Life Assurance Funds, Investment Procedures

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During 1965 the Life Discussion Group of the Insurance Institute of N.S.W. published a Report by its Advanced Study Group No. 2 dealing with Life Office Investment in Australia, and I had the privilege of being the Chairman of that Study Group. This Report, which exceeds 100 pages and is available from the Insurance Institute, covers a wide field in a fair measure of detail, and so I am restricting my comments to certain aspects of Life Office Investment.

In the March-April, 1966, issue of the American Financial Analysts' Journal, Mr. Leonard D. Schutt, C.F.A., stressed the safety of principal and income needs in regard to Life Office Investment—"Most of the companies who have failed to perform as promised appear to have done so because of bad investment underwriting not bad Life underwriting. There has never been enough margin in the pricing of Insurance Contracts to permit many investment losses. Therefore the first obligation to the policyholder and the most basic determinant of investment policy is unquestionably financial strength and safety of principal. The second obligation to the policyholder is to earn a return on all funds being held to pay future claims to the policyholder's family. They are entitled to all the yield they can get without violating the cardinal principle of safety."

In the United Kingdom we find Mr. Basil Robarts at an Investment Seminar held by the Institute of Actuaries, London, in 1966, said—"The primary aim of all Life Insurance Investment must be to ensure that liabilities under the contracts on which premiums and contributions have been collected could be met. Subject to this requirement a further aim must be to secure the maximum return on capital invested, at the same time preserving a balance between the interests of present and future generations of policyholders or members."

Turning to Australia, we have two statements in 1966 on the subject. Firstly, Mr. W. D. Brookes, Chairman of Colonial Mutual Life, at his Society's annual meeting, replied to charges that Australian Life Offices are too conservative and over-cautious in their investments and said, "As quasi-trustee for funds which represent family savings and family protection, a Life Office could not provide risk capital where the risk is high, even though potential profits are correspondingly high. For this reason, too, the Society could not lend at rates of interest which were unrealistically low in relation to interest rates current from time to time." Secondly, Mr. M. J. O'Neill, Chairman of the City Mutual, at his Society's Annual Meeting, said, "We at the City Mutual regard ourselves as being bound to invest our policyholders' funds to the best advantage of such policyholders and we therefore seek proper security for all our investments both as regards capital and income. In regard to interest rates, we feel it our duty to endeavour to obtain, in the majority of cases, the best rates offering without charging such rates as would impose hardship on borrowers or be against the national interest."

The prime aim in investing policyholders' funds, in my opinion, is to produce the maximum possible return to the policyholder, whilst never forgetting that the funds must be invested in such a way that the guaranteed benefits under the policies are met.

Actuary's Role in Investment:

Some may wonder just precisely what is the Actuary's role in this field and why the subject should be discussed by an Actuary rather than an Economist, an Accountant, or a Stockbroker. The English Actuary, Mr. H. G. Clarke, recently said, "Over the years Actuaries have been concerned with calculations in connection with Life Assurance Funds, Pension Funds, Friendly Societies, etc., involving rates of mortality, rates of sickness, rates of withdrawal and, of course, rates of interest. In the last century mortality, sickness and withdrawal claimed almost the whole of the Actuary's attention, it being only considered necessary to take an occasional glance at the price of Consols as far as the interest factor was concerned. But the last 50 years or so have seen a great change, and the Actuary had come to realise that of all the factors he had to deal with, the rate of interest was now the most important variable and also the most variable variable. Not only have the levels of interest rates become more volatile, but the scope of investment had expanded into wider fields, and in particular into equities."

To give a simple illustration of why it is so necessary to invest the funds of a Life Office to obtain the maximum expected yield, I shall

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look at the effect on a Life Office of a reduction in its expense rate and compare this with an increase in its interest yield. In the Annual Report of the Insurance Commissioner for the year ended 31st December, 1964, which is the latest report available at the present time, the expense rate for 1963 for all Life Companies in respect of their ordinary business was 22.2% of premiums and the interest rate for Ordinary Department business was 6.16% gross and 5.64% net. If expenses were reduced by one-twentieth, the additional amount available for distribution to policyholders in one year would be $2.4m. If the net rate of interest earned on assets was increased by one-twentieth (or approximately one quarter of 1%) the additional amount available from interest earnings in one year would be $4.6m. or twice the amount from the one-twentieth reduction in expenses. Therefore, for all Life Companies in Australia at the present time a one-quarter per cent increase in the interest rate is equivalent to a reduction in expenses by one-tenth.

The expense rate for all companies has been relatively constant for the past 10 years and has been at a level of about 20% of premiums for Ordinary and Superannuation business. Between 1953 and 1963 the expense position was relatively unchanged but this is not a poor performance on the part of the Life Offices in view of the substantial increase in new business and in the inflation in salary levels during that period. The net rate of interest earned on funds in 1953 was 3.84% and this had risen by 1963 to 5.73%, i.e., an overall increase of 1.89% of assets.

The increased interest earnings over the last 10 years has had the same effect as if expenses today were only 6% of premium income (instead of 20%). Such a reduction in expenses is impossible of performance in current conditions, yet increased interest earnings have produced the same effect. In fact it is only necessary to increase average interest earnings by another three-quarters of 1% to a figure of about 6.5% (a rate by no means impossible in current conditions) to place Life Offices overall in the same position as they would be if they were earning their 1953 interest rate on funds but had no expenses of management or agency expenses whatsoever.

I think that this will make it clear just how important a part investment plays in the final result to a policyowner who takes a long-term contract of whole life or endowment assurance with a Life Office. I don't wish to imply that we can merely concentrate on investment and not worry about expenses but rather that, as the potential benefits from investments are so great, we should double our efforts to improve our investment results.

The Table shows the distribution of assets in 1965 by type of investment in Australia, the United Kingdom and the United States of America.

1965 PERCENTAGE DISTRIBUTION OF LIFE OFFICE INVESTMENTS

Type of Security		U.S.A. (a)	U.K. (b)	Aust. (c)
		%	%	%
Government Securities	(i)	7.2	23.2	32.8
Debentures, Notes and Preference Shares	(ii)	37.0	21.4	12.6
Mortgages	(iii)	37.8	16.2	28.8
Ordinary Shares	(iv)	5.7	22.5	11.7
Property		3.0	10.3	9.6
Other Assets	(v)	9.3	6.4	4.5
Total		100.0%	100.0%	100.0%
Total Assets		$A141,000m	$A25,000m	$A3,300m

(a) Source—Life Insurance Fact Book, 1966.
(b) Relates to combined life and non-life funds—the figure for life funds only not being readily available. The inclusion of the non-life funds (approximately one-sixth of the total funds) has only a marginal effect on the pattern of investment.
(c) Source—Insurance Commissioner.
(i) For U.S.A. comprises U.S. Government Securities 3.2%; State Provincial and Local Bonds 3.4%; Foreign Government Bonds 0.6%.
For U.K. comprises British Government and British Government Guaranteed Securities 17.0%; Commonwealth Government Provincial and Municipal Stocks 2.8%; Foreign Government Provincial and Municipal Stocks 3.4%.
For Australia comprises Government Securities 24.5%; Local and Semi-Government Securities 8.3%.
(ii) For U.S.A. comprises Industrial and Miscellaneous Bonds 24.2%; Public Utility Bonds 10.7%; Railroad Bonds 2.1%.
For U.K. comprises Debentures, Loan Stocks, Preference and Guaranteed Stocks and Shares.
For Australia comprises Debentures 6.7%; Secured and Unsecured Notes 3.7%; Preference Shares 2.2%.
(iii) For Australia comprises Rural Mortgages 2.2%; Housing Mortgages 10.7%; Other Mortgages 15.2%; Loans to Building or Housing Societies 0.7%.
(iv) For U.S.A. includes Preference Shares.
For Australia comprises Ordinary Shares 11.3%; Holdings in Controlled Companies 0.4%.
(v) For U.S.A. comprises Policy Loans 4.8%; Miscellaneous Assets 4.5%.
For Australia comprises Furniture, etc. 0.2%; Loans on Policies 3.7%; Loans to Controlled Companies 0.4%; Other Loans 0.2%.

To a large extent the difference between one country and another in some classes of investment (particularly in Government securities and the investment in equity type investments such as ordinary shares and freehold property) is a reflection of different legislation affecting the investment of Life Office funds.

Of particular importance is the trend in Life Office investment year by year and although only 21.2% of Australian assets were invested in property and ordinary shares at 31st December, 1965, during the year ended on 31st December, 1965, 40% of the increase in assets for that year were invested in these fields, but in the following six months, i.e. to 30th June, 1966, the corresponding figure was 33%.

Legislative Restriction on Investment:

The 30/20 taxation legislation in Australia, in effect, compels every Life Company to hold a minimum of 30% of its assets in public securities, including a minimum of 20% in Commonwealth Government securities. In 1954 Life Offices held 51% of their assets in Government securities and this fell to only 34% by 1960. At 30th June, 1966, 33% of assets were invested in Government securities. The 30/20 legislation has clearly halted the previous rapid decline in percentage of assets invested in Government securities. This legislation was the first and is the only material restriction on Life Office investments in Australia.

As public disclosures have revealed losses by Life Offices arising from investment in company undertakings, it was suggested in the N.S.W. Legislative Assembly in 1966 that, in order to give adequate protection to policyholders, Life Offices should be limited in their investment powers. It was suggested that Life Offices be limited to investment in:

(a) Government public loans;
(b) Government bonds and debentures;
(c) Semi-government loans guaranteed by Commonwealth and State Governments;
(d) Housing loans in which adequate security is available or guaranteed by Governments, Federal or State.

It should be noted that control of investments was suggested "in order that adequate protection should be given to policyholders" and that the proposals, if implemented, would preclude investment in property, rural and commercial mortgages, loans on policies, non-government guaranteed Local Government loans, company debentures, secured and unsecured notes, and preference and ordinary shares.

At 30th June, 1966, the above investments, which it was suggested should be prohibited, comprised 56% of the assets of all Life Companies and had a total value of $1,912m. At current interest rates these investments are showing yields of about 1½% greater than the types of investment suggested. Now 1½% of $1,912m. is $29m., so that the loss from the suggested precluded investments would need to be more than $29m. each year before they would produce less return for policyholders than the suggested alternative investments.

It seems unlikely that the losses arising from the failure of companies in which debentures or other investments were held will exceed $29m. per annum **in total for all investors,** let alone that losses of $29m. per annum would fall upon Life Offices, who in past years appear to have shown relatively small losses in respect of the large company failures we have witnessed.

The 30/20 legislation was not welcomed by Life Offices, but they have learned to live with it and have appreciated that there are some advantages for Life Offices.

Firstly, the Superannuation business of a Life Office, subject to compliance with 30/20 requirements, is now entirely tax-free (although there was no real justification to grant this only as part of the 30/20 legislation since previously Superannuation Funds outside of Life Offices had enjoyed a tax-free position without any restriction on investments whatsoever).

Secondly, the taxation benefits available from exceeding the 30/20 minimum means that Commonwealth Government securities become attractive investments (within certain limits) because they are very secure and show the same net yield as that obtainable from less secure fixed interest investment offering a much higher apparent yield. This second advantage only applies so long as the Life Office continues to pay tax and a change in the legislation, such as an increase in the 30/20 limits or a reduction in the concessions granted for the holding of investments in excess of the 30/20 minimum, could change the position and remove this advantage.

It does seem that the 30/20 legislation had led to an increase in interest rates for non-Government securities in order to allow such securities to compete with Government securities for the investment of Life Office funds.

Effect of Inflation:

Now let us turn to the question of inflation which, I am sure, is one of which we are always conscious. Although I feel we are agreed that it would be better if inflation could be solved and that no inflation existed, we seem to have to live with it and generally we have to come to expect it to continue in the future at an annual rate of something like 3%.

In the July, 1966, issue of the monthly economic letter of the National City Bank of New York, indices of value of money and annual rates of depreciation of money for the decade from 1955 to 1965 are shown for a number of countries and these figures show for Australia an annual rate of 2.3% for the decade and 3.8% for the year 1964-1965. There were in fact two countries shown which had a nil movement over the decade, these being El Salvadore and Guatemala, but for the western countries the Australian position was not unreasonable. It was, however, higher than the 1.7% per annum for the United States, the 1.8% per annum for Canada and the 2.2% per annum for Belgium, Switzerland, Germany and Portugal.

Higher rates for selected western countries than the 2.3% per annum shown for Australia were 2.7% for New Zealand, 3.0% for the United Kingdom and the Netherlands, 3.3% for Norway, Italy and Ireland and 3.8% for Denmark. Examples of higher rates still were 5.6% for Finland, 6.9% for Spain, 22.5% for Chile, 23.4% for Argentina and 29.7% for Brazil, these being annual rates for the decade, the last-mentioned country, Brazil, having a 38.2% rate of depreciation of currency for the year 1964-1965. In all cases the value of money was measured by reciprocals of official cost of living or consumer price indices. For the decade as a whole, the median rate of depreciation for the 45 countries quoted in the survey was 3.3% per annum.

If the rate of depreciation in Australia is subtracted from the interest earnings of Life Offices, it is seen that the interest earnings net of depreciation of currency are at the level of only about 3% per annum. In broad terms it is this low level of earnings which has, apart from the overall conviction of attractive yields irrespective of inflation, led Life Offices to wish to invest more heavily in equity type investments such as ordinary shares and freehold property. In these types of investment it is expected there will be some measure of protection against inflation. It might be said that if an ordinary share portfolio shows a dividend yield of about 5% per annum at the present time based on market values, then this dividend yield might reasonably be expected to grow at the same rate as the rate of inflation, or in other words, the long-term yield would be not 5% but about 8% per annum.

Certainly inflation presents a great challenge to the Investment Managers of Life Offices and, in fact, the Life Assurance industry itself. By virtually having to invest 30% of the assets of Life Offices in Commonwealth and other public securities at a yield of no more than 5½%, it is clear that the actual yield, after allowing for inflation, in respect of these investments is only about 2½% per annum. If inflation is to be controlled, it is the Government's task to do so and yet the Government might be said to have a vested interest in not discouraging inflation since as it is primarily a debtor then inflation effectively reduces the amount of the debt.

For a Life Office which has long-term commitments and needs to invest its assets to produce the best return for the policyholders, inflation is detrimental, particularly if investments are effectively controlled to a substantial extent by requiring, through taxation legislation, 30% of the assets to be committed to investment in low yielding fixed interest securities.

Public Securities:

Now for some comments on certain classes of investment. I have already referred indirectly to Public securities, i.e., Commonwealth Government securities and Semi-Governmental securities, but it should also be mentioned that the artificial nature of the market in Commonwealth Government securities and the unattractive yields available for Semi-Governmental securities are both a direct result of Governmental action.

Government Securities Market:

Each year in the Federal Budget papers is given a classification of Commonwealth and State Government securities by holder. At 30th June, 1966, total holdings were $9,135m. and 82% of these were held by Institutions and others whose investments in Government securities are controlled to a large extent by the Government. These investors comprise Reserve Bank, Trading and Savings Banks, Life Offices, Pension Funds, Money Market Dealers, Government Financial Institutions and Public Authorities (principally the Commonwealth Government).

The balance of 18% of Government Securities is held by more or less independent investors, namely, Non-Life Offices, Friendly Societies, Hospital and Medical Funds, Trustee Companies, Pastoral Finance Companies, Miscellaneous Private Financial Institutions, Companies other than Finance, Marketing Boards, Farmers, Non-Profit Organisations and all other holders.

The 18% held by non-controlled investors in 1966 compared with 24% held by these investors in 1960 (or 31% in 1960 if Life Office and Pension Funds are included as non-controlled, 1960 being before the days of the 30/20 taxation legislation). It is very apparent that the Government, if it wishes, can to a large extent control the market in Government securities and fix the terms of its loans to suit itself, since only 18% of investors are independent investors who are completely free to choose between Government and other securities solely on the basis of yields available.

Since 1960 independent investors' holdings have fallen by $100m. and Reserve Bank holdings have fallen by $250m., whilst Life Office holdings have increased by $380m. This increase of $380m. in Life Office holdings in the last 6 years compares with an increase of only $7m. in the 10 years from 1950 to 1960.

To Be Continued