

Options as an alternative

Without going into a comparison of the price of options used as reinsurance cover with the price of reinsurance for programs similar to those which are traded in the CBOT, American legislators do not believe that at the moment options are a valid alternative to reinsurance for various reasons. These reasons are basically related to the treatment which this instrument should receive and the consequences of this legal treatment.

- The purchase of options - is this an expense or an investment? (Premiums paid for catastrophe cover are an expense.)

- Treatment of the solvency margin, reserves for unearned premiums, cover for technical reserves, minimum capital, security etc.

Finally, the problems which are created by the calculation of the correlation between the individual portfolio of an insurance company and the globally considered loss should not be forgotten. These problems do not have an easy solution and their negative consequences can be the cause of large losses for insurers/reinsurers.

No one knows what will happen in the future with this new instrument or whether it will be exclusively used in only a few specific operations on the CBOT. Its advantages and disadvantages and the way it works have been dealt with very briefly in this article and only time will show its true usefulness.

Asset valuation

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One of the pillars on which the insurance sector depends in order to give satisfactory service to its policyholders is to find and establish uniform evaluation procedures concerning the sum insured or the compensation to be given in case of loss.

Introduction

One of the factors which causes the greatest problems in the insurer/policyholder relationship is, in a number of cases, the difference between the sum insured and the sum to be compensated which is determined by loss adjusting.

It is not infrequent that these differences are brought about due to the fact that the policyholder is unaware of the established evaluation criteria. These problems may also be caused by an inadequate distribution of insured sums (building, contents, merchandise and stock).

When an insurance policy is taken out, either due to poor advice, or due to tacit presumption of valuation criteria, erroneous values are frequently established which lead to greater compensation expectations than are in fact due to the policyholder.

Given the importance of the consequences of this situation, the most commonly used procedures and

criteria for asset valuation are given below.

Definitions

The most commonly used valuation concepts are: replacement value, as-new replacement value and new value.

Replacement value: also known as **real value**, this is the cost of replacing the assets by others of similar characteristics and economic value, discounting, if applicable, those factors which affect their value (depreciation), such as deterioration due to physical causes and functional or economic obsolescence. This is obtained by subtracting the corresponding depreciation from the as-new value.

As-new replacement value: this is the cost of replacing the asset by another of similar characteristics and economic value which exists in the market, without any kind of depreciation being made for use or obsolescence.

New value: the difference between the new value and the as-new replacement value does not come from the determination of the sum insured but from the calculation of the compensation, where the following limit is established. In the case of a loss, the damaged assets are compensated by adding to the real value of the assets a complementary compensation which should not exceed a given percentage (30 - 50%) of the as-new replacement value of the damaged assets.

Given the similarity of the terminology which is used there are numerous confusions amongst the policyholders in the interpretation of these terms.

When applying an as-new replacement value clause the insurance companies should pay special attention, above all, to the installations and machinery. It is necessary to assess the age of the installations

and to evaluate the subjective risk in order to prevent possible frauds.

The as-new value should be used in those installations whose assets are not very old, so that in the case of a loss the policyholder will not be faced with a possible excess over the compensation established by the insurance contract. It is preferable to use the replacement value in very old installations.

A capital compensation clause is generally included so as to reduce the negative consequences of an erroneous distribution of the values of the assets between the various sums insured of the buildings, installations and machinery. In this way, in the case of a loss, and in the same risk situation, the assignation of values to these assets is made more flexible.

Valuation procedures

Buildings:

The main procedures so as to determine the as-new replacement value are:

- Analytical: little used due to its high cost. This involves constructing a detailed breakdown of the various aspects of the construction.
- Historical cost: this is used in recent buildings where the cost of construction is known. This involves the updating of the values through the use of construction price variation indexes.
- Synthetic: this is the most commonly used procedure, although its application should be carefully reasoned. This consists of the determination of the unit cost by M² of the building by comparing it with other types and categories of real estate. These example prices can be obtained from specialised construction magazines, forms used by professional associations of architects for the determination of minimum construction prices on which to base their rates, physical methodologies which establish distinct types of construction site to determine the value of buildings for the later application of taxes, etc.

To determine the replacement value, the corresponding depreciation is subtracted from the as-new replacement value. The concept of depreciation is understood to be the sum of the costs which are necessary to transform the building in

its present state to its original state using present construction methods. In addition to this analytical procedure, there are also depreciation tables which are used by recognised authorities as well as others included in fiscal regulations.

Machinery and installations:

The difficulty in determining the as-new replacement value is increased due to the possible diversity of assets which are included in this section. The most usual procedures in this determination are:

- Historical: this procedure is similar to that given for buildings. Given the diversity of assets, the indices which are used for updating can introduce errors which should be corrected through a sampling of market prices.
- Comparative: this is used when there are either no purchase invoices or when the machinery or installations are of a certain age. This involves searching the market for values or assets of similar characteristics.

The replacement value is calculated in the same way as for buildings, but using specific depreciation tables provided by manufacturers. In this case it is necessary to know the number of hours of use and the conditions of that use, as possible wear and tear is fundamental for the calculation of the depreciation.

Merchandise and stocks:

In general, the value of the merchandise and stocks is estimated by using the usual price on the nearest market.

Conclusion

Valuations are based on well founded opinions, therefore the more progress is made in the procedures used to reach these opinions, the more solid they will be, reducing the problems which are brought about by discrepancies between the parties involved, lowering claims handling costs and reducing delays which are caused as a result.

Insurance companies should make these procedures more widespread both in their application for the determination of compensation in the case of a loss, and during the process of establishing the sums insured in the policy.

News

According to figures released by the banking supervisory authority in the Republic of Ecuador, net premiums accounted by insurance companies in the Ecuadorian market totalled 743,641 million sucres in 1996, showing an increase of 20% over the previous year. This growth was negative in real terms when compared with the rate of inflation which was 25.6% in 1996.

The wave of mergers and acquisitions has also reached the Greek market. After the acquisition of the insurer Metrolife by Banco Comercial Griego in 1996 and its merger with its own insurance company Ioniki to form the new "Embroki-Metrolife" with a 4.3% share of the market, two other important mergers will take place before the end of 1997.

The National Bank of Greece has decided to merge its four insurance companies (composed of Ethniki, Astir, Panellinois and Eteba) under the name of Ethniki. The new company will have a market share of 15% in life business and 23% in non-life business.

At the same time a three sided merger is being considered between Generali's subsidiary in the Greek market, the subsidiary of Banco de Credito Alpha (Emporiki) and Hellenobretanniki.

In Spain, an order of the Ministry of the Economy and Treasury of May 21, 1997, establishes a maximum technical rate of interest of 4% for life insurance contracts expressed in pesetas and signed after June 26, 1997. The notable decrease in interest rates in the financial markets caused this measure to be brought forward without waiting for the normal progression of Act 30/1995 on the Regulation and Supervision of Private Insurance

A spectacular tornado crossed the centre of Miami, Florida, on May 12, 1997. The giant tornado caused a commotion throughout the city, more due to its spectacular nature than to any damage caused.

There is no record of any victims, it only caused damage to various buildings, uprooted trees and caused other minor damage.