

1974 ECONOMIC AND INVESTMENT REPORT

A Report to the Membership  
of the  
American Life Insurance Association

by

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## 1974 ECONOMIC AND INVESTMENT REPORT

### Economic and Financial Developments in 1974

#### Recession with Inflation

1974 will be remembered as the year that everything seemed to go wrong. As the year opened, the public was plagued by "gasless Sundays" and mile-long gas lines brought on by the Arab oil embargo. Shortages of basic raw materials, together with fears that commodity prices would jump after the removal of wage-price controls, impelled businessmen to accumulate inventories well beyond current needs. Exceptionally strong demand for business loans pushed up the prime loan rate to record levels and interest rates in almost every sector of the financial market soared to new highs. Even though overall economic activity was trending downward, inflation rates advanced into the "double digit" range. Massive disintermediation of savings flows out of mortgage-oriented thrift institutions cut back the supply of housing credit and by November housing starts had dropped below a one million annual rate. The stock market suffered its steepest postwar decline, with market averages down more than one-third between March and October. Unemployment rates, after hovering just over 5 percent in the first half, moved above 7 percent in December, accentuated by widespread layoffs in the automotive industry. Consumer confidence faded in the face of persistent increases in living costs together with growing doubts over job security.

As if our economic troubles were not enough, the agonies of Watergate brought an added burden of uncertainty and dismay to the political scene. All in all, 1974 was a year the American public was glad to leave behind, even though 1975 holds little promise for a significant improvement in economic conditions.

On the inflation front, prices rose in 1974 by more than 10 percent above the average for 1973, as measured by the implicit price deflator for gross national product. The quarterly pattern of inflation rates may be seen in Table 1, against the background of the two previous years which now seem mild by comparison. The consumer price index rose even more steeply; during the 12 months ending November 1974, the CPI advanced by 12.1 percent, the biggest 12-month increase since 1947. Higher food prices and rising energy costs were material factors in this sharp advance but the widespread nature of the current inflation is indicated by the fact that consumer prices other than food and fuel increased no less than 11 percent during the same 12-month period. A graphic view of the accelerating pace of inflation during the past four years is provided in Chart A.

In real terms, after adjusting for price factors, gross national product declined in all four quarters of 1974, with an estimated 1.8 percent reduction in total output of goods and services for the year. As may be seen in Table 1, the first quarter witnessed the steepest rate of decline, stemming in large part from energy shortages, but the hoped-for recovery in the latter half of 1974 failed to materialize. In current dollars, GNP rose by 8 percent to approximately \$1,400 billion in 1974, but this statistical gain was more than accounted for by the 10 percent rise in the price level, as shown in Table 1.



In the financial markets, interest rates turned sharply upward after late February despite the weakening in economic activity. Heavy inventory buying brought an unexpected surge of business loan demand at the commercial banks and the Federal Reserve authorities responded in timely fashion with more restrictive credit policies designed to curb speculative excesses. A rapid sequence of increases in the prime loan rate lifted this key market rate from 8-3/4 percent in mid-March to 12 percent by early July.

In the corporate bond market, rising inflationary expectations, together with heavy borrowing demands, pushed long-term rates into new high ground as shown in Charts B and C. By the summer, Aaa-rated corporate borrowers were required to pay an unprecedented 10 percent or more on new long-term issues. Rates on long-term municipal bonds approached 7 percent in July, leading some issuers to defer offerings to await better conditions. In the mortgage market, many home buyers were confronted with 10 percent interest rates along with higher down payments, if they were able to locate a willing lender.

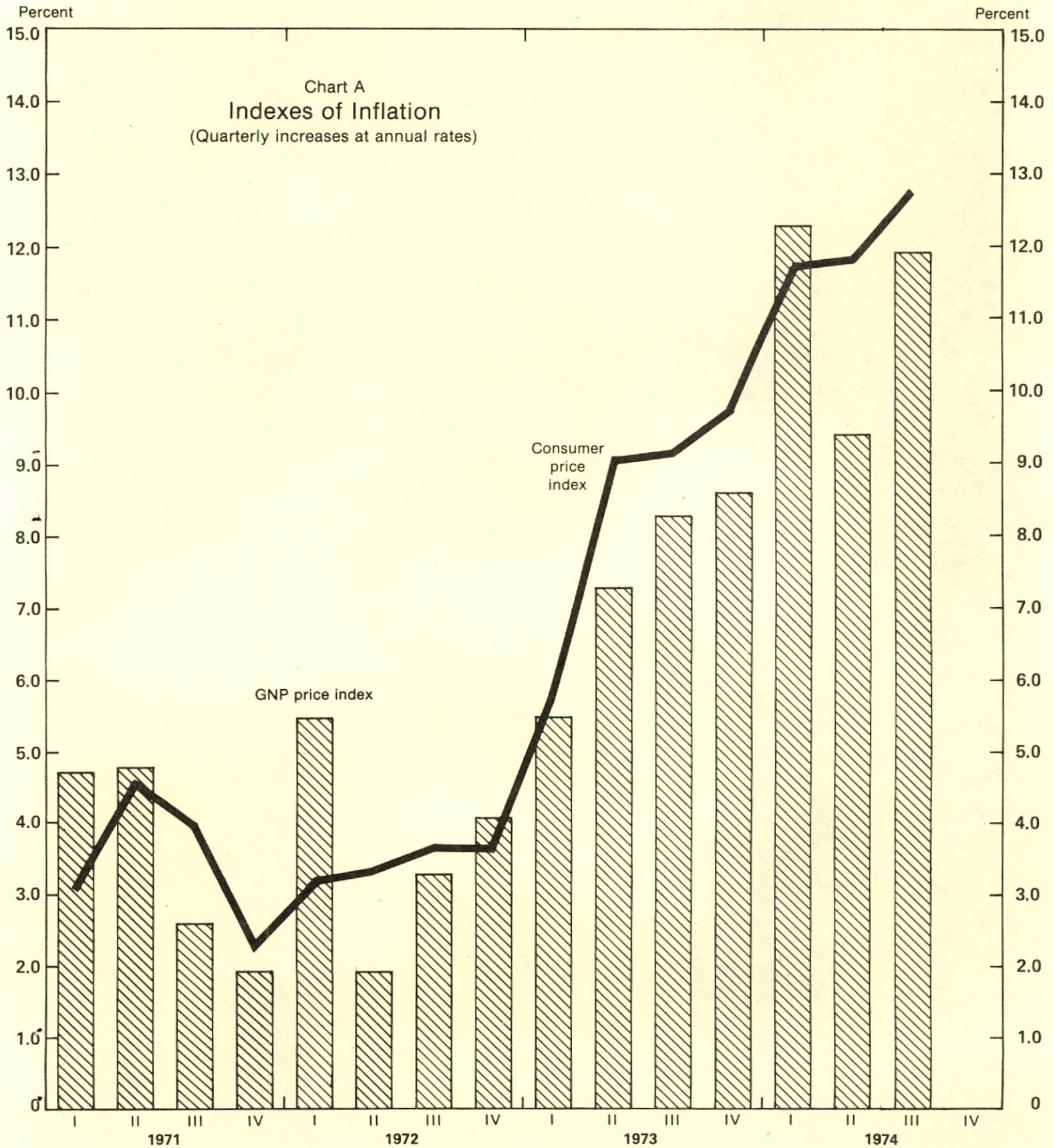
Table 1  
Gross National Product, 1972-1974  
(Seasonally adjusted annual rates)

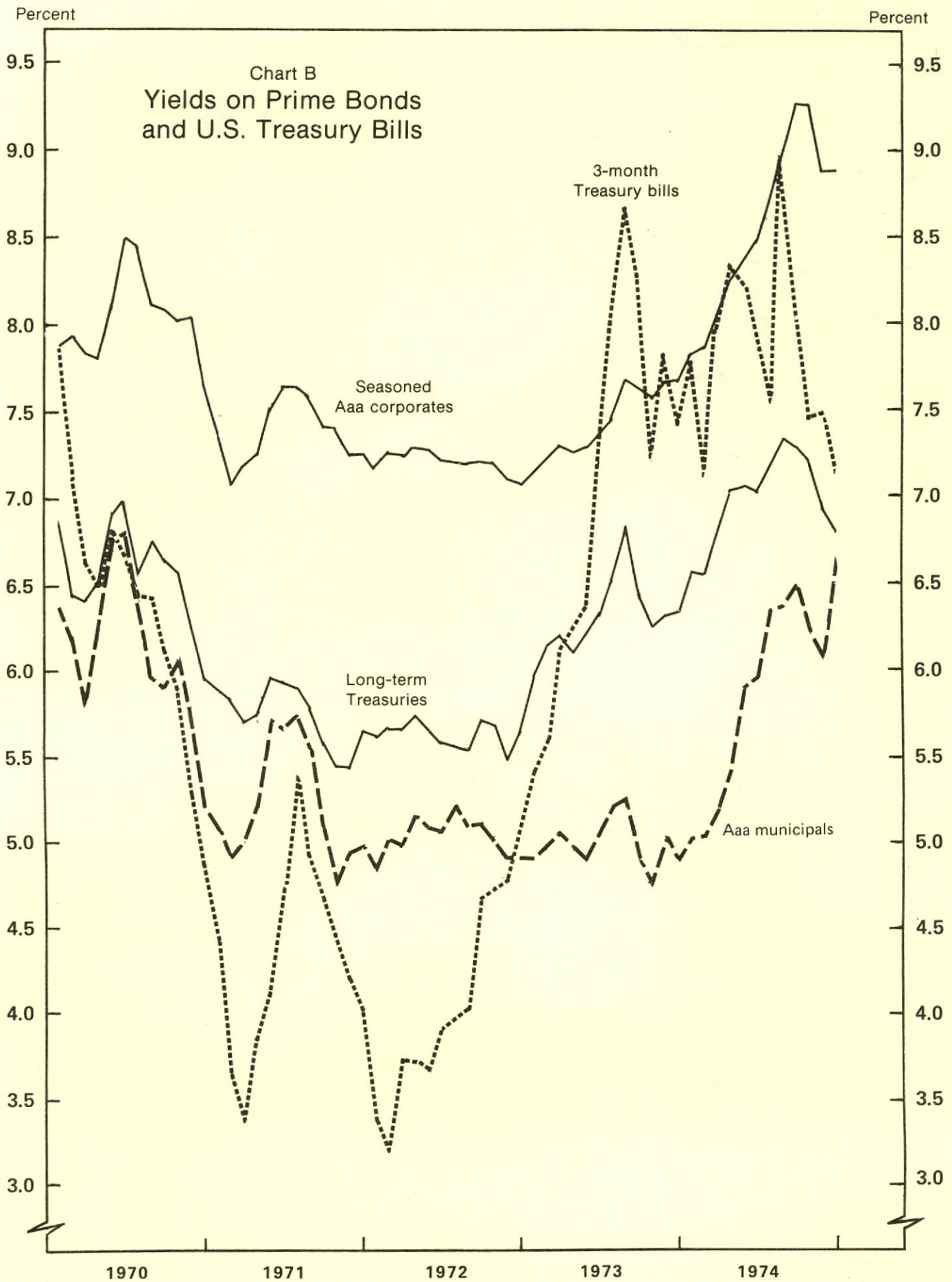
Year and Quarter	GNP (current dollars)		Annual Growth Rates		
	Level	Change	Current Dollars	Real Growth	Price Factor
	(In billions of dollars)		(In percent)		
1972 I	\$1,115.0	\$ 31.8	12.2%	6.4%	5.5%
II	1,143.0	28.0	10.5	8.4	1.9
III	1,169.3	26.3	9.5	6.0	3.3
IV	1,204.7	35.4	12.7	8.3	4.1
1973 I	1,248.9	44.2	15.5	9.5	5.5
II	1,277.9	29.0	9.6	2.2	7.3
III	1,308.9	31.0	10.1	1.6	8.3
IV	1,344.0	35.1	11.2	2.3	8.6
1974 I	1,358.8	14.8	4.5	-7.0	12.3
II	1,383.8	25.0	7.6	-1.6	9.4
III	1,416.3	32.5	9.7	-1.9	11.9
Calendar 1972	1,158.0	103.1	9.8	6.2	3.4
1973	1,294.9	136.9	11.8	5.9	5.6
1974e	1,400.0	105.1	8.1	-1.8	10.1

e - Estimated by ALIA economics department.

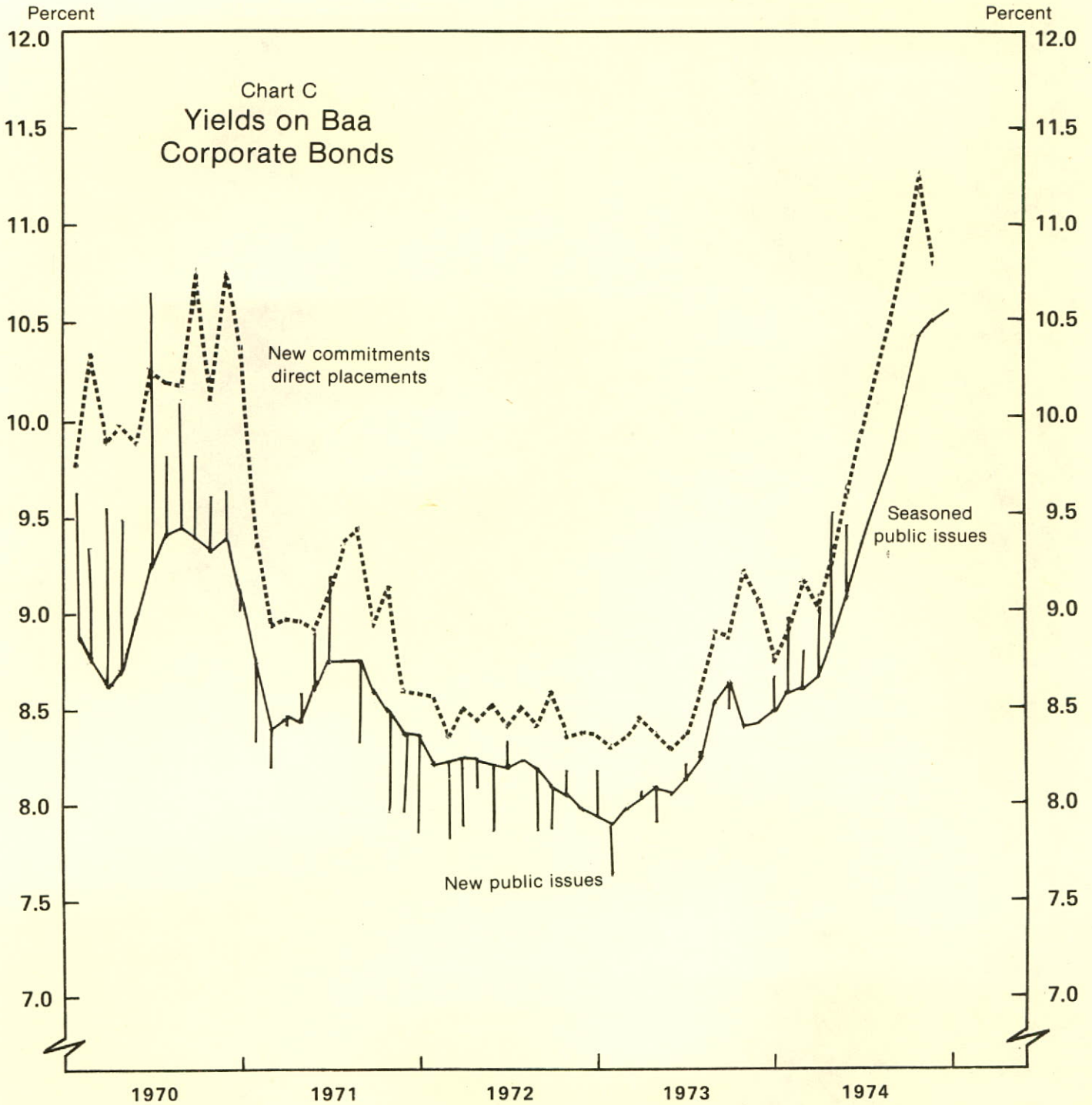


Chart A  
Indexes of Inflation  
(Quarterly increases at annual rates)









By September, signs of a less restrictive stance by the Federal Reserve became evident to market observers and short-term interest rates began moving down from their peaks. Corporate bond yields remained at high levels, however, reaching a record 12 percent reoffering yield on a new Aa utility issue in mid-October. Both bond yields and mortgage rates turned down in late October and November, partly in anticipation of growing slack in overall economic activity. In the latter weeks of the year, however, a firming rate trend reappeared, primarily in response to a heavy volume of new offerings and a record bond calendar ahead for early 1975.



Three noteworthy aspects of the corporate bond market in 1974 were (1) the advent of floating-rate note issues during the summer months, (2) growing investor resistance to lower-quality bond offerings, and (3) a greater attraction to medium-term securities with maturities of five to ten years. Floating-rate notes, offering a return pegged to the average rates on Treasury bills and a redemption option in later years, were pioneered by major bank holding companies but also were issued by industrial companies and a major savings bank. Close to \$1-1/2 billion of floating-rate note issues were marketed in the latter half of 1974, though the volume of new issues dried up shortly after the initial spate of offerings.

While investors were willing to buy issues with high coupon rates to offset the impact of future inflation, they were anxious to avoid significant credit risks. Growing fears of corporate bankruptcies, illustrated by the difficulties of real estate investment trusts and highlighted by the collapse of the Franklin National Bank, led to an increased aversion to lesser quality securities. Except for a few medium-term issues, Baa-rated corporate offerings disappeared from the list of new public bond issues after May and similar investor caution was visible in the markets for privately placed bonds and commercial mortgages.

Fears of future inflation and the risk of being "locked in" to fixed bond rates which depreciate in real value over the years impelled many investors to favor shorter maturities in their bond purchases during 1974. Medium-term offerings, with maturities of five to ten years rather than the usual 25 or 30 years, accounted for close to 30 percent of all public bond issues in 1974, compared with less than 8 percent in the preceding year and about 20 percent in 1972. A related factor was the reluctance of investors to tie themselves to the financial prospects of some business firms over an extended time period, in view of the sudden change in fortunes that has befallen many giant corporations in the past two years.

#### Money and Capital Market Flows in 1974

A systematic analysis of the credit flows through the financial markets in 1974 may be seen in Table 3, which presents estimates prepared by the ALIA economics department, based on partial and incomplete data for the year. These statistics measure the demand for and supply of money and capital market funds, based largely on the "flow-of-funds" data prepared regularly by the Federal Reserve. To facilitate comparison with the previous year, data for 1973 are shown in Table 2. In this form of analysis, dollar amounts refer to net increases in the outstanding debt of borrowers (rather than gross flotations of new issues) and to net changes in holdings of specified assets by various investor groups. (It may be noted that the format of the tables contains some changes in categories and definitions from similar tables prepared by the ALIA in previous years. Details of the underlying definitions may be obtained upon request.)

Life insurance companies were the source of \$15.4 billion in investment funds in 1974, equal to the amount provided in the previous year. As estimated in Table 3, corporate bond investments and nonresidential mortgage loans each accounted for a \$5.2 billion increase in life company portfolios. Net purchases of corporate stock (common and preferred) declined to \$2.1 billion, compared with \$3.6 billion in 1973; the common stock portion of this increase was about \$1.2 billion, approximately half the size of the previous year. Policy loans (shown in the "all other" category of the tables) turned upward once more starting in April after short-term market rates began to climb. For the full year, outstanding policy loans increased by an estimated \$2.7 billion, surpassing the previous record rise of \$2.5 billion in 1969.



Table 2

Sources and Uses of Funds in the United States Money and Capital Markets in 1973  
(In billions of dollars)

Sources of funds	Securities					Mortgages		Loans and Credit				Total sources of funds
	Corp. bonds	Corp. stocks	State & local	Fed. Gov't	Fed. agency	Residen- tial	Nonresi- dential	Con- sumer credit	Com- mercial paper	Busi- ness loans	All other loans	
Life insurance companies	5.5	3.6	*	-0.4	0.1	-0.7	5.0	-	*	-	2.2	15.4
Noninsured pension funds	1.6	5.3	-	0.1	0.5	-0.3	-	-	-	-	-	7.2
State-local retir. funds	5.9	3.9	-0.6	-0.1	0.2	-0.1	-	-	-	-	-	9.2
Savings and loan assns.	-	-	-	-1.0	1.0	23.8	3.1	0.2	-	-	-	27.1
Mutual savings banks	-1.1	0.4	*	0.2	0.1	4.0	1.7	0.2	-0.1	-	-	5.4
Commercial banking	0.5	0.1	5.7	-8.8	7.6	12.1	7.6	10.6	-2.5	41.1	9.3	83.3
Federal Reserve Banks	-	-	-	8.6	0.6	-	-	-	-	*	-	9.2
Federal loan agencies	-	-	0.3	1.4	*	7.6	2.2	-	-	1.1	1.8	14.4
Nonfinancial corporations	-	-	-0.1	-0.5	1.2	-	-	7.9	5.2	2.9	-	16.6
Fire and casualty cos.	-1.0	2.2	3.9	-0.1	*	-	*	-	-	-	-	5.0
Real estate inv't trusts	-	-	-	-	-	2.0	2.5	-	-	-	-	4.5
Mutual funds	-0.9	-2.3	-	0.5	-	-	-	-	0.2	-	-	-2.5
Foreigners	0.1	2.8	-	0.3	-	-	-	-	-	0.3	-	3.5
Individuals and others	2.1	-6.2	5.0	7.6	10.3	1.9	-0.5	4.0	3.6	-	-	27.8
Total uses of funds	12.7	9.8	14.1	7.9	21.6	50.3	21.6	22.9	6.4	45.4	13.3	226.0

\*\$50 million or less.

The uses of funds measure the net changes in outstanding loans and securities; the sources of funds measure the net changes in ownership.

Because of rounding, components may not add to totals shown.

Table 3

Estimated Sources and Uses of Funds in the United States Money and Capital Markets in 1974  
(In billions of dollars)

Sources of funds	Securities					Mortgages		Loans and Credit				Total sources of funds
	Corp. bonds	Corp. stocks	State & local	Fed. Gov't	Fed. agency	Residen- tial	Nonresi- dential	Con- sumer credit	Com- mercial paper	Busi- ness loans	All other loans	
Life insurance companies	5.2	2.1	0.2	-0.2	0.2	-0.3	5.2	-	0.3	-	2.7	15.4
Noninsured pension funds	5.5	1.9	-	-0.2	0.5	*	-	-	-	-	-	7.7
State-local retir. funds	7.0	3.5	-0.2	0.4	*	0.1	-	-	-	-	-	10.8
Savings and loan assns.	-	-	-	0.7	*	16.8	2.7	0.2	-	-	-	20.4
Mutual savings banks	0.8	0.3	*	*	-0.1	1.5	1.2	*	-0.3	-	-	3.4
Commercial banking	1.2	*	2.5	-4.5	4.0	7.2	4.6	4.5	-3.5	42.5	9.0	67.5
Federal Reserve Banks	-	-	-	2.0	3.2	-	-	-	-	0.9	-	6.2
Federal loan agencies	-	-	*	-2.0	*	13.9	2.8	-	-	0.3	2.2	17.2
Nonfinancial corporations	-	-	0.7	4.0	0.1	-	-	3.6	5.1	3.0	-	16.5
Fire and casualty cos.	-0.5	1.2	4.4	-0.4	0.2	-	*	-	-	-	-	5.0
Real estate inv't trusts	-	-	-	-	-	0.8	0.8	-	-	-	-	1.6
Mutual funds	-0.8	-0.6	-	-0.7	-	-	-	-	2.3	-	-	0.2
Foreigners	2.0	0.6	-	3.0	-	-	-	-	-	4.3	-	9.9
Individuals and others	3.6	-5.0	7.9	7.9	12.9	1.0	-0.3	2.7	4.6	-	-	35.3
Total uses of funds	24.0	4.0	15.5	10.0	21.0	41.0	17.0	11.0	8.5	51.0	14.0	217.0

\*\$50 million or less.

The uses of funds measure the net changes in outstanding loans and securities; the sources of funds measure the net changes in ownership.

Because of rounding, components may not add to totals shown.



Funds supplied by noninsured pension funds and by state and local retirement systems increased somewhat in 1974, in line with their long-term upward trend. For both types of institutions, net purchases of corporate stocks were down from the previous year while emphasis on corporate bond investments increased, as may be seen in a comparison of Tables 2 and 3.

Deposit-type savings institutions suffered severe disintermediation beginning in April and continuing through the early fall. The result was a second year of disruption in the mortgage credit flows in which the savings and loan associations and the mutual savings banks are so predominant. Residential mortgage loans by savings and loan associations increased by an estimated \$16.8 billion, down \$7 billion from the previous year, while savings banks placed an estimated \$1.5 billion in residential loans in 1974, against \$4 billion in 1973 (see Tables 2 and 3). The mortgage flows in 1974 were again bolstered by sizable advances from the Federal Home Loan Bank system to the savings and loans, supplementing the diminished inflow of savings funds from the public. In the case of savings banks, available investment funds in 1974 were spread among corporate bonds, residential mortgages, and nonresidential mortgage loans.

Commercial banking remained the largest single supplier of funds to the credit markets in 1974 with an estimated \$67.5 billion increase in loans and investments. However, this amount represented a reduction from the \$83 billion provided by commercial banking in 1973. By far the greater share of commercial bank funds was channeled into business loans of various types, which rose an estimated \$42.5 billion in 1974, slightly above the comparable figure for 1973. Commercial bank credit reaching the mortgage market was reduced substantially in the year, as were the net purchases of state and local government securities by commercial banks.

Federal loan agencies assumed a much greater role in the credit markets during 1974, primarily in support of the residential mortgage market. Almost \$14 billion in residential mortgage credit was provided by these agencies in 1974, up sharply from the \$7.6 billion of such lending in the previous year. As shown in Table 3, total credit supplied by federal loan agencies in 1974 rose by a record high of \$17.2 billion; these data do not include additional support to the mortgage market through the above-mentioned advances of the Federal Home Loan Banks.

Funds supplied by the "individuals and others" category rose substantially in 1974 to an estimated record volume of \$35 billion. In large part, this was the counterpart of the shift by individual investors away from depositary institutions with fixed deposit-rate ceilings, in favor of direct investment in higher-yielding market instruments. As shown in Table 3, tax-exempt municipal securities, federal government securities, and federal agency issues were the prime beneficiaries of this shift into direct investments, impelled by the exceptionally high market yields on these instruments over much of the year. Along with the household sector, such investor groups as personal trust accounts, credit unions, brokers and dealers, and mortgage companies are included in this category of the tables.

On the demand side of the market, business corporations were enormous users of credit in various forms during 1974. Business loans from commercial banks and other suppliers increased by an estimated \$51 billion, even more than the previous record rise of 1973. Commercial paper outstanding rose by an estimated \$8-1/2 billion, or \$2 billion more than in 1973. Funds raised by corporations through net bond issues in 1974 rose to an estimated \$24 billion, almost twice the amount issued in 1973 and about equal to the previous record volume of corporate bond issues in 1971. Corporate stock issues were a smaller figure in 1974, with an estimated \$4 billion net increase for the year, almost \$6 billion below the net issues of 1973.



U.S. Treasury demands on the credit markets were somewhat larger than in 1973, with an estimated \$10 billion in borrowings from the public. As shown in Table 3, the bulk of these funds was provided by individuals and others seeking both safety and relatively high yields. The enlargement of Treasury financing requirements primarily reflected the widening federal deficit in fiscal 1975 compared with a fairly modest \$3.5 billion deficit in fiscal 1974. Heavy demands on the market were made by federal agencies which increased their outstanding debt by an estimated \$21 billion in 1974, following record borrowings of \$21.6 billion in the previous year. Proceeds of agency issues were used mainly to supply credit to the residential mortgage market as noted earlier. State and local governments stepped up their borrowings in 1974 to an estimated \$15.5 billion, against \$14 billion in the previous year. As estimated in Table 3, more than half of the municipal bond offerings were taken by individuals and miscellaneous investors.

The residential mortgage market in 1974 reflected the disruption in credit flows brought on by disintermediation from the thrift institutions. The net increase in outstanding debt for residential mortgages was an estimated \$41 billion in 1974, compared with \$50.3 billion in 1973 (see Tables 2 and 3). Savings disintermediation in the summer of 1973 and renewed disintermediation at thrift institutions beginning last April resulted in a double dip in the volume of loan commitments available for home mortgages. In addition, the continued rise in the average price of new and existing homes meant that fewer housing units could be financed per dollar of mortgage credit. In the nonresidential mortgage field (primarily commercial properties), a setback was also experienced in 1974, with \$17 billion of mortgage credit reaching this market, compared with \$21.6 billion in 1973.

Still another area of sharp decline was the consumer credit field, where outstanding debt rose by \$11 billion in 1974, against a record \$22.9 billion in the previous year. With new car sales down sharply, automotive installment credit has risen more slowly than in 1973. But the consumer credit figures also appear to reflect a higher degree of financial caution by consumers, stemming from uncertainties over job security and the future of inflation.

#### Economic and Financial Outlook for 1975

Not much cheer can be taken from the somber economic outlook for 1975, though there are prospects that a modest business upturn will develop before year-end. The recession now appears to be gathering momentum with production cutbacks and rising unemployment in sight for the months immediately ahead. Consumers have become extremely wary in their spending patterns, postponing purchases of autos and household durable goods where possible. Retail sales have turned down, leaving businessmen with a towering overhang of inventories that can only be corrected by cutbacks in factory orders and production, leading to further layoffs. Automobiles have been a dramatic example of the current imbalance between production and sales, but many other lines of business face a similar need for adjustment. Under such conditions, the unemployment rate is expected to surpass 8 percent by the summer months.

With the prospect of further softening in consumer demand, business corporations have become more cautious in their capital spending plans. Even the moderate dollar increases indicated by business spending surveys for 1975 are the result of higher prices, while physical volume is expected to turn down. Residential construction activity is likely to show very little improvement over 1974 in view of the backlog of unsold housing units and the doubtful outlook for supplies of mortgage credit. Until expansion of homebuilding provides a better basis for suburban shopping centers and office facilities, commercial construction is unlikely to show significant gains.



On the inflation front, the worst now seems to be behind us. Recent signs of improvement carry the prospect that the rate of price increases will moderate during 1975. The consumer price index for October and November rose much less than in earlier months and the recent retreat in prices for many basic materials indicates a better picture for the period just ahead. More broadly, the overhang of inventories and the slackening of consumer demand has limited the ability of many producers to pass along their higher costs in the form of higher prices. The resulting squeeze on profit margins, together with flat or declining sales volume, is expected to pull down operating profits while the shrinkage in inventory profits will further depress corporate earnings in 1975.

In developing specific forecasts for the year ahead it is necessary to make certain assumptions, particularly with respect to government economic policies that can be crucial to the course of economic activity. First, it is assumed that broad-scale wage and price controls will not be imposed in spite of the various claims that they are needed. Indeed, the better outlook for prices has already reduced the clamor for a renewal of direct controls. A second assumption is that federal budgetary policy will become much more stimulative within the next few months in an effort to counter the decline in production and employment. It is expected that federal spending will be increased by substantial amounts, especially through new programs of public service employment and outlays for extended unemployment benefits. A major cut in both personal and corporate income taxes is also assumed, with an expected revenue loss upwards of \$10 billion. For the fiscal year 1975, the federal budget deficit is projected to exceed \$25 billion, followed in fiscal 1976 by a deficit close to \$40 billion, a new peacetime record in dollar terms.

Monetary policy is likewise assumed to follow a course of further easing during the greater part of 1975 as a counterpart of stimulative fiscal efforts. Bank reserves will be supplied more generously in an effort to accommodate continuing credit demands of business alongside the enlarged needs for Treasury financing that the rising federal deficits will entail. Successive cuts in the Federal Reserve discount rate, along with more aggressive open-market operations to provide bank reserves, will be used to edge short-term interest rates downward and increase the availability of bank credit.

In statistical terms, gross national product in current dollars is expected to rise by \$93 billion or about 6.7 percent to a total of \$1,493 billion in 1975. More important than this apparent gain, however, is the division of the change as between real output and prices. Real output of goods and services is expected to decline in 1975 by 2-1/2 percent, extending the 1974 decline of almost 2 percent. An upturn in constant dollar GNP is not anticipated until the final quarter of 1975 and economic recovery beyond that period may be sluggish at best. Stated another way, the current recession which began in late 1973 is expected to last almost two years, reaching a bottom in the late summer of 1975. In contrast, the recession of 1969-70 lasted barely one year.

The rate of price increases is expected to abate by moderate proportions. Using the overall inflation index calculated for GNP, prices in 1975 are estimated to advance about 9-1/2 percent above the average for 1974. However, the quarterly pace of price increases during 1975 is expected to decline through the year to an annual rate of about 7-1/2 percent in the final quarter. While this trend will mean welcome improvement, it will still leave the nation with inflation rates that would have been viewed as intolerable not long ago. There can be no question that inflation remains a major unsolved economic problem, temporarily dampened by the current economic downturn but likely to resume with renewed vigor in 1976 after economic activity has turned up again.



The financial implications of the forecast presented above have been translated by the ALIA economics department into estimates of the sources and uses of funds in the money and capital markets for 1975. Table 4 presents a detailed cross-section analysis of expected flows between various sources and uses of funds. A summary tabulation of the 1975 estimates is shown also in Table 5 against the background of prior years beginning in 1965.

Total capital market flows in 1975 are expected to rise to an estimated \$234 billion, an increase of about \$17 billion over the preliminary total for 1974 and \$8 billion above the previous record high of 1973 (see Table 5). The larger total for 1975 reflects, first and foremost, an increase in Treasury borrowings to an estimated \$38 billion in 1975, against \$10 billion in the preceding year. Net issues of corporate bonds are expected to rise to a new record of \$29 billion, as corporations attempt to bridge the gap between rising capital outlays and falling profits while also improving overstrained liquidity by refunding of bank loans. State and local governments are also expected to raise their demands on credit markets in 1975 and consumer credit is estimated to increase somewhat more than in 1974. On the other hand, business loans and commercial paper are expected to rise in 1975 by considerably less than in the past year, particularly as the rate of inventory accumulation recedes from the extremes of 1974. The net flow of residential mortgage credit, which fell back in 1974 to \$41 billion, is expected to remain at about this same level in 1975.

On the supply side of the credit markets, commercial banking is projected to provide \$77 billion in 1975, about \$10 billion more than in the past year, as a progressive easing of Federal Reserve policy augments the availability of bank credit. As may be seen in Table 4, commercial banks are expected to step up their government securities holdings by substantial amounts, in contrast with a net run-off in such holdings in 1974. Net purchases of municipals and federal agencies are also expected to rise over last year. The net increase in business loans at commercial banks is estimated at \$30 billion in 1975, against a \$42.5 billion rise in 1974. If realized, these projected trends should result in an improvement in the liquidity position of commercial banks in the year ahead, following the severe strains on bank liquidity arising from heavy loan demands in 1974. As in the bond markets, banks have placed greater emphasis on improved loan quality in recent months, and this objective is expected to remain important during the year ahead.

Life insurance companies are estimated to supply \$16.5 billion to the money and capital markets in 1975, just over a billion dollars more than in the past year. Policy loans, which rose by about \$2.7 billion in 1974, are expected to increase by \$2 billion in the coming year, thereby releasing larger flows for capital market investments. As shown in Table 4, life company holdings of corporate bonds are expected to show the largest gain, \$6.4 billion in 1975, more than \$1 billion above the increase in 1974. Net purchases of corporate stock (common and preferred) are also expected to rise to an estimated \$2.5 billion, moderately above 1974 but still well below the net amounts purchased in 1972 and 1973. Nonresidential mortgage loans (commercial and farm) will continue to occupy a major place in life company investment programs, with an increase of \$5.6 billion estimated for 1975.

Like the life insurance companies, the noninsured pension funds and state and local government retirement systems are expected to continue their emphasis on corporate bond investments in 1975, with some pickup in their net purchases of corporate stock (see Table 4).



Table 4

Outlook for Sources and Uses of Funds in the United States Money and Capital Markets in 1975  
(In billions of dollars)

Sources of funds	Securities					Mortgages		Loans and Credit				Total sources of funds
	Corp. bonds	Corp. stocks	State & local	Fed. Gov't	Fed. agency	Residen- tial	Nonresi- dential	Con- sumer credit	Com- mercial paper	Busi- ness loans	All other loans	
Life insurance companies	6.4	2.5	0.2	-0.1	0.1	-0.5	5.6	-	0.3	-	2.0	16.5
Noninsured pension funds	6.0	2.2	-	0.1	0.4	-0.2	-	-	-	-	-	8.5
State-local retir. funds	7.3	3.9	-0.1	0.2	0.1	0.1	-	-	-	-	-	11.5
Savings and loan assns.	-	-	-	0.5	1.0	20.0	2.5	0.1	-	-	-	24.0
Mutual savings banks	2.0	0.2	0.1	0.5	0.2	1.8	1.4	0.1	-0.1	-	-	6.2
Commercial banking	1.2	*	6.5	9.0	5.0	8.5	4.6	6.5	-1.5	30.0	7.2	77.0
Federal Reserve Banks	-	-	-	9.0	3.0	-	-	-	-	0.5	-	12.5
Federal loan agencies	-	-	0.1	*	*	10.0	3.0	-	-	0.3	3.5	17.0
Nonfinancial corporations	-	-	-0.2	2.0	0.2	-	-	5.5	3.5	2.5	-	13.5
Fire and casualty cos.	-0.5	1.2	4.9	-0.1	*	-	*	-	-	-	-	5.5
Real estate inv't trusts	-	-	-	-	-	0.5	0.7	-	-	-	-	1.2
Mutual funds	-0.2	*	-	-0.1	-	-	-	-	1.5	-	-	1.2
Foreigners	2.8	1.0	-	10.0	-	-	-	-	-	3.5	-	17.3
Individuals and others	4.0	-5.0	5.5	7.0	7.5	0.8	-0.3	2.8	0.3	-	-	22.6
Total uses of funds	29.0	6.0	17.0	38.0	17.5	41.0	17.5	15.0	4.0	36.8	12.7	234.5

\*\$50 million or less.

The uses of funds measure the net changes in outstanding loans and securities; the sources of funds measure the net changes in ownership.

Because of rounding, components may not add to totals shown.



Table 5

Sources and Uses of Funds in the United States Money and Capital Markets, 1965-75  
(In billions of dollars)

<u>Sources of funds</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974e</u>	<u>1975e</u>
Life insurance companies	7.7	7.7	8.2	8.3	8.6	8.9	11.9	12.8	15.4	15.4	16.5
Noninsured pension funds	5.2	6.3	5.3	5.8	6.0	6.9	7.4	6.5	7.2	7.7	8.5
State and local retirement funds	3.3	4.2	4.0	4.7	5.6	6.1	6.2	7.8	9.2	10.8	11.5
Savings and loan associations	9.6	4.2	9.2	10.2	9.9	11.6	29.2	36.4	27.1	20.4	24.0
Mutual savings banks	3.9	2.7	5.2	4.3	3.2	4.1	10.0	10.4	5.4	3.4	6.2
Commercial banking	28.6	18.1	37.4	40.1	17.2	36.6	51.4	75.4	83.3	67.5	77.0
Federal Reserve Banks	3.8	3.5	4.8	3.7	4.2	5.0	8.9	0.3	9.2	6.2	12.5
Federal loan agencies	2.6	6.7	4.4	4.7	7.0	10.3	7.3	7.7	14.4	17.2	17.0
Nonfinancial corporations	5.4	0.7	1.8	10.3	10.2	-1.7	10.1	9.1	16.6	16.5	13.5
Fire and casualty companies	1.1	1.9	1.8	2.7	2.6	4.9	6.3	6.6	5.0	5.0	5.5
Real estate investment trusts	-	-	-	0.2	0.9	2.1	2.5	4.9	4.5	1.6	1.2
Mutual funds	2.1	2.5	1.3	3.5	2.6	1.7	0.4	-1.8	-2.5	0.2	1.2
Foreigners	-0.3	-1.9	2.7	2.4	1.3	11.0	27.3	10.7	3.5	9.9	17.3
Individuals and others	3.2	17.5	-5.1	2.7	30.2	1.9	-16.5	13.0	27.8	35.3	22.6
Total sources	76.1	74.1	80.9	103.6	109.6	109.4	162.3	199.9	226.0	217.0	234.5
<u>Uses of funds</u>											
Corporate bonds	8.1	11.1	16.0	14.0	13.5	22.9	23.9	19.1	12.7	24.0	29.0
Corporate stocks	*	1.3	2.5	0.4	4.7	7.7	13.6	14.0	9.8	4.0	6.0
State and local gov't issues	7.7	6.3	7.9	9.8	10.7	11.3	17.9	14.7	14.1	15.5	17.0
Federal Government issues	1.7	2.2	8.2	9.8	-2.2	12.9	26.0	14.3	7.9	10.0	38.0
Federal agency issues	2.4	6.4	3.6	6.4	6.8	8.2	3.4	9.7	21.6	21.0	17.5
Mortgages: Residential	19.0	13.8	16.0	18.6	20.4	19.2	36.8	51.2	50.3	41.0	41.0
Nonresidential	6.6	7.5	7.0	8.8	7.4	7.2	12.1	17.7	21.6	17.0	17.5
Consumer credit	9.6	6.4	4.5	10.0	10.4	6.0	11.2	19.2	22.9	11.0	15.0
Commercial paper	0.9	4.3	3.4	4.1	11.4	0.5	-1.0	2.6	6.4	8.5	4.0
Business loans	16.3	10.4	6.1	16.0	22.4	6.9	9.1	22.3	45.4	51.0	36.8
All other loans	3.7	4.4	5.6	5.8	4.2	6.5	9.3	15.2	13.3	14.0	12.7
Total uses	76.1	74.1	80.9	103.6	109.6	109.4	162.3	199.9	226.0	217.0	234.5

\*\$50 million or less.

e - estimated.

The uses of funds measure the net changes in outstanding loans and securities; the sources of funds measure the net changes in ownership.

Because of rounding, components may not add to totals shown.



Savings and loan associations, along with mutual savings banks, are expected to experience a moderate return flow of savings during 1975, in contrast to the massive outflows during the disintermediation of 1974. Interest rates on competing open market instruments have retreated from the very high levels of last summer, permitting the depository thrift institutions to attract a bigger volume of the savings of individual investors. In Tables 4 and 5, total capital market funds supplied by savings and loan associations have been estimated to rise to \$24 billion in 1975, while funds provided by savings banks are expected to increase to \$6 billion. As a corollary, mortgage credit supplied by savings and loans in 1975 is estimated to increase by \$3 billion to \$22-1/2 billion, while the savings banks are expected to supply about \$3.2 billion in mortgage loans, as against \$2.7 billion in 1974. Nevertheless, the outlook for the mortgage market, taking into account the credit flows from other investors, is for no year-to-year improvement in the flow of mortgage credit in 1975. As shown in Tables 4 and 5, residential mortgages are estimated to rise by \$41 billion, the same amount as in 1974, while nonresidential mortgages are expected to increase by \$17.5 billion, against \$17 billion in 1974.

Foreign investors have become an increasingly important, though volatile, element in the U.S. capital markets in recent years, as may be seen in the historical data of Table 5. Their participation reflects a multitude of crosscurrents ranging from the size of the U.S. payments surplus or deficit, speculation against or in favor of the dollar, accumulations of international reserves in dollars versus other currencies, changing attitudes toward U.S. economic prospects, etc. For 1975, funds supplied by foreigners have been estimated at \$17 billion, up \$7-1/2 billion from 1974 and primarily flowing into U.S. government securities.

Individuals and others, the final category in the accompanying table, have been estimated to supply about \$23 billion to various sectors of the capital market in 1975, down from a record \$35 billion in 1974. This projection reflects the expectation that a greater share of these funds will be channeled into savings intermediaries rather than directly invested in the record amounts of the past year. Most of the estimated decline in such flows is expected to take place in such open market instruments as federal agency issues and commercial paper, which were both highly popular investments when interest rates on these kinds of paper rose to record highs in the summer of 1974.

The outlook for interest rates in 1975 reflects a combination of influences which include the market forces of demand and supply, the monetary policy of the Federal Reserve authorities, and the changing state of inflationary expectations. A distinction must also be made between the outlook for short-term interest rates and the prospect for long-term bond yields and mortgage rates. As noted earlier, business borrowing at commercial banks and through commercial paper is expected to be less intense than in 1974 because of lower rates of inventory accumulation and substantial refunding of bank loans through bond proceeds. At the same time, the enormous federal deficits in prospect for fiscal years 1975 and 1976 imply extremely heavy Treasury financing requirements during calendar year 1975, with the main burden expected to fall upon the short-term market. While it is anticipated that Federal Reserve policy will ease, partly to accommodate such financing, the combined short-term credit demands of government and business will serve to limit the magnitude of any decline in short-term rates. During the first few months of 1975, short-term rates may work somewhat lower, but the net decline by mid-year is expected to be within a range of 50 to 150 basis points below year-end levels. The beginnings of economic recovery in the latter part of the year, once the adjustment in inventory levels has been accomplished, are likely to bring a resumption in business loan demand at a time when Treasury financing requirements remain heavy, with a consequent renewal of upward rate pressures.



In the long-term capital market, the estimates of Tables 4 and 5 point to record levels of corporate bond financing and near-record amounts of municipal issues. These heavy demands are expected to keep bond yields close to their year-end levels during the early months of 1975. As the year progresses, the influence of lower inflationary expectations, together with the modest decline in short-term rates, may bring some easing in long-term yields on high-grade issues but still within a range of 50 to 75 basis points from year-end levels. Yields on lesser-rated issues may decline little, if any, in view of widespread investor reluctance to incur risks on doubtful credits. In the home mortgage market, rates typically move downward somewhat later than bonds and the continuing shortage of mortgage credit is unlikely to permit any significant reduction beyond year-end levels in mortgage lending rates. In the latter half of 1975, corporate bond yields appear likely to turn upward, depending on the timing and extent of economic recovery. An additional force toward higher bond yields in the closing months of 1975 may be changing expectations about inflation, as those who look ahead into 1976 consider the possibility of an upward tilt in inflation rates.

Summing up, the normal expectation in a period of deepening recession, reduced inflation rates, and prospective easing of monetary policy would be for a substantial downturn in both long- and short-term interest rates. In the year ahead, however, a record amount of long-term corporate financing is in prospect and the need for Treasury financing of federal deficits is expected to reach a postwar high. Primarily as a result of these overriding influences in the money and capital markets, both short-term and long-term interest rates are expected to move down by relatively small amounts in the first half of the year, with a likelihood of renewed upward pressure on rates in the latter part of 1975 as business activity begins to recover.



### The Economic and Investment Research Program

For nearly thirty years, the life insurance business has demonstrated its interest in the improvement of financial and economic knowledge through a continuing program of economic and investment research under Association auspices. This program has consisted of two distinct but related aspects: research and analysis undertaken by the staff of the economics department and outside research studies conducted by universities and other research organizations with financial support from the ALIA. The main objective of the program, both internal studies and outside research, has been to assist the investment side of the life insurance business through factual analyses of national economic trends and the functioning of financial markets.

#### Staff Activities of the Economics Department

Collection and analysis of data on the investment operations of the life insurance business represent a major continuing function of the economics department of the ALIA. The industry data gathered and distributed to life companies in periodic statistical surveys serve not only as a management tool for company operations but also as a valuable source of current financial information for the Federal Reserve and other government bodies concerned with economic and financial policy. The continuing staff studies include monthly statistics on forward investment commitments of life insurance companies, quarterly data on the volume and sources of cash flow for investment, semiannual data on mortgage loan delinquencies and foreclosures, and annual data on mortgage lending income and costs of life insurance companies. In addition, monthly data on yields of directly placed corporate bonds and quarterly data on interest rates and other characteristics of income-property mortgage loans are tabulated by the economic research staff. Some of the information developed in these studies is presented in later sections of this report.

A major function of the economics department is its work with various policy-making committees of the Association. For example, the economics staff provides support to the Economic Policy Committee and its subcommittees which, on behalf of the life insurance business, prepare testimony each year for submission to the Joint Economic Committee of the Congress in its hearings on the Economic Report of the President. In addition, the Economic Policy Committee conveys the viewpoints of the life insurance business to officials in Washington through periodic meetings with the U.S. Treasury Department, the Federal Reserve Board, and various Administration officials involved in planning economic policy. As a part of this continuing effort, the Economic Policy Committee met with President Ford and top Administration advisors last September in an exchange of views on economic policy issues and measures to bring inflation under control. Although this meeting was arranged several months in advance, it came at a time when the Administration was focusing national attention on the inflation question through its pre-summit and summit conferences which were also scheduled in September. Several of the chief executive officers of ALIA life insurance companies also participated in these latter conferences.



In its capacity as the research arm of the Association, the economics department worked closely this year with the Subcommittee on Investment Aspects of Valuation Problems. For this Subcommittee the staff conducted a statistical survey of the Mandatory Securities Valuation Reserve (MSVR) transactions of about 160 life insurance companies over the past five years, including data on the extent to which the companies' bond reserves had been reduced by credit losses as against "managed losses" taken deliberately for tax offset or other purposes of investment strategy. From this survey it was learned that for the last three years (1971-73), investment management losses accounted for somewhat less than half of total gross losses. In 1970, credit losses accounted for over four-fifths of gross losses--largely due to the Penn Central failure. The study showed that at the end of 1973, 25 of the companies in the sample had exhausted the bond and preferred stock component of the MSVR and 41 had exhausted the common stock component.

Activities of the Financial Section of the ALIA and the operation of the annual Life Officers Investment Seminar also receive staff support from the economics department. The Life Officers Investment Seminar is held at Rockford College in Illinois for two weeks each June. The Financial Section holds an annual meeting each fall, and in April three regional meetings are scheduled to facilitate discussion of financial topics by investment officers.

Another staff function is to conduct special research projects of timely interest to the investment side of the life insurance business, as well as to persons outside the life insurance industry. This year, staff completed a research study on "Life Insurance Companies and the Commercial Mortgage Market, 1960-73," which focused upon the major determinants of the size and growth of this sector of the mortgage market, lending patterns of life insurance companies during the 1960-73 period, the impact of monetary policy on the commercial mortgage market in the context of other investment markets, and the potential for increased competition by other institutional lenders in this market historically dominated by life insurance companies. Dr. Thomas Robinson, associate economist of the ALIA, was the author of this study.

Still another staff research project, of considerably broader scope, has been the preparation of a book-length monograph on "The Role of Life Insurance Companies in the U.S. Economy." This study, now in manuscript form, is designed for people outside the industry and for those in the life insurance business who lack a convenient means of gaining an overall view of the operations of the business and its growth in recent years. The study examines the role of the life insurance business in the economy by describing the major types of "products" and the investment function of life insurance companies and by analyzing the growth of both the product side and the investment side of the business over the period 1950-73. The study proceeds as follows: (1) it describes the major products sold and their significance to the policyholder; (2) it analyzes the growth of these products in terms of life insurance in force, premiums and benefits paid, etc., in relation to the size of the economy as indicated by gross national product, disposable personal income, and other aggregate economic series; (3) it describes the functions of the life insurance business as a financial intermediary between those who save



and those who seek capital funds; (4) it describes the importance of life insurance companies in various sectors of the capital market--the corporate bond market, the mortgage market, the stock market, and the markets for real estate, government securities, and short-term money market securities--and examines their changing role in these markets over the past two decades. A short review is also provided of life insurance as a business, in terms of the growth of the number of companies, persons employed, and diversification of products and operations. The analysis ends with a summary review of past changes and the prospects for the future of the life insurance business in an inflationary economic environment. Dr. George A. Bishop, director of economic research of the ALIA, is the author of this monograph, which is expected to be available for distribution by mid-1975.

As a guide to investment strategy and the future course of interest rates, the economics staff also prepares analyses of the demand and supply of funds in the money and capital markets, setting forth estimates of future trends against the background of historical data. The current staff analysis of the sources and uses of capital funds, including forecasts for 1975, is presented in preceding sections of this report.

Still another function of the economics department is its liaison role with the academic community, especially in matters concerning the investment activities of life insurance companies. This role involves responding to inquiries for investment data, describing current investment attitudes and policies, and reviewing research manuscripts by academic authors working in the investment field. In a broad sense, the economics staff serves as a spokesman on the investment aspects of the business in an effort to improve public understanding of the investment policies and practices of life insurance companies.

#### Outside Research Financed by the Association

In addition to the research activities of the ALIA economics department staff, the Association sponsors and finances outside research projects of particular importance to the investment side of the life insurance business. This research, conducted independently by universities and private research groups, is planned and followed closely by senior staff and by the Investment Research Committee of the ALIA. Since 1946, this program has provided research grants totaling close to \$3 million for basic research in the fields of savings, capital markets, housing, and interest rates. These various projects are widely regarded by scholars and public officials as having been among the most important studies published in these vital areas of financial research. They have been directed by a large number of outstanding economists, men of national reputation such as Arthur F. Burns, Raymond J. Saulnier, Raymond W. Goldsmith, and Simon Kuznets.

Two Major Research Projects in Progress. In 1971 the Association sponsored a research project of considerable interest to scholars and public officials, as well as to the life insurance business. Under the auspices of the National Bureau of Economic Research and directed by Dr. Phillip Cagan of Columbia University, a team of researchers from several universities began a study of "The Effects of Inflation on Financial Markets." These researchers are investigating the impact of inflation in five main areas: institutional portfolio policies,



interest rates, household savings, convertible bonds and common stocks. A report on some highlights of this study was contained in the 1973 Economic and Investment Report of the ALIA.

In 1973 the Association sponsored another major project entitled "Demand and Supply Conditions in the U.S. Capital Markets, 1975-85." The research on this project is being undertaken through the Salomon Brothers Center for the Study of Financial Institutions of the Graduate School of Business Administration of New York University. Under Dr. Arnold Sametz's direction, a team of New York University professors and other researchers are analyzing the principal factors determining the evolution of the financial structure and secular trends in interest rates. This investigation uses the following research sequence: (1) develops aggregate and sectoral financial forecasts; (2) makes aggregate and sectoral economic forecasts; (3) examines prospective changes in capital markets, financial institutions and instruments; and (4) projects changes in the level and structure of interest rates. The end result will be a projected matrix from gross national product accounts through flow-of-funds accounts to the sources and uses of funds for major financial institutions along with forecasts of interest rate levels and differentials.

On the basis of the recently completed preliminary flow-of-funds matrix, Dr. Sametz has projected a demand for funds of \$340 billion in 1985. He observed this demand to be only 70 percent more than the 1972 volume of \$200 billion. In contrast, the flow of funds into capital markets during the six-year period 1967-72 increased 2.5-fold. This NYU flow-of-funds estimate was based upon a Bureau of Labor Statistics forecast of gross national product in 1985, with modifications for different rates of inflation and real economic growth.

With the completion of this preliminary research, the NYU team is now working on the integration of econometric, behavioral, and empirical approaches in order to improve the first matrix of estimates. During 1975 all this work will be combined into: (1) a new 1985 matrix of stocks and flows with associated interest rates; (2) matrices for selected intermediate years; and (3) expected changes in the financial and institutional structure.

Two New Research Studies Approved. In 1974 the ALIA Board of Directors authorized financial support for two additional research projects which are expected to have widespread interest not only for investment officers and others in the life insurance business, but also for the general public and interested business leaders. The first of these studies will provide an overview of the economic and financial consequences of sustained inflation at a rate of 10 percent or more, drawing largely upon the experience of foreign countries in both Europe and South America. Dr. Hendrik Houthakker, a former member of the Council of Economic Advisers and now on leave from Harvard University, began work on this study in the fall of 1974 with a view to completion by the end of 1975. Degenerative effects of inflation on economic processes will be the main focus of the study. Among the areas to be examined are the impact of "double digit" inflation on financial markets and various forms of saving including life insurance; the effects on utilities and other regulated industries where rate structures lag behind rapidly rising costs; the consequences for redistribution of real income among various sectors of the population; and the impact upon international trading relationships and foreign



exchange rates. Also considered will be governmental responses to high rates of inflation that have either served to aggravate the problem or led to structural changes in the economic system. The resulting monograph by Dr. Houthakker will be cast in non-technical language for the intelligent layman rather than for professional economists.

The second new project is an investigation of "The Role of Private Pension Funds in Saving and Capital Formation in the United States" by Dr. Norman B. Ture under the auspices of the American Enterprise Institute for Public Policy Research. The basic objective of the study is to examine and analyze the future role of private pension plans in mobilizing private saving and allocating this saving among its alternative uses in financing capital formation. As a prelude to this analysis, initial focus will be upon the development of private pension plans since World War II, their contribution to total private saving, their impact on the functioning of the nation's capital markets, and the allocation of saving among capital formation demands.

Following this historical review, Dr. Ture will focus upon the recently enacted Employee Retirement Income Security Act of 1974, with the objective of analyzing the effects of the new law on the direction and magnitude of the flow of funds into private pensions and thence into investment. This portion of the study will be followed by an analysis of the serious challenge to the future development of private pension systems presented by the potentially explosive expansion of the social security system. Since inflation poses collateral problems for retirement plan investment policies which are required to provide secured benefits, Dr. Ture will also examine the implications of varying assumptions about the rate of increase in the general level of prices for the future development of the private pension system. Finally, the study will project the future growth in private pensions and examine alternative policies which might enhance the growth and efficiency of private pension operations.

A complete listing of the outside research studies which have received financial support through the Association's investment research program since its inception in 1946 may be found in the Appendix to this report.



Assets and Investments in 1974

Assets of life insurance companies reached \$263.8 billion at the end of 1974, 4.5 percent above the total of \$252.4 billion a year earlier. Estimates of year-end assets by investment classes are given in Table 6, together with the actual amounts held at the end of 1972 and 1973. The 1974 estimates reflect an unusually large net capital loss of \$6 billion, nearly all from the writedown in market values of common stock holdings, and a rate of growth of 6.9 percent when assets are adjusted to exclude the net capital loss. The 4.5 percent increase in assets was the lowest in the range of rates observed during the past fifteen years, equaling the low rate in 1969, which was also a year of net capital loss. The adjusted growth rate of 6.9 percent compared favorably, however, with most other recent years, exceeding any year of the 1960's and falling below only the 1973 adjusted rate of 7.3 percent.

The percentage distributions of assets set out in Table 6 indicate a significant rise during 1974 in the proportion for policy loans, which increased to 8.7 percent of the total from 8 percent at the end of 1973; further growth in the shares for the two principal investment outlets, corporate debt issues and mortgage loans; and a sharp drop in the proportion of assets held in common stocks.

Corporate debt issues continued as the single largest component of life company assets, amounting to over \$97 billion or 36.9 percent of the total. Market demands for corporate bond financing were sizable in 1974, with the growth over 1973 concentrated in public offerings while the amount of financing through direct placements declined from the unusually large totals of 1972-73. Although life insurance companies are a major source of funds to the direct placement market, they also purchase public offerings so that the decline in direct offerings was not a seriously limiting factor in the growth of corporate bond portfolios. Included in the \$97 billion of corporate debt issues held at the end of 1974 was \$3.2 billion for issues with maturities of one year or less, primarily commercial paper held for liquidity purposes. The year-end level was below the amount held in other months during the year since this component is typically reduced in the final weeks of the year when long-term investments are made in sizable amounts.

Mortgage loans amounted to over \$86 billion or 32.8 percent of assets at the end of 1974 and for the fourth consecutive year ranked second to corporate debt issues in importance. (From 1965 through 1970 mortgage loans had represented the largest asset category.) Of the total, nearly \$84 billion represented mortgages on properties in the United States and the balance of about \$2.5 billion for foreign mortgages was nearly all on Canadian properties.

With respect to U.S. mortgages, the year 1974 witnessed the emergence of two developments in the investment data. For the first time on record, mortgages held on nonresidential properties exceeded residential loans in the mortgage portfolios of life insurers, and mortgages held on multifamily properties emerged as the larger part of residential loan holdings. Nonresidential (nonfarm) loans of \$40.4 billion surpassed the residential mortgage total of \$37.2 billion at the end of 1974, in contrast with all earlier years (back to 1946). These amounts compared with 1973 figures of \$35.5 billion for nonresidential loans and \$37.5 billion for residential mortgages. The 1974 residential mortgage total included nearly \$19 billion for multifamily loans, somewhat above the \$18.3 billion for 1-4 family loans.



Table 6

Assets of U.S. Life Insurance Companies, 1972-1974

(Dollar amounts in millions)

Asset Class	December 31, 1972		December 31, 1973		Estimated December 31, 1974	
	Amount	%	Amount	%	Amount	%
Bonds, Notes and Debentures						
U.S. Treasury	\$ 3,827	1.6	\$ 3,444	1.4	\$ 3,225	1.2
U.S. Federal Agency	735	0.3	884	0.4	1,050	0.4
U.S. State and Local	3,367	1.4	3,412	1.4	3,625	1.4
Foreign Government and International	3,443	1.4	3,663	1.5	3,850	1.5
Total Government	11,372	4.7	11,403	4.5	11,750	4.5
Corporate--1 year or less	2,981	1.2	3,004	1.2	3,250	1.2
U.S. Corporate--Over 1 year	78,478	32.7	83,974	33.3	89,175	33.8
Foreign Corporate--Over 1 year	4,681	2.0	4,818	1.9	5,000	1.9
Total Corporate	86,140	35.9	91,796	36.4	97,425	36.9
Stocks						
Preferred	5,052	2.1	6,313	2.5	7,150	2.7
Common	21,793	9.1	19,606	7.8	14,925	5.7
Total Stocks	26,845	11.2	25,919	10.3	22,075	8.4
Mortgages						
Farm	5,678	2.4	5,996	2.4	6,350	2.4
Nonfarm	71,270	29.7	75,373	29.9	80,100	30.4
Total Mortgages	76,948	32.1	81,369	32.2	86,450	32.8
Real Estate	7,295	3.0	7,693	3.0	8,125	3.1
Policy Loans	18,003	7.5	20,199	8.0	22,900	8.7
Cash	1,981	0.8	2,071	0.8	2,100	0.8
Other	11,146	4.6	11,986	4.7	13,000	4.9
Total Assets	\$239,730	100.0	\$252,436	100.0	\$263,825	100.0

The valuation basis for each classification is admitted asset (statement) value.

Source: Institute of Life Insurance, 1972-73.



At the end of 1973, multifamily mortgages had totaled \$17.8 billion as against \$19.7 billion for 1-4 family mortgages. In addition to these loans on nonfarm properties, the companies held about \$6.3 billion of mortgages on farm properties.

Corporate stocks dropped sharply in amount and as a share of total assets in 1974, a reflection of the drop in market values of common stocks. The total of \$14.9 billion for common stocks at year-end 1974 was based on an estimated market valuation loss averaging 30 percent or about \$5.9 billion, a loss that completely overwhelmed a modest net investment during the year. In contrast with common stocks, most preferred stocks are carried in the annual statements at stable values (usually at cost) and these investments, amounting to \$7.15 billion, increased as an asset share. Market offerings of preferred stocks, although somewhat less than in the three preceding years, ran considerably above the annual totals prior to 1971 as the flotations of public utility firms stepped up in recent years.

Rate of Net Investment Income

The net rate of income from the invested assets of life insurance companies is estimated at 6.15 percent for 1974 when separate accounts are included and at 6.25 percent when separate accounts are excluded. As shown in Table 7, the estimates reflect an increase from 1973 of 27 basis points in the rate of income on total invested assets (including separate accounts) and an increase of 25 basis points in the rate for the general accounts (excluding separate accounts). The 1974 rates were a full percentage point above those five years earlier and they compared with a 1964 income rate of 4.53 percent (with or without the minimal amount of separate accounts then held by the companies). The dollar amount of net investment income of \$14.95 billion in 1974 increased 9.4 percent from 1973 as against the comparable 1973 increase of 12.7 percent.

Table 7

Net Investment Income and Ratio of Income to Invested Assets  
U.S. Life Insurance Companies

<u>Year</u>	<u>Net Investment Income</u> (Including Separate Accounts)		<u>General Accounts</u>
	<u>Millions</u>	<u>Rate</u>	<u>Rate</u>
1969	\$ 9,354	5.12%	5.15%
1970	10,144	5.30	5.34
1971	11,031	5.44	5.52
1972	12,127	5.56	5.69
1973	13,670	5.88	6.00
1974	14,950e	6.15e	6.25e

e - Estimated.

Source: Institute of Life Insurance, 1969-73.

Note: Rates are derived from dollar aggregates. Investment income is after investment expenses but before federal income taxes and includes interest, dividend, rental, and other income but excludes capital gains or losses.



Net Changes in Assets

The estimated net changes in broad categories of life company assets in 1974, together with the actual changes in 1972 and 1973, are shown in Table 8. The figures reflect valuation changes as well as net investment during the year. The increase in total assets of \$11.4 billion in 1974 reflected an estimated net capital loss of \$6 billion as compared with a capital loss of \$4.7 billion in 1973 and a net capital gain of \$2.3 billion in 1972. When adjusted for valuation changes, the asset increases came to \$15.3 billion in 1972 and \$17.4 billion in both 1973 and 1974.

In addition to a larger net capital loss in 1974 than in 1973, both the net increase in policy loans and the net investment in mortgage loans accelerated over 1973. On the other hand, the net investment in corporate debt issues represented a somewhat slower rate of growth and the net investment in stocks was considerably below 1973.

Despite a somewhat slower growth than in 1973, corporate debt issues nevertheless continued in 1974 to show the largest dollar increase among the asset categories. The rise of \$5.6 billion for both long- and short-term issues represented a growth rate of 6.1 percent as compared with 6.6 percent in 1973 and a recent high of 8.8 percent in 1972. The corporate bond component increased \$5.4 billion as against \$5.6 billion in 1973, while short-term issues increased by \$200 million in 1974 as compared with only a nominal increase in 1973.

Table 8

Net Changes in Assets, 1972-1974  
U.S. Life Insurance Companies

(In millions of dollars)

Asset Class	1972	1973	Estimated 1974
Bonds, Notes, and Debentures			
U.S. Treasury and Federal Agency	\$ 107	\$ -234	\$ -53
U.S. State and Local	4	45	213
Foreign Government and International	261	220	187
Corporate	<u>6,942</u>	<u>5,656</u>	<u>5,629</u>
Total	\$ 7,314	\$ 5,687	\$ 5,976
Stocks	6,238	-926	-3,844
Mortgages	1,452	4,421	5,081
Real Estate	391	398	432
Policy Loans	938	2,196	2,701
Cash and Other Assets	<u>1,295</u>	<u>930</u>	<u>1,043</u>
Net Increase in Assets	\$17,628	\$12,706	\$11,389

Note: Included in the above figures are a net increase in assets of separate accounts of \$2.5 billion in 1972, a net decrease of \$28 million in 1973, and an estimated decrease of \$730 million in 1974.



The net increase in mortgage holdings of \$5.1 billion set a record for these loans in dollar terms, and the percentage increase of 6.2 percent was the largest in eight years. Mortgages held on U.S. properties increased by over \$4.9 billion, up from \$4.3 billion in 1973. Among these properties, nonfarm nonresidential mortgages alone increased by nearly \$4.9 billion, even more than the previous year's high of \$4.7 billion. Loans on multifamily properties increased by \$1.15 billion, somewhat above the 1973 increase of \$1.07 billion, and farm mortgages increased by about \$355 million as against \$322 million in 1973. The net decrease in holdings of 1-4 family mortgages slowed to \$1.45 billion from \$1.83 billion in 1973, in part reflecting a slower rate of repayments from loans paid off in full. These prepayments are generated from the sales of existing homes and under the conditions prevailing in the home mortgage market in 1974, sales were sharply reduced by the lack of financing available to potential purchasers.

The sizable net decrease in corporate stock holdings of \$3.8 billion in 1974, as well as the smaller decrease in 1973, reflected declines in market values. The 1974 valuation loss on stocks was estimated at \$5.9 billion and followed a 1973 loss of \$4.5 billion. Excluding valuation changes, the net increase in stocks amounted to nearly \$2.1 billion in 1974, noticeably below the \$3.6 billion in 1973. The greater part of the slowdown was traceable to common stocks for which 1974 net investments amounted to \$1.2 billion, roughly half as much as the 1973 figure of \$2.3 billion, while the net investment in preferred stocks of \$0.9 billion declined from \$1.3 billion in 1973.

The net increase in policy loans set a record at \$2.7 billion in 1974, surpassing the previous high of \$2.5 billion in 1969. In percentage terms, policy loan holdings increased 13.4 percent in 1974, following a 12.2 percent increase in 1973. In all but two of the past ten years, policy loan growth outpaced the growth in total assets, particularly so in 1969 when policy loans increased by 22 percent as against 5.4 percent for total assets, adjusted for valuation change. The extraordinarily high interest rates available on market investments in 1974 were a further strong inducement to policyholders to borrow on the cash values of their policies at the relatively low rates set in their contracts. The net increases were persistently larger in every month of 1974, noticeably above those in 1973 except that the peak 1974 months of August-September were slightly below the earlier year when the same two months had witnessed a sharp acceleration in policy loan demands.

#### Acquisitions of Investments

The activity of life insurance company investment departments is more fully shown by the figures on investment acquisitions than by net changes in assets. Acquisitions reflect funds from new money--i.e., net asset growth adjusted for valuation changes--from sales, calls, and repayments of existing investments, and also the amounts involved in exchange and refinancing transactions. Accordingly, fluctuations in these items produce changes in the volume of acquisitions. In 1974, acquisitions of investments turned down from the record amount in 1973, largely reflecting lower amounts from sales and repayments of assets and an associated reduction in the turnover of short-term debt issues. Total acquisitions of about \$112 billion, including over \$75 billion of short-term issues, decreased 7 percent from 1973. When short-term issues were excluded, 1974 acquisitions of some \$36 billion were 8 percent below those in 1973.



As shown in Table 9, short-term issues account for a large part of acquisitions, roughly two-thirds of the total in both 1973 and 1974. The 1974 total of over \$75 billion for these temporary investments was about \$6 billion below the 1973 volume, a downturn that is explained, in the face of record high short-term yields, by the reduced inflows of funds requiring temporary investment. Corporate issues, such as commercial and finance company paper, accounted for \$70 billion of the 1974 total with the balance of \$5.6 billion reflecting U.S. Treasury and federal agency issues.

Corporate bond acquisitions of \$11.7 billion in 1974 were \$1 billion less than in 1973, with U.S. corporates of \$11.3 billion accounting for the shortfall while foreign corporate bond acquisitions were little changed from 1973. Bond sales were considerably below those in 1973, and the amounts from maturities and calls were also lower; even though the amounts from these transactions need not be matched by reinvestments in the corporate bond account, a reduction in these sources of funds was undoubtedly a factor in the slower pace of corporate bond acquisitions.

Corporate stock acquisitions dropped to \$4.75 billion in 1974 from \$8.2 billion in 1973 as market prices declined and the growth of separate accounts slowed. Common stock acquisitions of \$3.7 billion were 43 percent below the 1973 volume of \$6.5 billion, and preferred stock acquisitions of \$1.05 billion ran 38 percent below the \$1.7 billion total in 1973. These declines accompanied reduced sales and other disposals of stocks, which dropped by a roughly similar proportion, 42 percent, and amounted to \$2.7 billion as compared with \$4.6 billion in 1973.

Table 9  
Acquisitions of Investments, 1972-1974  
U.S. Life Insurance Companies

(In millions of dollars)

Asset Class	1972	1973	Estimated 1974
Bonds, Notes, and Debentures - Over 1 year			
U.S. Treasury and Federal Agency	\$ 678	\$ 468	\$ 625
U.S. State and Local	436	501	525
Foreign Government and International	490	416	425
Corporate	14,257	12,741	11,725
Total - Over 1 year	15,861	14,126	13,300
Stocks	8,468	8,198	4,750
Mortgages	8,696	11,463	11,800
Real Estate	976	1,177	1,125
Policy Loans	3,252	4,602	5,350
Acquisitions excluding short-term issues	37,253	39,566	36,325
Short-term debt issues	61,368	81,223	75,600
Total Acquisitions	\$98,621	\$120,789	\$111,925

Source: Institute of Life Insurance.



Mortgage acquisitions reached \$11.8 billion in 1974, the largest amount on record. Mortgage acquisitions, however, showed limited growth over 1973 relative to the acceleration of the net increase in mortgage holdings, noted in the preceding section, since the growth in mortgage holdings also reflected a contraction in repayments during 1974. Included in the acquisitions total of \$11.8 billion were \$10.2 billion of nonfarm conventional loans and about \$1.1 billion of farm mortgages, while government-backed loans at \$525 million continued in about the same volume as in the preceding two years.

Policy loan acquisitions of \$5.35 billion in 1974 were in record amount for the second consecutive year, 16 percent above the large 1973 total. The escalation of policy loan acquisitions during the past two years ran well ahead of the strong and prolonged demands for such loans in 1969-70. In the latest two years, policy loan acquisitions amounted to about \$10 billion as compared with under \$8.3 billion in 1969-70.

These data on acquisitions include all transactions, cash and noncash, that increase an investment account. For example, when borrowers under existing mortgage loans or direct placement bonds seek additional financing, the refinanced portion of the loan may be included with acquisitions, and the full accounts include a counter entry in disposals for the existing loan. Transfers, conversions, and exchanges within or between assets categories are also included, and many of these involve little or no cash. Because of the inclusion of refinancings, exchanges, and bookkeeping transfers, acquisition figures do not provide a fully meaningful measure of the amount of investment funds available from life insurance companies, and for this purpose information on cash flow is provided.

#### Cash Flow for Investment

Quarterly surveys of cash flow, instituted in 1957 by the research staff, provide information on the amount and sources of funds available to life insurance companies for long-term investment. In this reporting system, "cash flow" is defined as the net increase in ledger assets (reflecting premium payments and investment income, net of all benefit payments and expenses), the return flow from existing investments (i.e., repayments and sales), and miscellaneous items, including borrowed money; funds available from these sources are reduced by net increases in cash position, by net repayments of borrowed money, and by net increases in policy loans when arriving at the total of funds available for long-term investment in securities, mortgages, and real property. Since by definition cash position includes holdings of short-term securities as well as cash and bank deposits, total cash flow reflects the change in holdings of short-term issues but excludes the turnover of these securities.

On the basis of this definition, cash flow of life insurance companies is estimated to total \$27.4 billion during 1974, about \$3.6 billion below the 1973 total of \$31 billion, as shown in Table 10. The estimates in the table for all U.S. life insurance companies are expanded from the cash flow totals reported by a sample group of companies and reflect their projections for the final quarter of the year. Nearly all sources of funds were lower than in 1973, and the increase in policy loans diverted \$2.7 billion from investment funds otherwise available for market investments, about \$500 million more than in 1973 (when policy loans increased by \$2.2 billion).



Table 10

Estimates of Cash Flow for Market Investments  
U.S. Life Insurance Companies  
(In billions of dollars)

<u>Year</u>	<u>Amount</u>	<u>Year</u>	<u>Amount</u>
1964	\$16.7	1970	\$16.6
1965	18.2	1971	25.3
1966	16.9	1972	30.8
1967	16.8	1973	31.0
1968	17.3	1974	27.4p
1969	14.9		

p - Preliminary.

Quarterly totals during 1973 and 1974 of cash flow and its components as reported by the sample group are provided in Table 11. In each of the first three quarters of 1974, total investment funds (before meeting the net increase in policy loans) and the cash flow total (after policy loans) fell below the corresponding period of 1973 and by increasing amounts; for the three quarters combined, the shortfall in total cash flow came to \$2.8 billion. The return flow from the securities accounts fell sharply below the 1973 total largely because of reduced sales of stocks and bonds, but bond maturities (including amortizations) and calls of securities were also lower. The amounts from mortgages prepaid in full declined significantly from 1973, more than offsetting the slight growth in amortization and partial prepayments. The net increase in ledger assets in the nine months of 1974 showed some acceleration over the comparable period of 1973, although in the first half of the year this important source of funds had lagged behind the comparable 1973 period. But the acceleration in ledger asset growth was nearly matched by the more rapid pace of policy loan increases. For the reporting group, the net increase in policy loans during the first three quarters of 1974 ran about \$370 million more than in the same period of 1973.

Mortgage Commitments of Life Insurance Companies

Estimates of new and outstanding commitments for future mortgage lending by life insurance companies have been provided by the research staff to the Department of Housing and Urban Development (HUD) over the past five years. The estimates are based on the monthly reporting of a large sample of companies that for many years have provided data on forward investment commitments to the Association. HUD serves as the collecting agency for mortgage commitment data and for figures on gross mortgage flows of eleven lending groups. The gross mortgage flow data of life insurance companies are provided by the Institute of Life Insurance, and the statistics for all lending groups are available in monthly news releases of HUD.

Changes in new mortgage commitments may differ considerably from the pattern shown by mortgage disbursements during the same time period, particularly when, as has been true for life insurance companies in recent years, a substantial proportion of commitments represents long-term loans on income-producing properties yet to be constructed. Most of the mortgage loans acquired by life companies during



Table 11

Inflow of Investment Funds of Reporting Life Insurance Companies, Quarterly

(In millions of dollars)

Sources of Investment Funds	1973				1974		
	I	II	III	IV	I	II	III
Net change in:							
Ledger assets	\$3,287	\$2,107	\$2,503	\$3,318	\$3,158	\$2,172	\$2,944
Cash position*	-1,386	904	428	339	-629	632	-285
Mortgages - total	1,324	1,301	1,238	1,077	1,225	1,112	1,003
Amortization and partial prepayments	758	643	647	675	762	673	649
Other repayments	556	632	586	384	453	413	341
Sales	9	26	5	18	10	26	13
Securities - total	2,338	2,080	1,938	2,274	1,491	1,555	1,419
Maturities	641	886	706	926	565	781	785
Calls	244	154	141	168	95	169	160
Outright sales	1,453	1,040	1,092	1,179	831	606	475
(bonds)	(336)	(392)	(532)	(350)	(221)	(162)	(198)
(stocks)	(1,116)	(648)	(568)	(829)	(609)	(445)	(276)
Sales of real estate	52	63	36	29	42	30	30
Sales and repayments of other assets	19	7	6	8	6	8	8
Net change in liability for borrowed money	-49	66	143	-190	43	88	-137
All other sources	**	8	2	**	7	1	19
Total investment funds	5,585	6,536	6,294	6,854	5,343	5,596	5,002
Net increase (-) in policy loans	-218	-299	-690	-450	-337	-521	-717
Total cash flow	\$5,367	\$6,237	\$5,604	\$6,404	\$5,006	\$5,075	\$4,285

\* An increase in cash position is shown as a negative and decrease is shown as a positive figure.

\*\* Less than \$500,000.

Reporting companies represent 77 percent of the total assets of U.S. life insurance companies.



1974 came from the backlog of commitments accumulated prior to 1974 and, as indicated in an earlier section of this report, mortgage acquisitions compared favorably with those in 1973. In contrast, new mortgage commitments made by the companies in 1974 fell sharply below the record high volume in 1973. The quarterly totals in Table 12 indicate a marked curtailment in commitment activity beginning in the final quarter of 1973. During the first nine months of 1974, new mortgage commitments amounted to \$7.2 billion, 40 percent below the total of nearly \$12 billion in the same period of 1973. Nonfarm nonresidential mortgage commitments of \$5.1 billion for the nine months of 1974 fell \$3.2 billion below the comparable period of 1973. Residential mortgage commitments of \$1.1 billion were \$1.6 billion lower while farm mortgage commitments were about \$100 million above the 1973 nine-month total. The decline in new commitments produced a drop in the backlog of outstanding mortgage commitments, since disbursements from prior commitments were well maintained. At the end of September, the backlog amounted to \$14 billion, about 10 percent below the level at year-end 1973.

Table 12

New Commitments Made for Mortgages on U.S. Properties  
U.S. Life Insurance Companies

(In millions of dollars)

Year or Quarter	Farm	Nonfarm		Total
		Residential	Nonresidential	
1970	\$ 285	\$1,979	\$3,381	\$ 5,645
1971	590	2,912	6,122	9,624
1972	817	4,052	8,260	13,129
1973	1,128	3,129	9,768	14,025
1973 I	273	1,000	2,444	3,717
II	338	998	3,189	4,525
III	273	725	2,718	3,716
IV	244	406	1,417	2,067
1974 I	318	367	1,426	2,111
II	429	493	2,173	3,095
III	224	263	1,533	2,020

Income Property Mortgage Commitments

During the past ten years a sample of life insurance companies has provided to the research staff detailed information on each nonfarm mortgage commitment of \$100,000 and over. The reporting was undertaken in order to continue a series covering the period 1951 through June 1965 developed by the Study of Interest Rates, a research project financed by the Association and conducted by the National Bureau of Economic Research. This part of the Study of Interest Rates had the benefit of substantial support from the Federal Reserve Board in the form of staff and computer time provided for the processing and analysis of the extensive volume of statistics collected under the NBER project. A Federal Reserve Board staff economic study by Robert Moore Fisher and Barbara Negri Oppen, cited in the Appendix to this report, provides an analysis and summary of the data for the period 1951-70.



Table 13 provides commitment totals and averages for some of the loan characteristics covered by the ALIA surveys. As measured by the quarterly averages, interest rates on income property mortgage commitments began to rise noticeably in the third quarter of 1973, having fluctuated within a relatively narrow range during the preceding six quarters. Rates eased somewhat in the first quarter of 1974 and resumed their rise in the second quarter. The underlying monthly figures indicated an increase in contract rates of roughly 70 basis points from June 1973 to June 1974, a rise that lagged behind the increases shown by bond yields, which moved up rapidly in the first half of 1974.

Table 13

Commitments of \$100,000 and Over on Multifamily and Nonresidential Mortgages  
Made by Reporting Life Insurance Companies, 1966-1974

<u>Year or Quarter</u>	<u>No. of Loans</u>	<u>Total Amount Committed (\$000,000)</u>	<u>Average Loan Amount (\$000)</u>	<u>Average Interest Rate (by #)</u>	<u>Weighted Average Interest Rate</u>	<u>Average Loan-to- Value Ratio</u>	<u>Average Term (Years/ Months)</u>	
<u>Annual Totals and Averages</u>								
1966	2,796	\$2,516	\$ 900	6.42%	6.35%	70.0%	20/5	
1967	2,726	3,027	1,111	6.97	6.92	71.0	21/2	
1968	2,569	3,244	1,263	7.66	7.65	73.6	22/11	
1969	1,788	2,921	1,633	8.69	8.62	73.3	21/8	
1970	912	2,341	2,567	9.93	9.86	74.7	22/8	
1971	1,664	3,983	2,393	9.07	8.99	74.9	22/10	
1972	2,132	4,987	2,339	8.57	8.50	75.2	23/3	
1973	2,140	4,833	2,259	8.76	8.70	74.3	23/3	
<u>Quarterly Totals and Averages</u>								
1972	I	449	1,152	2,567	8.60	8.48	74.7	23/2
	II	714	1,464	2,050	8.50	8.44	75.8	23/7
	III	500	1,291	2,582	8.56	8.52	75.0	23/1
	IV	469	1,079	2,301	8.64	8.60	75.0	23
1973	I	534	1,362	2,550	8.62	8.53	74.8	23/1
	II	634	1,493	2,355	8.64	8.61	74.6	23/7
	III	661	1,309	1,981	8.80	8.82	73.8	23/6
	IV	311	670	2,153	9.13	9.06	74.1	22/6
1974	I	268	540	2,014	9.05	8.97	73.9	22/1
	II	436	947	2,171	9.23	9.19	74.6	21/6

Averages are based on number of loans except for the weighted interest rate which is derived by weighting each rate by the amount of the commitment.

Reporting companies have accounted for about 55 percent of nonfarm mortgages held by U.S. life insurance companies over the years shown.



The dollar amount committed by the reporting companies in the first six months of 1974, about \$1.5 billion, fell 48 percent below the amount in the comparable period of 1973 and was the lowest for a half-year period since 1970. Although the average size of loan tended to increase over the years shown in Table 13, reaching a peak of nearly \$2.6 million in 1970, there was a noticeable downturn in loan size in the latest several quarters. Data on square footage of projects is not included in the reporting but in the face of continuing rises in construction costs, the decrease in loan size implies a smaller scale for many of the projects covered by commitments made after mid-1973. Also, in early 1974 numerous loans were made on industrial properties for which loan size usually runs considerably below that of such income-producing properties as apartments, office buildings, hotels-motels and shopping centers.

Loans on industrial properties represented 15 percent of the dollar amount committed in the first half of 1974, noticeably above their share of 4 percent or less in the preceding four years. This dollar share, however, involved an even larger proportion--31 percent--of the total number of commitments since loans for industrial properties averaged about \$1 million each, well below the average for all commitments of \$2.1 million in the first half of 1974.

Average term to maturity has been affected by variations in the mix of loans as to repayment provisions--i.e., whether fully amortizing or partially amortizing loans. Average maturity of all loans shortened somewhat in late 1973 and early 1974 even though there was no accompanying decrease in loan-to-value ratios and interest rates moved up on balance. Although most loans are fully amortizing, the proportion represented by partially amortizing loans increased noticeably in late 1973. Partially amortizing loans, which generally carry maturities of under 20 years, increased from about 32 percent of all loans in 1972 and early 1973 to 42 percent in the latest three quarters covered in Table 13. Since average term for fully amortizing loans varied little at around 25-26 years, the increased share for partially amortizing loans was reflected in the downturn in the average maturity of all loans.

Weighted average interest rates in Table 13 are broken down by major property types in Table 14 for recent years and quarters. As may be seen, the quarterly average interest rate for all loans increased 58 basis points over the year ending with the second quarter of 1974, and the increases for office buildings, commercial retail, institutional and recreational, and industrial properties were all roughly similar, up by 59 to 63 basis points. The increase for conventional apartment loans, however, was below average at 48 basis points, while the increases for hotels-motels and for commercial services were well above average at 70 or more basis points. Although the three property types of conventional apartments, office buildings, and commercial retail stores had accounted for over 80 percent of the amount committed in each year 1970-72, the proportion fell to 69 percent in 1973 and decreased further to 65 percent in the second quarter of 1974. Much of the decrease was in the share represented by conventional apartments, which was under 18 percent of the total in the latest quarter, down from 26 percent in 1973 and 29-33 percent in 1970-72. The acceleration in the demands for mortgage financing of industrial properties, noted above, about offset the decline in the share represented by apartments.



Table 14

Average Contract Interest Rates by Major Property Type  
on Commitments of \$100,000 and Over Made by  
Reporting Life Insurance Companies

Property Type	1970	1971	1972	1973	1973			1974	
					II	III	IV	I	II
Conventional apartments	9.78%	8.98%	8.53%	8.67%	8.56%	8.84%	9.05%	8.99%	9.04%
Office buildings	9.86	8.90	8.46	8.61	8.51	8.71	8.94	8.94	9.12
Commercial retail	10.24	9.04	8.40	8.58	8.57	8.70	8.93	8.83	9.16
Commercial services	10.19	9.18	8.65	8.82	8.66	8.79	9.12	9.02	9.40
Institutional and recreational	9.54	9.08	8.73	8.90	8.95	8.79	9.41	8.64	9.58
Industrial	10.05	9.26	8.54	8.77	8.62	8.87	9.08	9.07	9.25
FHA apartments	8.50	7.57	7.21	-	-	-	-	-	-
NHA apartments	10.49	9.40	9.04	9.02	*	*	-	*	-
Hotels and motels	9.78	9.62	8.75	9.11	8.95	9.35	9.22	9.37	9.65
Total*	9.86	8.99	8.50	8.70	8.61	8.82	<b>9.06</b>	8.97	9.19

\*Data not shown where there are fewer than three loans. The total may include a few commitments for property types not shown separately. Averages are derived by weighting each rate by the amount of the commitment.

Income and Costs of Mortgage Loan Portfolios

Surveys of income and costs of the mortgage portfolios of life insurance companies have been conducted by the research staff since 1948. The surveys had their origin with similar studies, covering the years 1945-47, conducted by the National Bureau of Economic Research. The NBER studies had aroused considerable interest among investment officers of the companies, and the research staff was asked to provide continuing data in this area. Results of the survey covering 1973 are given in Table 15 in the perspective of selected earlier years.

As shown in the table, the average net income rate increased markedly over the thirteen years from 1960 to 1973, due largely to improved gross income rates--especially in the latest three years--and also to decreases from 1960 to 1971 in the ratio for total operating costs. Costs, however, have been stable in the latest three years. The improvement in cost ratios during the 1960's accompanied the shifting of



portfolios from 1-4 family mortgages into loans on multifamily and nonresidential properties, since these larger loans involve lower unit costs than home mortgage loans. It should be noted that the averages in Table 15 are derived from aggregates of dollar figures and thus are heavily influenced by the experience of companies having sizable investments in mortgages. The underlying studies indicate that the majority of reporting companies experience higher costs than shown by the weighted average for all companies. The average of cost ratios based on number of companies came to 0.45 percent in 1973 as against the 0.31 percent ratio derived from dollar aggregates and given in the table.

During 1973, the gross income ratio reached 6.97 percent, a marked rise of 30 basis points above the 1972 rate. New loans moving into the portfolio carried rates averaging 8.59 percent, about the same as in 1972, but new loans represented less than 14 percent of the total portfolio.

With respect to the components of total costs, originating fees and premiums (paid in order to acquire loans) have been an insignificant item for a number of years. There usually is not a separately stated originating fee when loans are generated by correspondents who retain the servicing on these loans. Servicing fees, paid to mortgage correspondents on a continuing basis over the life of the loans, declined during the 1960's as mortgages on income-producing properties increased as a proportionate share of mortgage portfolios. Income property loans, although varying widely in size, typically involve service fees that represent a smaller percentage of the loan amount than is needed for home loans. Also, service fee ratios in the table are based on the total loan portfolio, which includes loans that are serviced directly by company personnel. The underlying data indicate that loans serviced by mortgage correspondents carried service fee costs averaging about 0.25-0.30 percent.

Table 15

Average Rate of Income and Costs and Turnover Period of Mortgage Loans Held by Reporting Life Insurance Companies

	<u>1960</u>	<u>1965</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>
	(In percent)					
Gross accrual income	5.04%	5.54%	6.14%	6.39%	6.67%	6.97%
Operating costs	.49	.44	.34	.32	.31	.31
Originating fees and premiums	.03	.03	.01	.01	.01	*
Servicing fees	.21	.18	.14	.13	.12	.12
Home and branch office costs	.25	.22	.18	.17	.18	.19
Net accrual income	4.55	5.11	5.80	6.07	6.37	6.66
	(In years)					
Turnover period	12.6	10.6	17.0	13.2	11.9	12.7

\* Less than .005 percent.

Note: Because of rounding, components may not add to totals shown. Cost items were available only on a cash accounting basis prior to 1973. Net income ratios assume that costs were equal on the two accounting bases. Reporting companies have accounted for about 85 percent of mortgage loans held by U.S. life insurance companies.



Mortgage repayments in 1973 slowed somewhat from the pace in 1972, and the average turnover period of the mortgage portfolios of surveyed companies lengthened from 11.9 years in 1972 to 12.7 years in 1973. This was still considerably shorter than the record long turnover period of 17 years in 1970 when mortgage prepayments were in minimal amounts.

Mortgage Delinquency and Foreclosure Experience

Data on mortgage loan delinquencies and foreclosures have been reported to the ALIA research staff in considerable detail by a representative sample of life insurance companies since 1954. The reporting, which currently is semiannual (quarterly prior to 1972), permits the computation of delinquency and foreclosure rates on two bases, dollar amounts and numbers of loans. The two sets of rates may differ widely in their levels and often diverge in their direction of change, particularly so in recent years when new loans--those most likely to become delinquent--have been relatively few in number and large in dollar size as compared with seasoned loans in the portfolio. Rates based on dollars have been noticeably above those based on numbers in recent years but prior to 1964, rates by numbers were higher. In Table 16, only rates based on dollar amounts are shown.

Table 16

Mortgage Delinquency Rates of Reporting Life Insurance Companies

End of Period	Nonfarm Mortgages				Total Nonfarm	Total Farm	Total Mortgages
	FHA	VA	Canadian NHA	Conventional			
1955	.62%	.83%	.51%	.44%	.58%	.48%	.57%
1960	.82	.98	.42	.40	.61	.21	.58
1965	1.79	1.29	.83	.58	.93	.28	.87
1966	1.47	1.15	.54	.64	.86	.25	.81
1967	1.41	.98	.35	.61	.80	.60	.78
1968	.91	.88	.32	.53	.63	.57	.63
1969	.98	.87	.39	.44	.57	.36	.55
1970	1.34	.95	.84	.74	.85	1.51	.91
1971	1.65	1.00	.94	.74	.90	1.59	.96
1972	1.85	1.08	.41	1.02	1.13	1.38	1.15
1973 June	1.46	.84	.34	1.26	1.26	1.47	1.27
December	1.99	.96	.79	1.56	1.57	.63	1.49
1974 June	1.63	.89	.27	1.93	1.83	1.18	1.77

Note: Rates are based on dollar amounts and represent the ratio of delinquent loans to total loans held in the specified category. Delinquent loans include loans in process of foreclosure as well as those with two or more monthly interest payments past due in the case of nonfarm mortgages and, for farm mortgages, those with interest in arrears more than 90 days. Reporting companies have accounted for 75-85 percent of the assets of U.S. life insurance companies.



At mid-1974, the latest reporting date, total mortgage delinquencies reached their highest level in the twenty-one years covered by the surveys, 1.77 percent of the dollar amount of loans held. The low point of the range, 0.45 percent, was set in the late 1950's. The current upward trend in delinquency rates began with a sharp rise in 1970; as shown in Table 16, the latest reading compared with 0.55 percent at the end of 1969 and 1.49 percent at the end of 1973.

The rise in delinquency rates after 1969 occurred in both farm and nonfarm loans, at first more sharply in farm loans. In the latest three years, however, the rate for nonfarm conventional loans, by far the largest component of mortgage holdings, increased persistently to reach 1.93 percent in mid-1974, not only a high for these loans but also a level that for the first time was above the rates for both FHA and VA mortgages. At the same time, the farm loan rate of 1.18 percent was well below its peak (2.44 percent) set in mid-1971. In contrast with these levels, rates by numbers of loans averaged 0.85 percent in total, including 0.68 percent for nonfarm conventional mortgages and 0.46 percent for farm loans in mid-1974.

Further detail on nonfarm loans by property type underlying the mortgages is provided by most of the reporting companies, in addition to the type of financing information shown in Table 16. These breakdowns have indicated relatively high delinquency rates for multifamily properties for several years. In mid-1974, delinquency rates averaged 2.96 percent for multifamily properties as compared with 1.61 percent for nonresidential properties and 0.97 percent for 1-4 family properties.

Loans in process of foreclosure, which are included with delinquent loans, reached a series high in mid-1974, averaging 0.31 percent of total loans held. In-foreclosure rates generally followed the path of delinquency rates, upward in the 1970's after a downward trend in the late 1960's. Based on numbers of loans, the in-foreclosure rate for total mortgages at mid-1974, 0.09 percent, was less than one-third the rate based on dollar amounts, since rates by numbers are virtually determined by the relatively favorable experience with 1-4 family loans which continue to dominate mortgage portfolios in terms of numbers of loans.



## Appendix

### Outside Research Studies Supported by the Association

- I. A Study of Saving in the United States, Raymond W. Goldsmith (published in three volumes by the Princeton University Press, 1955 and 1956)
- II. The Study of Capital Formation and Financing (conducted by the National Bureau of Economic Research under Simon Kuznets)
  - A. Monographs (Princeton University Press)
    1. Capital Formation in Residential Real Estate: Trends and Prospects, Leo Grebler, David M. Blank and Louis Winnick, 1956.
    2. Capital in Agriculture: Its Formation and Financing Since 1870, Alvin S. Tostlebe, 1957.
    3. Financial Intermediaries in the American Economy Since 1900, Raymond W. Goldsmith, 1958.
    4. Capital in Transportation, Communications, and Public Utilities: Its Formation and Financing, Melville J. Ulmer, 1960.
    5. Capital in Manufacturing and Mining: Its Formation and Financing, Daniel Creamer, Sergei Dobrovolsky, and Israel Borenstein, 1960.
    6. Trends in Government Financing, Morris A. Copeland, 1961.
    7. Capital in the American Economy: Its Formation and Financing, Simon Kuznets, 1961.
  - B. Papers
    1. The Role of Federal Credit Aids in Residential Construction, Leo Grebler, Occasional Paper 39, 1953.
    2. Capital and Output Trends in Manufacturing Industries, 1880-1948, Daniel Creamer, Occasional Paper 41, 1954.
    3. The Share of Financial Intermediaries in National Wealth and National Assets, 1900-1949, Raymond W. Goldsmith, Occasional Paper 42, 1954.
    4. Trends and Cycles in Capital Formation by United States Railroads, 1870-1950, Melville J. Ulmer, Occasional Paper 43, 1954.
    5. The Growth of Physical Capital in Agriculture, 1870-1950, Alvin S. Tostlebe, Occasional Paper 44, 1954.



6. Capital and Output Trends in Mining Industries, 1870-1948, Israel Borenstein, Occasional Paper 45, 1954.
7. The Volume of Residential Construction, 1889-1950, David M. Blank, Technical Paper 9, 1954.

III. The Study of the Postwar Capital Markets (conducted by the National Bureau of Economic Research)

A. Monographs (Princeton University Press except as noted)

1. Postwar Market for State and Local Government Securities, Roland I. Robinson, 1960.
2. The Postwar Residential Mortgage Market, Saul B. Klamman, 1961.
3. The National Wealth of the United States in the Postwar Period, Raymond W. Goldsmith, 1962.
4. Studies in the National Balance Sheet of the United States, Volume I: Raymond W. Goldsmith and Robert E. Lipsey, Volume II: Raymond W. Goldsmith, Robert E. Lipsey, and Morris Mendelson, 1963.
5. The Flow of Capital Funds in the Postwar Economy, Raymond W. Goldsmith, 1965 (Columbia University Press).

B. Papers

1. The Volume of Mortgage Debt in the Postwar Decade, Saul B. Klamman, Technical Paper 13, 1958.
2. The Postwar Rise of Mortgage Companies, Saul B. Klamman, Occasional Paper 60, 1959.
3. United States Savings Bond Program in the Postwar Period, George Hanc, Occasional Paper 81, 1962.
4. The Measurement of Corporate Sources and Uses of Funds, Eli Shapiro and David Meiselman, Technical Paper 18, 1964.

IV. Corporate Bond Project (Financial Research Program, conducted by the National Bureau of Economic Research)

A. Monographs (Princeton University Press except as noted)

1. The Volume of Corporate Bond Financing Since 1900, W. Braddock Hickman, 1953.
2. Corporate Bond Quality and Investor Experience, W. Braddock Hickman, 1958.



3. Statistical Measures of Corporate Bond Financing Since 1900, W. Braddock Hickman, assisted by Elizabeth T. Simpson, 1960.
4. Trends in Corporate Bond Quality, Thomas R. Atkinson, assisted by Elizabeth T. Simpson, 1967 (Columbia University Press).

B. Occasional Papers

1. Trends and Cycles in Corporate Bond Financing, W. Braddock Hickman, No. 37, 1952.
2. Corporate Bonds: Quality and Investment Performance, W. Braddock Hickman, No. 59, 1957.

V. Studies in Agricultural Finance (Financial Research Program, conducted by the National Bureau of Economic Research under Raymond J. Saulnier)

A. Monographs (Princeton University Press)

1. Mortgage Lending Experience in Agriculture, Lawrence A. Jones and David Durand, 1954.
2. Patterns of Farm Financial Structure, Donald C. Horton, 1957.

B. Occasional Papers

1. Costs and Returns on Farm Mortgage Lending by Life Insurance Companies, 1945-1947, Raymond J. Saulnier, No. 30, 1949.
2. Agricultural Equipment Financing, H. Diesslin, No. 50, 1955.

VI. Studies in Urban Mortgage Finance (Financial Research Program, conducted by the National Bureau of Economic Research under Raymond J. Saulnier)

A. Monographs (for the National Bureau of Economic Research by H. Wolff Book Manufacturing Co., Inc., except as noted)

1. Urban Mortgage Lending by Life Insurance Companies, Raymond J. Saulnier, 1950.
2. The Impact of Government on Real Estate Finance in the United States, Miles L. Colean, 1950.
3. Urban Real Estate Markets: Characteristics and Financing, Ernest M. Fisher, 1951.
4. History and Policies of the Home Owners' Loan Corporation, C. Lowell Harriss, 1951.
5. Commercial Bank Activities in Urban Mortgage Financing, Carl F. Behrens, 1952.
6. Urban Mortgage Lending: Comparative Markets and Experience, J. E. Morton, 1956 (Princeton University Press).



VII. The Study of Interest Rates (conducted by the National Bureau of Economic Research under Jack M. Guttentag)

A. Monographs (Columbia University Press)

1. The Behavior of Interest Rates: A Progress Report, Joseph W. Conard, 1966.
2. Yields on Corporate Debt Directly Placed, Avery B. Cohan, 1967.
3. Essays on Interest Rates, Volume 1, edited by Jack M. Guttentag and Phillip Cagan, 1969. Contains the following essays:
  - a. "The Influence of Interest Rates on the Duration of Business Cycles," Phillip Cagan.
  - b. "The Behavior of Residential Mortgage Yields Since 1951," Jack M. Guttentag.
  - c. "The Structure of the Mortgage Market for Income-Property Mortgage Loans," Royal Shipp.
  - d. "A Study of Liquidity Premiums on Federal and Municipal Government Securities," Phillip Cagan.
  - e. "The Yield Spread Between New and Seasoned Corporate Bonds, 1952-63," Joseph W. Conard and Mark W. Frankena.
  - f. "Interest Rates and Bank Reserves--A Reinterpretation of the Statistical Association," Phillip Cagan.
4. New Series on Home Mortgage Yields Since 1951, Jack M. Guttentag and Morris Beck, 1970.
5. Essays on Interest Rates, Volume 2, edited by Jack M. Guttentag, 1971. Contains three essays first published as Occasional Papers (see below) and the following essays:
  - a. "The Influence of Call Provisions and Coupon Rates on the Yields of Corporate Bonds," Mark W. Frankena.
  - b. "The Geographic Structure of Residential Mortgage Yields," E. Bruce Fredrikson.
  - c. "The Ex Ante Quality of Direct Placements, 1951-1961," Avery B. Cohan.
  - d. "Expectations at the Short End of the Yield Curve: An Application of Macaulay's Test," Thomas Sargent.
  - e. "The Expectations Component of the Term Structure," Stanley Diller.



6. The Channels of Monetary Effects on Interest Rates, Phillip Cagan, 1972.

B. Papers

1. The Cyclical Behavior of the Term Structure of Interest Rates, Reuben A. Kessel, Occasional Paper No. 91, 1965 (Columbia University Press).
2. Changes in the Cyclical Behavior of Interest Rates, Phillip Cagan, Occasional Paper No. 100, 1966 (Columbia University Press).
3. The Seasonal Variation of Interest Rates, Stanley Diller, Occasional Paper No. 108, 1969 (Columbia University Press).
4. Mortgage Commitments on Income Properties: A New Series For 15 Life Insurance Companies, 1951-70, Robert Moore Fisher and Barbara Negri Opper, Board of Governors of the Federal Reserve System, Staff Economic Study #79, 1973.

VIII. Tax Policies for Economic Growth (conducted by the National Bureau of Economic Research under Norman Ture and Hal B. Lary)

A. Monographs (Columbia University Press)

1. Accelerated Depreciation in the United States, 1954-60, Norman B. Ture, 1967.
2. Executive Compensation in Large Industrial Corporations, Wilbur G. Lewellen, 1968.
3. Tax Changes and Modernization in the Textile Industry, Thomas M. Stanback, Jr., 1969.

IX. A Study of the Effects of Inflation on Financial Markets

A. Published Articles

1. "Interest Rates and Prices in the Long Run," Thomas J. Sargent, The Journal of Money, Credit, and Banking, Vol. V, No. 1, Part II, February 1973 (Ohio State University Press).
2. "Rational Explanations and the Dynamics of Hyperinflation," Thomas J. Sargent and Neil Wallace, International Economic Review, Vol. 14, No. 2, June 1973 (University of Pennsylvania).
3. "What do Regressions of Interest on Inflation Show?" Thomas J. Sargent, Annals of Economic and Social Measurement, NBER, Vol. 2, No. 3, July 1973.
4. "Common Stock Values and Inflation--The Historical Record of Many Countries," Phillip Cagan, National Bureau Report Supplement #13, March 1974.



5. "Price Expectations and Households' Demand for Financial Assets," Lester D. Taylor, National Bureau of Economic Research, Explorations in Economic Research, Vol. 1, No. 2, Fall 1974, pp. 258-339.

X. Other Published Studies

- A. Economic Aspects of Atomic Power, Samuel Schurr and Jacob Marschak, 1950 (Princeton University Press).
- B. Investment Timing: The Formula Plan Approach, C. Sidney Cottle and W. Tate Whitman, 1953 (McGraw-Hill).
- C. The Mutual Mortgage Insurance Fund, Ernest M. Fisher and Chester Rapkin, 1956 (Columbia University Press).
- D. Corporate Earning Power and Market Valuation, 1935-1955, C. Sidney Cottle and W. Tate Whitman, 1959 (Duke University Press).
- E. The Secondary Mortgage Market, Oliver Jones and Leo Grebler, 1961 (University of California).
- F. The Value of the Call Privilege, Arleigh Hess and Willis Winn, 1962 (University of Pennsylvania).
- G. Valuation of Securities Holdings of Life Insurance Companies, Harold G. Fraine, 1962 (Richard D. Irwin, Inc.).
- H. The Effect of Pension Plans on Aggregate Saving: Evidence from a Sample Survey, Phillip Cagan, NBER Occasional Paper 95, 1965 (Columbia University Press).
- I. Private Pension Funds: Projected Growth, Daniel M. Holland, NBER Occasional Paper 97, 1966 (Columbia University Press).
- J. Inflation and the Price Indexes, Jules Backman and Martin R. Gainsbrugh, 1966 (National Industrial Conference Board).
- K. Pension Funds of Multiemployer Industrial Groups, Unions, and Nonprofit Organizations, H. Robert Bartell and Elizabeth T. Simpson, NBER Occasional Paper 105, 1968 (Columbia University Press).
- L. Economic Aspects of Pensions: A Summary Report, Roger F. Murray, 1968 (Columbia University Press for NBER).
- M. The Economics of Interest Rate Ceilings, J. Robert Lindsay, The Bulletin of the Institute of Finance, December 1970 (New York University).
- N. Inner-City Housing and Private Enterprise, Frederick E. Case, 1972 (Praeger Publishers for Graduate School of Management, University of California, Los Angeles).