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REPORT TO THE CONGRESS

Need For Specific Criteria For Adjusting The Interest Rate Charged On Insurance Policy Loans By The Veterans Administration

B-114859

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114859

To the President of the Senate and the
Speaker of the House of Representatives

This is our report on the need for specific criteria for adjusting the interest rate charged on insurance policy loans by the Veterans Administration. Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Bureau of the Budget, and to the Administrator of Veterans Affairs.

Elmer B. Staats

Comptroller General
of the United States

Contents

ABBREVIATIONS

GAO	General Accounting Office
NSLI	National Service Life Insurance
SDVI	Service-Disabled Veterans Insurance
SGLI	Servicemen's Group Life Insurance
USGLI	United States Government Life Insurance
VA	Veterans Administration
VRI	Veterans Reopened Insurance
VSLI	Veterans Special Life Insurance

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

NEED FOR SPECIFIC CRITERIA FOR ADJUSTING THE INTEREST RATE CHARGED ON INSURANCE POLICY LOANS BY THE VETERANS ADMINISTRATION B-114859

D I G E S T

WHY THE REVIEW WAS MADE

The Veterans Administration (VA) administers five Government life insurance programs for veterans. Loans are available to those who hold permanent plan policies. At December 31, 1968, there were about 550,000 loans and about 3 million permanent plan policies.

By law the interest rate established by the Administrator of Veterans Affairs for policy loans must be reasonable and practicable. The law, however, does not specify criteria for determining reasonable and practicable interest rates. The rate has been 4 percent since 1946. Under one of the programs--United States Government Life Insurance--the VA, by law, cannot charge more than 5-percent interest on policy loans.

The General Accounting Office (GAO) wanted to know whether the 4-percent interest rate was reasonable and practicable under present conditions.

FINDINGS AND CONCLUSIONS

VA officials informed GAO of the major factors that VA considers in determining when a change in the interest rate is warranted. They stated that there was no specific threshold which any of these factors must attain to trigger a change in the loan interest rate and that decisions to change or maintain the rate were essentially judgmental. (See p. 20.)

GAO believes that the 4-percent rate is not reasonable because of the recent and substantial increases in market interest rates and in interest rates on investments of the insurance funds and the higher interest rates on loans on commercial insurance policies. (See pp. 11 and 12.)

VA insurance program funds recently invested in Treasury securities are earning in excess of 7 percent. Most commercial life insurance companies have been charging interest at rates of 5 and 6 percent on their policy loans. As of January 1970, market interest rates were generally about 8 percent. (See p. 8.)

GAO believes that an interest rate on policy loans which is substantially lower than market interest rates tends to encourage the policyholder to borrow his equity, and this reduces the insurance funds that can be invested in Treasury securities at more favorable terms. (See p. 8.)

When insurance funds are not used to make policy loans but are invested in Treasury securities having interest rates greater than those on policy loans, the interest earnings to the funds would increase and would benefit all policyholders. (See p. 8.)

GAO estimated that, if VA had charged a 5-percent interest rate on policy loans during calendar year 1968, the earnings distributable to policyholders would have been increased somewhere between $523,000 and $1,375,000; at 6 percent the increased earnings would have been between $1,046,000 and $2,750,000; and at 7 percent they would have been between $1,569,000 and $4,125,000. (See p. 17.)

GAO noted also that a policy loan, to the extent not repaid, reduced the proceeds available under the policy in the event of death of the insured, and, if the total indebtedness, including any unpaid interest, equals or exceeds the cash value of an insurance policy, the policy ceases and there is a complete loss of insurance protection. (See p. 18.)

RECOMMENDATIONS OR SUGGESTIONS

See "Matters for Consideration by the Congress" below.

AGENCY ACTIONS AND UNRESOLVED ISSUES

VA is opposed to an increase in the loan interest rate. The Deputy Administrator of Veterans Affairs said that the VA had been periodically reviewing the rate of interest on policy loans and that it would "continue watching the insurance loan trends and if significant events warrant a change, [VA] will take appropriate action." (See p. 20.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO believes that there is a need for more specific criteria for governing adjustments in the policy loan interest rate to ensure that the rate is reasonable and practicable as required by law. GAO believes that the rate should approximate the interest rate earned on new investments of the insurance funds.

To accomplish this, GAO suggests that the interest rate to be charged on new policy loans be adjusted whenever the interest rate for loans is more than one or two percentage points lower or higher than the rate of return on insurance program funds most recently invested in Treasury securities.

GAO stated that, in view of the reluctance of VA to adjust the interest rate, the Congress may wish to consider legislation that would

--provide the Administrator of Veterans Affairs with specific criteria for the adjustment of the interest rate on policy loans and

--remove the statutory limitation now applicable to one program, United States Government Life Insurance, to give the Administrator the authority to establish the interest rate under this program in accordance with the criteria suggested above.

CHAPTER 1

INTRODUCTION

The General Accounting Office has made a review of the criteria used by the Veterans Administration in establishing the interest rate charged on policy loans made under the Government life insurance programs administered by VA. The laws establishing these programs provide that the Administrator of Veterans Affairs be responsible for establishing a reasonable and practicable interest rate on policy loans.

During our survey of VA's administration of the insurance programs, we noted that the interest rate on policy loans was 4 percent even though (1) the recent rates of return on insurance program funds invested in Treasury securities generally were more than 7 percent, (2) commercial life insurance companies were charging interest at rates of 5 and 6 percent on similar loans, and (3) market interest rates had increased substantially. Thus, we made a review to examine into whether the policy loan interest rate established by VA was reasonable and practicable under the current circumstances.

This report is directed to a matter that we believe warrants consideration by the Congress; it does not include an overall evaluation of the Government life insurance programs. The scope of our review is discussed on page 26 of this report. A list of principal VA officials responsible for the activities discussed in this report is included as appendix II.

The VA administers five life insurance programs for the purpose of providing insurance protection for veterans, their families, and their dependents and supervises a sixth program, administered by a commercial life insurance company, which provides insurance for members of the uniformed services on active duty.

Program	Insureds
U.S. Government Life Insurance (USGLI)	World War I veterans
National Service Life Insurance (NSLI)	World War II veterans
Veterans Special Life Insurance (VSLI)	Korean conflict veterans
Service-Disabled Veterans Insurance (SDVI)	Veterans separated after April 1951 with service-connected disabilities
Veterans Reopened Insurance (VRI)	World War II and Korean conflict veterans with service-connected or serious non-service-connected disabilities
Servicemen's Group Life Insurance (SGLI)	Members of the uniformed services on active duty

Each of the five programs administered by VA is operated separately through specific funds established in the U.S. Treasury. The fund for each program is credited with premiums and interest payments as well as other income. The U.S. Government, by law, bears the expenses of administration for all the programs except VRI and SGLI. For these two programs the administrative expenses are paid by the insureds. The U.S. Treasury is responsible for investing the cash balances of each fund, which are not required to meet current expenditures, in interest-bearing securities issued or guaranteed by the Federal Government.

The USGLI and NSLI funds are invested primarily in special nonmarketable long-term public debt securities at interest rates determined from a formula set by the Secretary of the Treasury after consultation with VA. The VSLI and VRI funds are invested in special nonmarketable certificates reissued each June 30 at interest rates determined from a formula written into the law establishing the insurance programs. The SDVI fund operates at a loss and therefore has no funds available for investments.

The life insurance programs, with the exception of VRI, offer both term and permanent-plan policies. The size of the programs as of December 31, 1968, is shown by the following information obtained from VA statistics and reports.

Insurance programs	Number of 5-year-term policies	Number of permanent-plan policies	Total number of policies	Total amount of insurance
USGLI	2,070	210,854	212,924	$ 922,244,797
NSLI	2,182,071	2,367,606	4,549,677	29,965,416,716
VSLI	457,271	169,201	626,472	5,500,644,613
SDVI	38,033	38,202	76,235	663,085,649
VRI	-	197,743	197,743	1,381,543,548
Total	2,679,445	2,983,606	5,663,051	$38,432,935,323

Each permanent-plan life insurance policy includes guaranteed values which are available to the insured at any time after the end of the first policy year. The guaranteed values include cash surrender values and a policy loan provision. The 5-year-term policies have no guaranteed values.

After the payment of premiums for 1 year, a permanent-plan policyholder may borrow an amount not exceeding 94 percent of the policy cash surrender value. The laws establishing the various insurance programs administered by VA provide that the Administrator be responsible for establishing a "reasonable and practicable" interest rate on these loans but do not define reasonable and practicable.

Except for the USGLI program, there is no statutory maximum rate of interest that can be charged on policy loans. The Congress enacted legislation in 1939, which provided that the interest rate on loans made under the USGLI program not exceed 5-percent per annum.

Policy loans outstanding as of December 31, 1968, are shown by the following information obtained from VA statistics and reports.

Insurance programs	Number of policy loans outstanding	Amount of policy loans outstanding
USGLI	41,535	$ 78,100,000
NSLI	478,372	724,900,000
VSLI	17,040	14,800,000
SDVI	6,625	7,900,000
VRI	4,588	1,900,000
Total	548,160	$827,600,000

CHAPTER 2

EVALUATION OF THE INTEREST RATE CHARGED ON INSURANCE POLICY LOANS

The Administrator of Veterans Affairs has the legal responsibility for establishing a reasonable and practicable rate of interest on policy loans made under the life insurance programs for veterans that are administered by VA. The 4-percent interest rate on policy loans in effect since 1946, in our opinion, is not reasonable because recent rates of return on insurance program funds invested in Treasury securities are generally more than 7 percent, commercial life insurance companies have been charging interest at rates of 5 and 6 percent on similar loans, and market interest rates have increased substantially. (See schedule on p. 11.)

We believe that an interest rate on policy loans which is substantially lower than market interest rates tends to encourage the policyholder to borrow his equity, and this reduces the insurance funds that can be invested in Treasury securities at more favorable terms. Any increase in the amount of funds that is invested in securities issued by the Federal Government having interest rates greater than those on loans to policyholders would increase the interest earnings to the funds and would benefit all policyholders.

At the beginning of calendar year 1968, the interest return to VA on new funds invested in Treasury securities was generally more than 5 percent. If VA had charged interest at a rate of 5 percent on policy loans made during calendar year 1968, we estimate that earnings to the insurance fund would have been increased somewhere between $523,000 and $1,375,000 for that year. To further illustrate the effect on earnings of changes in interest rates, at a 6-percent rate earnings would have been increased between $1,046,000 and $2,750,000 and at a 7-percent rate they would have been increased between $1,569,000 and $4,125,000.

CIRCUMSTANCES LEADING TO ESTABLISHMENT OF THE 4-PERCENT INTEREST RATE

Under the USGLI program established in 1919, the interest rate on policy loans was set at 6 percent. At that time, commercial life insurance companies were also making policy loans at 6 percent. The USGLI rate remained unchanged until 1939. During the 1930's there was a general decline in market interest rates.

Records were not available at VA to enable us to determine the VA's reasons for not lowering the interest rate on policy loans during the 1930's. However, our review of congressional hearings held during 1945, indicated that VA was reluctant to revise the interest rate on policy loans because it was of the opinion that a reduction in the interest rate would not only encourage loans but also constitute a discrimination against those policyholders who do not borrow against their policies. It appears to us that this opinion was based on the assumption that a lower rate of interest on policy loans would reduce interest earnings to the insurance funds and hence would reduce dividends payable to all policyholders including those who did not secure loans.

On July 19, 1939, the Congress enacted Public Law 198 (38 U.S.C. 744c) which provided that the interest rate on policy loans made under the USGLI program not exceed 5 percent per annum. A 5-percent interest rate was in effect in 1940 for loans under the USGLI program when the Administrator of Veterans Affairs set a 5-percent interest rate for the NSLI program.

Our review of the legislative history authorizing Public Law 198 did not reveal any specific evidence concerning the intent of the Congress in establishing the 5-percent maximum interest rate on policy loans under the USGLI program. It appears to us, however, that the Congress established this rate because the existing 6-percent rate under the USGLI program was discriminatory in view of the general decline in interest rates on other forms of borrowing and because VA was reluctant to lower the 6-percent rate. For example, veterans in straitened circumstances were forced to borrow at 6 percent against their insurance policies because policies under the USGLI program could not be assigned as security for other loans which would have carried a lower interest rate.

The downward trend in market interest rates continued during the 1940's. In 1945 the Congress considered legislation to lower the interest rate on policy loans to 3 percent. During the Senate hearings on this legislation, the Administrator of Veterans Affairs stated, in part, that:

> "The reduction of such rates for the benefit of borrowers will be accomplished at the expense of those of the insurance group who do not avail themselves of loan privileges."

In July 1946 a leading commercial life insurance company announced a sliding scale of interest rates for policy loans, consisting of 5 percent on the first $750 of the loan, 4 percent on the second $750, and 3 percent on the amount over $1,500. Subsequently, in August 1946, VA lowered the interest rate to 4-percent on both USGLI and NSLI policy loans.

Also, the 4-percent interest rate on policy loans was prescribed for the VSLI, SDVI, and VRI programs. The VSLI and SDVI programs were established in 1951, and the VRI program was established in 1965.

FACTORS INDICATING INTEREST RATE IS NOT REASONABLE AND PRACTICABLE

The laws establishing the various VA-administered insurance programs provide that the Administrator be responsible for establishing a reasonable and practicable interest rate on policy loans. The laws, however, do not specify criteria for determining reasonable and practicable interest rates. In our opinion, the following factors indicate that the 4-percent rate, in effect since 1946, is not currently reasonable and practicable: (1) there has been a substantial increase in recent market interest rates and (2) the interest earned on new investments of the insurance funds have increased as a result of higher interest rates on Treasury securities. We also noted that commercial life insurance companies charged higher interest rates on their policy loans.

There has been a substantial increase in market interest rates as indicated by the following information obtained from statistics of the Federal Reserve System.

Securities and term of security	Market interest rates--percent per annum					
	July 1946	July 1950	July 1960	July 1968	May 1969	Jan. 1970
Prime paper--4 to 6 months (note a)	.77	1.45	3.85	5.90	7.35	8.78
Finance company (note b) paper placed directly-- 3 to 6 months	Not available	1.41	3.54	5.69	6.54	8.15
U.S. Government securities:						
9 to 12 months	.84	1.26	3.55	5.45	6.10	7.50
3 to 5 years	1.13	1.50	3.99	5.59	6.33	8.14

[a]Short-term loans from banks to their most creditworthy business customers.

[b]Loans by finance companies which are sold directly to investors.

Interest rates on recent investments of insurance program funds also have trended upward, as indicated in the following table.

Insurance program	Investment in Government securities Interest rates--percent per annum				
	June 1966	June 1967	June 1968	June 1969	Oct. 1969
USGLI	4.38	4.25	5.25	6.00	-
NSLI	4.38	4.25	5.50	6.25	7.38
VSLI	3.63	3.63	4.00	4.38	4.38
VRI	4.88	4.75	5.63	6.50	7.63

(Although VA invests insurance funds several times during each month, most of the funds are invested in June.)

Most commercial life insurance companies charge a 5-percent interest rate on loans secured by life insurance policies; a few of the smaller companies charge as high as 6 percent. It should be noted, however, that the maximum interest rates that can be charged by the commercial life insurance companies are governed, in most States, by State laws. Prior to 1939, the rate generally charged was 6 percent but in that year the State of New York enacted a law to provide a maximum interest rate of 5 percent on loans under new policies. This law applied to both domestic and out-of-State companies. Currently the legal maximum interest rate that a company may charge on policy loans varies from 5 to 6 percent except in those States that do not prescribe a maximum interest rate on policy loans.

We believe that (1) the substantial increases in market interest rates, (2) the trend to higher investment return on the investments of the insurance program funds, and (3) the interest rates currently charged by commercial life insurance companies on policy loans indicate that the interest rate on policy loans should be adjusted upward.

DISPOSITION OF EARNINGS ACCUMULATED IN THE INSURANCE FUNDS

The additional benefits that could be made available to the veterans through an increase in the interest rate on policy loans vary between the insurance programs depending on the methods prescribed for utilizing or disposing of the gain or loss from operations accumulated in the respective insurance funds. Following is a schedule showing the disposition of the gain or loss from operations for calendar year 1968 in each of the five insurance programs administered by VA.

	USGLI	NSLI	VSLI	SDVI	VRI
	(millions)				
Gain or loss(–) from operations	$14.9	$218.8	$3.8	$–7.7	$0.3
Less dividends paid	18.0	213.1	-	-	-
Increase or decrease(–) in fund balance	$–3.1	$ 5.7	$3.8	$–7.7	$0.3

The $3.1 million decrease in the USGLI fund was applied to the fund's contingency reserve. Contingency reserve funds are amounts in excess of the regular reserves that provide an additional safety margin against unexpected developments. A VA publication shows that the reduction in the USGLI fund balance is planned to gradually reduce and eventually eliminate the USGLI contingency reserve fund as the need for it diminishes with the program's moving toward final liquidation. The $5.7 million gain in the NSLI program, after dividend payments, was added to the program's contingency reserve fund.

The VSLI program was established by law on a nonparticipating basis and consequently did not provide for the payment of dividends. In fiscal year 1962, however, a special dividend was authorized by legislation for this program. The gain experienced in calendar year 1968 was added to the program's contingency reserve fund.

The SDVI program insures veterans with service-connected disabilities at standard life insurance premium rates. Therefore, the program is not self-supporting and the losses experienced in the program are met by periodic congressional appropriations. VA officials advised us that the additional earnings to the SDVI fund that would result from an increase in the policy loan interest rate would reduce the losses experienced in the fund and, consequently, would reduce congressional appropriations.

Finally, since authorizing legislation requires that the VRI program be nonparticipating, the premiums for insurance under this program have been set at a low level and no dividends are paid. The Administrator however, may, by law, increase or decrease the premium rates in accordance with the experience in this program. The gain experienced in calendar year 1968 was added to the program's contingency reserve fund.

We believe that the insurance funds are administered by VA as trustee for the sole benefit of the policyholders and that any beneficial interest in the reserves belongs exclusively to the policyholders.

More specifically, we believe that when an insured borrows on his policy he borrows from the insurance fund which is for the benefit of all policyholders. Consequently, we agree with the statement made by the Administrator of Veterans Affairs at the Senate hearings in 1945 that, when money is loaned to a policyholder at a low rate of interest, the loan is made at the expense of the other policyholders who have not exercised their loan privilege. (See p. 10.)

A publication of the Institute of Life Insurance points out that during the past several years the number of loans on commercial life insurance policies has had larger than usual increases. The publication attributes a large part of this increase in policy loans to the general rise in interest rates on other forms of borrowing.

We believe that, when the interest rates on policy loans are substantially less than those on other forms of investments, there is a greater incentive for the policyholder to borrow his equity. Therefore any increase in policy loans would reduce the amount of money available in the funds for investing at more favorable terms.

Conversely, when insurance funds are not used to make policy loans but are invested in Treasury securities having higher interest rates, the interest earnings to the funds would increase and would benefit all policyholders.

ADDITIONAL EARNINGS OF INSURANCE FUNDS IF INTEREST RATE IS INCREASED

On the basis of statistics obtained from VA, we estimated that, if VA had charged interest at the rate of 5 percent on policy loans made during calendar year 1968, earnings to the funds would have been increased somewhere between $523,000 and $1,375,000.

We were unable to make a more precise estimate because VA did not have historical data on the dollar amount of new policy loans made annually and on the average length of time the loans remained outstanding. Therefore, for purposes of our estimate, we have assumed that the loans made in 1968 remained outstanding for the entire year.

The estimated increased earnings of $523,000 were based on information taken from VA reports, which showed that, during calendar year 1968, the amount of policy loans outstanding increased by $52.3 million. The $52.3 million represented the amount of new loans less old loans repaid during calendar year 1968 and therefore represented the minimum possible value of new loans.

Our estimate of the increased earnings of $1,375,000 was based on a tabulation provided to us by VA officials, which showed that for calendar year 1968 the maximum amount of loans, including replacement loans, made against policies issued under the five VA insurance programs totaled $137.5 million. The VA officials advised us, however, that the $137.5 million was not limited to new policy loans made during the specified period because of the manner of accounting. For example, if a policyholder had a loan of $200 and made application for an additional $100, then the old loan was recorded as paid and a new loan (replacement loan) was recorded in the amount of $300. The VA officials informed us that it would not be practicable to isolate the separate amounts.

Thus, the statistics obtained from VA indicate that the dollar amount of new policy loans made during calendar year 1968 was somewhere between $52.3 million and $137.5 million. At the beginning of calendar year 1968, the interest return on new investments of the insurance program funds was generally more than 5 percent. As shown in the table on page 12, the rate of return on new investments was generally more than 6 percent in June 1969 and more than 7 percent in October 1969. Assuming that the loans made in 1968 remained outstanding for the full year, increases in the interest rate on policy loans would have produced the following additional annual earnings on loans made in the year.

	Estimated additional annual earnings		
	At 5 percent	At 6 percent	At 7 percent
Minimum new loans--$52.3 million	$ 523,000	$1,046,000	$1,569,000
Maximum new loans--$137.5 million	1,375,000	2,750,000	4,125,000

Of these additional earnings, between $12,000 and $66,000 would have been available to offset the loss experienced in the SDVI fund during calendar year 1968 and would have reduced the amount of congressional appropriations.

Although there is no reliable basis on which to estimate the amount of new policy loans that will be made in the future, VA statistics indicate that, at least in the near future, there will probably be no significant decrease in the total annual dollar amount of new policy loans currently experienced in the insurance programs.

EFFECT OF POLICY LOANS ON THE CONSERVATION OF INSURANCE PROTECTION

VA regulations require that the amount of any unpaid policy loan be deducted from the proceeds of an insurance policy before final settlement of a death claim. In addition, when the amount of an unpaid loan and unpaid interest charges equals or exceeds the cash value of an insurance policy, the policy ceases and becomes void. Consequently, a policy loan, to the extent not repaid, reduces the proceeds available under the policies in the event of death of the insureds and, as described above, could result in complete loss of insurance protection.

During hearings held in April 1945 before a subcommittee of the Senate Committee on Finance concerning proposed legislation to reduce the rate of interest on policy loans secured by Government life insurance, the Assistant Administrator of Veterans Affairs stated:

> "Obviously, if a man can borrow money at a lesser rate than he is getting for his money, it would be to his advantage, and it is not unlikely that many who were not in need of the money would borrow their money as a financial proposition, <u>and, as we know through the experience of life insurance, a loan is often the first step to a lapse of the insurance</u>."
>
> "This encouragement would probably be to the disinterest of many of the policyholders because it would encourage them to borrow and start them on the road to lapsing their policies." (Underscoring supplied.)

In a report included in the hearings, the Administrator of Veterans Affairs stated:

> "The experience of insurers generally has definitely demonstrated that the rate of interest on policy loans has a decided effect upon the question of conserving the insurance for the beneficiaries. Any material reduction in the interest rate might result in many unnecessary

loans, thus defeating the very purpose for which the insurance was intended and, as it is the policy of the Government to expend every effort toward conserving the veterans' equities in their policies, it is not believed that it would prove generally beneficial to reduce the interest rate on policy loans."

Also, a VA official has advised us that in his judgement the present interest rate on policy loans can have an adverse effect on the protection feature of the insurance programs because an interest rate on loans that is substantially lower than market interest rates tends to encourage the veterans to borrow against their policies.

He provided us with information showing that, at December 31, 1967, 9.5 percent of the insurance program funds were invested in policy loans whereas only 5.7 percent of commercial life insurance companies' funds were invested in policy loans. The official stated that, although no studies had been performed, it was his opinion that a substantial portion of the difference might have been attributable to the fact that most commercial life insurance companies charged at least a 5-percent interest rate on policy loans whereas VA charged only a 4-percent rate.

CHAPTER 3

AGENCY COMMENTS

In a draft of this report submitted to the VA for comment, we proposed that the Administrator of Veterans Affairs establish procedures that would provide for periodic review and adjustment of the interest rate on policy loans.

In a letter dated October 23, 1969 (see app. I), commenting on our draft report, the Deputy Administrator of Veterans Affairs stated that VA agreed that the rate of interest on policy loans should be reviewed periodically and that it had been doing this; however, VA was opposed to an increase in the loan interest rate at that time. He stated further that VA would continue watching the insurance loan trends and that, if significant events warranted a change, VA would take appropriate action.

After receipt of this letter, we held discussions with the Director of the Insurance Service and members of his staff, primarily to obtain a clarification of the criteria followed by VA in determining when a change in the loan interest rate is warranted. We were advised that the major factors considered were:

1. The traditional 1-percent spread between VA and commercial loan interest rates.

2. The trend in the volume of new loans.

3. The increase in the percent of dollar amount of loans outstanding.

4. The conservation of insurance protection.

The Director stated that essentially that there was no specific threshold which any of these factors must attain to trigger a change in the loan interest rate and that decisions to change or maintain the rate were essentially judgmental.

Following are VA's comments on our draft report and analysis of these comments.

1. "While rates charged by commercial life insurance companies are for consideration, it must be kept in mind that our insurance programs are in may respects dissimilar. Commercial companies can be divided into two classifications: stock and mutual companies. Stock companies by their very nature must make profits in order to award their stockholders dividends. Mutual companies must make profits to provide for expansion if they are to survive and maintain their economic position plus build up reserves for the future. We are not in the business of making profit. Our administrative costs are paid by the Government and our major programs are closed so that we have no need for building large reserves for future contingencies. Accepting a comparison with commercial companies, it must be noted that the going rate on loans made by the commercial insurance companies is less than what the same money would bring on investments made in the open market."

We agree that VA is not in the business of making a profit. We believe, however, that VA should provide insurance to veterans at the lowest reasonable cost to them. When premiums are fixed, the net cost to the policyholder is directly affected by the investment return to the insurance fund.

We recognize that the going interest rates on insurance policy loans made by commercial companies are less than the interest rates in the open market. These companies are regulated as to what they can charge on policy loans by State laws. A recent issue of the National Underwriter, an insurance trade magazine, reported that four leading life insurance companies were planning to start issuing--except in one State--policies having a variable policy loan interest rate with a top limit of 6 percent. This contrasts to the general rate of 5 percent on commercial policies. Should this plan be adopted throughout the industry, the spread between the commercial and VA interest rates on policy loans will double--from 1 to 2 percent.

2. "There is no connection between commercial and bank interest rates and insurance policy loan rates. We believe Justice Holmes opinion in the case of Board of Assessors v. New York Life Insurance Company, 30 S. Ct. 385, expresses this clearly. Justice Holmes pointed out that while a policy loan is called a loan, it really isn't. The insurance company never advances more than it already is absolutely bound for under the policy. It has no interest in creating a personal liability and if it is not paid, it is automatically extinguished from what is called the reserve fund of the policy. It never exists as a personal liability and is never a debt. In substance, it is extinct from the beginning, because it is really a payment, not a loan."

We agree that a policy is not the same as a commercial or bank loan. We believe, however, that this difference does not have any relevancy to our position that the VA insurance program should provide insurance protection at the lowest reasonable cost.

3. "*** any increase in future policy loan interest rates would have a minimal effect on the Fund's income; and as a result, any increase in the amount of dividends to other insureds would be nihil.

"The report implies that due to our operations, the cost of insurance has increased. We presume that the report means the net cost of insurance may be slightly increased. This is not true. Premium rates on permanent plans *** are constant and since dividends have been increasing, the net cost of insurance is somewhat less than in prior years."

We agree that the increase investment income generated by increasing the present 4-percent interest rate on policy loans to the interest rate earned on current fund investments would result in small increases in the dividends payable to each policyholder. We believe, however, that the resulting increase in earnings would be a substantial amount (see p. 17) to add to the dividend pool, and its distribution would reduce the net cost of insurance to each policyholder. This report does not state nor indicate, in our opinion, that the cost of insurance had increased but does state that the net cost of insurance to the policyholders would be reduced by the increased dividends payable if the interest rate on policy loans were increased.

4. "With respect to the report comment concerning the percentage of insurance fund assets invested in policy loans by the VA being greater than commercial life insurance, we believe this is largely attributable to the more favorable policy provisions wherein the period of loan availability on government life insurance is one year as opposed to two and three years for commercial life insurance contracts."

In subsequent discussions with the Director, Insurance Service, he stated that he did not have any information on the number and amount of loans made on 1-year-old insurance contracts. The Chief Actuary advised us that the cash value of a policy at the end of its first year would be minimal. We believe therefore that the higher percentage of insurance funds invested in policy loans by VA is more properly attributable to the interest rate on VA policy loans being lower than the interest rate on commercial policy loans rather than being "largely" attributable to the 1-year availability of loan privileges.

5. "With regard to the report proposal that higher rates would discourage borrowing, we believe that a veteran borrower, with a legitimate or emergent need for funds, would not be discouraged by higher interest rates. It is recognized that speculators as such would be discouraged. These should comprise a distinct minority."

As to the number of loans made for "legitimate or emergent need," the VA loan application does not require the borrower to state the purposes of the loan or how the proceeds will be applied. Consequently, we do not know, nor does VA know, the extent of such loans. We believe, however, that, when the interest rate on policy loans is considerably less than market rates, there is an incentive for policyholders to seek alternative forms of investment.

For example, currently a policyholder may borrow 94 percent of the cash value of his policy and deposit this in a riskless, Government-insured savings account paying 5 percent and realize a net return of 1 percent.

CHAPTER 4

MATTERS FOR CONSIDERATION BY THE CONGRESS

We believe that there is a need for more specific criteria for governing adjustments in the policy loan interest rate to ensure that the rate is reasonable and practicable as required by law. In our opinion, the rate should approximate the interest rate earned on new investments of the insurance funds.

To accomplish this, we suggest that the interest rate to be charged on new policy loans be adjusted whenever the interest rate for loans is more than one or two percentage points lower or higher than the rate of return on insurance program funds most recently invested in Treasury securities.

In view of the reluctance of VA to adjust the interest rate, the Congress may wish to consider legislation that would

--provide the Administrator of Veterans Affairs with specific criteria for the adjustment of the interest rate on policy loans and

--remove the statutory limitation now applicable to one program, United States Government Life Insurance, to give the Administrator the authority to establish the interest rate under this program in accordance with the criteria suggested above.

CHAPTER 5

SCOPE OF REVIEW

We reviewed the provisions of the laws authorizing the Government life insurance programs, the legislative history of the laws, and implementing regulations. We examined pertinent records and documents at the VA headquarters in Washington, D.C. Discussions were held with VA officials responsible for administration of the insurance programs and related policy loan provisions.

APPENDIXES

VETERANS ADMINISTRATION
OFFICE OF THE ADMINISTRATOR OF VETERANS AFFAIRS
WASHINGTON, D.C. 20420

OCT 23 1969

Mr. Max Hirschhorn
Associate Director, Civil Division
U. S. General Accounting Office (801)
Room #137, Lafayette Building
811 Vermont Avenue, N. W.
Washington, D. C. 20420

Dear Mr. Hirschhorn:

Thank you for the opportunity to review and comment on your proposed draft report titled "Need to Review and Adjust Interest Rates on Policy Loans Under Insurance Programs of the Veterans Administration." Members of our respective staffs met and discussed the report on September 10, 1969, and minutes of the meeting have been furnished to all participants.

We agree that the rate of interest on policy loans in the insurance program should be reviewed periodically, which we have been doing. The objective of our reviews is the establishment of a rate that is reasonable and practical in the light of all the surrounding circumstances that must be considered. Based on our reviews, it is our opinion that present circumstances do not warrant an increase.

The report discusses various areas for consideration in determining the reasonableness of insurance loan interest rates. We feel that some of these are pertinent factors, but would give minimal weight to others. Our comments on the factors follow.

While rates charged by commercial life insurance companies are for consideration, it must be kept in mind that our insurance programs are in many respects dissimilar. Commercial companies can be divided into two classifications: stock and mutual companies. Stock companies by their very nature must make profits in order to award their stockholders dividends. Mutual companies must make profits to provide for expansion if they are to survive and maintain their economic position plus build up reserves for the future. We are not in the business of making profit. Our administrative costs

Mr. Max Hirschhorn
Associate Director, Civil Division
U. S. General Accounting Office

are paid by the Government and our major programs are closed so that we have no need for building large reserves for future contingencies. Accepting a comparison with commercial companies, it must be noted that the going rate on loans made by the commercial insurance companies is less than what the same money would bring on investments made in the open market.

There is no connection between commercial and bank interest rates and insurance policy loan rates. We believe Justice Holmes' opinion in the case of Board of Assessors v. New York Life Insurance Company, 30 S. Ct. 385, expresses this clearly. Justice Holmes pointed out that while a policy loan is called a loan, it really isn't. The insurance company never advances more than it already is absolutely bound for under the policy. It has no interest in creating a personal liability and if it is not paid, it is automatically extinguished from what is called the reserve fund of the policy. It never exists as a personal liability and is never a debt. In substance, it is extinct from the beginning, because it is really a payment, not a loan.

As to the factor of increased earnings to the Fund for the benefit of the other policyholders, any increase in future policy loan interest rates would have a minimal effect on the Fund's income; and as a result, any increase in the amount of dividends to other insureds would be nihil.

The report implies that due to our operations, the cost of insurance has increased. We presume that the report means the net cost of insurance may be slightly increased. This is not true. Premium rates on permanent plans (excluding the J program which is nonparticipating) are constant and since dividends have been increasing, the net cost of insurance is somewhat less than in prior years.

With respect to the report comment concerning the percentage of insurance fund assets invested in policy loans by the VA being greater than commercial life insurance, we believe this is largely attributable to the more favorable policy provisions wherein the period of loan availability on government life insurance is one year as opposed to two and three years for commercial life insurance contracts. We believe that the first year of loan eligibility has been critical since in many instances a veteran may overestimate his earning capacity and ability to pay the larger premium identified with permanent plans

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Associate Director, Civil Division
U. S. General Accounting Office

of insurance, especially the limited-pay contracts with shorter premium-paying periods and more especially the endowment plans with higher premium rates. First year loans are a natural reaction to these conditions.

With regard to the report proposal that higher rates would discourage borrowing, we believe that a veteran borrower, with a legitimate or emergent need for funds, would not be discouraged by higher interest rates. It is recognized that speculators as such would be discouraged. These should comprise a distinct minority.

(See GAO note.)

In conclusion, we are opposed to an increase in loan interest rates at this time. We will continue watching the insurance loan trends and if significant events warrant a change, we will take appropriate action.

Your interest in the VA insurance program is appreciated.

Sincerely,

FRED B. RHODES
Deputy Administrator

GAO note: The deleted comments related to matters discussed in the draft report, which are not discussed in the final report.

PRINCIPAL OFFICIALS OF THE VETERANS ADMINISTRATION RESPONSIBLE FOR THE ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
ADMINISTRATOR OF VETERANS AFFAIRS:		
W. J. Driver	Jan. 1965	May 1969
D. E. Johnson	June 1969	Present
DEPUTY ADMINISTRATOR OF VETERANS AFFAIRS:		
A. W. Stratton	Nov. 1967	May 1969
F. B. Rhodes	May 1969	Present
CHIEF BENEFITS DIRECTOR:		
A. W. Farmer	Nov. 1967	July 1969
R. H. Wilson	July 1969	Feb. 1970
O. B. Owen	Feb. 1970	Present
DIRECTOR, INSURANCE SERVICE:		
F. J. Petraitis	Oct. 1968	Present

U.S. GAO, Wash., D.C.