Economics and business

530: 2021 edition

Web update 1: 4 February 2021

Please note the following update to your copy of the 2021 edition of the **530** study text:

Chapter 6, section E, page 6/29

The following text should be inserted after the first paragraph.

Probable effects of an increase in unemployment on the insurance industry are as follows:

- potential for increases in social disruption leading to increased claims;
- possible increased government intervention in the economy including regulation to combat unemployment;
- potential for protectionist measures in a country which then results in corresponding measures in overseas countries, resulting in damage to the insurance industry;
- disproportionate effects of unemployment on industry sectors and individuals leading to an imbalance in insurers' risk portfolios;
- claims incidence rates in general will increase as people will ensure they take the benefit of their insurance cover, with some making claims that are valid but may not have been paid in more positive economic circumstances;
- claims on payment protection policies, i.e. unemployment cover, will increase significantly;
- theft and crime rates are likely to increase as some individuals judge that they lack an income to purchase the goods and services they require;
- the incidence of fraudulent claims and claims with exaggerated financial values is likely to increase as businesses and individuals attempt to make up for declining profits/incomes;
- the demand for certain types of insurance will change as people seek basic protection of income, mortgage/credit repayments or health. Public provision of certain services will decline at the same time. Non-essential insurances will be less attractive as will the very goods and services they are protecting, e.g. travel;
- premium income will be reduced as wage rolls and turnover fall. Policy adjustments will result in return premiums. This reduces investment income and ultimately profits;
- there might be a knock-on effect in the insurance industry, forcing redundancies;
- there may be skills shortages in the insurance industry despite unemployment. The right mix of skills will include policy wording technicians, loss adjusters and claims managers; and
- if the country is in recession, spending on risk management is likely to reduce, leading to insurance claims due to lack of maintenance and reduced health and safety standards. Risk managers of commercial companies could be made redundant in a cost-cutting exercise.

As inflation is created by an entirely different set of economic factors, the effects of an increase in the rate of inflation on the insurance industry will be as follows:

- Inflation creates uncertainty. This uncertainty obviously creates problems for the insurance industry and increases replacement costs. Therefore, the cost of paying insurance claims is affected by the future rate of inflation. Predicting the future rate of inflation accurately is vital to insurance companies, especially if premiums are set on a cost-plus basis. Insurers have to do this in a specific way, e.g. service cost inflation and medical cost inflation may be far higher than CPI/RPI.

- Holders of fixed term life insurance policies and defined benefit pensions and annuities will find that the real value received may not be as much as expected when the policy was taken out, and of course house and contents cover may become under-valued unless regularly adjusted upwards in line with the expected rate of inflation. With a high expected inflation rate, more current household income will have to be used to cover future risks. This means that businesses and individuals may find it difficult to determine the exact level of monetary cover they require. The value of an insurance policy is then questioned and potentially confusion can arise as there is simply an illusion of proper protection. Insurers have to devise or attempt to devise complicated arrangements.
- Wage increases tend to be high during inflationary periods. As the insurance industry is predominantly labour intensive, the cost and cash flow implications of wage increases made necessary by inflation may be severe.
- Inflation reduces the purchasing power of money. Insurance companies which have to hold substantial cash balances to meet claims made by policyholders are penalised.
- Some businesses and individuals may move out of cash holdings and into holding riskier assets. Although this can mean extra demand for insurance of such assets, the moral hazard may increase, plus poor risk management measures are taken to protect such assets.