HOUSING, INTEREST RATES AND THE COST OF LIFE INSURANCE

TESTIMONY OF MR. LEWIS W. DOUGLAS, PRESIDENT OF THE MUTUAL LIFE INSURANCE COMPANY OF NEW YORK, BEFORE THE SENATE BANKING AND CURRENCY COMMITTEE ON DECEMBER 17, 1945 ON THE WAGNER-ELLENDER-TAFT BILL (No. S-1592)

Printed by the Life Insurance Investment Research Committee, a joint undertaking of the American Life Convention and the Life Insurance Association of America.

FOREWORD

Mr. Lewis W. Douglas, President of The Mutual Life Insurance Company of New York, recently appeared at the hearing of the Senate Banking and Currency Committee, at the invitation of the Life Insurance Investment Research Committee, on the Wagner-Ellender-Taft Bill. This bill proposes among its other provisions, a substantial reduction in the rate of interest on certain types of mortgage loans as a means of stimulating new building.

Mr. Douglas took this occasion to explain to the Senate Committee the significance of the interest rate to the 71,000,000 policyholders, the 27,000,000 American families who have acquired security through taking out life insurance. He showed how the precipitate fall in the rate of interest during the course of the last fourteen years had increased enormously the cost of life insurance.

He pointed out (1) that the bill was deficient in that it aggravated the consequences of the declining rate of interest to this large segment of the American public and, (2) that it was completely indifferent to the fundamental problem of housing, namely, the cost of land, of construction, of materials, and the unit cost of labor.

In preparing and presenting this testimony, Mr. Douglas has performed a real service in the best interests of policyholders and the public. Because of the great importance of the questions involved, the Life Insurance Investment Research Committee has obtained Mr. Douglas' permission to publish his testimony for the information of interested persons, governmental agencies and financial institutions.

Mr. Douglas has asked me to thank all those who contributed so generously of time and material in the gathering of the data.

JOHN S. SINCLAIR, *Chairman*

Life Insurance Investment Research Committee

HOUSING, INTEREST RATES AND THE COST OF LIFE INSURANCE

I

MAY I express my gratitude to the Committee for inviting me to appear before it and to discuss, candidly and frankly, certain phases of the housing legislation which it is now considering.

It would require the most ingenious man to exaggerate the meaning of housing—its immediate and future importance to the American people.

The immediate significance is, I think, now unmistakable. The returning servicemen and women and their families, the war workers migrating to places where peacetime factories are now beginning to hum or will begin to hum, face a grave shortage of housing facilities. Unless we deal promptly with this critical situation, we will, I fear, experience, in some measure at least, mounting prices of homes, rising rentals and widespread inconvenience, if not privation. One of the alternatives to rising rent prices is to clothe the Government with authority arbitrarily to suppress prices and hold down rents. But this will not cure the deficiency in housing accommodations. It will not provide homes that do not exist.

Housing's Importance

Stretching out over the future years, housing, in dramatic fashion, is of equal importance to the American people. There is, I believe, a relationship between the quality of the quarters in which men and women live and the sense of responsibility they, as citizens, possess.

It is certain that clean and sanitary housing facilities and a clean and wholesome environment tend by themselves, though they are not by any manner of means the only factors, to reduce the amount of disease and the volume of crime, and to improve health, and to create a more wholesome life.

During the last quarter of the last century, one of the important events in our economic history which resulted in a high level of industrial activity, accompanied on the whole by full employment, was the construction of the railroad systems that were to span the continent. During the 1920's, the development of the automobile industry and the expansion of the electrical generating and distributing systems played a similar role.

It is not an exaggeration to say that housing, if undertaken in an appropriate economic environment and under a legislative mantle of encouragement, can play the same role during the next decade, perhaps even during the next quarter of a century, that the construction of the railroads, the development of the automobile industry, and the expansion of the public utilities have played in the past. Hence, any legislation which deals with the problem of housing is of pressing significance, now and in the future.

Life Insurance and Housing

Life insurance companies, as you know, are deeply concerned with the general health of the people of the country. They realize the relationship between living conditions and disease, or the absence of disease. They realize the part that housing, if undertaken in an appropriate environment, can play in providing, or going far toward providing, full employment and full production during the coming year, and they realize that housing has been throughout the years, and should continue to be, in one form or another, a very appropriate and legitimate outlet for the investment of the funds which have been placed in their hands as custodians by 60 to 70 million policyholders.

I do not want to bore you with a carefully documented statement which would demonstrate beyond doubt that life insurance companies have in the past looked upon housing as an appropriate and prudent field for the investment of funds. **Perhaps, however, you will be interested to know that at the end of last year the insurance companies held approximately one-third of all the FHA mortgages insured under Title II, Section 203.** This amounted to about one billion dollars. They held

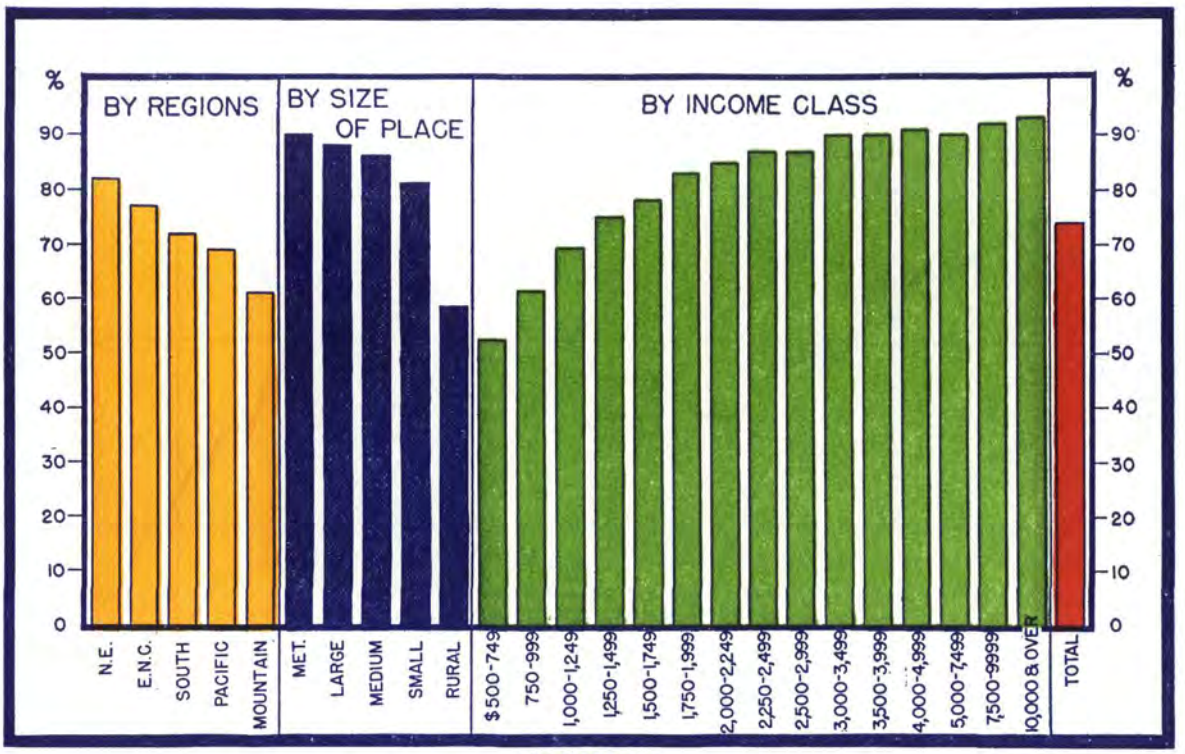


EXHIBIT I

PROPORTION OF TOTAL FAMILIES
PAYING LIFE INSURANCE PREMIUMS — 1935-1936

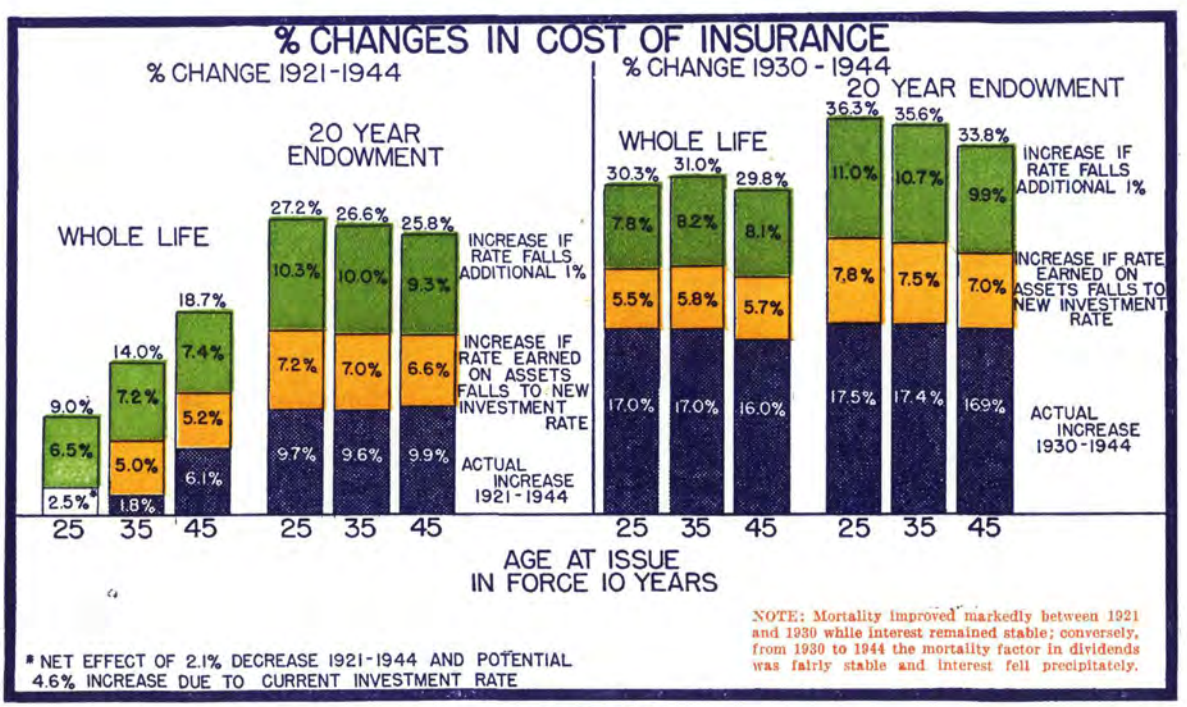


EXHIBIT II

PER CENT CHANGES IN COST OF INSURANCE

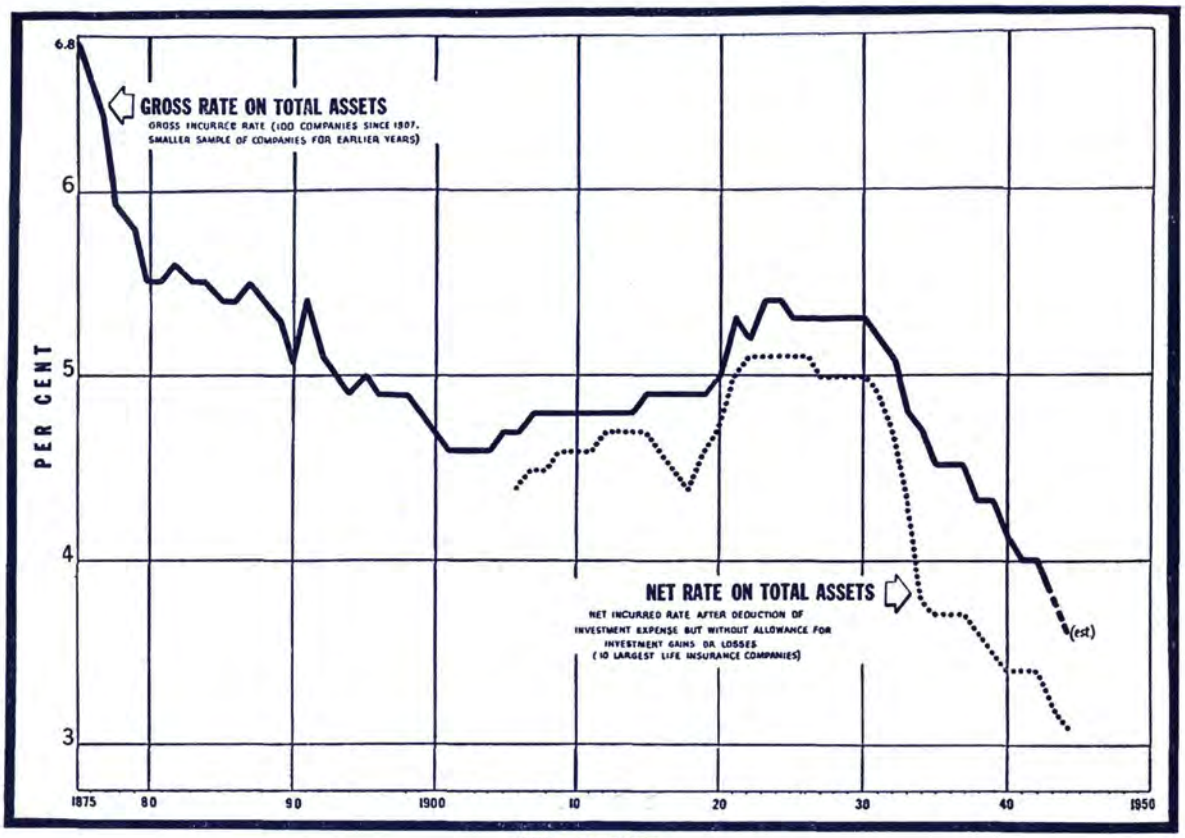


EXHIBIT III

INTEREST RATE EARNED BY U. S. LIFE INSURANCE COMPANIES SINCE 1875

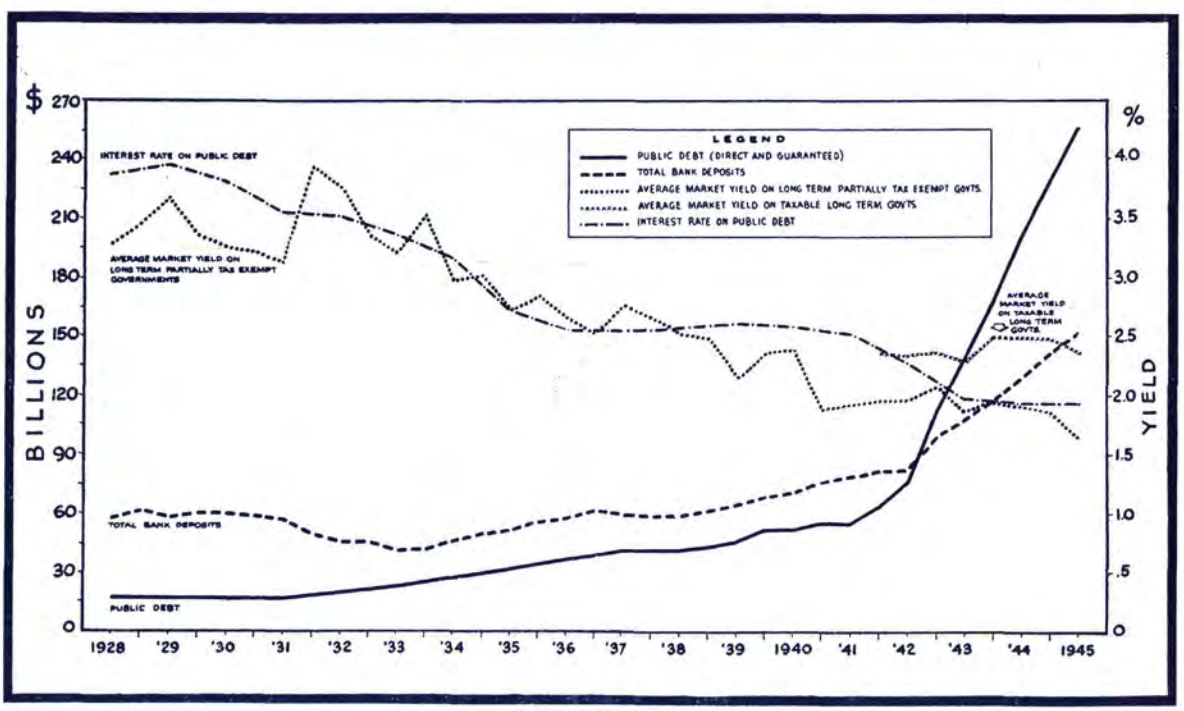


EXHIBIT IV

RATES ON GOVT. SECURITIES, PUBLIC DEBT AND TOTAL BANK DEPOSITS

non-farm mortgage loans in the total amount of about $5.6 billions. Many millions were secured by single family residences which were not insured under the FHA. Many millions were on apartment houses of various kinds.

The sum of all the non-farm mortgages represented about 14% of all the funds which the life insurance companies held in custody for their policyholders, and accounted for over 18% of all the non-farm mortgage debt.

Effect on Public Welfare

The life insurance companies are, I believe, as enthusiastic about the possibilities of providing homes for the American people as is any group in the country, for housing offers a much needed outlet for the investment of the funds of its policyholders; it is related to the general health of the public which is of such a vital concern to life insurance; and it is irrevocably linked with a high level of industrial activity and the general public welfare.

In a broad sense, certain provisions of the bill under consideration affect the public interest. In a somewhat narrower sense they have important implications and consequences for those who have, through life insurance, acquired security for their old age or an estate for their heirs.

This is not a small group. It is not a wealthy group. It is a group consisting principally of middle and lower income people — the frugal, the industrious and the diligent people of the country. I have had a series of charts prepared which I hope, graphically and more clearly than would otherwise be the case, present many of the considerations I would like to lay before you.

Life Insurance Widely Held

The first chart (Exhibit I, page 5) is an analysis of the group, the exceedingly large group, affected by certain of the provisions of this bill. **The study of consumer incomes and expenditures made by the National Resources Committee, the Bureau of Labor Statistics and the Bureau of Agricultural Economics reveals that in 1935-1936, 74% of all the families in the United States held life insurance and that 86% of the families paying premiums for life insurance received incomes of $3,000 a year or less.** Chart No. 1, which is reconstructed from the study to which I referred, discloses that even in the lowest income brackets of our population, that is to say, with annual incomes ranging from $500 to $750, more than one-half of all the families carry life insurance; in the $1,500 to $1,750 income bracket nearly 80% of the families are paying for life insurance protection. You will observe from the chart that the percentage of families owning life insurance rises very rapidly from 52% in the $500-$750 income bracket to 85% in the $2,000 to $2,250 income bracket and that the trend thereafter to the bracket embracing the $10,000 group rises slowly from 85% to approximately 93% of all the families. This entire group is, therefore, an exceedingly large one and represents a very preponderant and dominant part of the families of the country. Only an exceedingly small percentage of the families of the country are not represented in this group.

The geographical distribution of families carrying life insurance indicates likewise a broad distribution, ranging from about 60% of all the families in the Mountain States to more than 80% in the New England States. As between small and large communities, the coverage is likewise startlingly broad. For example, the chart reveals that in the metropolitan areas nearly 90% of all the families have life insurance and that the percentage declines to about 60% in the rural districts. Thus, in terms of percentage of the family population, in terms of geographical distribution and in terms of distribution in various sized communities, the group of which I am speaking and which is affected by certain provisions of this bill is a singularly significant and important one in American life.

Cost of Security

A review of the cost of security obtained through life insurance during the course of the last quarter of a century discloses clearly that it has, for the average American family, risen markedly, principally during the course of the last 14 or 15 years. This is particularly true of policies in which the interest element or investment factor predominates. The cost of endowments and annuities, which represent a type of policy purchased or carried by those who wish to provide a nest egg for their later years, has risen exceptionally.

Chart No. 2 (Exhibit II, page 5) represents the combined performance of 11 mutual companies that account for 13¼% of the total insurance in force. [This experience is characteristic of the busi-

ness.] It shows how the costs of ordinary life policies issued at specific ages and endowment policies issued at the same ages have risen since 1921 and, thus, adversely affected the economic status of the large number of people to whom reference has been made. [*The charts shown at the hearings displayed changes only from 1921 to 1944. Mr. Douglas emphasized before the Committee that if the period 1930-1944 were taken, the increase in cost would be very much greater. This is shown by the charts herein which display changes both from 1921 to 1944 and from 1930 to 1944.*] It reveals that the actual increase in the annual cost of life insurance has ranged from 1.8% on an ordinary life policy issued at age 35 and in force 10 years, to 9.9% in the case of an endowment policy issued at age 45 and in force 10 years. But this is not a full reflection of the rise in costs.

Old Investments a Buffer

As old investments made at much higher rates than presently prevailing ones pass out of the portfolios, and are replaced by investments yielding current rates – a process which is progressing with alarming speed – the cost rises. If and when all old investments have been replaced, the cost as compared with 1921 figures, increases 6.8% on an ordinary life policy issued at age 35 and in force 10 years, and 16.5% in the case of an endowment policy issued at age 45, and in force 10 years.

And if and when the rate on new investments falls another 1%—a movement which is now under way and to which this bill would add momentum—then the increase in cost of the ordinary life policy would be more than 14% and of the endowment policy over 25%. [This illustration presumes that the mortality factor and the operating ratio remain constant.]

If single premium policies were taken as examples, the increase in cost would be substantially greater. But because single premium policies do not constitute a predominant part of the total amount of life insurance in force, it would be unfair and misleading to use them as examples.

By themselves and standing alone, while these trends of costs are very disturbing, they fail to represent the real and singular significance of the interest rate to insurance. When viewed in their context and in the light of the full importance of interest to insurance, they reflect a serious condition.

Rising Cost of Insurance

The decline in the rate of interest, continuous and steady and the precipitant fall in the rate during the course of the last 14 years, is the sole and exclusive explanation of the striking rise in the cost of insurance.

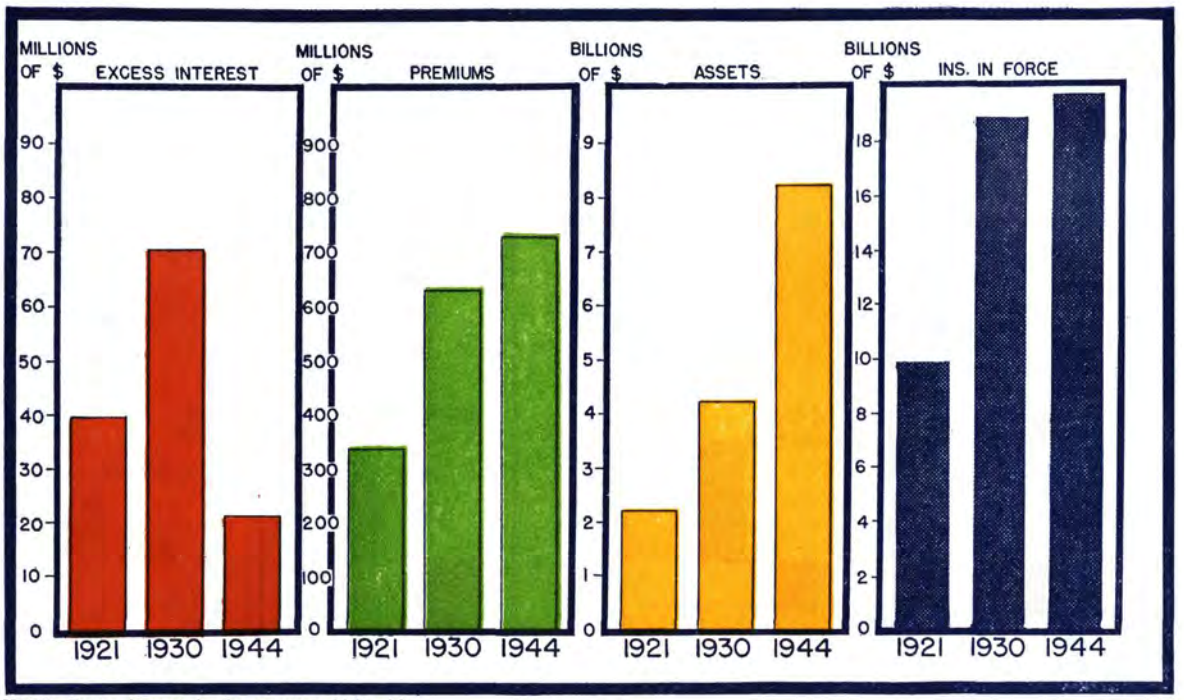
At this point, let me call your attention to Chart No. 3 (Exhibit III, page 6) which shows the gross interest rate earned by life insurance companies since 1875. You will observe that throughout the Twenties the rate remained approximately steady, but that beginning in 1930 the rate earned plummeted downward. This was not due entirely to a decline in the rate of interest, for during the first 3 or 4 years of the Thirties the decline in the rate of interest earned, was aggravated by the default in interest payments on many securities, bonds and mortgages. On the other hand, during 1942 and 1943 the decline in the rate of interest earned, was retarded by the payment of accumulated interest on securities that had theretofore been in default. Nevertheless, the chart is a reasonably fair representation of the effect of the decline of the interest rate on investment earnings of insurance companies.

Interest Rate Trends

Chart 4 (Exhibit IV, page 6) shows the actual interest rate on the public debt and on long-term governments since 1928. This is perhaps a truer reflection of the decline in the interest rate than almost any other chart which I could introduce, except possibly a chart on corporate issues which, as you would expect, parallels generally the trend of the yield on long-term governments. You will observe in Charts No. 3 and 4 that the gross rate earned by life insurance companies since 1930 has fallen from 5.3% to approximately 3.6%; while the rate on governments has fallen from approximately 3.2% to somewhere in the vicinity of 2%. (I say somewhere in the vicinity of 2% because an adjustment must be made between yield and tax-exempt governments still outstanding in 1945 and the taxable governments outstanding at the same time. You will recollect that generally government bonds were not taxable in 1930 and that new issues became taxable in 1941.)

Accordingly, it is, I think, beyond the area of debate to say that the decline in the interest rate and, as a result, the shrinkage of earned income of life insurance companies have been marked and profound.

While speaking of interest rates, may I remind



NOTE: Excess interest is the amount which with gains from other sources constitutes the sum which may be paid to policyholders in the form of dividends.

EXHIBIT V

11 COMPANIES, REPRESENTING 13¼% OF TOTAL INSURANCE IN FORCE AND 20% OF TOTAL ASSETS

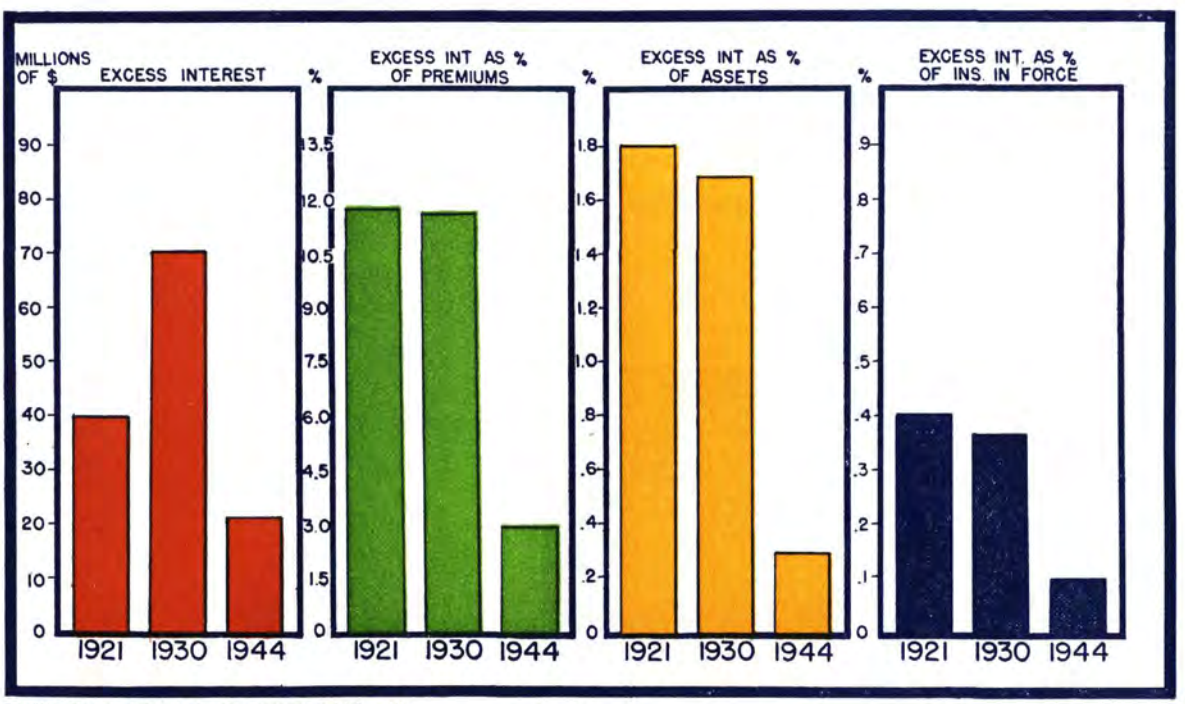


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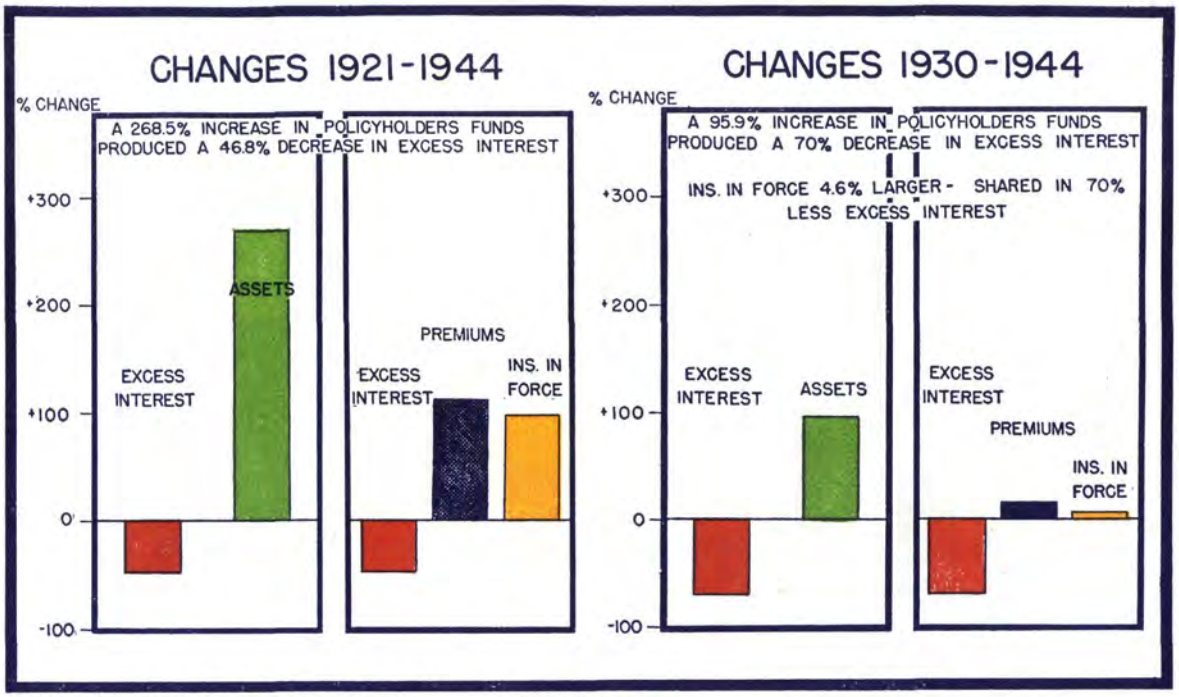
EXHIBIT VI

11 COMPANIES, REPRESENTING 13¼% OF TOTAL INSURANCE IN FORCE AND 20% OF TOTAL ASSETS



NOTE: Excess interest is the amount which with gains from other sources constitutes the sum which may be paid to policyholders in the form of dividends.

EXHIBIT VII

CHANGES 1921 TO 1944 AND 1930 TO 1944

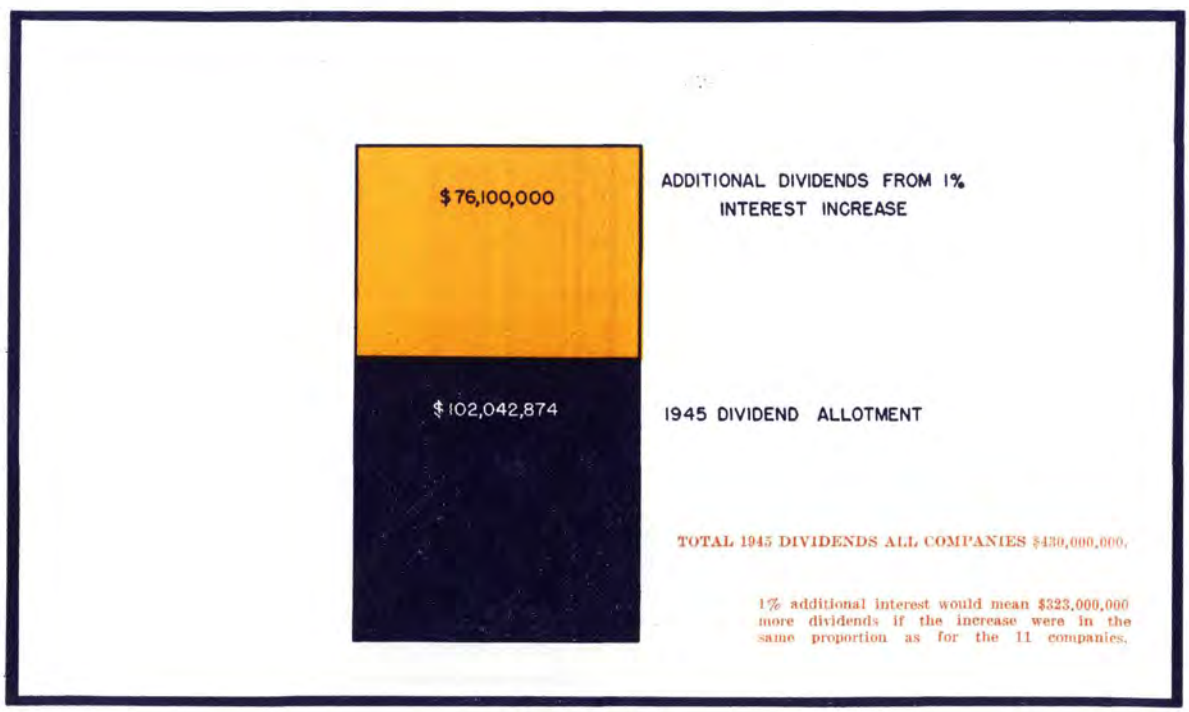


EXHIBIT VIII

EFFECT OF INTEREST CHANGE ON DIVIDENDS

(Eleven Companies)

you of a fundamental distinction between a life insurance company and a bank. The earnings of a bank need not be seriously or adversely affected by a decline in the interest rate, if at the same time the decline in the rate is accompanied by an increase, or a corresponding increase, in deposits, for the bank need not put up additional capital. A life insurance company, however, and the amount of its investment income available for refund to policyholders, is very seriously affected by a decline in the interest rate. For a life insurance company must each year add to its capital in the form of additions to its policy reserves. If these increments were not made, the life insurance company would be unable to meet the death claims of its policyholders when they fall due. It is only by making additions to reserves out of premiums and investment income, and the interest compounded upon those reserves each year, that a life insurance company is able to discharge its obligations, and pay its claims when they are presented to it. It is because of this characteristic of the life insurance institutions that a decline in the interest rate affects it and its policyholders so violently.

Decline of Insurance Earnings

Chart 5 (Exhibit V, page 9).* In 1921 when these same eleven companies had $9.9 billions of insurance in force and $2.2 billions in assets, their funds earned $40 millions over and above the minimum amounts required to maintain reserves. [This amount is known as excess interest and with gains from other sources constitutes the sum which may be paid to policyholders in the form of dividends.] In 1944, with about double the volume of insurance in force, and assets over three and a half times as large, the companies had only $21 millions above their requirements. (See Chart 6, Exhibit VI, page 9).* Excess interest represented a return of 1.8% on admitted assets in 1921; in 1944 it was only 0.3%, a decline of about 83%. In 1921, excess interest was equal to 0.4% of the insurance in force; in 1944 the percent was only a quarter as large. Similarly, excess interest as a percent of premiums dropped from 11.8% to 2.9%—a fall of 75%.

(See Chart 7, Exhibit VII, page 10).* A 268.5% increase in policyholders' funds produced a 46.8% decrease in excess or refundable interest. A volume of insurance in force 98.5% larger was accompanied by a 46.8% smaller amount of excess interest.

This trend of course, does not imply impending insolvency. The striking decline in interest earnings does mean, however, an increase in the cost of security to the large group that owns life insurance. The increase applies both to new and existing business. (See Chart 8, Exhibit VIII, page 10.) If the net interest rate earned by these companies in 1944 had been 1% higher than it was, their dividend allotment [to policyholders] would have been increased from $102 millions to $178 millions, or by 75%. If this ratio holds for all companies, it would mean that 1945 dividends [to policyholders] of $430,000,000 could be increased by $323,000,000.

This is a model of extreme understatement. For if the interest rate were 1% higher, the many, many millions of dollars that are being set aside annually to strengthen reserves in efforts to compensate for the fall in interest rates, would be available for refund to the policyholders.

Therefore, if the interest were 1% higher, the amount of dividends paid to policyholders would be increased probably by as much as, if not more than, 100%—or for all companies by as much as $430,000,000, and the cost of security would be reduced by that much.

II

Long Term Nature of Life Insurance Commitments

THE decline in the interest rate is not a mere temporary and passing phenomenon of immediate significance without future implications. Life companies' contracts extend far into the future – in many cases for more than three-quarters of a century, and the reserves held

*Charts 5, 6 and 7 as presented at the hearings showed only 1921 and 1944, but it was stated that more significant changes had occurred between 1930 and 1944. The charts herein show all three years.

against them remain equally as long. These commitments made in the past will continue for a long time to represent the major portion of the life companies' obligations. Because of the fact that beneficiaries under existing policies usually have the right to take the proceeds in the form of an annuity, or to leave funds on deposit at guaranteed rates of interest, these obligations will extend well into the twenty-first century.

Life companies, accordingly, make long term investments on which prevailing low rates will be projected forward for a protracted period of time. In the company of which I am president, there will still be funds requiring interest in the year 2000, resulting from insurance in force outstanding at the present time. Chart No. 9 (Exhibit IX, page 13) clearly reveals this.

One more word on interest as it affects a life insurance company. It is important to understand that there is a wide difference between the gross rate and the net rate after investment expenses. If net rates are considered, the figure for net investment return on all assets has fallen from about 5.10% in the early 1920's to about 3.10% at the present time.

If you will turn back to Chart No. 3 you will observe the wide difference between net rate and gross rate.

American Families Penalized

The further reduction in interest rates effected through certain provisions of the Bill you are now considering, it seems to me, will be adding arbitrarily penalty upon penalty to a group of about 27,000,000 American families, by increasing still further the cost of family security to them.

I hope these graphic representations have revealed the truth of this conclusion and the vital significance of the interest rate to the extraordinarily large part of the American population that has obtained, through life insurance, security for their older years and financial support for their family.

The question I lay before you is whether, as an offset to the serious consequences already having been caused by the reduction in the interest rate for this predominant part of the American population—and in view of the more serious consequences that the future holds for them—there will be made any contribution of significance to the objective of providing good quality housing at reasonable prices by the further reduction of the interest rate which this bill contemplates.

The housing problem consists of two parts. There is the immediate one of the next year or two, when housing shortages in many areas, suitable or appropriate to the income of various groups, must be diminished. The demand is very great, the supply is now very short. New housing construction is the only answer to this part of the problem.

Building supplies, labor in the factories that produce building supplies and, of much less importance, construction organizations and site labor, are the factors which limit our ability to increase the supply of suitable housing facilities. There are no other limiting factors. There is an ample supply of credit—indeed, there is an ample supply of everything else that affects housing.

The reduction in the rate of interest is much more likely to add a further restricting factor than it is to add encouragement to housing. The same is true about increasing the coverage of mortgages and extending the period of amortization.

Security, Housing Costs Higher

These financial devices; i.e., lower interest rates and extended periods of amortization, will produce two results, and I shall be surprised if you wish to accomplish either one. The first is to damage further the personal security in the United States by making life insurance more expensive and putting further and serious pressure on the institutions which provide it. Secondly, it will make housing more expensive for the returning veterans and American people generally and cause their financial burdens to increase.

This latter results because, through making credit easier, the bidding for limited supply of housing is made more spirited. Prices of houses and rentals, already at a high level, will thus be driven higher. Against these pressures, price controls, while they may provide some relief, are not likely to be able to hold the line. They will not provide homes.

But beyond this, these financial devices will impose a larger financial burden and a greater risk of loss to the purchasers when supplies become less tight. These are the two results that I believe will be

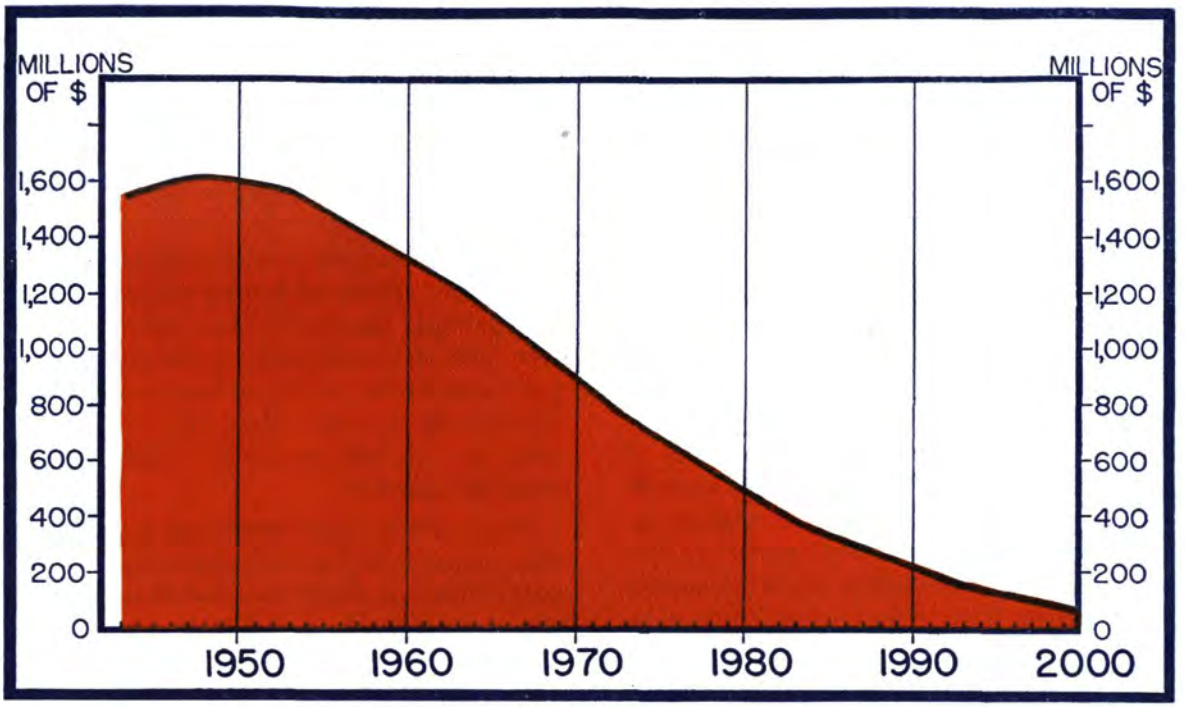


EXHIBIT IX

FUNDS WHICH MUST BE INVESTED AT INTEREST

(Existing Business — One Life Ins. Co.)

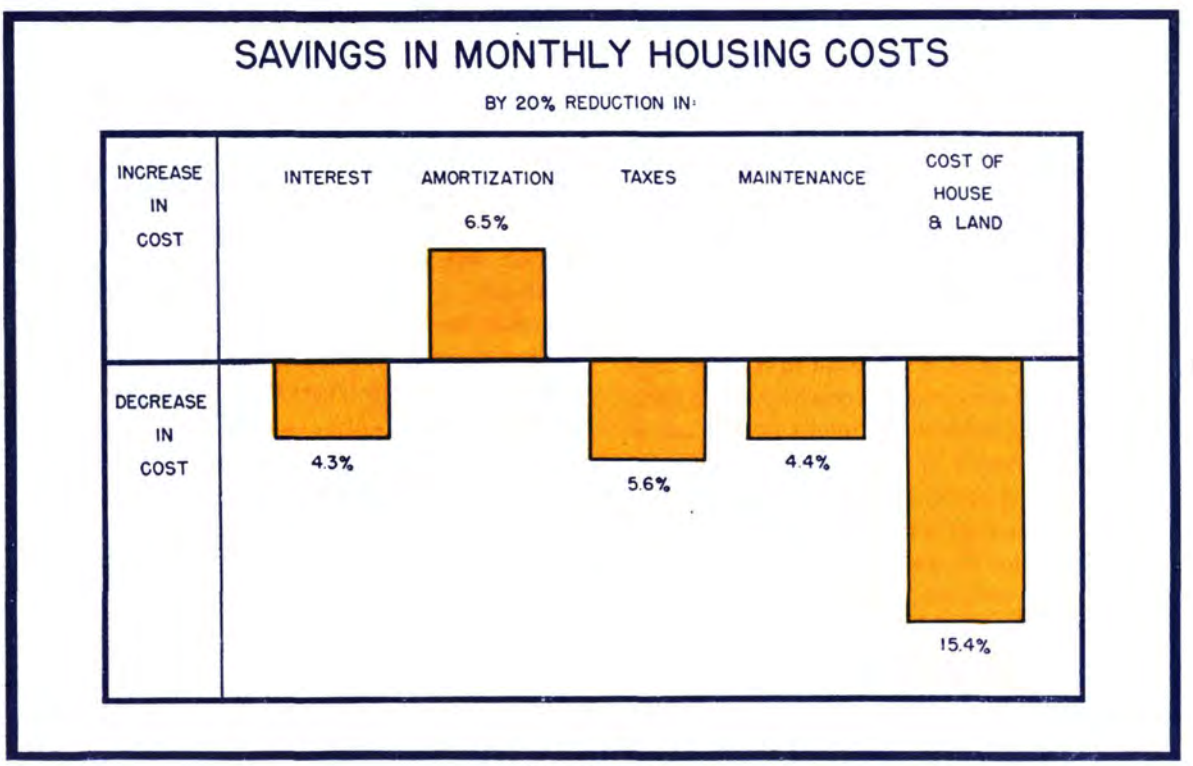


EXHIBIT X

SAVINGS IN MONTHLY HOUSING COSTS

achieved by the financial devices which the bill contemplates.

Different Approach Required

The conclusion seems to me to be inescapable that financial devices alone will not add one shingle to a roof, not one board to a floor, not one room to an existing structure, not one house on a vacant lot. The problem is a different sort of a problem.

The second part of the housing problem carries forward into the distant future. I have already indicated how important to our future, in terms of health, of crime, of civic responsibility, in terms of industrial activity and employment, housing can be during the ensuing decade or even quarter of a century. But it can play its role fully only if the auspices are appropriate. It can be strangled and throttled by inappropriate auspices.

This leads me to what appears to be the guts of the problem, and that is the cost of land and materials and the unit cost of labor.

The National Housing Agency has completed a study which I have graphically represented on Chart 10 (Exhibit X, page 13). This chart shows that a reduction of 20% in the interest on a mortgage will reduce the cost by only 4.3%. It shows that extending the maturity of the mortgage 20% will increase the cost of a house by 6½%, through an extension of the period in which interest is due and thus through increasing the total amount of interest payable. Accordingly, the financial devices suggested in the bill will increase the cost to the home owner.

How to Obtain a 25% Reduction

On the other hand, a reduction in taxes of 20% has the effect of decreasing the cost by 5.6%. A similar reduction in maintenance results in a decline in cost of 4.4%. And a 20% reduction in the cost of materials for the house, land, and unit labor cost—and this is the significant part of the study — produces a reduction in cost of 15.4%. If the cost of taxes, maintenance, supplies, land, and unit labor costs, could be reduced by 20%, the cost of housing would be made lower by 25% to all those who buy homes.

Much the same results apply to almost any type of housing. The N.H.A. has itself prepared a chart, which I have here, (Chart No. 11, Exhibit XI, page 15) and which confirms everything I have said as to the significance and importance of the cost of materials, land, and so forth.

This is the heart, the bone, and the sinew of the problem, and I doubt that housing will play the part that you would like to see it play—and indeed that every well-intentioned person would like to see it play — unless the problem of costs is adequately, appropriately, and wisely solved. This bill, I am confident, not only fails to solve it; I think it almost completely ignores it.

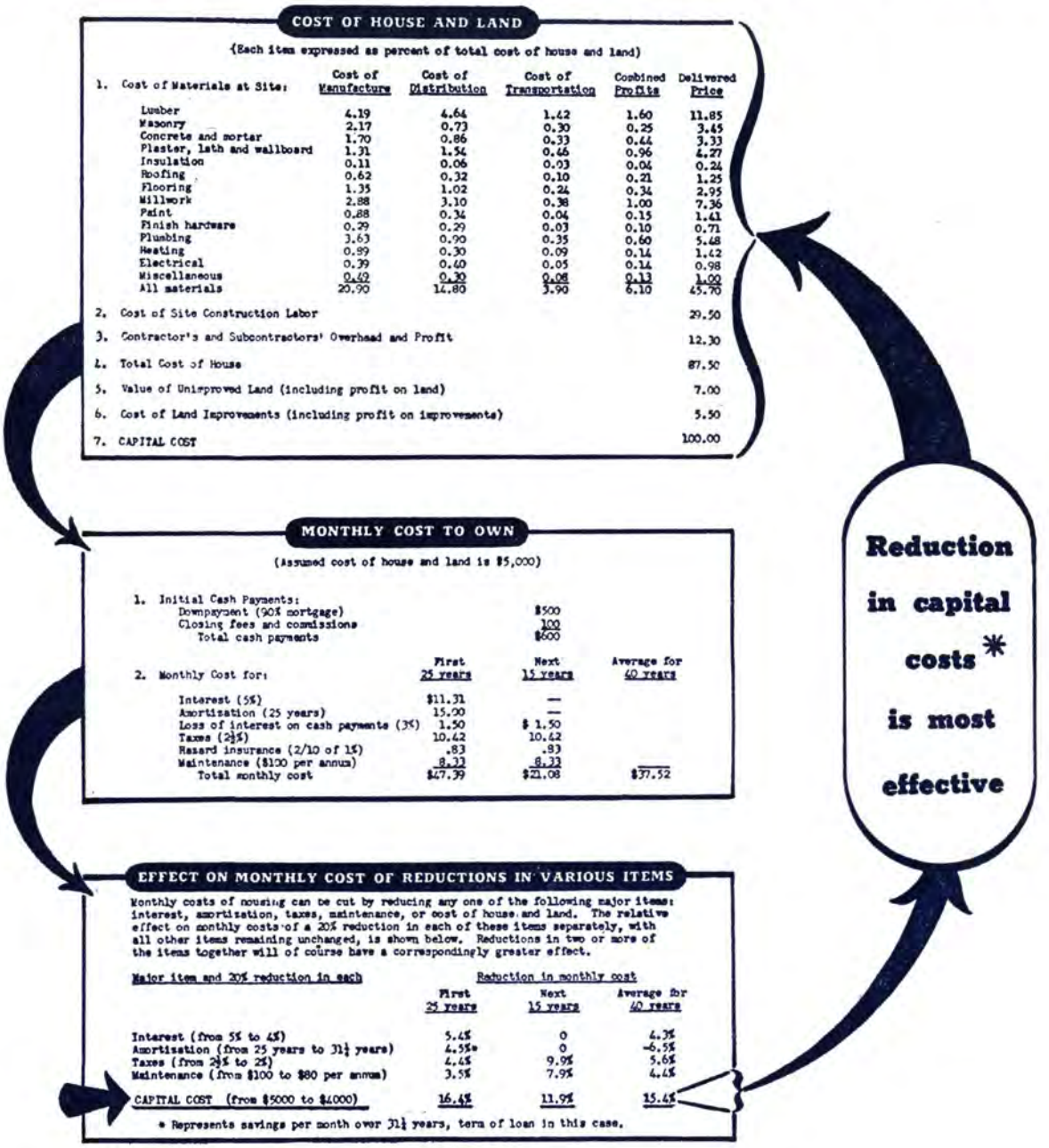
May I make one final observation. I was one of those who, as a member of the administration in the early thirties, was deeply concerned about organization of the mortgage market as an instrument of recovery and as an aid to housing, and in an unimportant and modest way played a part in advising on the provisions of the housing legislation that led to the FHA. Therefore, I can speak as one who is a friend and has been a friend of housing in many forms.

Housing Bill Inadequate

In that setting may I say my final say. **The question I would like to raise with you is whether a housing bill whose principal provisions, other than the administrative ones, have to do with financial devices will actually encourage the construction of housing in adequate amounts and of suitable quality, appropriately located and within the income reach of a large part of the population, either for the immediate emergency or throughout the years that stretch ahead.**

I am not now raising the question whether housing, under the provisions of this bill, can be adequately provided, as the bill contemplates, under the auspices of private enterprise. *I think they cannot be.* I am raising the broader question as to whether adequate housing facilities within the income reach of a large part of the population of the United States can be provided economically by any instrumentality or agency, public or private, under the terms of this bill.

WHERE THE HOUSING DOLLAR GOES



NOTE: Capital cost means cost of materials, labor and land.

EXHIBIT XI

WHERE THE HOUSING DOLLAR GOES

(SOURCE: "HOUSING COSTS" – National Housing Agency, December, 1944)