Life Offices Association of Zimbabwe

Demystifying Insurance Part 20

Welcome to part Twenty of Demystifying Insurance, a continuation of the Life Offices Association (LOA)'s ongoing National drive to make insurance easily understood by all. In this week's article, we look at how hyperinflation affected Zimbabwe's financial services industry.

Last week in Causes of Hyperinflation: The Zimbabwean Story, we examined the effects of hyperinflation on Zimbabwean citizens during the late 1990s. This week we look at how the financial services sector was affected by hyperinflation.

Income earners and creditors
Fixed income recipients are those people that are in receipt of an income that remains constant. These include incomes paid out by building societies and banks, who give out mortgage bonds and long term loans to clients.

Companies with excess cash may also issue out loans in the form of debentures. In times of low inflation, the purchasing power of their income from repayments remains relatively stable over time. However, when a country is experiencing hyperinflation (as Zimbabwe did 1999-2009) the purchasing power of the fixed income rapidly decreases. This is because prices will be rapidly increasing while income remains constant. The longer the period of hyperinflation the greater the loss in purchasing power. Existing creditors are adversely affected because the value of the money they will receive from their borrowers later will be lower than the money they gave before. This is because they would receive the same amount owed to them while the prices of commodities or other investments would have increased.

How hyperinflation affected borrowers
Most of the time, borrowers were the main beneficiaries of hyperinflation. Take for instance mortgage bond holders. They borrowed money at a fixed interest rate but repaid at an amount that was worth less than they had borrowed, since the fixed amount lost its value.

With regularly high salary increases, some individuals found out they could pay out their bonds in as little as three months. The money that lending institutions ended up receiving was literally worthless. This is how institutions like insurers and banks lost value in investments such as government bonds.

Borrowers were sometimes disadvantaged when they received loans applied for late through Real Time Gross Settlement. The money would be received valueless having been eroded by hyperinflation. Prices on invoices were ultimately not guaranteed and those of financial instruments such as shares were skyrocketing.

How hyperinflation affected pensions and life policies
For pensioners and life policy holders, their money would depreciate in value as a consequence of inflation. As an example, if an individual received Z$500 as a pension during the pre-hyperinflation period, the pensioner would have maintained a reasonable standard of living because the value of the money would not be quickly eroded during that era of stable prices. However, if the same person was to receive the same amount in 2006, he would have suffered from loss in value of the money because during that time prices rose rapidly.

Life policies were affected in the same way that pensioners were affected. A member who had contributed his premiums to the insurer would have done so while the premium had value but, in Zimbabwe's hyperinflation period, inflation way outmatched investment return, and in the long run, the value of the promised benefit was lost.

Effects of hyperinflation on Zimbabwean assets
The performance of investment assets is one of the factors which determine the level of pensions paid out or fully commuted. Together with a holding of 30% of assets in prescribed assets (mainly government bonds), insurers took care in selecting growth-type assets such as shares and property which delivered some value to our clients.

With the exception of the prescribed assets, the assets held tend to be a good hedge against inflation but not against hyperinflation. Insurers could not fully protect their policyholders and pensioners against the decline in value caused by the economic meltdown during the hyperinflation period. There are no assets that can protect against hyperinflation.

The reason for this is that, the value of equities is derived from the company's ability to make profits. During the hyper-inflation period, companies made losses and some of them closed down. As a result, the value of the equities held declined. The value of property is derived from the rental income expected to be received throughout its lifetime, which in turn is used to pay out benefits.

Due to voids arising from the closure of many companies that rented premises and the inability of other tenants to pay appropriate levels of rentals, the value derived from property fell. Also the value of prescribed assets, such as fixed interest bonds, were wiped out, since (as the name indicates) income and capital values do not increase in line with inflation.

All these factors lead to a loss of value in the asset holdings of insurers. This left a smaller pot of assets to be shared amongst the same number of policyholders and pensioners resulting in a smaller share for each of them.

Next week's highlights
Be sure to read next week's fascinating article in which we compare hyperinflation in Weimar Germany, Hungary, Yugoslavia and Zimbabwe.

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