# A note on changes in income and asset values of long-term insurers

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## Introduction

This note briefly reviews the influence of financial markets and economic conditions on the income stream and the total value of the assets of long-term insurers in South Africa.

*1 The views expressed are those of the author and do not necessarily reflect the views of the South African Reserve Bank.*

## Changes in income and assets

The composition of long-term insurers' total income is summarised in Table 1, and the various components are then briefly discussed in the sections below.

Table 1 Composition of long-term insurers' total income

| | |
|---|---|
| Current investment income | interest + dividends + rent |
| *Plus:* Net capital profits | on the sale of investments and assets |
| *Plus:* Net asset revaluations | as a result of changes in exchange rates and market prices |
| Total investment income | |
| *Plus:* Current income surplus | premium income + other net operating income - current expenditure - dividend payments |
| Total income | |

Annual current investment income of long-term insurers increased by 143 per cent and total assets by 131 per cent between 1994 and 2002, yielding an average annual rate of return on such assets of 5,42 per cent[2]. Net capital profits and asset revaluations boosted returns further to an average annual rate of 8,68 per cent, while introducing additional volatility.

*2 Data source: Registrar of Long-term Insurance,* Annual Reports *up to 1990 and South African Reserve Bank survey data in later years.*

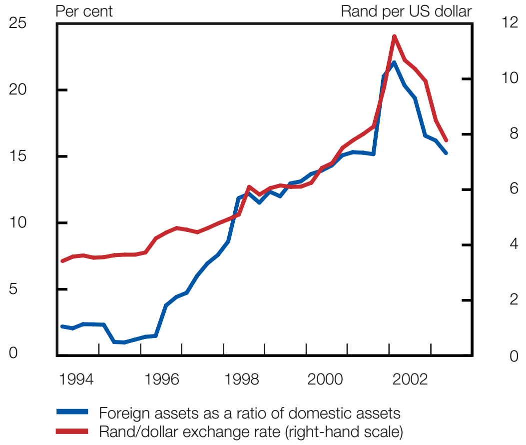
The total of net capital profits and asset revaluations varied from a profit of R103 billion in 1999 to a loss of R50 billion in 2002. From 1997 to 2002, the cumulative current income surplus was negative to the value of R37 billion, which weighed on overall asset growth during this period. In 2002
- the current income shortfall was at its highest since 1999;
- total investment income recorded an annual shortfall; and
- the value of total assets shrunk.

A recovery in domestic share prices would help to restore asset values as the industry's domestic equity exposure was some 51 per cent of total domestic assets in December 2002.

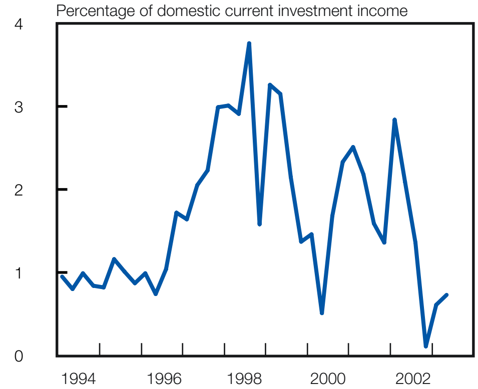
## Current investment income

Holdings of foreign assets by long-term insurers as a ratio of domestic assets increased from 1 per cent in the third quarter of 1995 to 22 per cent in the first quarter of 2002, before receding to 15 per cent in the second quarter of 2003 as shown in Graph 1.

Graph 1 Foreign asset holdings of long-term insurers



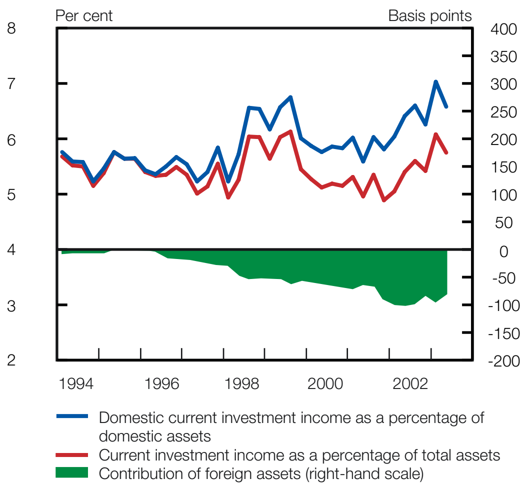

Graph 2 Foreign current investment income of long-term insurers



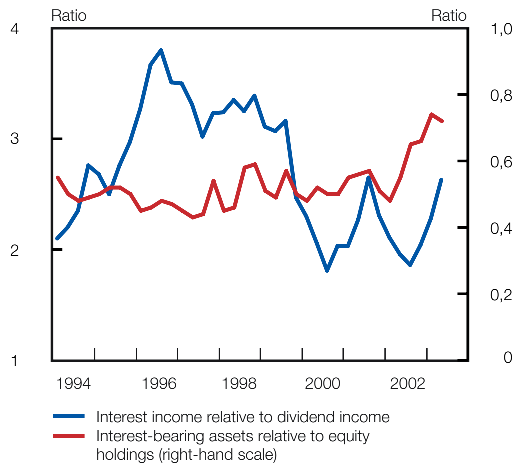

The change in this ratio resulted from the diversification of asset holdings across national boundaries and from the change in the exchange value of the rand. However, foreign assets contributed little to current investment income in comparison with the contribution made by domestic assets. From 1994 to 2002 foreign current investment income as a ratio of domestic current investment income averaged only approximately 1,6 per cent (see Graph 2). It should, however, be kept in mind that the amount of foreign assets was limited by regulation, and that nominal returns on such assets were generally lower than in South Africa, partly due to lower inflation abroad.

By contrast, domestic annual current investment income as a percentage of domestic assets averaged 5,87 per cent in the period 1994 to 2002. This was 45 basis points higher than the 5,42 per cent average return recorded by overall annual current investment income as a percentage of total assets in the period 1994 to 2002. The yield difference was directly related to the lower returns on foreign assets. The margin between these ratios peaked at more than 100 basis points in the second quarter of 2002, before narrowing to 82 basis points in the second quarter of 2003 (see Graph 3). Changes in the margin were due to differences between foreign and domestic interest rates, bond yields, dividend yields and movements in the exchange rate.

Graph 3 Current investment income of long-term insurers




Graph 4 Composition of domestic current investment income and assets of long-term insurers



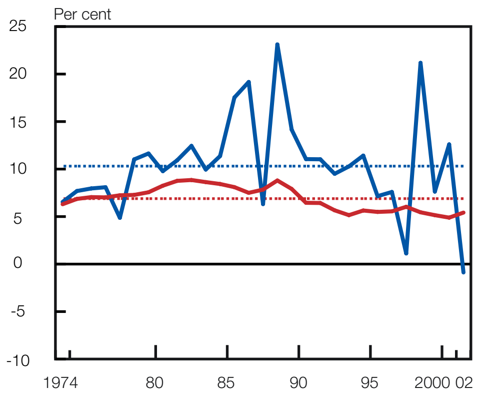
As yields on interest-bearing assets were higher than the dividend yield on equities, annual interest income on domestic investments accounted for 68 per cent of annual domestic investment income during the period 1994 to 2002, despite the holdings of these types of assets representing just 28 per cent of total domestic asset holdings. By contrast, holdings of domestic equities represented 54 per cent of domestic assets but generated dividends accounting for only 26 per cent of domestic investment income.

As indicated in Graph 4, the influence of the general downward trend in domestic interest rates and yields since 1996 is reflected in a decline in the ratio of domestic interest income relative to domestic dividend income from 3,8 in the third quarter of 1996 to 2,6 in the second quarter of 2003. Simultaneously, the ratio of domestic interest-bearing assets relative to the holdings of domestic shares increased from 0,48 to 0,72 as equities were substituted for fixed-income assets.

## Net capital profits and asset revaluations

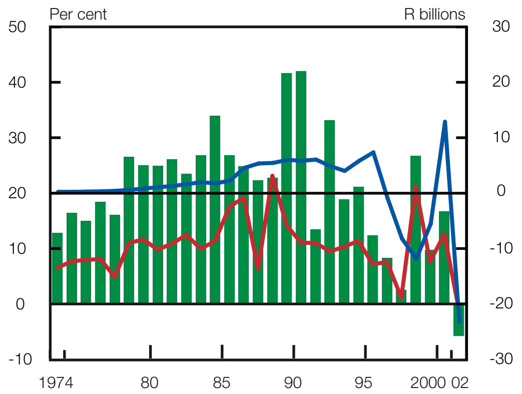
Overall returns on investments are influenced by the realising of capital gains and losses when assets are actively bought and sold and by the revaluation of assets at varying exchange rates and market prices. For example, annual current investment income of long-term insurers as a percentage of total assets averaged 6,9 per cent in the period 1974 to 2002 but when net realised and unrealised capital profits are added to obtain total investment income, the average yield increased by 350 basis points to 10,4 per cent (see Graph 5).

Graph 5 Investment income of long-term insurers as percentage of total assets*




* Assets valued at book value prior to 1990 and at market value in later years

Graph 6 Changes in income and assets of long-term insurers*




*Assets valued at book value prior to 1990 and at market value in later years
** Including other net operating income from 1993

Inflation had an eroding effect on investment income between 1974 and 2002. Total annual nominal investment income as a percentage of total assets averaged 10,4 per cent between 1974 and 2002, while the average inflation-adjusted return[3] was negative to the value of 1 per cent. However, to this may be added further unrealised capital profits on long-term insurers' holdings of fixed property that are not fully accounted for in the reporting of total investment income. The substantial difference between nominal and real returns nevertheless bears testimony to the importance of keeping inflation low over the longer term so as to preserve the purchasing power of investments.

*3 Nominal returns were adjusted using changes in the overall consumer price index for metropolitan areas.*

## Asset values

The year-on-year percentage change in the market value of the total assets of long-term insurers is determined by changes in their total investment income and by their current income surplus. Graph 6 shows that capital profits and asset revaluations added to asset growth in 1999 and 2001 but that asset revaluations were mainly responsible for an absolute decline in the market value of assets in 2002. The decline in the current income surplus from 1996 to 2002 curbed the growth in the asset values of long-term insurers. This decline in cash flows was, among other things, a result of

- perceptions of poor investment performance in the industry which impacted negatively on premium income; and
- high interest rates and associated financial distress among policyholders which contributed to an increase in lapses and surrenders of policies.

## Summary

In 2002, the finances of the long-term insurance industry reflected the unfavourable influence of financial market and economic conditions on returns in the industry. The return-enhancing and risk-reducing outcome which was expected to follow the deliberate diversification of asset holdings across international markets failed to materialise. On balance, investment income from foreign assets compressed investment returns.

The shift away from equities to cash and bonds in the domestic asset allocation of long-term insurers added to investment income, while active asset management capitalised on changes in asset prices and further enhanced returns. However, wide fluctuations in capital profits and losses made cash flows quite volatile. Inflation further eroded real returns.

The combined effect of these events, together with a current income shortfall and the negative effect of asset revaluations, reduced asset growth. This helped to explain the absolute decline in the market value of assets in 2002.

The total asset base of long-term insurers is expected to increase swiftly when share prices recover.  Real returns on assets are also likely to benefit from the lower level of inflation brought about by the consistent application of counter-inflationary policies.