



## Demystifying Insurance Part 25

**Welcome to part Twenty Five of Demystifying Insurance, a continuation of the Life Offices Association (LOA)'s ongoing National drive to make insurance easily understood by all. Today's article explores how values of individual policies were determined during the hyperinflation cycle.**

Last week, we established that insurance companies invest money in different types of assets in order to value-protect the 'promise' they make to policyholders.\* Products sold by insurance companies are essentially promises to pay out a set amount when certain events occur.

When one buys an insurance product the premium paid will be pooled with other premiums paid by other policyholders and then invested on the various investment vehicles we discussed last week. When the time comes for the policyholder to be paid, insurance companies will sell these investments and pay the policyholders.

### Concept of liability

Promises that insurance companies make to policyholders are presented as a liability on their balance sheets. The strength of each insurance company is its ability to pay these liabilities as and when they fall due. When the value of an insurance company's assets is more than the value of the promises it has made to policyholders, it is said to have a good solvency position.

Much of the excess assets are shareholder funds which are set aside as a safety cushion. This cushion ensures that if the value of policyholders' assets falls below the value of the promised benefits, funds are available to restore a balance.

The amount of shareholder assets that an insurer must hold as a cushion is prescribed by the insurance regulator. If this cushion falls below the prescribed level, the company will be regarded as insolvent.

### Importance of the solvency position

Solvency position is a key concept in insurance. If a company is insolvent then it must not be writing insurance business. If an insurance company was solvent in ZW\$ terms, then following the change to multi-currency regime, the same insurance company should still be solvent.

### Consistent basis

Insurance companies also speak about a 'consistent basis' — whereby assets are valued consistent to the way liabilities are valued. When the economy dollarized, the value of property and equities became available in USD\$. It therefore became necessary to convert the values of the liabilities into the same currency.

### No gain, no loss

Establishing the value of the liabilities in USD\$ terms required that no policyholders or shareholders should gain or lose from the conversion process. In fact, for any monies to move from shareholder to the policyholder or vice versa, it requires the authorisation of a qualified actuary and board of directors. In addition, in order to protect policyholders, the services of external auditors were employed and a valuation report was supplied to the regulator.

The assets that are held for meeting liability payments are held separately from the assets held for the shareholder-representing capital.

### Conversion of the liabilities

The total value of assets held to meet the policyholder liabilities, which were now denominated in USD\$, were taken to be the value of the promises to policyholders in USD\$ terms.

Insurance companies sell various products and each product has a pool of funds that represent the promises made. The value of each product's fund in USD\$ was derived by first taking the individual ZW\$ value of that fund as a proportion of the total ZW\$ value of the funds for all products.

The resultant proportions were then multiplied by the total USD\$ value of assets.

### Individual policy values

A method of proportioning was used to do this. That means the value of your policy relative to the rest of the policies was used in determining the value of your individual policy.

Within the pool of each product, the US\$ value of each policyholder's fund was derived by taking the ZW\$ value of the benefit promise to each policyholder as a proportion of its respective product pool's total ZW\$ fund value. The resultant proportion was then multiplied by the total value of that product's fund in USD\$ (as derived above) to give the USD\$ value of each of the promises.

This means that the value of each policy was determined in such a way as to maintain the ratio of its fair share of assets after its conversion to a USD\$ value.

To visualise this, imagine a cake having layers that represent all the different asset classes (bonds, cash, equities and property). Policyholders know they will get a share of this cake.

Some will obviously have bigger slices than others depending on how much they contributed in buying the cake. Similarly, the value of a policy is in line with the value of your premium relative to premiums paid in by other policyholders. The size of your slice is the proportionate value of your policy in ZW\$ terms.

### Cake to crumbs

What happened with hyperinflation would be similar to having some of the layers of the cake vanishing or being eaten up. The fixed interest security layers were gobbled up totally.

The equity and property layers melted due to the heat of hyperinflation but at least something was salvaged. The cake maintained its circular shape but was now very much smaller and had to be fairly distributed.

The only fair way to do this was to share it according to how big your slice of the original cake was relative to its total initial size. He causes of the loss of value of the various asset classes (i.e. the destruction or shrinkage of the layers of the cake described above) were discussed in the previous article.

Join us next week as we look at how insurance companies responded to inflation.

*\*Please note In this article the word policyholder includes pensioners.*

