SYNOPSES

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INFLATION AND THE MUTUAL INSURANCE SOCIETY

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Introduction

The paper in its original form was read to an International Conference of mutual insurers. Much of its thinking derives from modern techniques of business management. Inflation poses considerable problems for long-term insurance business, and for survival in today's unstable financial conditions it is essential for business to be based upon sound principles. The paper, therefore, attempts to set out some of the management principles that are considered to be essential.

The Mutual Life Insurance Society

The members of U.K. Mutual Life Insurance Societies normally receive their share of profits in the form of bonus additions to their policies. To qualify for participation, the member pays a premium substantially higher than would otherwise be required. Mutuals operate in a very active market, competing with proprietary companies. The Market enjoys greater freedom in the United Kingdom than in many other parts of the world. Premium tariffs are not imposed and there is a degree of freedom in selection of valuation bases. There are no direct restrictions on insurance company investments.

Cost Inflation

The most obvious impact of inflation is on operating costs. It is necessary to generate additional premium income. New business must, therefore, grow at a rate at least equal to the rate of inflation. However, the generation of additional business in turn results in higher costs; therefore, productivity must be improved. Full advantage should be taken of high technology office equipment. Investment strategy can help. Ownership of office space protects the company against rises in rents.

Capital Resource

A particular problem for mutuals during a period of prolonged inflation is lack of capital resources. The capital of a mutual is defined as the excess of its assets over

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its technical reserves, plus amounts equal to the excess of the technical reserve of any policy over its natural reserve; the latter being the premiums received from the policy, plus any investment earnings, less the expenses and death risk cost directly attributable to the policy. Capital is used to finance reserves over and above the technical reserves, such as explicit solvency margins and to finance the difference between the technical reserve and the natural reserve defined above. The bonus system may also involve the use of capital resource by allocations to some policies in excess of the surplus actually generated.

Impact of Inflation on Capital Resource

If new business is increased at the rate of inflation, the capital resource required to finance it will grow at a similar rate. The capital resource available will grow at the after-tax rate of interest earned on assets. Where net real returns are negative, the capital resource will not grow at an adequate rate. Suitable investment policies must, therefore, be adopted, although investment in traditional hedges, such as ordinary shares, can cause problems due to their volatility. Increasing inflation is usually accompanied by higher interest rates and hence depreciation in capital values. Under the net premium method, changes in the valuation rate of interest may not provide a corresponding reduction in reserves. Active management of the capital resource is necessary; modern techniques should be used to design policies and sales strategies which minimize the use of capital. Careful consideration has to be given to the bonus system.

Product Design

Design of products must take account of the inflationary environment and ultimately index-linking will be essential if a state of hyper-inflation is reached.

Conclusion

Inflation poses a serious threat to long-term business. Firstly, to counteract its effects, business should be expanded so that premium income grows at least as fast as the rate of inflation. Secondly, modern technology should be used to improve productivity. Thirdly, an active investment policy should be pursued. Fourthly, care should be taken in the management of capital resources through marketing strategy and an appropriate bonus system. Fifthly, modern corporate planning techniques should be used. Lastly, new forms of product must be researched that remain attractive to the public at a time of monetary instability. Nevertheless, it is virtually impossible to avoid retention of profits in order to build up the capital resource, and hence there is a growing element of subsidy from one generation to the next. So, should mutual insurers look for ways of obtaining outside capital? In the words of Douglas Thornsjo "Does management of a Mutual Insurer have a duty to consider conversion to a shareholder-owned company?"