stocks. The Committee therefore based its recommendation upon investigation of the common stock investment practices of insurance companies then in effect.

It was the opinion of the Committee that the then existing laws had operated to permit life insurance companies "to engage indirectly in enterprises foreign to the purposes of their organization." Serious evils were pointed out. Through control of subsidiary corporations by means of stock ownership some life insurance companies had practically transacted the business of banks and trust companies. In addition, the life insurance companies had placed millions of dollars at the disposal of these banks and trust companies through the maintenance of inactive deposit accounts at low rates of interest. Stockholding relationships with banks and trust companies were used to carry irregular, hidden accounts and to further the selfish interests of individual interlocking officers. Life insurance companies had furnished their support to financial ventures through participation in underwritings of syndicates. There were speculative purchases of stocks by life insurance companies with a view to resale on a rising market. Many officers of life insurance companies,

through interlocking directorates and connections, had frequently been in a position to profit by these investment practices. The Committee showed particular concern about the dangers of undue capital and financial combinations through life insurance company purchase of the stocks of banks and trust companies.

It is noteworthy that the Armstrong Committee was not severely critical of the investment practice of purchasing stocks, as such, but condemned the abuses connected with the practice. Only a few arguments were advanced why the practice itself was undesirable. For instance, common stock investments were said to be fundamentally objectionable because they subjected the life insurance company to corporate liabilities as stockholders. The report also indicated that stock investments carried a concomitant responsibility to sustain the enterprise in which the insurance company had invested and perhaps even to undertake its management. In summary, the Armstrong Committee recommended that investment in common stocks by life insurance companies should be prohibited in order to remedy "many of the evils to which the investigation has directed attention."

Of course 1906 was not 1941. Many of our large productive corporations were just getting started then. Some were yet unborn. Investment tables in the Armstrong Committee report show that most of the common stock investments were in banks, trust companies, railroads and traction companies. Industrial securities were practically unknown, and utility securities were comparatively new. Many stocks were yet unseasoned. In fact, the Armstrong Committee report shows that some of the stock investments were promotional ventures. Our economy has matured greatly since those days. We have large, strong

corporations today with long-established earnings records. Many of the evils at which the Armstrong recommendation was aimed have been eliminated. Stock speculation in its more anti-social aspects has been outlawed and regulated by government administrative authorities. The activities of interlocking directors and corporate insiders have been bathed in broad daylight by government investigation and regulation. Our modern corporation laws, with few exceptions, no longer provide for stockholder's liability. The growth of state insurance supervision has lessened the opportunity for irregular and hidden accounts through stock subsidiaries of life insurance companies. Financial cartelization through combinations of banks and trust companies with life insurance companies is not likely in our present economy. Investment practices of insurance companies today are better regulated and subject to greater disclosure requirements than at any previous time. Since many of the evils which the Armstrong Committee sought to eliminate no longer exist or appear to be adequately regulated, the underlying reasons for the blanket prohibition upon common stock investment then advocated have disappeared.

As the country has expanded during the last 35 years, so must our conception of investments expand. The Armstrong Committee pointed out some of the abuses in stock investments and obviously its findings were based upon conditions known to it at the time of its investigation. It was never meant as an inflexible rule of investment for all times.

2. Some persons contend that life insurance company purchases of common stock may give them control and influence over corporate management in many utility and industrial companies and thereby tend towards undue

concentration of power. I believe that undue concentration of power in our economy is socially undesirable. Therefore, I think that there is a good deal of force to this argument. But at the same time, I believe that it is not entirely realistic.

By virtue of their tremendous aggregations of assets, even though invested in bonds today, the life insurance companies can and do exert a considerable degree of control and influence over American utilities and industry. As the largest institutional long-term creditor in our American economy, their investment policies have very real force. It is undeniable that the power to invest the tremendous assets of the life insurance company enables officers of these companies to exert influence over corporate management. Indeed, their decisions with respect to investments are of such great moment that they often influence actions of the whole business community. It is well to remember too that a powerful creditor like the large life insurance company exercises such great influence over the debtor, particularly in bad times, that it may border upon control of management.

There are more concrete evidences of life insurance company control and management today. Foreclosures on mortgages held by life insurance companies have thrust them into a position of control and management. Many life insurance companies by virtue of their bondholdings have found themselves in the position of managers of companies in bankruptcy reorganization. The real estate ventures of some of the large insurance companies are in effect equity interests, and insurance companies have controlled and actively managed many of them.

Some persons seem to regard the life insurance company as a passive by-stander in a creditor status with respect to the corporation in which

the insurance company has invested. Of course, as a matter of fact, officers and directors of life insurance companies with huge bondholdings do take an active interest in what corporate management is doing. The earning capacity of the corporation which enables it to pay interest upon its bonds depends largely upon the efficiency of its management. It is, therefore, the natural function of a life insurance company which invests the funds of other people to maintain a continual and alert interest in what corporate management does.

In short, life insurance companies are powerful influences in the American economy today. They actually manage and control many businesses. Although I believe that it is undesirable for life insurance companies to engage in management of utility and industrial enterprises, I doubt whether limited investment in common stocks will aggravate the problem. Certainly the recorded experience of many investment companies and fire insurance companies shows that common stock ownership does not necessarily involve control and management. At the same time, I believe that limitations upon the amount of common stock investments by life insurance companies and implemented supervision by the state insurance department should be considered by this Committee in order to guard against undue concentration of control in life insurance companies.

3. Some point out that since the life insurance company is in need of an assured steady return, it should not invest in common stocks since the dividends on such stocks are not required by contract to be paid at definite intervals. Bonds on the other hand carry fixed charges and therefore a steady income. The truth of the matter is that, if there are no earnings, all the language in the bond about fixed charges is not going to

make any difference. Similarly, no matter what the language is in the share of common stock, if the earnings are there and the health of the corporation permits, common stock dividends are going to be paid out regularly. The records of some of the high-grade common stocks which I have submitted for the record bear out that regularity and dependability of dividends can be equal to that of interest on bonds. Income-producing securities are dependent upon continued earning power of an enterprise, and not upon paper contract terms.

Along the same lines, some believe that life insurance company investments should be in securities with maturity dates approximating those of the maturity dates on its policies. This has meant adherence to bond investment because stocks have no maturity dates. Of course, this argument overlooks some important factors. The T.N.E.C. investigation revealed that as of the end of 1938, demand liabilities for 20 companies were about 9-1/2 billions as against 12 billions of total liabilities including policy reserves. These demand liabilities are from cash surrender and loan options provisions of the policies which are exercisable at the option of the policyholder or beneficiary. In addition, the T.N.E.C. report shows that during a studied period more than 75% of the policies written terminated by modes different from those provided in the policies. Moreover, examination of the maturity dates of bonds held in life insurance company portfolios reveals no particular correlation of these maturities with those on presently outstanding insurance policies. Maturity dates of policies are therefore not particularly important in considering the investment problem of the life insurance company.

RESTRICTIONS ON COMMON STOCK INVESTMENT

I wish to make clear that I do not recommend unrestricted and unlimited investment by life insurance companies in common stock. I believe that such investment should be in seasoned common stocks with established earnings records, and not in stocks of new and untried ventures. Reasonable limitations upon common stock investment by life insurance companies should be imposed. On the whole, however, I believe that it is not advisable to write many restrictions on common stock investments into the New York Insurance Law because sound investment requires flexibility and lends itself with great difficulty to rigid statutory molds. The legal list, in many ways, constitutes frozen judgment. It may be more practicable for the state legislature to lay down flexible statutory standards and allow the New York department of insurance to exercise considerable discretion in permitting common stock investments by life insurance companies.

There are detailed problems of technique and mechanics of limitation of common stock investment by life insurance companies which I do not have the time to discuss here. However, I suggest that this Committee consider carefully recommendations that:

(1) No more than a limited percentage of the total assets of a life insurance company should be invested in common stocks.

(2) No more than a limited percentage of the fund available for common stocks should be invested in the common stock of any single company.

(3) No more than a limited percentage of the common stock of any single company should be owned by a life insurance company.

(4) No more than a limited dollar amount should be invested in the common stock of any single company.

(5) Common stock eligible for life insurance company investments should be listed on the national securities exchanges, so that information regarding the insurance companies' securities investments may be made publicly available in the public interest.

## VII

## SUMMARY AND CONCLUSION

The life insurance companies are confronted today with a grave investment problem. A mounting stream of funds is being entrusted by the public to their care. This has created a pressing demand on their part for high-grade bonds in order to enable them to protect these funds and meet their policy guarantees. Meanwhile, there has been a fast shrinking supply of high-grade corporate bonds and a declining rate of return on bond investments. As a result, the maintenance of essential safety reserves to protect insurance company policyholders is already endangered. And guarantees on policies which must be met are frequently higher than the rate of return the life insurance companies earn on their investments. These conditions are becoming increasingly acute. Should these conditions continue, efficient operation of life insurance companies and protection of the funds of their policyholders will be seriously impaired.

New investment outlets for the life insurance companies must be found. It is clear that unless the laws restricting life insurance company investments are liberalized, serious consequences adverse to the interests of the life insurance companies, their policyholders, and the general public will ensue.

Many high-grade common stocks are safe, sound and sane investments. Yet life insurance companies which need new investment outlets are prevented by statute from investing in seasoned common stocks. Of course the safety of life insurance company investments must at all times be a matter of paramount concern. I believe, however, that limited investments in high-grade common stocks will foster greater safety of life insurance company investments. Common stocks will not only provide a necessary outlet for investment of life insurance funds, but this equity money will also put new blood in American industry and assure the basic soundness of present life insurance company bond investments.

In conclusion, therefore, it is my recommendation that this Committee, recognizing the serious problems which exist, will urge amendment of the New York Insurance Law to permit life insurance companies to invest in common stocks.

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