JIA 84 (1958) 0037-0055

INSURANCE CONTRACTS IN TERMS OF EQUITY SHARES

THE Sessional Meeting held on 25 November 1957 was devoted to a discussion on the issue of insurance contracts expressed in terms of equity shares.

An abstract of the evening's discussion follows:

Mr A. C. Edwards, in opening the discussion, began with a quotation: 'There ought to be a special kind of with-profits insurance with an understanding that it was to be based on ordinary shares.' The discussion was to range over a wider field than that, but the germ of the idea was already there in those words spoken at the Institute just 30 years earlier by Mr R. G. Hawtrey in the discussion of Raynes's paper *The Place of Ordinary Stocks and Shares in the Investment of Life Assurance Funds* (*J.I.A.* **59**, 21). After the 1914–18 war the idea of basing insurance policies on something other than currency died out, presumably because currencies became comparatively stable again quite quickly. During and after the war of 1939–45, however, the depreciation in the value of money was, and so far remained, continuous, and it was not surprising that the whole system of issuing policies in terms of money should again have been called into question. But money, depreciating or not, had for centuries been the one virtually universal medium of exchange and store of value in which people had pinned their faith, and the choice of a replacement to act as the basis of insurance contracts posed difficult problems, not only the practical problems of putting an alternative to use, but also the ethical problem of the extent to which they should promote the use of an alternative at all.

Both in the 1920's and at the time of Recknell's paper *Insurance against Inflation* to the Faculty in 1949 (*T.F.A.* **19**, 17), various commodities had been considered. Gold, coal, wheat, rye, afforestation and even unmatured Scotch whisky had all had their advocates. All those commodities, however, were impracticable for one reason or another; they certainly all failed on the grounds that the office could not hold interest-earning investments in terms of the same commodity as the sum assured. As a commodity in terms of which sums assured could be expressed, however, equity shares had that essential prerequisite that offices could hold them as income-earning investments. They had been available to investors in some degree for perhaps a century, but they had not the integral part in everyday life which money was already playing when life assurance began. Although they had since become widely accepted for life offices' investments, they had been a controversial subject of discussion only 30 years previously. Though it was a reasonable argument that, because they represented the value of real goods, ordinary shares would, if left to themselves, maintain their value in the long run if the currency depreciated, there was also the fact that factories and machinery were wasting assets. Over a long period ordinary shares maintained their value only if sufficient profits were retained for replacements; they improved in value only if still further amounts of profit were held back for expansion and improvement. Though that practice had been spreading in the United Kingdom it was not universal; he understood that in the United States, for example, fuller distributions of profits were customary. Fashions might change. They did not know how the forces of politics and of changes in taxation or in the desires of sections of the investing public might mould the views of boards of directors on their dividend policies.

Various investigations had suggested that the market values of ordinary shares moved more or less in the same direction as the cost of living. He had calculated some coefficients of correlation between values of the ordinary share price index and the cost of living index over various periods, using for that purpose the convenient table of those values given in a recent paper to the Students' Society (*J.S.S.* **14**, 281). Over 10-year periods beginning 1925, 1930, 1935, 1940 and 1945, the figures were ·5, ·1, −·2, ·9 and ·5. Over 20-year periods beginning 1925, 1930 and 1935, the coefficients were ·1, ·6 and ·7, while over 30 years beginning 1925 the figure was ·7. Those figures gave no more than a broad indication—that in the past, when there had been no variable contracts to influence either index, there had been a useful degree of correlation over some periods which were comparable in length with endowment assurances and annuities.

He thought that supporters of equity-linked policies could therefore reasonably argue that, at least in the kind of conditions they had known after the war, such policies could serve a useful purpose; except over short periods, however, equity price indices had not kept up with, and they were far more volatile than, the cost of living index.

Turning to the kinds of contract which might be suitable for equity-linked policies, attention appeared to have been focused largely on deferred annuities, especially in the United States. Retirement annuities clearly came within the 'suitable' category. But a man's dependants were just as much in need of protection against currency depreciation as he was himself. If, therefore, there was a case for equity-linked policies, it surely applied equally to death benefits as to maturity proceeds. That suggested that whole life and endowment assurances should also be considered. It seemed to him that if a man wanted his insurances to keep up with an equity index, he ought to be prepared to pay a variable premium, and that under any such policy, therefore, the premiums and benefits should be in terms of units in some equity share index—either a special one conducted by the office itself, or an outside one to which the office would adhere so long as its basis of operation remained unchanged. The office would then receive and pay the prevailing cash equivalent of premiums and benefits, respectively.

Most of their conventional assurance contracts provided lump sum benefits without any settlement options in the form of instalments or annuities. That aspect would evidently need special consideration because of the rapid changes that took place in equity prices. For example, in the last twelve months the *Financial Times* ordinary share index had moved from 162 up to 207 and back to 159. A policyholder would not be pleased to find that the maturity date of his policy coincided with a trough in his office's equity price index. If his widow were claiming on his death, she would be similarly dissatisfied, especially if she had thought that her husband had taken out a special kind of policy which moved with the cost of living. One suggestion for smoothing out those fluctuations was that the office should calculate an index value (say) once a year, and use it for fixing cash equivalents of premiums and benefits. Under such a system, dissatisfaction seemed sure to arise sooner or later, among premium payers if prices fell significantly after the year's value was fixed, and among beneficiaries if they rose appreciably. Moreover, that method gave an undesirable option of timing to those who surrendered. Apart from that, why should the office protect the policyholders from that particular risk which, like the risk entailed in guaranteeing a minimum cash value of benefit, would not be susceptible of actuarial assessment? A better solution might be to allow the claimant to take a series of instalments in lieu of a lump sum benefit, or possibly to give the claimant the option to take the actual equity shares in some suitable unit form. Those difficulties did, of course, stress the practical advantage of the annuity as a form of benefit.

He had begun with benefits; but the policy had first to be put on the books, and with a revolutionary contract it would be even more important to be sure that proposer and office were *ad idem*. If a man who had had some experience of investment proposed for an equity-linked policy after full consultation with a specialist member of the office's staff, the office could feel satisfied, but he did not see how the general selling of such policies could be put in the hands of any office's field staff. There would be the difficulty of ensuring that they understood all the implications of the contract. Some of them might be unwilling to canvass a policy under which they could not talk to the prospect in terms of hard cash. But among those who were willing to canvass, how many could and would refrain from canvassing on the dangerous basis that they and their office and their prospect had no faith in the currency?

They should also consider the Prevention of Fraud (Investments) Act, 1939, which barred dealing in securities except by certain classes of person. 'Dealing in securities' included making or offering to make with any person, any agreement the purpose of which was to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities. Surely that was not a bad description of the purpose of variable assurances or annuities. On a limited scale the difficulties could obviously be overcome, but he doubted whether wholesale canvassing could legitimately be undertaken.

If an existing life office were to commence such a class of business, some questions might be raised by existing policyholders. They might well want to know why, if the office claimed that the new system of investing predominantly in equities made equity-linked policies better than money ones, the office was not using the system already to provide them with bigger bonuses. Some offices already had an answer to that, but the general reply would presumably be that the office gave them certain guarantees in money terms which it did not give to the holders of the new-style policies. The existing policyholders might also be anxious about the application to new policies of appreciation in the existing assets. If the answer was that the equity-linked policies would have their own segregated assets then it must follow that they would not have the security of the normal life fund of the office. Incidentally, Inland Revenue requirements regarding realized profits on investments would presumably compel segregation. Wholesale switching into the new policies might also cause difficulties unless the office could successfully resist the transfer of reserve values.

Actuarial problems of a technical character appeared to be much the same for equity-linked as for money policies, assuming that the office covered traditional risks. Investment, however, could provide problems on a vast scale. It had been estimated that insurance companies held 6% or 7% of the equity shares of all industrial companies, and that such shares currently represented over 16% of the offices' assets. The combined balance sheet value of offices' holdings of ordinary shares was some £75 m. more at the end of 1956 than at the end of 1955. In addition to the offices' interest in those shares, there was, of course, a large and growing interest on the part of pension funds. One large fund was said to be aiming at 100% investment in equities and another at 50%.

An over-all holding of 6% or 7% of all industrial equities suggested that there was ample room for expansion of offices' holdings without causing concern.

Though it would be difficult to judge how far institutional investing in equities had contributed to the tendency for equity yields and fixed interest yields to come closer together, there could be little doubt that there would be a significant effect on market prices if the offices' combined annual investment in equities rose even to a figure still well short of the annual increase in their funds. The possible additional consequences of a future State-run superannuation fund, or even of direct State acquisition of equity shares, were perhaps problems to be considered only when they arose, but such State activities could be accompanied by some form of interference in Stock Exchange working or of control over Stock Exchange prices. Before then, however, the normal operation of the market could have resulted in equity share prices being driven up and yields down to a point where offices, committed to invest in equities, might not wish to buy. Conversely, and probably unwelcome to the Government of the day, gilt-edged and other fixed interest securities might have reached a point where the yield was so high as to provide a reasonable return on the money invested plus an offset against a moderate rate of inflation.

An essential feature of an equity-linked contract would be the distribution of capital appreciation, but would offices be justified in distributing appreciation in market prices which had been brought about by the offices' own investment activities, rather than by an increase in the intrinsic worth of the securities? Would not the writing-up of values which would be involved constitute a profit on realization of investments, and would the Chancellor be content to let such organized profit-taking remain free from income tax or some form of capital gains tax? It was a wise precaution to include in any equity-linked policy some protective words to ensure that the policyholder bore any future capital gains tax affecting the policy.

A further question was how to immunize a fund insuring a mixed bag of contracts—endowments and whole-life policies, immediate and deferred annuities—when all the investments were in irredeemable securities.

All those practical problems and the basic ethical problem, taken together, seemed to point to the limited possibility of equity-linked policies being made available to what might be called a sophisticated public. Having started, however, could the definition of sophisticated public be kept within the initial bounds?

He doubted very much whether it was any part of life offices' duty to their policyholders to protect them against inflation, especially to the extent that it stemmed from the policyholders' own actions elsewhere. That was not to say, however, that offices should not seek to make their contracts as profitable as possible for the policyholders, or should not seek to provide suitable special policies.

To the extent that a with-profit policy provided larger maturity proceeds than would a non-profit policy for the same premium, the with-profit policy provided some degree of protection against loss of purchasing power. On current annual premium rates and bonus declarations, the maturity proceeds of 20- to 30-year endowment assurances with profits would be greater than the corresponding non-profit sums assured by amounts representing about $\frac{3}{4}\%$–$1\frac{1}{4}\%$ of the non-profit sum assured per annum. Offices could, therefore, claim that if current bonuses were maintained, with-profit policies on current annual premium rates would provide, by comparison with the offices' own non-profit policies, an offset to an inflation rate of about double those figures—say $1\frac{1}{2}\%$ to $2\frac{1}{2}\%$ per annum. But those were favourable figures based on current bonus rates. The actual experience for (say) 20-year contracts maturing in 1957 would almost certainly show much lower figures, even for those offices which had begun to distribute special additional bonuses to old policies designed to reflect the results of investment of past premiums. The variety of methods adopted for those special bonuses and the movement in equity prices since the end of 1955 suggested that there was still room for thought about that problem, but there would be evident advantages if development were along the lines of bigger bonuses on conventional contracts, with the decisions on what and how much to distribute, especially of capital appreciation, left in the hands of the office instead of being defined in the terms of a contract.

He had assumed earlier that under an equity-linked policy the premiums and sum assured would vary in cash terms from year to year. For policyholders who were willing to pay premiums which increased as the currency depreciated, it might be possible to introduce that feature into money contracts. For example, an office might issue a money contract under which it would give the policyholder the option, which would continue only as long as he elected to exercise it, to increase the sum assured from year to year on the basis of some equity price index or cost of living index maintained by the office, the increases in sum assured being made without medical evidence and on guaranteed scales of premiums. Reductions in sum assured and premium if the index went down would present difficulties and might have to be dealt with outside the terms of the policy, as also might the effect of a very rapid rise in the index, as for instance happened with ordinary share prices between 1953 and 1955. Combined with participation in profits, such a policy would be likely to provide more stable results than would an equity-linked policy, although it would be rather complicated to operate.

A different possibility for those interested in some form of variable contract might be the issue of reducing temporary assurances in conjunction with regular subscriptions to an equity-based unit trust. The sort of thing he had in mind was that a man would undertake to purchase (say) one hundred units a year in the unit trust, for (say) 20 years; the interest earnings would buy more units. While he kept up his purchases the office would keep him covered, on a guaranteed scale of single premiums, for a sum equal to perhaps 2000 times the current price of a unit less the current value of the units purchased to date by premiums and interest.

That suggestion appeared to require unit trusts to be organized for significantly longer periods than had been the case hitherto, but it would have the merit for the particular problem they were discussing of separating the investment and insurance aspects and leaving each in the hands of a suitable specialist institution.

Mr E. H. Potter said that the question had been raised whether there was a need for insurance contracts providing benefits linked to the value of ordinary shares. In a free economy that was virtually equivalent to asking whether there was a demand for such policies. Of that, there could be no doubt. It might be asked whether such policies were likely to yield better results than the traditional forms of policy, and all that he could say on that score was that if such policies had been in existence in the past, the policyholders would usually have had a very good bargain. They might well do so in the future.

The current demand for that type of policy came largely from the self-employed who could effect deferred annuities under s. 22 of the Finance Act, 1956. As it happened, the form of that legislation was especially suited to policies providing variable benefits, inasmuch as the statutory restrictions on such policies applied not to the benefits but to the amount of premium payable.

Furthermore, the self-employed as a class, particularly the more wealthy among them, who might be supposed to have some knowledge of investment conditions, were the persons most likely to appreciate the true nature of contracts of that sort. Before the 1956 legislation many of those people had, in making their own provision for retirement, chosen to invest a substantial part of their savings in ordinary shares. The 1956 Act had given them the opportunity to secure valuable tax reliefs, but in order to do so they were compelled to effect insurance policies, unless there was a trust scheme for their particular profession. It was not unnatural, therefore, that many of them should now seek some form of contract which would both offer to them the tax reliefs available and at the same time enable them to enjoy the benefit of investment in ordinary shares.

In embarking on a revolutionary scheme such as a variable annuity scheme it was, of course, necessary to look beyond the wishes and interests of the contracting parties and to consider whether the existence of such a scheme militated in any way against the national interest. If a situation was accepted in which the bulk of industry was conducted by private enterprise, then automatically those investors who chose to invest their savings in the form of risk capital had to be regarded with favour. It could surely be only to the disadvantage of the country if the supply of such capital from private individuals, whether directly or through the medium of insurance companies, were to diminish. Yet that would be the effect if those self-employed persons who in the past had invested in ordinary shares were now compelled by tax considerations to put their money into traditional insurance contracts, which in the main were not backed by investment in ordinary shares.

They were forced to the conclusion, therefore, that the issue of a variable type of contract to policyholders who fully appreciated its nature was not contrary either to the public interest or to the interests of the policyholders themselves. Was the issue of such policies contrary to the interests of the life assurance industry? It had been suggested that traditionally life assurance companies granted benefits which were fixed and guaranteed in monetary terms, apart from the relatively minor question of bonuses on with-profit policies, and that the insuring public believed that no insurance company would sponsor a scheme under which the actual cash benefits might represent a poor return for the premiums paid. It had been suggested that the resulting disillusionment, if things went badly, would react to the detriment of the whole industry. He quite appreciated those fears but he thought that the remedy lay in the hands of the insurance companies sponsoring such schemes. In other words, it was up to them to make quite sure that their clients knew what they were buying. In particular, the prospective policyholders should be warned that the benefits would fluctuate in a way which was quite unknown in connexion with the traditional forms of insurance contract.

In practice, he thought, the question which the insurance companies had to decide was not so much whether the advent of variable annuity business in the United Kingdom was against their interests, but whether it was better that the business should be in the hands of well-established and responsible life offices or whether it should be left to other organizations. He suggested that there could be only one answer to that question.

Earlier he had mentioned that the self-employed were a suitable class for that type of policy, and he was very doubtful whether it would be wise to extend such contracts beyond that class then. He would not advocate offering that type of contract to the public generally until it had been in existence for some time and until its implications had become familiar and clear to the general public. In his opinion a great burden rested on insurance companies to ensure that any scheme was properly understood by its clients and, furthermore, that the scheme was not over-sold. To that end he thought that the inducements offered to agents and field staff for introducing that class of business should be on a very modest scale.

The opener had quoted some words from the Prevention of Fraud (Investments) Act, 1939, and he agreed that any company embarking on a variable annuity or variable insurance scheme must be very careful not to fall foul of that Act. There were two distinct questions involved. First, there was the narrow legal point that the Act must not be infringed. That, he thought, could be avoided if the insurance company offering the scheme were an exempted dealer for the purposes of the Act and if the policyholders did not receive their benefits as beneficiaries under a trust. The second and wider question was whether it was desirable in the public interest to seek ways and means of escaping from the controls imposed by the Act. That was a point on which any company contemplating transacting such business had to make up its own mind. His own opinion was that any scheme which was adequately explained, and which was directed to a class of the community likely to be able to understand it, was not contrary to the public interest.

There were various forms in which the variable principle could be applied, including one in which the insurance company virtually divested itself of all risk by throwing on to the policyholders not only the investment risk but also the mortality risk. It could be asked whether the granting of such contracts was a proper function of insurance offices. If it were admitted that the issue of those contracts was not contrary to the public interest, then he could see no objection to the business being handled by insurance companies, provided always that the nature of the contract was adequately explained. The handling of such business involved actuarial and administrative techniques with which life offices were familiar. Furthermore, it might be considered desirable, in order to minimize fluctuations, to link those contracts to contracts providing fixed monetary benefits. The latter contracts could be issued only by insurance offices. He thought that insurance companies, whose present interests lay so heavily in the field of fixed benefit contracts, could be relied upon to present the advantages and disadvantages in a fair manner.

Finally, he did not see how offices could be held responsible to their policyholders for seeing that the policy proceeds were worth what they had been expected to be worth. Price inflation resulted from an expansion in the volume of cash and credit, or from an increase in the velocity of circulation unaccompanied by a commensurate increase in the volume of goods. An insurance company had no control over any of those matters, though it might be argued that if it became apparent that insurance companies had lost faith in the currency, there would be a tendency for the velocity of circulation to increase. There might be some truth in that, but the effect on public sentiment of any action by insurance companies would be marginal and probably temporary. The true remedy lay in the hands of the Government, inasmuch as they alone were able to control the volume of cash and credit, which in the long run was likely to be the determining factor in fixing the level of prices. If prices continued to rise at the rate at which they had been rising in the post-war years, then, although life offices would be very sorry to observe that state of affairs—since it would militate against their traditional forms of business—it would be perfectly fair and reasonable for them to issue contracts suited to the needs of the times. Indeed, he would go further and say that provided they were sure that their policyholders understood what was being done, they had a positive duty to the community to make such policies available.

Mr G. W. Bridge (a visitor) had listened with very great interest to the opener's objective description of the subject. Mr Potter, in a forthright, well-reasoned and well-stated case for the issue of contracts linked to some other denomination than currency, had made his position quite clear. Nevertheless, Mr Potter had been very careful to emphasize, all through his remarks, the question of the selling of such contracts, and he (the speaker) was very concerned about that aspect. He could well imagine the conversations which might take place between an insurance company salesman, an insurance broker or an agent, and someone who was contemplating effecting a policy under which, throughout practically all its term, the premiums might rise and under which there was the possibility that during the period when the benefits became payable they might diminish. That was probably an extreme case, but it was quite possible.

A few months previously a policy to which he had been subscribing for some 20 years had fallen due. The policy had been for a very modest sum, in terms of money, but while he had been paying the premiums he had regarded them as a material charge on his finances. When he had received the cheque from the office he had looked at it somewhat ruefully. No doubt like a great many other people, he had wondered what would have happened if he had invested those annual premiums in a well-selected list of equity shares, and what the present value would be by comparison with the somewhat small sum of £2000 which the insurance company had paid him.

Those who were not among the select company of actuaries looked with awe at what the actuaries said and thought, although not always at what they did. They were very concerned about the problem which the meeting was discussing. He wanted to put one or two points which appeared important. First, one of the dangers which was looming upon the horizon was that of Government interference and Government control. The Government had to run the country and they had to issue loans. The Corporations had to have money. All sorts of people had to be able to borrow money on fixed interest terms. At the time of speaking the country was operating on an extremely high rate of interest, and many people wondered how that could continue. Suppose that the £280 m., which was the estimate of the net savings of life assurance, were all to be invested in equity stocks, and the gilt-edged market and the fixed interest market became completely friendless from the point of view of the insurance company or the pension scheme investor. What was likely to happen? The Government would naturally seek means to defend themselves against that situation, which they would find almost intolerable, and then there would probably be some kind of control, which so far had been avoided in the United Kingdom, over the direction in which investments might be permitted. Such control was customary in many foreign countries, where scheduled lists of investments were offered, or where definite percentages must be placed in certain categories of investments. It seemed to him that such a move would in all likelihood be the direct outcome of a wholesale embarking on equity-linked policies. He could not but feel that the very fact that those policies would need such a great deal of explanation and would be suitable only to a restricted number made it extremely doubtful whether it would be wise to embark on a scheme of that kind.

While it was wise for the offices to increase their investments in equity securities—and the percentage since the war had considerably increased—it seemed to him that the traditional balance which had been observed by insurance companies for a hundred or more years, with a proper spread of risk and of investment, was something which they should still guard very carefully. The with-profit element had helped. It seemed to him that if a company, while preserving a proper balance, invested in equity shares in order to keep up and improve its bonuses, that was a far better way of dealing with the problem. They were suffering from inflation and might suffer more from it, but if everybody sought to insulate himself against inflation, that very fact defeated the objective they had in mind. By investing their money over a wide spread of investments, wisely and carefully, by selling the goods which they had to sell, by keeping down their expenses and by increasing the savings of the people, those in the life insurance world were doing something which could stop inflation, and surely that must be one of their main objectives.

Mr R. H. Blunt said that he would confine his remarks to one aspect of the subject which Mr Bridge had mentioned, namely, their responsibility to the community. Thousands of millions of pounds were entrusted to them for safe keeping and investment and they were allowed to discharge those duties with the minimum of governmental control.

What was needed in the face of the enemy, inflation, which was eating away the fruits of their labours, was perseverance in the struggle against it. The last thing they ought to do was to entertain any policy of appeasement. They should be thankful, therefore, that the Government had declared their firm intention of making a determined attack on inflation and were calling upon all classes of the community to co-operate. In his opinion, it was the duty of every individual to co-operate even at cost to himself. More particularly it was the moral responsibility of the Institute to give a clear lead in a matter which so vitally affected them all.

He considered that if the life assurance industry launched out substantially on the sale of equity-linked contracts they were embarking on a policy of appeasement, and he would be very sorry to see that happen. In fact, he would say that for the Institute to choose that very moment to lend its support and approval to the issue of such contracts, based, as they were, on the assumption that inflation had come to stay, would be the worst possible way of supporting the Government in their present endeavours. It might set in train events which they could not adequately control and thereby shake the public's confidence in their ability to administer the funds they already held in trust.

By all means let the technical problems involved be discussed in private as a theoretical exercise; but when it came to the practical issue of whether to exploit inflation, let them show their measure of self-control by resisting the temptation. Let them have the courage to go on record as saying that they would have nothing to do with such appeasement policies.

Mr R. J. Kirton wanted wholeheartedly to endorse Mr Blunt's views that inflation was something they should fight rather than something from which they should attempt to save small groups of people. He did not think it was possible in any general way to issue equity-linked contracts without denigrating the currency and he could think of nothing more serious for the pound sterling than for those who were responsible for a very large part of the personal savings of the people to seek to use some other yardstick.

He had been very interested in Mr Potter's remarks about such contracts. Personally, he did not think they were even necessary. Mr Potter had spoken of variable annuities for the self-employed, but it was quite possible to effect with-profit 'self-employed' annuities in offices which held a reasonable proportion of equity shares. If an office held equity shares and if, regrettably, those who sponsored the variable contracts were correct and there were inflation, then the profit from those equity shares could go only to the with-profit policyholders and the with-profit annuitants. There was nowhere else they could go. They might not go there exactly generation by generation, but they would go there sooner or later.

There were one or two technical points of interest that had struck him as particularly difficult. Suppose an office transacting ordinary business started to transact variable contracts. The funds had to be segregated. They immediately began to serve two masters, the segregated fund and the ordinary life fund. In his view, the great strength of the life fund was that those who served it were single-minded in their purpose.

He wanted to repeat a comment which had been made at the Faculty and had again been made during the discussion—that those of them who were responsible for thousands of millions of pounds of contracts written in sterling must do nothing to damage the currency, however slightly.

Mr J. R. Hemsted agreed with those who did not believe that an equity-linked policy of the type suggested was practical or worthwhile. As had been pointed out, equity shares fluctuated wildly and did not directly provide a link with the cost of living, which was the measure they were seeking. They wanted to give the policyholder a contract stable in terms of the cost of living, and if they were to consider any alternative to equity-linked policies, that was exactly what they should consider.

He did not think that there would be any great difficulty in issuing a policy guaranteed in real values, nor did he see that there could be any ethical objection. When insurance started the currency was stable, and probably the idea of loss of real value of money scarcely occurred to anybody. They had learned that that could happen and it seemed to him logical that they should consider issuing policies in terms of real values, by linking the sum assured to the cost of living index. In that way there would be no violent fluctuations, because the cost of living index moved only slowly.

If desired, they could avoid the question of variable premiums by issuing policies with premiums fixed in terms of money but with an index-linked sum assured. The calculation of premiums might be done in much the same way as for compound bonus policies. As an investment man, he spoke freely about the problems of premium rates, because he did not know very much about them. Presumably, at the outset they could assume an expected rate of increase of the cost of living index per annum and then reduce by that amount the rate of interest by which they were discounting the sum assured. They could go further and have a variable premium linked to the cost of living index in the same way as had been suggested in connexion with equity-linked policies, but there were obvious practical difficulties.

There was one possible development in the future which would provide a clean solution to the problem of issuing a policy in real values. In an article in the *Financial Times* entitled 'An Index-Linked Currency', it had been remarked that in Finland, apparently, the finance houses became so tired of the loss of real value that the banks decided to accept deposits which were linked with the index of the cost of living so that the nominal amount of the money deposited rose as the cost of living rose. The cost was met by borrowers by way of increased interest, or possibly even by indexing their loans so that they had to pay back the loans in real terms. The idea had apparently become acceptable, and the result, he understood, was that from the beginning of 1957 every loan in Finland was indexed in some way, by law, both as to interest and capital.

If the current crisis could be overcome and the Government mastered inflation, he did not suggest that there should be any alteration. But if the Government failed, then he thought there was something to be said for financial institutions standing together and requiring an index clause on all loan contracts. They might even reach the stage where they had an indexed pound existing alongside the ordinary pound and were able to issue policies in terms of the indexed pound—in other words, in terms of real values. The investment problems concerned would immediately be solved by the existence of Government loans, mortgages and debentures which would be available in terms of real values.

He could not work out whether that would be good for the country and would stop inflation or act in the other direction, but he was satisfied that if they thought in terms of real values they would not be accused of denigrating the currency.

Mr R. C. B. Lane said that in a very practical way he had had to consider the problem under discussion. The main issue on which the debate had concentrated seemed to him to be the overriding question whether or not it was advisable for life offices to issue contracts which admitted the existence of inflation and sought to give, directly to the policyholders, some of the benefits of equity investment. He could not follow the argument that that was bad. His approach was different. Every form of investment and saving was needed. Equity investments had been accepted, boosted, sold and talked about for years, partly for the sake of the reinvestment which went on within the companies concerned and partly as a hedge against inflation—since they had become more and more accustomed to live with inflation. It was now so commonly recognized that he could not see that much more damage was done by admitting it frankly. Indeed, he would go further and say that in so far as the existence of such policies tended to turn investment into real savings, they might even do some positive good. It was possible, but he thought very unlikely, that they might discourage investment in other forms to a greater extent, but in so far as they put money back into real goods and real investment, surely they were acting in the interests of the community.

It had been said that such a policy would denigrate the currency, but it was a little difficult to understand what that meant. Did it mean that they were saying that inflation was present when it was not, that they were defaming the currency unwarrantably? It was difficult to hold that view after the post-war experience. Did it mean that such policies would cause inflation? That, as he had already said, was doubtful. The word 'denigrate', therefore, no doubt, meant that they were admitting something which existed. But inflation existed and it was better to admit it. The more everyone talked about it and emphasized its mischief, and the more everyone tried to persuade the powers governing them to realize its mischief and to take active measures to cure it, then the better the chance of the ultimate salvation of the country.

Some speakers had spoken as though the type of policy would spread very widely, but he did not think that that was likely. There were many practical reasons why a very large number of offices would be unlikely to try that type of policy. Even if they did, he did not believe that it would have universal appeal and sweep out the traditional kind of insurance. Consequently, they need not fear, in turn, that it would provoke interference with life assurance which would not have been provoked in any event. That was a risk with which they were living; the large offices were more or less threatened with it in certain events in the near future. He could not see that the introduction of the new method would make much difference; if interference by the State came, it would come in any case.

Other speakers had suggested that the issue of equity-linked contracts was a policy of appeasement, and that argument, too, he could not fully follow. It was possible that if the public generally came to prefer equity investments, as many life offices, pension funds and private individuals had come to do, it would be more and more difficult for the Government to issue its fixed interest securities. Possibly the country was suffering a little from that already. He thought there were many other reasons, too, for the current situation. Surely the cure was not to interfere with the devices through which the public chose to invest its money, but to see that the finances of the country were sound and that fixed interest securities were not so plentiful that nobody wanted them. The cure was to put the finances right.

Turning to some of the technical problems involved, he asked how, in a free country and without any Government-sponsored cost of living index with special standing, they could possibly hope to use as an indicator for those policies anything but an invested fund. The unit trust was a fairly obvious invested fund to use, but it must be a real fund to give it reality and to enable the life fund to hedge properly against what was being done. He thought that the unit trust or the fund—the indicator—must also be one which was operated with an emphasis on equities, but nevertheless in a controlled way and without running to any extreme. It was important that the indicator should represent and reflect a balanced investment policy—perhaps something between what a sound private investor would do on his own and what was commonly accepted as proper in a life fund. He would not say that it need always include a fixed interest element, but it should certainly be restricted to the sounder types of equities, the less spectacular ones, but with an emphasis on growth.

Reference had been made to the reinvestment which took place within equity investments, and that was important because it meant that quite apart from inflation there was an inherent growth element which was likely to build up, which made more practicable the idea being discussed and which made it unlikely that the result would turn out to be disappointing and also unlikely, in certain events, that too heavy a strain would be thrown upon the office conducting it. He thought that it was desirable that a guaranteed minimum sum assured should be written into the policy. Above all, it removed the possibility of misunderstanding. They had to face the fact, however, that the introduction of such a provision added a certain hazard. It was a hazard which he thought was controllable, but it had to be kept in proper proportion to the resources of the office operating the plan.

The calculation of the premiums was fairly straightforward. He thought that it meant a lower effective rate of interest would be realized because they were stripped of the capital profit on which they were otherwise also relying, but if they worked to a lower rate of interest and added a little, perhaps, for any guaranteed sum assured or anything of that nature, they would have a contract at a premium which was basically practicable in every way.

Overriding everything was one big proviso—that the total amount of that type of business issued by any one office should surely be kept, as all insurance should be kept, properly within the resources of the office. That, he thought, was a protection to the community. It was a protection to the industry as well. If it were kept within those bounds, he did not think that the development was such that anyone had anything to fear. He thought there was no chance at all of its flooding and completely altering the face of life insurance in the United Kingdom so as to create the kind of problem which seemed to be feared.

Mr G. F. M. Mayo said he had been particularly struck by Mr Lane's remarks because it seemed to him that the trouble in the United Kingdom was that far too large a section of the population considered itself protected from inflation. It seemed to be the attitude of the working class that if prices rose, all they need do was to threaten a strike to make sure that their wages kept pace with the prices. By issuing contracts which pretended to protect people against inflation—and might even do so—the profession would be adding further fuel to the inflationary fire which was troubling the country so much.

Mr J. Plymen thought that it was a healthy development for the ownership of equity shares to be distributed as widely as possible among the public, especially to the 'small man'. They were much behind America, where public interest in the share market was widespread. It was commonplace there to be told by a taxi driver of tips for the stock market. Almost everybody in America invested in ordinary shares. In that country there seemed to be little antagonism towards capital and, on the whole, he thought that their labour relations were better than in the United Kingdom. Their trade unions were prepared to combine with management to secure increased productivity, and to eliminate restrictive practices. Further interest in ordinary shares by the general population would make for a better political climate, and such participation by the 'small man' would be best secured through the medium of the unit trust movement. Currently there were a number of schemes whereby the 'man in the street' could subscribe monthly and build up a portfolio of unit trust shares. That seemed to be a very desirable practice. Although unit trust shares might fluctuate considerably in price, their income should remain fairly steady. He thought that a man could build up a portfolio of unit trust shares with every prospect of securing therefrom a satisfactory retirement income.

Buying unit trust shares, however, was not a good policy for the family man because it did not give him any life cover. It would therefore be a good idea for schemes to be introduced as suggested by the opener, whereby the life office and the unit trust combine. The subscriptions would be applied basically to obtain the unit trust shares and the life office would provide cover so that in the event of death a substantial amount was payable. In all those schemes, he thought, the emphasis should be on obtaining the unit trust shares as the principal benefit under the policy. It might, however, be necessary to have a certain amount of guaranteed sum assured, possibly to obtain the benefit of tax relief as a life policy.

Mr Lane had said that for such a scheme a guaranteed minimum sum assured entailed a certain element of risk. He (the speaker) had studied long-term price indices of ordinary shares, using the actual records of a leading unit trust over the last 25 years and, before that, the London and Cambridge Share Index. He had made some calculations over a 35-year period, assuming that each premium had been applied to buy unit trust shares and that at the end of a period of 10 years the policy matured: the appreciation or depreciation had been calculated according to the results of the unit trust. Over the period 1922–57, a period when ordinary shares had had very considerable fluctuations, there were only 6 out of 25 years when policies maturing showed the amount payable below 100. For a policy taken out in 1922 and maturing in 1932, there was a depreciation of 24%. For a similar policy maturing in 1933, there was a depreciation of 15%. For similar maturities in the years 1941, 1942, 1952 and 1953, the corresponding losses were 17%, 4%, 8% and 2%, respectively. He thought that if a guarantee had been made of not more than 80% of the whole value there would have been little if any risk, despite the very trying economic conditions of the period chosen. Indeed, what little risk there was could have been covered by a modest extra premium.

Mr W. H. Clough said it was significant that the opener had begun the discussion with a quotation from Mr R. G. Hawtrey, than whom no one was more likely to know what was in the national interest. Thirty years previously Mr Hawtrey was advocating exactly what was being currently discussed.

Mr Lane had expressed better than he (the speaker) could many of the things he wanted to say. If the school of thought represented by Mr Kirton and others held the field, then he stood before the meeting as one of the guilty men, in the sense that he was offering to a sophisticated body of people, a professional body, the choice between taking retirement annuities in terms of depreciating cash or taking them in terms of a unit investment trust. He could assure the meeting that there was a demand from sophisticated people for the unit investment trust idea of securing their annuities, although he had grave doubts about how far that could be extended to life assurance as a whole. They should remember the ordinary tendency for currencies to depreciate in any event. Furthermore, if there was to be such a high rate of interest as 7%, there was the inevitability of depreciation in the currency, otherwise the economy could not stand up to that rate of interest.

He asked what was wrong with passing on to the assured the equities which were being purchased. After all, it was advocated that pension and life assurance funds should be invested in them and that they should be used by the insurance companies as a source of profit and bonus. Quite apart from that, the assured was being persuaded to invest in equities direct. What was wrong in using them for retirement annuities? Surely it was no crime against the currency or the country to pursue such a policy. The important point was that those policies should be sold to sophisticated people.

Dr C. H. Walker (a visitor) explained that he was concerned with running unit trusts. Certain problems connected with the use of unit trusts in variable annuity schemes and variable insurances had to be made clear if the unit trust movement was to be used for such a purpose.

In the United Kingdom annuity insurances were already offered in variable terms and linked to existing unit trusts, but there was a conflict of interest between the assured and the assurer, where the interest of the assured was expressed purely in terms of the price of a unit trust, using the unit trust price as an index number of what the insured person should receive.

Drawing the contrast with a subject with which he said he was not nearly so familiar—with-profit schemes of insurance—he pointed out that under a with-profit policy the insured was interested both in the appreciation in the value of the fund and also in the income which had gone to create that appreciation. In other words, income was accumulating within the fund and, together with the market movements of the securities held in the fund, it contributed to the creation of extra profit for the insured. On the other hand, if a unit trust were to be used in variable insurances and the benefits were expressed only in terms of the price, then there was a conflict because the insured was interested in capital appreciation while the insurer was interested in the income from the units. The insured wanted the highest price to be achieved in the units whereas the insurer was interested not in the price but in the income, because his contract had been expressed in terms of the price of the unit trust. He thought that that was likely to be the *pons asinorum* of that type of variable insurance. A way had to be found of associating the insurance company with the unit trust management so that the insurer and the insured were on the same side of the counter in that matter of income and capital value.

It had been suggested by some speakers that investment by the masses in equity shares was a desirable thing but that it should be associated with some form of insurance. There was already such a plan for purely accumulative investment in unit trusts associated straightforwardly with insurance of a diminishing sum as the investor's equity interest grew. That already existed and what was wanted was progress from that point.

Mr A. T. Jamieson wished to make a brief comparison between policies of the type they were discussing, with a minimum guaranteed sum assured, and the traditional type of with-profit policy. Although immediate annuities with profits were comparatively unknown in Great Britain, there was no theoretical check upon their issue and both life assurance and annuity contracts might therefore be brought within the same discussion.

If the investment policy of an office were directed to achieving security of capital and thereafter to producing profits consistent with that security, no real modification need be made in it. The proportion of capital to be held secure might be reduced in order to provide a greater profit, but the fundamental approach would not be altered by the introduction of equity-linked policies.

The current practice was to accept fixed annual premiums only under each contract. A policy could be written, however, to provide for increases in premiums and sums assured or annuities at later periods to match any depreciation in the currency which might take place. It was clear that both the options against the office and the mechanics of operation were capable of elementary solutions. That variation in policy conditions appeared most desirable in order to ensure that the necessary life assurance which a policyholder required was maintained. In fact, that problem had already been faced and resolved in the provision of pensions for the self-employed and should therefore cause no concern.

Although it was customary to declare bonuses in a retrospective form which remained fixed for the remaining duration of the policy, it would not be difficult to declare bonuses of which no guarantee was given except shortly before a claim fell due. Like mortuary bonuses, they would be guaranteed only for, say, a year at a time. That would permit a more flexible investment policy, since the guarantee would no longer apply to the accumulated bonus. Hitherto, that assumed liability had been a limitation on the pursuit of an active investment policy involving equity shares.

Again, referring to the distribution of profits, it was well known that such methods as had been used gave a broad degree of equity in a stable economy, but there was some loss of equity when there was the high degree of inflation which the country had recently experienced and which made comparison between payments made at different durations a matter of economics and not simple arithmetic. The most convenient solution was to have recourse to the contribution method of surplus distribution. The valuation liability under a policy might be adjusted to allow for depreciation in real terms and the resulting surpluses employed to increase the policy's proportion of the profits available. Even if the method were applied to only a small random sample in the office, the results would ensure that the policyholder received reasonable value for his premiums.

His conclusion was that a reassessment of the system of distributing profits might be of greater benefit to both present and future policyholders than the introduction of entirely new provisions for life assurance.

Mr K. A. C. Wheeler thought that the essence of the discussion was whether a policyholder should have any protection against inflation by virtue of his arrangement with the insurance company. He could not see what was wrong with the simple application of the with-profit policy. It was then up to the individual office concerned to issue the contracts in the with-profit form or not as it chose. It could put its investments into gilt-edged or into equities. Incidentally, if anyone had put his money consistently into rubber shares over the past 30 years, then the return would have been much better than that from the best equities in the United Kingdom! In other words, the company could do what it liked with its own investment policy. The returns which it made to its policyholders under the with-profit contracts would be the measure of its success or failure and the policyholders would have to stand by what had been done.

Much of the trouble arose on the question of degree. Some people seemed rather frightened, and he thought rightly frightened, that if they went wholeheartedly into such a scheme on a large scale, they might well invite interference with the industry, where they so highly prized their freedom of action. He thought the answer was to leave it to the with-profit policy.

The problem had been considered in the first instance some thousands of years ago by a man sitting in the desert who wondered what to do with his wealth in order to preserve its value. After due consideration, he decided that the answer lay in goats. His argument was that goats could be described as having an anti-inflationary built-in device which periodically multiplied the herd and which thereby protected the owner against depreciation in the value of each goat. However, that inevitably led to a goat-multiplication race as other people followed his plan, drastic over-production of goats, and finally the collapse of the goat basis of wealth. In short, automatic protection schemes against inflation of that nature were, in his view, an invitation to the destruction of the 'store of value' concept of money.

Mr F. M. Redington wished to make two comments hinging on the word 'automatic'. The moment they announced that they intended extensively and automatically to invest in equities they would artificially inflate the value of the equity shares which they proposed to sell to their policyholders. They were not only blowing up the balloon but were giving it a special annual puff by, in effect, guaranteeing to continue to invest in equities in the future.

The Americans were very concerned about the subject and he and others had discussed it with them. In America they were in the awkward position that they had no weapon against the inflationary position because they could not invest in equities. In the United Kingdom, however, the insurance industry had such a weapon; they could not only invest in equities but they could do better than that —they could invest in either equities or gilt-edged, whichever was the better.

Since they could already invest freely in equities the two special effects of the new contracts, both hinging on the word 'automatic', were first that they threw the onus of investment on the policyholder, who decided what the type of investment should be and bore the brunt of it, and secondly that they guaranteed to the policyholder how the surpluses would be distributed. The second point might touch the weak spot in the current situation. They could invest in equities, but did they distribute the resulting surplus properly? He thought that the actuarial profession should give the most serious consideration to the applicability of all their traditional methods in the inflationary situation which the country had been facing. He believed that they could do more for their policyholders whose policies were now maturing and in that way could have a good answer, even if only partial, to the problem of inflation. Moreover, they could do so without weakening their basic tenet of doing nothing less than complete justice to the current policyholders and those coming in the future.

Mr G. H. Ross Goobey said that the opener had referred to a pension fund with a policy of investing 100% in equities. He was associated with that fund and the meeting might be interested in his reactions to the discussion. One of the main points which he put forward as an advocate of a policy of equity investment for a pension fund was that the market value of the investments at any time could be ignored. For equity-linked contracts, however, they were putting the market value of the investment into the forefront of their policy, and from that point of view there were great difficulties. They were overlooking the important point about investment in equities, namely, the higher return. That would perhaps be reflected in a better rate of premium, for which they could assume a higher rate of interest, but to his mind fluctuations in market prices would defeat the scheme. There would be many more complaints about reductions in sums assured than expressions of gratitude from the majority who received increases; just as, in a reverse way, there were those who spoke about the profits they made on their investments—but who never talked about the shares which did not come up to expectation!

The remedy for the difficulty was for insurance companies to increase their investments in equities, if they could. That might mean that the provisions of the Assurance Companies Act, 1909, concerning balance sheet values might have to be rescinded. That was another advantage possessed in the pension fund world: they did not necessarily have to make their books balance at any point of time. If the insurance companies were allowed to invest in equities in greater quantity their with-profit policies would produce an answer to inflation.

One of the remedies for inflation was greater production which would mean a growth in the economy and would benefit ordinary stocks and shares.

Mr A. G. Simons, in closing the discussion, said that variable annuities and variable insurances, whether with or without variable premiums, were a new concept which might cause them to reject a number of bases on which life assurance had been built. That was not necessarily a reason why they should not give the matter very careful consideration. Some actuaries had already had experience of policies which were not payable in cash but which were linked to Government securities. When, on the policy maturing, the Government securities were over par, there was a rubbing of hands, but no gratitude was expressed. Undoubtedly the opposite was the case when, on maturing, the Government securities were below par.

He had a great deal of sympathy with the man who asked why the office could not issue a contract based on the price of equities if he wanted them to do so, but the discussion had emphasized one of the great dangers of complying. The opener and Mr Bridge, in particular, had stressed the trouble that might arise in selling. Nearly every speaker in the discussion had spoken about inflation, but they were not discussing contracts which varied directly with inflation; they were discussing contracts which varied with the price of equities, and while the price of equities had tended to go in the same direction as the cost of living, nobody would pretend that the two had marched in step. Although there might be no confusion in their own minds, they had only themselves to blame if the policyholders expected their benefits to march in step with the cost of living. He would hesitate very much before trying to explain to an annuitant why his quarterly instalment was lower than the previous one if the annuitant had believed that his annuity was based on the cost of living. They had, therefore, to be very careful about the words they used when discussing such contracts and they had to remember that the contracts were not linked with the cost of living.

There was a technical point which speakers had tended to walk round. He was not certain what Mr Lane had meant when he had referred to a fund. There were two ways of dealing with that problem. In America, they worked, in effect, on the basis of a fund invested in equities, and the fund itself was valued at the end of each year. In the United Kingdom they could start by investing in unit trusts. He had been delighted to hear Dr Walker draw attention to the fact that they could not divorce interest from capital. If an industrial company made £1 m. in trading profit, it might pay a dividend of 25 % or 100 % of that profit, and the resulting price of its ordinary shares would depend on which it did. If it paid 25 %, the interest income was lower but the price of the shares should be higher because of the extra money retained for expansion—although stock markets were very curious and the fact that the company declared 100 % of its profits as dividend might cause the price to rise, at least temporarily. If they tried to pass on the resulting capital profit and did not run the fund as a complete fund, with interest, mortality and expense profits and losses in it too, they were trying to sort out two pieces of the same puzzle and were more likely to run into trouble.

When they looked back over the past 20 or 30 years they were looking back over a period when there had been little political effect on industrial companies, apart from limited nationalization. Who knew what would happen in the future about nationalization, limitation of dividends, profits taxation or steps of that kind? The effect of such things on market prices would be blamed on the insurance companies. In the past they had issued policies based on currency. Nobody could blame the office if the currency depreciated. But if the office proceeded to issue policies based on the prices of ordinary shares, it had itself to choose them, whether it tried to pass the responsibility on to the unit trust or not. After all, it selected the unit trust even in the former event and so indirectly it selected the ordinary shares. There would always be the man who thought he knew better than the insurance company about those things—certainly after the event. They had, therefore, to remember that if they chose ordinary shares, then in the same way as with policies based on Government stocks, there would be no gratitude on the part of policyholders if they were right, but plenty of recrimination if they were wrong.

The President (Mr C. F. Wood) said that it was his pleasant duty to propose a vote of thanks to Mr Edwards for opening the discussion. Everyone would agree that Mr Edwards had given an excellent and carefully prepared speech which had stimulated a keen and well-sustained discussion. He asked the meeting to accord Mr Edwards a very hearty vote of thanks.

Mr N. Benz has written:

If time had permitted, I should have liked to take up the implications of the phrase 'segregation of assets' which was used by one or two speakers. It was not clear to me whether they contemplated that the particular contracts under discussion should be entirely self-supporting, or whether the whole of the funds of a life office should be answerable for any shortfall arising, say, from adverse mortality. Though this question would obviously be of considerable importance in selling the contracts the main purpose of this contribution is to consider the taxation consequences in relation to annuity contracts.

One of the essential features of any scheme whereby a life office issues contracts with variable benefits is an intention to distribute to the holders of the contracts sums equal to the appreciation in the market values of assets, whether or not the appreciation has been realized. As it has long been established that liability to taxation on life assurance business is independent both of sums distributed to policyholders and of appreciation of assets there would appear to be no special problem in regard to, say, variable endowment assurances, but for variable annuities the problem cannot readily be dismissed.

If the office were assumed both to hold against its total liabilities under life assurance and annuity business only one particular holding and to synchronize the realization of investments with the payment of the variable annuities, unpredictable distortions of annuity profits (or losses to be carried forward) could be avoided; these are clearly two most unrealistic assumptions. If, however, the life office were to be in the usual position, holding a wide variety of assets, then some such distortion seems inevitable in the light of what are generally accepted as the Revenue's rulings on the determination of annuity profits for taxation purposes. The extent and timing of the distortions is a matter which opens a wide field for speculation, dependent upon the assumptions made as to the precise nature of the variable annuity contracts and the relative weight of the office's life assurance business, pension annuity and general annuity business.

Whether or not these matters could be resolved with the Revenue within the framework of the present legislation can only be a matter for conjecture at this stage.