INFLATION AND INSURANCE

BILA SEMINAR IN COLOGNE

by P V Saxton, Secretary
British Insurance Law Association

Germany is an interesting country in which to study the subject of inflation. Not that the Germans themselves have experienced the recent savage rises in costs that we have faced but they do have unhappy memories of two collapses of their currency in this century, which explains to some extent their current willingness to co-operate with their government in strong anti-inflationary measures. The strength of the DMark too provides some reminders of the international weakness of our pound. Prices in the shops in Cologne for some items, at least, seem enormous to British visitors. A battery for my camera which would have cost me about £1 in London was the equivalent of £3 there, while a lady member of the BILA group found that the price of a leather handbag was over £100.

Recently, the Sunday Times has suggested that to compare the prices we pay at home to those that the Germans pay in their shops one has to use a conversion factor of about £1:DM 7.40 but that is of no consolation to the traveller who can only get the official exchange rate of DM 4.60 or less.

The BILA seminar, organised by our good friend Professor Ernst Klingmüller of the University of Cologne, looked first at the general aspects of inflation and then at its effects upon certain types of insurance. In our first meeting at the impressive offices of the Allianz, Professor Klingmüller himself introduced the topic by saying that trying to define inflation was like describing an elephant: everyone knows what it is but has difficulty in putting it into words. There was a temptation to look at the past and to try to draw parallels but life today and the expectations of people differ greatly from those of even ten years ago and what were luxuries then are now part of the ordinary standards of living. One cannot simply compare prices and wages. Perhaps a better comparison was the length of work-time necessary to purchase staple articles, and he gave examples using the work-time needed to buy a loaf of bread, a suit and a wardrobe to illustrate his point, as follows:-

YEAR	Work-time necessary to buy		
	Bread	Suit	Wardrobe
1938	$\frac{1}{2}$ hour	62 hours	141 hours
1958	22 minutes	25 hours	82 hours
1974	12 minutes	12 hours	27 hours

The table makes no allowance for changes in the quality of the goods concerned. From this table it appeared that if inflation was merely a matter of adjustments between wages and prices it would not give cause for too much concern except for those on fixed incomes, or with nominal assets, and for savers, unless there were index-linked investment rates.

Professor Klingmüller accepted that the current inflation rate in Germany was comparatively reasonable at 6-8% p.a. but that did not make it good in absolute terms. Since 1970 prices had risen by 37%. Government expenditure in 1975 was 30 times its pre-war level (and surprisingly similar to UK government expenditure - something for economists to ponder), while since 1960 wages had risen by 300%.

Carrying on with this topic, Mr. A. L. McCrindell said that there seemed at present to be no escape from inflation which had long been accepted as the fuel of progress. At least, however, it was hoped that in the UK wage and price agreements might reduce the current excessive rates but even that was not assured without significant reductions in public spending, increases in which were responsible for 60% of the rise in the cost of living. Here there was little room for optimism as all recent governments had proved inept in the control of expenditure, and were equally guilty of printing money to escape from shortages.

For insurers, both speakers realised the problems of coping with a financial compensation service. To compensate in real terms was not too difficult for annual valued policies - though this begs the question of underinsurance as we shall see later - long-term compensation, say for permanent disability, was very difficult unless future generations of policyholders were prepared to pay steep increases in premiums to increase annuities already issued to past claimants (or to provide extra lump sums). The concept of annuities in liability settlements is, of course, accepted in Germany; will inflationary problems force them upon British insurers?

Mr. D. G. Sasserath looked at the special problems for motor insurers which he listed as:

1. Increases in staff and administrative costs.
2. Increases in repair costs, to save which led to increased inspection costs.
3. Substantial increases in the costs of long-tail claims.
4. 'Switching' of companies by policyholders to save money.
5. Increased use by business clients of risk management as a means to cut insurance premiums.
6. Effects of VAT.
7. Government action, especially in relation to price controls which obstructed attempts to earn realistic premiums.
8. Increasing levels of court settlements arising from social pressures in addition to inflation.

The German side pointed out, however, that at least the British insurer had more freedom to seek remedies to these problems. In Germany rates and policy wordings were strictly controlled. The rates were calculated for two years but the profit element was not allowed to exceed 3%. This usually led to high losses in the second year of the period. There were other special problems such as the increasing awards being made in their courts for 'pain and suffering' claims. In 1973 these amounted to 10.2% of the total claims costs, compared with only 5.7% in 1964. In fact, while standardised methods and new claims handling methods had reduced the property damage cost percentage to 64.6 from 72.3 in the same period, that of personal injury had risen from 23.1 to 29.6.

The progress made in handling claims was very good and we were shown not only the Allianz's computerised claims handling service but also their 'instant settlement' station into which policyholders can drive their damaged cars for an on-the-spot examination and estimate of repair costs. If accepted, the amount of the estimate can be paid to the claimant there and then.

Back though to the problems. The German social security system has subrogation rights following payments for accidents against motorists who are fully liable for those accidents. Insurers usually have to pay a lump sum to cover current benefits paid, plus 6-10% more to cover possible inflation in future benefits.

Loss of use payments are also awarded by their courts even if the victim is unable to drive (e.g. he is in hospital) or even if he does not wish to do so! In addition an award usually includes an amount to cover the depreciation in value of a damaged car because of the accident. Restitution of wages claims usually include an extra amount for holiday costs.

There are no special rates allowed for motor fleet insurances, though proposals are being made to the supervisory authority for special commercial tariffs. Recently some companies have been fined for making 'under-the-counter' refunds to large fleet users.

After an excellent meal in the Allianz's elegant luncheon room the BILA party moved on to the offices of the Colonia, situated close to the east bank of the Rhine. This company has an impressive growth record having now become the second largest in Germany.

Here, Mr. A. von Krosigk, the Colonia's Overseas Manager, spoke on the effects of inflation upon general insurance. He dwelt firstly on the fact that administration and acquisition costs now consumed more than $33\frac{1}{3}$% of premium income. Pressures to cut costs and to try to operate more efficiently were therefore stronger than ever. Brokers' costs were rising but companies wished to cut commission rates on inflated premiums. This was an added complication which could affect the level of service provided by both insurers and intermediaries for their clients.

Premiums for personal insurances fell behind possibly more in Germany than in Britain because of the practice of issuing ten-year policies without provision for annual premium adjustments. Some sort of index linking of sums insured and premiums seemed to be inevitable in this area. He suggested that the cost-of-living index was most acceptable in this connection, but it could be a factor based on national pensions increases or even a fixed annual percentage.

Indexing could, however, become complicated and did not always provide the right answer if one happened to pick the wrong index.

In business covers, the German market found it hard to calculate premiums for future risks correctly because their rates were fixed by the long bureaucratic processes of the supervisory authority and thus always lagged behind the times. The system could also be affected by political considerations (it would be a brave political party that would sanction large rate increases just before an election, for instance). In inflationary conditions these problems became more acute and the only solution was to allow for adjustments at shorter intervals.

Talking of claims, Mr. Krosigk made the point that despite underinsurance smaller losses were often paid in full, either to save investigation costs or to avoid adverse publicity. He suggested three essentials in dealing with claims:

(a) settle them as quickly as possible

(b) reduce their number by the use of franchises or forms of co-insurance

(c) set up special schemes with garages, private hospitals, etc. to save costs

Mr. M. Cohen spoke from the British side and pointed to some of the measures taken by insurers to deal with inflation. On commercial business, average clauses helped to deal with underinsurance, while an inflator clause provided automatic increases in sums insured. A special provision for older buildings which would not be replaced if fully destroyed provided full cover for partial losses but a lower sum on total loss.

For household insurance automatic percentage increases had been introduced, sometimes by 'inertia selling' methods (which our hosts informed us were at present prohibited in Germany although attempts were being made to get something like them agreed with the supervisory authority). Other ideas were the 'new for old' replacement conditions and the 'open cheque' policies which based the premiums on the size of the house plus a percentage for fees, without specifying a sum insured.

One other worrying form of inflation was that of crime. (Perhaps a 'rising-crime index' would be best for premiums, he suggested!) This had its effects upon first loss policies and, of course, upon the cost of protections.

In his view the worst problem was posed by the large liability claims, exacerbated by greater social pressures; cover on new technologies and on drugs, all of which could lead to enormous claims. How could insurers cope with inflation to build up real reserves to meet disastrous claims? He wondered if we could learn more from South America where insurers apparently survived the huge rates of inflation.

It was generally agreed in discussion that the British insurance system gave insurers a better chance of coping with inflation by innovation, faster reaction to circumstances and by greater investment flexibility. However, the German system forced companies to be more efficient because the margins they have to work to are fixed for them. The difficulties of indexing were agreed, including public acceptance, which the Germans with their greater experience had found grudging at best.

There was agreement, too, that all the points made dealt only with the effects of inflation, not its causes. The business world would have to work closely with governments in a positive way to try to find methods of reducing inflation.

There followed an Imbiss (light snack) of such huge proportions that one was tempted to feel that even the language was subject to inflation.

The next morning saw the BILA group at the head office of the Central Health Insurance Company, a subsidiary of the Aachen and Munich. There, through the medium of a beautiful lady interpreter we were given a complete account of private health insurance in Germany which covers about 9% of the population's health cover, plus supplementary cover for those in the state scheme - e.g. private doctor's fees, better hospital accommodation and cash while in hospital. The demand for additional benefits today is on the increase, partly due to the effects of inflation on the basic standards. The total premiums paid for health insurance in Germany (DM 6,500 million) are about nine times those in the UK. The administration costs of health insurance are high in labour terms and for this reason staff had had to be made redundant, through rationalisation and mergers in recent years or wages and salaries would have exceeded the amount of new business.

Naturally the companies had had to take into account the increases in hospital and medical charges, as well as expensive new drugs and their greater use. An adjustment clause was now incorporated into policies by which cover is automatically raised on the basis, for example, of average daily hospital charges for daily allowances, and premiums adjusted accordingly at an annual review. To cut down what had been a growing tendency to make claims for small amounts, excesses were being more widely used. Originally, the insured was also made to bear part of the costs of some types of treatment according to schedules of (a) maximum benefits payable; (b) percentage payments limits, or (c) a combination of both (e.g. for dentures: 50% of the invoiced amount, but not exceeding DM 200 in any one year). For today's very costly treatments, however, maximum benefit limits could not be used so that inflation had played its part in creating a situation in which the only options available to policyholders were various levels of deductibles, rising to DM 1,000. The private health insurers still faced criticism for having continually to put up their rates.

The subject of life assurance was next discussed and from the British side it was postulated that inflation was not totally damaging to life assurance. Total savings in the UK were at an all-time high, suggesting that people had more disposable income.

The question for long-term business was, 'Would inflation at current levels continue for long enough to affect the basis of actuarial calculations, or were we in a temporary period of aberration?'. If the latter, the business would simply have to hold its course and wait for better times, otherwise there would have to be drastic changes if life business was not to contract to a term-only protection market.

A lot of effort had been devoted to devising hedges against inflation by various linkings, special bonuses, optional increases in benefits, flexible policies and the like which tended sometimes towards gimmickry and obscured the real purpose of life assurance. It was generally felt that while life companies should keep in contact with the main stream of new developments they should keep a balanced view of the future; remember their obligations to existing policyholders; try to maintain an efficient service, and always put basic life assurance concepts first.

One or two other points made were that if high inflation continued investment by life assurance would be better achieved by making each premium a purchase price of a share in the life fund and its future increases in value. This would seem to turn life companies into investment trusts. A serious problem was the effect upon the attitude of the public to life assurance if policies did not seem to be keeping pace with inflation. Both in Germany and the UK increases in sums assured up to agreed limits, without further medical evidence, were possible but only at greater cost.

In a final session the subject of consumer protection was introduced by Mr. H. A. L. Cockerell and Professor E.Klingmüller. Both speakers covered the insured's needs for sound advice, reasonable cover, security, and a complaints service. Current legislation and the decisions of the courts in most countries favoured policyholders and third-party claimants against insurers and thus increased costs which could only be reflected in higher premiums. The lesson was that there were various levels of protection at differing rates and a compromise had to be reached between absolute security and the price the market would bear.

Needless to say, there was always time-lag between the imposition of regulations, etc. which increased insurers' costs and their ability to recoup them. Again, some of the protective measures imposed, such as standardised policy wordings, restricted innovations which could in the long run be detrimental to both sides.

The whole picture was, therefore, one of great difficulties for the insurance industry with which the British market was perhaps more favourably placed to deal. It behoves us, therefore, to keep a very careful watch on future EEC insurance directives to try to ensure that we spread our flexibility rather than accepting the more restrictive systems of the Continent. The advantages to consumers could be a potent argument to our own government and to the European Commission in seeking to achieve this goal.

The business sessions completed, a free afternoon in Cologne and an enjoyable evening cruise on the Rhine rounded off the seminar. The hospitality of our hosts was, as always, of a very high order, leaving us at the end of a busy two days mentally stimulated and bodily refreshed.