

The scheme: a life annuity fund before its time

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The practical operation of these schemes varied from banker to banker and from period to period, but their general structure can be described as follows. A Genevan banker or group of bankers formed a company or syndicate. The syndicate bought life annuities from the Royal Treasury, spreading the amounts equally over the thirty chosen lives. Investors subscribed for shares in the company, which could be of modest amounts, allowing savers of moderate means to participate. The income paid by the Treasury was collected by the company, which distributed it to the shareholders after deducting its costs and commissions.

Over time, as lives died, the income declined. Shareholders therefore received a diminishing income whose curve followed the mortality of the group. The shares could be transferred, which created a secondary market. The bankers handled the administration: collection of the annuity payments, production of certificates of life, bookkeeping, distribution of income and information to the shareholders.

This structure bears striking analogies with modern financial instruments. It resembles an investment fund, since it pools the contributions of many investors in a portfolio managed by a professional. It also resembles a securitisation, since it transforms a set of receivables into negotiable shares whose cash flows depend on the flows from the underlying receivables. And it constitutes an early form of longevity risk management, since it rests on the assessment and pooling of the lifespans of a group of persons.

Element of the Genevan scheme	Function	Contemporary equivalent
Selection of thirty lives	reduction of the risk of premature mortality	construction of a diversified portfolio
Company or syndicate of bankers	vehicle for holding the annuities	investment fund, securitisation vehicle

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Element of the Genevan scheme	Function	Contemporary equivalent
Shares subscribed by investors	access of savers to the investment	fund units, asset-backed securities
Certificates of life	proof of the survival of the lives	verification of the underlying data
Management by the bankers	collection, distribution, information	fund management, securities administration

Worked example. An investor places 100 livres in a life annuity at 9 per cent constituted on the life of a young girl whose expected remaining lifespan is fifty years. If he receives 9 livres a year for fifty years, his internal rate of return reaches about 8.9 per cent a year, whereas a royal perpetual annuity yields 5 per cent. If the life dies after five years, he has received only 45 livres and loses more than half his capital. With thirty lives chosen on the same criteria, the premature deaths of a few are offset by the longevity of the others, and the overall return approaches the expected 8.9 per cent. The figures, fictitious and simplified, illustrate the value of pooling and the advantage that uniform pricing conferred.

The calculation in the example shows why the scheme was so attractive. A return of about 9 per cent over several decades, apparently guaranteed by the foremost state in Europe, was an exceptional opportunity for savers accustomed to returns of 3 to 5 per cent. Diversification across thirty lives eliminated most of the mortality risk. There remained a risk that investors underestimated: that the state would stop paying.

The success of the scheme rested on a combination of skills that the Geneva financial centre brought together better than others. It required demographic and medical knowledge to select the lives, banking networks to buy the annuities in Paris and distribute the shares in Geneva, a close-knit community to produce reliable certificates of life, a reputation for probity to attract investors, and proximity to Parisian financial circles to follow the course of the issues. The meeting of these skills makes the scheme a remarkable example of financial engineering under the Ancien Régime.

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