Theme: Global Convergence: An Increasingly Inter-Connected And Balanced Global Economy

Economic Convergence

We will see the fastest economic convergence in the history of humanity, the process of 'globalisation' which encompasses the dynamic effects of the digital revolution, the relative opening up of the Chinese and Indian economies, the growth of giant trading blocks such as the EU and NAFTA driving economic liberalisation, the fall of Communism in Eastern Europe and the exponential effects of increasingly educated populations in developing countries. Two caveats are important here. Continuous globalisation is not a certainty; protectionism will flare up at times and could threaten the trajectory of change described here, with the losers of globalisation increasingly challenging mainstream politics. Secondly, convergence may further aggravate the plight of the world's poorest nations as the effects of climate change and rising commodity prices disproportionately impact them.

In this new economic environment, capital will flow - in many cases irreversibly – to the prosperous and fast-developing countries of Asia, South America and some parts of Africa where there will be very significant demand both for investment in infrastructure and in providing insurance products to the burgeoning middle class population.

The growth of the consuming classes, primarily in China and India, will fuel much of this capital flight. As recently as 1990, only 20% of the world's population had the financial capacity to make discretionary purchases beyond their basic economic needs, mostly in the US, Japan and Western Europe. Yet by 2025, an estimated 4.2 billion people from an estimated global population of 7.9 billion will be able to do so.

International Regulation

Some core international standards covering capital, systemic risk, resolution and supervision will be established by 2030, although it is far from certain that the agreement of such standards will be effective in helping tackle future crises even if a degree of harmonisation between the EU, US and Asian regulators can be agreed. However, with new economic centres emerging and sophisticated financial interconnections between all parts of the world, considerable amounts of effort will be expended on making structures work and on designing and agreeing practical fixes to problems as they emerge.

Those regulators exerting the most influence will be those able to work with other countries and regions to find common ground and execute a workable plan, at the same time as demonstrating thought leadership to the broader systemic questions. One effect of this will be to increasingly take regulatory leaders away from their own countries as they focus their efforts on protecting their home economy and institutions from contagion, yet the pressure will remain formidable for them to revert to being national cheerleaders at times of difficulty.

Think Piece 3: Growth and Regulatory Disruption in a Globalising Insurance Market


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Summary

- The pace and scale of regulatory disruption for the insurance and long-term savings sector is unlikely to slow down, even after the implementation of Solvency II.
- As the macro-economic focus shifts from financial stability towards growth and competitiveness, there is a significant opportunity for the sector. Specialisation or scale are likely to be required to take advantage of this.
- The tension between the harmonisation of capital standards and their local implementation will make a truly level playing field unlikely – both across Europe and globally. Protectionism is also likely to place some limits on the free flow of capital and risk.
- In the context of such a globally uneven playing field, it will be important for regulators to retain a strong focus on the competitiveness agenda of their jurisdictions.

In recent years, insurance and savings firms have faced significant economic and regulatory disruption. Low interest rate environments in developed economies have now been coupled with uncertainties over the Eurozone and regarding the growth rate in developing economies – the summer rout of the Chinese markets, and global volatility that followed, provided a timely reminder of this.

On the regulatory front, the implementation of Solvency II ahead of January 2016 has been a key strategic priority for insurers across Europe. It has been a focus of management time and driven changes in areas including governance, asset and liability management, business models, systems and data, reporting and disclosure. According to recent estimates by the UK Government, the one-off implementation costs across the UK will reach £2.7bn, with

Solvency II: Five years on

By 2021, the long and winding road developing and implementing Solvency II, the EU-wide insurance capital standard which comes into force at the start of 2016, will be well behind us. It will have taken time to bed down and the first few years will have been awkward and choppy as national regulators and EIOPA, the pan-European insurance and pensions authority, slowly converge but not fully. With so much actual and political capital having been invested by a wide range of stakeholders, it will have been declared a success by regulators. And with reference back to the overall objectives of enhancing policyholder protection and modernising supervision, this claim will not be unfair.

However despite being a ‘maximum harmonising’ supervisory regime, the playing field may not be truly level. The rules of the game may now be the same – but with different referees in different jurisdictions, there will be divergence. The balance of influence between EIOPA and national supervisors will be critical here. A strong EIOPA will be required for convergence – and industry will need to develop close links with EIOPA, in addition to the national supervisor.

Given the protracted negotiations required for Solvency II, there will not be the appetite for a sequel, although a review of sorts is scheduled for 2018. Instead, clarifications and refinements will continue to be made, leading to some friction between national regulators, national governments and European institutions.

annual ongoing costs of £200m. In parallel, significant product regulation changes, such as pension freedoms and auto-enrolment, are underway. Regulatory disruption will continue on a variety of fronts and become the new norm.

These economic and regulatory dimensions will crystalise into two separate but interrelated strategic challenges for the industry:

1. Delivering growth in a turbulent economic environment
2. Constantly adapting to major regulatory developments at an international, regional and local level

Delivering growth in a turbulent economic environment

Global economic growth and rebalancing from West to East is continuing, although the pace of rebalancing will slow. A recent World Bank report suggests the recovery in advanced countries is gathering momentum, whilst there is a broad-based slowdown underway in developing countries (although it should be noted their growth rate still remains more than double what is seen in the West).[18] A separate report by the accountants PwC points to a doubling of the world economy by 2037 and tripling by 2050. However, growth in emerging economies, particularly China and India, is to moderate after 2020 towards advanced economy norms.[19]

The need for the West to remain competitive

Driven by the need to ensure the West remains competitive over this time horizon, we are beginning to see increased emphasis from governments on economic growth and competitiveness, compared with the unrelenting focus on financial stability and soundness following the 2007-2008 global credit crunch. This will shape many government initiatives in the coming years, both national and European, including the EU's "Europe 2020" growth strategy.

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This is welcome news for UK companies – and those who have strategically positioned themselves will be able to take advantage of it. In particular, this is an opportunity for the insurance and long term savings industry, given the important role it plays in boosting economic growth by facilitating the transfer of risk and capital around an economy, and supporting the consuming middle classes. The UK government recognises this role, as well as the sector's contribution to GDP and the tax base, and has in place a dedicated growth plan for the medium-term with the aim of strengthening the sector's competitive position and enhancing the UK's position as a global leader.

But there is only so much that policymakers can do

A desire for firms to be well placed to be a part of the growth story and to operate efficiently within the regulatory environment will incentivise scale, resulting in a continuation of merger and acquisition activity that has been seen recently. Such scale enables firms to reduce the frictional cost of regulation, have the capacity to take on more volatility, and benefit from diversification across product lines and geographies. This will also help to alleviate the margin squeeze that will otherwise be felt by mid-size firms from other players in the distribution chain – such as brokers (themselves consolidating) and online aggregators.

Such M&A activity as well as less formal alliances between insurers could result in a very different landscape: One that is dominated by specialist players who have carved out a niche in the market and continue to innovate but are constrained by regulatory capital requirements; and larger insurers – perhaps even mega-insurers - operating across multiple products and geographies, applying their own economic capital models on a global level, flexing them accordingly to calculate solvency under a variety of regimes.

An excess of capital in the markets is seeing more capital flow into the insurance sector, available for insurers to trade risk with, both as traditional and alternative forms of reinsurer capital. It will continue to flow from sources such as pension funds and hedge funds, seeking yield and diversification benefit, and offering cheaper funding than the more traditional sources of equity or retained earnings. The result could be rock-bottom reinsurance rates for insurers and a maturing alternative risk transfer market for insurance-linked securities. The broker Aon Benfield, in their latest 'Aggregate' report of the reinsurance market, noted continuing strong growth of 28% in alternative capital and observed that, as with primary insurers, reinsurance consolidation is underway as companies seek scale and diversification.[20] In a report for the London Markets Group, management consultants the Boston Consulting Group also identified embracing the rise of alternative risk capital as an opportunity to enhance and retain London's status as a global insurance hub.[21]

In addition to the insurance side of the balance sheet, there will be growth on the asset side. After the financial crisis, assets were moved by insurers towards safer classes such as bonds, leading to a prolonged period of low investment returns, with firms deploying more diligence to their underwriting to partially off-set this. Continuing low yields will see firms working their assets harder, with more sophisticated choices of assets in order to optimise their return for a given level of risk – this is likely to include investment in infrastructure and securitisation. This will align with EU initiatives, including the flagship Juncker Plan, to stimulate economic growth. A similar opportunity was identified by Insurance Europe in its report, Funding the Future, highlighting a role for long-term savings firms to invest in the real economy through long-term lending by stepping into the gap left by banks because of reform to their regulations. Oliver Wyman, the management consultants, estimate this opportunity could increase the aggregate market value of European insurers by €200bn, of which €50bn is attributed to UK insurers.

The reaction of regulators

However whilst flows of capital and government initiatives can play a role in helping the insurance and long-terms savings sector to grow and support economic growth, this may not be embraced as warmly by the regulators, with their primary objective of economic stability and soundness. It is vital that messaging from both the Bank of England and government is consistent to avoid uncertainty for firms. Senior officials at the Bank have already publically stated the need for care when considering turning back the overall regulatory dial or trying to trade off the risk of financial instability for short-term growth[22]. Ambivalence has also been expressed regarding their approach to new asset classes, such as infrastructure.

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Constantly adapting to major regulatory developments at an international, regional and local level

Beyond the European Union's Solvency II, recent years have seen efforts from international bodies to lay the foundations for the harmonisation of insurance regulation on a global level. The International Association of Insurance Supervisors – which counts both the PRA and FCA in its membership – has, under direction from the G20's Financial Stability Board: established its Insurance Core Principles; identified nine global systemically important insurers (G-SIIs); and developed its Common Framework (ComFrame) relating to the supervision of Internationally Active Insurance Groups (IAIGs). The nine insurers designated as 'global systemically important insurers' (GSIIs) have a series of additional policy measures to be implemented, including Systemic Risk Management planning and Recovery and Resolution planning. Other insurers are keeping an eye on these developments as they are likely to influence national or regional policy.

Continuing regulatory disruption – not just prudential but also increasingly with regards to conduct – will become part of business as usual. It will require early industry engagement to shape the emerging regulatory landscape, and significant resources and management time from firms to operate and optimise within it. In the 2015 edition of their annual global survey of CEOs, the accountancy firm PwC found that 88% of insurance CEOs believe regulation will be a disruptive trend for the industry over the next 5 years – higher than for any other industry. More still, 91% of insurance CEOs, see over-regulation as a threat to their growth prospects over the next year, also higher than any other industry and an increase from the previous year.

The principle versus the reality

Whilst the goals are certainly laudable, practicalities and politics will lead to slippages in timelines, fragmentation in application and inevitable compromise. Solvency II is an obvious case study here: achieving significant regulatory reform is difficult, involving protracted negotiations, extensive resources and costs. The accountants KPMG, who interviewed leading regulators and insurance CROs to inform their Evolving Insurance Regulation report, found that whilst both industry practitioners and regulators saw value in greater international consistency and harmonisation of insurance requirements, they also raised concerns as to whether this could be achieved in practice.[23] Achieving such international harmonisation with a low cost of implementation is even less likely.

The sector and a range of other interested parties will engage constructively as the debate and developments around international standards move forward over the next ten years. There will, however, be some concern from industry, based on past experiences, that the supervisory community uses this as a further opportunity to raise capital requirements regardless of how sufficiently capitalised firms already are, despite senior PRA officials speaking at ABI events seeking to bust this myth in the context of Solvency II.

Global standards, local interpretations

Another tension which will surface is between national supervisors and governments, wishing to ensure regulation is appropriate for the specificities of their society and economy, and international efforts to harmonise regulation with a 'one size fits all' approach. How local requirements will coexist alongside international standards will be a focus for much further debate. Neither the Americans nor Europeans will be embracing of wholesale change to their respective regimes. A likely compromise is therefore global capital standards which are principle-based, and which are implemented through more detailed and varying local and regional standards, by national supervisors maintaining control of direct supervision.

Geopolitical issues will add to this pressure and add more practical challenges to the harmonisation agenda. Referendums on independence and on the European Union; the politics of identity; anti-immigration sentiment in Europe in response to crises in the Middle East are just three examples. These factors could lead to protectionism as societies turn in on themselves, even as companies become more multi-national, and this public sentiment could be reflected in government policy and action. Governments may be unwilling to surrender too many levers of control over their financial services sectors to supra-national bodies. Amongst other effects, this will restrict the fungibility of capital across borders, even when staying within the same set of regulatory standards.

A level playing field?

Paradoxically, efforts to harmonise standards which are then implemented and interpreted locally by supervisors, will bring into sharp focus material areas of divergence between jurisdictions. This will create regulatory arbitrage opportunities for firms. Branches and 'passporting' will be used by firms to optimise their group structure.

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Bold decisions and strong enforcement action will be required at an international level to resolve this tension of global standards which are global only in name due to the politics and practicalities of local implementation. Strong and centralised institutions with a powerful mandate to directly supervise would be required to act as a counterbalance to the diverging interests of local institutions. These will not materialise overnight; instead, this will be a long-term and iterative journey.

Challenges - and opportunities

The coming years will be ones where economic turbulence causes challenges, but a focus on growth from both policymakers and government brings opportunities too. A patchwork of overlapping and inter-relating local, regional and international standards, with differing interpretations, will create a complex landscape for insurers to navigate, but this again presents competitive opportunities for firms that can adapt to it.