Association of British Insurers

Identifying the Challenges of a CHANGING WORLD

THE TRENDS FACING INSURERS TOWARDS THE 2020s

CHAPTER ONE

Our Changing World

Because major change has been a constant for the Western world for the last two centuries, it can make it harder to assert the significance of the forces facing us over the next 20 years. Yet the evidence is clear that all the major societies and economies of the world are facing change at astonishing pace and on many fronts. The world in the 2020s will feel much-changed from today.

This matters more for insurers than almost any other sector; the more societies and economies change and the faster they do it, the more insurers have to change their products and how they underwrite risk to reflect this. As a highly regulated sector selling contract-based products, legislative and regulatory systems are central to the ability of insurers to perform their function as are customer attitudes and macro-economic trends.

The seven over-arching trends most relevant to insurers seeking to understand the world of the 2020s are:

i. The digital revolution & the capacity of the technologies which connect us

ii. Global convergence; an increasingly inter-connected and balanced global economy

iii. The development of Western economies post the financial crisis

iv. Global ageing

v. Political challenges

vi. Interventionist regulation

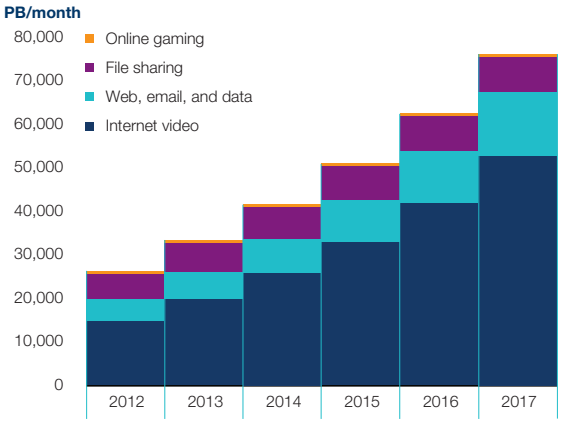
vii. The continued impact of climate change on our environment

The digital revolution and the capacity of the technologies which connect us

Between now and 2025, the exponential growth in computer processing capacities should mean individuals routinely having access to computing capacities in excess of 64 times that available today[1], through mobile phones, tablets, laptops and television.

Feeding this processing power will be a huge jump in both the production and consumption of data with consumer internet traffic predicted to increase by 24% each year to 2017 (see Figure 2), chiefly led by video and mobile data and with the capacity to transmit this data even faster thanks to recent advances in fibre optic cable technology. If these advances alone were the only consequence of the digital revolution, it would be life-changing; taken together with the potential growth in cloud computing, additive 3D printing and autonomous robotics, we can begin to comprehend how different these advances will make the world of tomorrow feel.

Figure 2: Predicted worldwide consumer internet traffic, 2012-17



Source: Cisco Visual Networking Index: Forecast and Methodology, 2012–2017
Note: 1 PB = 1 Petabyte (1024 terabytes / 1 million gigabytes / 21,000 blu ray disks)

[1]Moore's law suggests that the complexity of integrated circuits doubles every two years, and has held true for the last four decades.

"Our world will continue to be changed by digitisation with cyber-crime an increasing risk to internationalised supply chains. At the same time, customers will still have houses and business to protect and it will be vital to protect the principles of risk pricing so we can deliver the best possible products to them."

Bronek Masojada, Chief Executive, Hiscox

For insurance customers by 2030, empowerment through technology will be a central fact of life, underpinning the most basic and most sophisticated of daily tasks through the use of small, portable devices that could easily replace the wrist watch. At the heart of this empowerment will be **constant access to information**, much of it tailored to the individual's requirements and available through a variety of channels. As a result, customers will view it as the norm to interact publicly (through social media and other online communities) as well as privately with their insurer to provide feedback about their experience and to have complaints resolved swiftly, albeit the personal aspect of the industry will remain important.

Among the challenges this will throw up is the **handling of data**. **Data protection will be one of the key challenges of the age** as politicians, regulators and the law struggle constantly with establishing appropriate standards of data protection and clarity of data ownership across national boundaries at the same time as people routinely cede access rights to large chunks of their individual data to participate actively in aspects of society. In this environment, some of the data required by insurers may seem less intrusive than it does at the moment, especially if insurers build brand reputations which are in tune with public attitudes about how data is used. This level of connectivity and data transfer does not only affect retail customers; it will change further the nature of commercial risk as extended supply chains become more normal even for relatively small enterprises in a world where every business has the potential to be connected to each other. This puts a different complexion on the risks posed by cyber crime, data theft and poor quality assurance.

For insurers, more than most industries, the IT challenges this world poses are very significant. For a sector which partly has to support long-term contractual obligations which then operate in ever-changing regulatory and legislative environments, the imperative will be to invest with sufficient ambition and scale in 'built for change' systems that can meet customer expectations, allow product innovation and respond to regulatory interventions. One of the biggest challenges for insurers may be adapting to handle the sheer volume of data their customers are capable of uploading. It will be physically impossible to analyse this volume of information within many existing systems with insurers needing to embrace more flexible and efficient approaches, such as cloud-based computing systems.

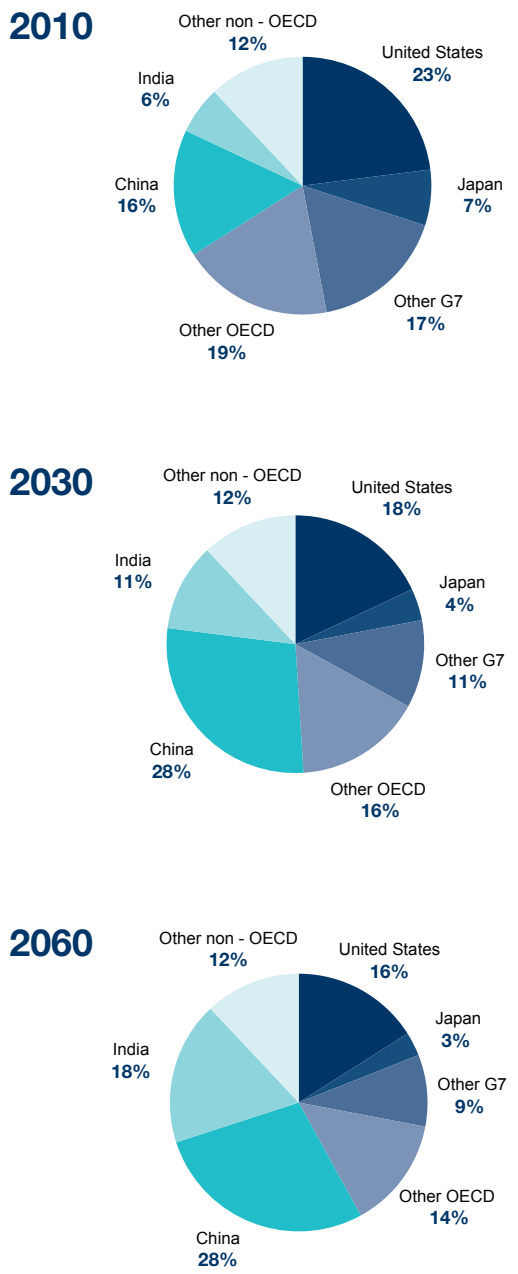
Global convergence; the increasingly inter-connected and balanced global economy

By the mid 2020s, it will be hard to believe that within living memory wealth and power was still overwhelmingly concentrated in the West. China and India's 'emergence' will be a matter of history[3] and the rebalancing of economic growth and prosperity between Western Europe & North America and Asia & South America will have almost certainly reframed the current Western-centricity of international bodies such as the UN Security Council, G8, IMF and World Bank. This will be driven by the fastest economic convergence in the history of humanity[4], 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. However, on the basis of trends already well under way, it would seem reasonable to expect the following factors to follow from globalisation which are relevant to insurers.

[3] OECD Economic Outlook, May 2013 [4] Mahbubani, The Great Convergence; Asia, The West and The Logic of One World.

Rebalancing between East & West. The world is moving back to the pre-19th century position of a powerful Chinese economy which will have comfortably overtaken the United States as the world's largest by 2030, meaning a more equal sharing of the geopolitical levers of power and influence between East & West (see Figure 3).

Figure 3: Changes in the breakdown of global GDP, 2010 - 2060



Source: OECD Working Paper 1000 "Long-Term Growth Scenarios".
Note: Percentages of world GDP are real measures at 2005 purchasing power parity (PPP).

Capital Flows. 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[5]. With economic growth will come **greater urbanisation**, a process already fuelled by population increases which will stimulate infrastructure development and regeneration. Again, this will be most notable in the fast-developing economies of Asia and South America but this capital flow need not be all one way as the UK and Western economies face the challenge of upgrading their own infrastructure to compete as well as meeting the housing needs of their changing societies. With banks continuing to be under capital pressure, there will be opportunities for insurers to either lend directly or invest in housing and commercial development close to home. The growth in the consuming classes will also lead to longer life expectancy meaning a significantly bigger market in these regions as consumers devote more of their income to post-retirement products.

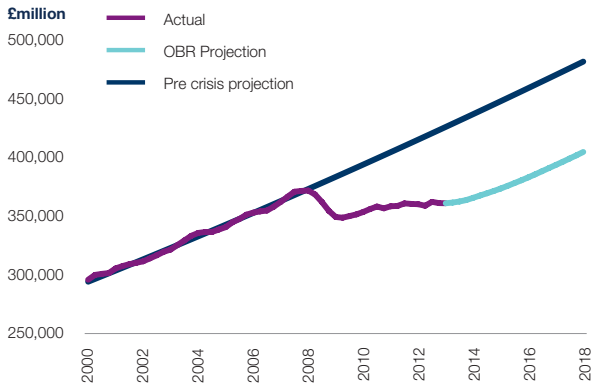
Finally, a converging global economy will need stable energy supplies to meet its consumption needs. This will continue to drive the market for **energy innovation**, maximising the benefits of shale and carbon capture technologies and reinforcing the role of nuclear power too, all needing to be underpinned by large scale insurance and reinsurance programs.

The development of Western economies post the financial crisis

Just as significant and potentially more worrying for the UK in the 2020s will be the **long-term macro-economic consequences of the financial crisis**. **With an eye-watering £375billion of quantitative easing to be unwound** over the years leading up to 2030, the UK's economic leaders will have their work cut out to avoid an economy struggling either with unpredictable low interest rates, inflation or tepid growth – or a politically unpalatable combination of all three. As the EU – the UK's largest trading partner – continues to struggle with painful Eurozone economic adjustments and as EU banks adjust to a post-crisis world of higher capital requirements and lower credit/leverage risk, the UK economy will struggle with lower growth; 2007 levels of GDP growth are unlikely to be returned to until well into the 2020s (see Figure 4). At the same time, household budgets are likely to be stretched by the projected increased percentage of spending on housing and utilities[6], while any significant increase in inflation between now and 2030 could have a devastating impact on the value of savings and the delicate balance of Western economies.

[5] McKinsey Quarterly 2012/4 "Winning the $30 trillion decathlon: Going for gold in emerging markets". [6] Which? Consumers in 2030 Report

Figure 4: UK Quarterly GDP 2000-18, actual & projected



Sources: Actual - ONS Quarterly National Accounts; OBR Projection - Office for Budget Responsibility "Economic and Fiscal Outlook, March 2013"; Pre crisis projection - ABI calculations.
Note: GDP levels are presented as seasonally adjusted chained volume measures.

The consequences of this for insurers are important. With low economic growth will come even lower public spending, increasing the likelihood for insurers of increased risk and cost from reduced investment in areas such as flood defences, health spending and infrastructure. With anaemic UK economic growth will come continued low investment returns, forcing even more pressure on underwriting performance and cost-cutting to deliver profit, while insurers' asset managers would face the risks of asset bubbles caused by QE unwind. As the cost of living continues to pose a challenge, the risk will be reduced spend on insurance overall and on protection and long-term saving in particular, despite the visibly ageing society. On the other hand, this environment will offer opportunities for those insurers with an appetite to extend their credit function and the stability and longer investment horizon of insurers will potentially be a more visible and valued part of this world.

A social group whose fate will be of particular importance to the UK economy of 2030 will be that of the lowest 20% - those at the bottom of the so-called **'hourglass economy'** whose economic capacity is blighted and whose needs will be an increasing focus of economic and welfare policy makers. Sitting above this 20% will be the vast majority of self-identified middle classes who will range from the mass affluent through to the 'squeezed middle' whose place above the lowest 20% will only be precariously held in place by employment. **How the insurance needs of this 20% will be met could increasingly be a political issue, not just a market decision (**see Figure 5 for current household insurance expenditures). Meanwhile, the supply-side to the UK economy will be the subject of greater focus in 2030 than it is today. With a more balanced world economy and ever-growing global middle class, the UK will have to fight harder to train and retain the **skilled workforce** it will need to compete. **Emerging countries have been investing heavily in their own universities** and education systems, presenting a permanent challenge to the UK to retain the strength of its higher education sector. At the same time, we will have been forced to develop our workforce much more broadly with the IT skills necessary to complement our natural command of the world's business language, English. While protecting and developing the UK's reputation as a world-leader for professional services such as law, accountancy and consultancy in a fluid global labour market.

Finally, on the supply side, will have been the need to restore the **investibility of the UK banks** through a combination of sustainable profitability, regulatory certainty, facilitation of equity and long-term debt and stable dividend policies. Without secure and properly capitalised banks, the UK will remain deprived of the credit and maturity transformation a sophisticated economy will still require in 2030.

Figure 5: Household spending on insurance by income decile, 2010

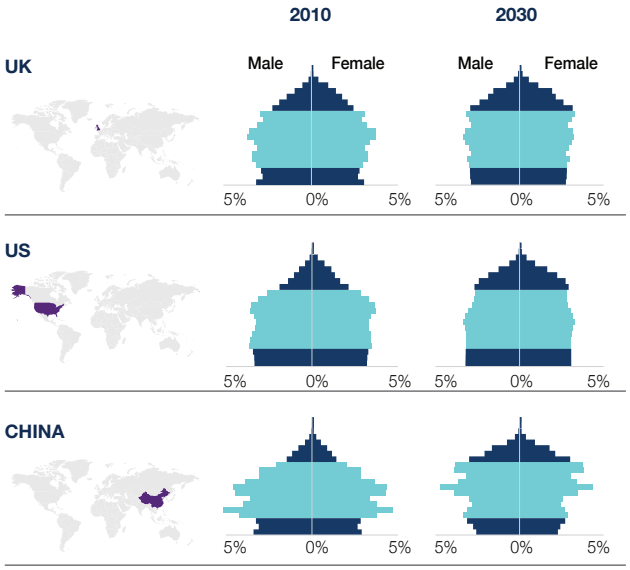
Income decile	Median annual Income	Households with NO insurance	Percentage of households WITH insurance expenditure, and average annual expenditure of these households: Home Contents		Motor		Life	
1st	£6,660	38%	44%	£148	33%	£387	11%	£261
2nd	£10,560	21%	61%	£124	45%	£382	15%	£168
3rd	£14,355	15%	70%	£133	59%	£360	18%	£207
4th	£18,825	11%	71%	£158	68%	£422	19%	£266
5th	£23,922	5%	76%	£162	78%	£441	21%	£293
6th	£30,010	4%	83%	£158	86%	£497	20%	£258
7th	£37,072	3%	83%	£170	87%	£588	22%	£336
8th	£46,146	2%	86%	£176	90%	£634	29%	£312
9th	£59,359	1%	92%	£211	94%	£671	31%	£440
10th	£91,233	2%	90%	£249	94%	£791	34%	£583

Source: ABI (2012) "Household Expenditure on Insurance, 2010".
Notes: Percentages relate to the proportion of households either with no annual expenditure on insurance or with some annual expenditure (base = 26million in 2010). Monetary values under each insurance type indicate the average annual spend of households with the insurance type in that decile.

Global ageing

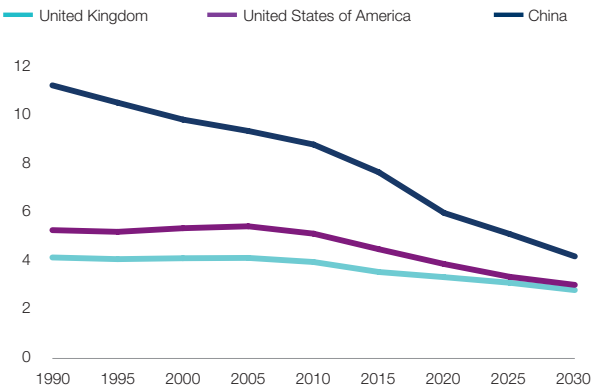
While the world's population will continue to grow dramatically over the next two decades, our own society is ageing and our ratio of workers to retirees is falling (see Figure 6 and Figure 7). This makes the current pensions system increasingly unaffordable. But ageing also brings with it wider challenges for which our society is financially unprepared; the impact of dementia on our health system, the household economics of living for 30 years post-retirement and the need to fund care in later life either at home or in residential facilities.

Figure 6: US, UK and China age distributions in 2010 and 2030



Source: United Nations Population Division "World Population Prospects: The 2012 Revision"
Notes: Uses "medium fertility" population projections. Population pyramids show population of 5 year age groups as a proportion of total population, ages 15-64 are highlighted

Figure 7: Old age support ratio 1990 – 2030, population aged 15-64 per population aged 65+



Source: United Nations Population Division "World Population Prospects: The 2012 Revision"

This will make **radical reform of our welfare state** a pressing concern over the next decade; while the Beveridge reforms of the 1940s envisioned a basic safety net for all with additional benefits for those who contributed to them during their lifetime, recent decades have seen the contributory element diminish while the overall level of welfare has increased. This has left a system mismatched for modern requirements which will have to radically reform to become more affordable and be better aligned to wider society.

The ageing society will pose its own economic challenge for the UK and the West, increasing demand for more flexible housing, driving growth in the residential and private care sectors, stretching the welfare state's ability to fund dignity in retirement and potentially creating a new labour force of the semi-retired. For insurers, the most obvious challenge will be to innovate to help fund a range of solutions to long-term care provision in a way that meets shareholder, political and regulatory approval. But potentially an equal challenge will be to develop flexibility in retirement solutions to reflect the financial requirements of the semi-retired and to adjust to a labour market with fewer younger workers and more older part-time employees. In the absence of mass market advice, this may also see insurers playing an increasing role helping customers plan for their financial future.

Political challenges

Politicians in the 2020s will face formidable challenges of structural change, demonstrable relevance, the capacity to act effectively, and the pressures of short-termism.

Structural Change. The structure of the EU and the UK will have evolved from today, whether through giant steps or small ones.

In Europe, the institutions and power structures of the **European Union** will have adjusted profoundly by the 2020s to reflect the realities of a large trading block with marked differences of economy, culture and possibly, currency. Its framework will have been established by the realities of Eurozone banking union, the consequences of a UK decision to either remain or leave and the differing appetites for integration within an EU made up of at least 28 states. Institutionally, this is likely to mean greater power for an ever-more politicised European Parliament at the expense of the Commission, with the EU-wide regulators (especially in banking) increasingly influential, not least as a point of EU continuity amid the rotation of presidencies, commissioners and MEPs. However, these authorities will also have to battle even more for power and influence with national governments, which can deprive them of their authority by sidelining them or increasingly ignoring them altogether.

If the UK has stayed, it will likely be the leading power within an outer circle of EU member states, albeit as a country whose economic power should still determine its

involvement in key decisions (see Figure 8 for current EU / UK comparison). If it has remained in the EU, it will have reinforced the development of a more flexible and pragmatic EU with greater use of permissive legislation and a structure that allows for those member states with a greater appetite for the Single Market than political integration, in the teeth of opposition from large member states such as France. Ongoing UK membership will also have bolstered the economically liberal trading ethos promoted most consistently by the Northern Europeans and will have acted as a counterweight to permanent EU action against financial services as a sector.

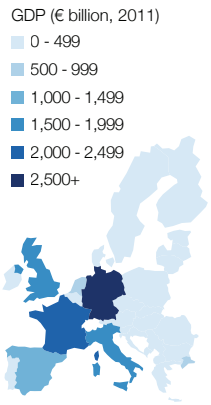
Within the UK, the structural foundations of the United Kingdom will probably have evolved, irrespective of whether Scotland has voted to leave the Union either in 2014 or in a subsequent plebiscite. Structurally, the trend will continue towards increased devolution towards the constituent parts of the UK with Wales and Northern Ireland having ever greater autonomy over their own fiscal decisions with inevitable consequences for insurance. A similar but less advanced trend may also be in evidence towards city government as the digital revolution makes it easier for civic government to take place virtually and as people increasingly channel their political energies into local issues, having lost patience with heavily constrained national politicians. The most obvious change here would be if London went further down this route, especially given its enormous economic significance for the UK as a whole.

Demonstrable relevance. For national politicians, whatever the structural landscape, the battle will be one of relevance in a world where global economic factors and the power concentrated in individual hands through technology and prosperity can make political leaders seem increasingly powerless or marginal, compared to previous generations. As the impact of mainstream media continues to weaken through the proliferation of outlets and the range of on-demand media, political discourse will increasingly be conducted with self-selecting communities of interest via the internet and social media. The politicians who succeed with their agendas are likely to be those who can navigate a world of fast-moving information flows to shape opinion and cut through the noise. Reputation will be the most vital and most fragile asset for those in the political and lobbying arena, especially in the face of the almost uncontrollable discourse dynamic that will be the norm with mainstream digitalised social media.

Short-termism and capacity. Increased short-termism is a natural consequence of the speed of this political environment in which hard-to-reverse critical judgements can be formed in a matter of minutes. Power spread thinly between a range of governments and institutions and the constant threat of legal challenge will also constrain ministers wanting to effect major change. In the UK, this may mean more EU-style policy making with openly speculative policy development eventually narrowing down into concrete legislation, compared to the Executive-driven top down governmental policy making framework we have traditionally had. In practice, this would hand even greater power to Parliament and especially to scrutineers like Select Committees. A likely development by 2030 will be that think-tanks, not-for-profit groups and single issue campaign groups operate on a much bigger scale in the UK with a more open mission to change government policy, funded more substantively from the private sector as happens in the USA.

For insurers, as for other sectors of the economy, all this will change the dynamic with central governments. Insurers will be under almost constant pressure to help develop – and, critically – implement public policy given the reduced policy instruments and smaller public finances these governments are likely to have. This is an opportunity to help frame public policy in a way that enables insurers to manage liabilities effectively in the public interest, but it brings with it the big risk that the industry is viewed as an alternative source of public funding with the industry constantly pressurised to spend resources on preventing risk rather than managing it, while still blamed by governments when things go wrong.

Figure 8: Top 10 EU economies by GDP, population and intra-EU trade, 2011



	GDP (€bn)		Population (million)		Intra-EU27 Imports (€bn)		Intra-EU27 Exports (€bn)	
1.	Germany	2,593	Germany	81.8	Germany	572	Germany	628
2.	France	2,001	France	65.0	France	348	Netherlands	369
3.	UK	1,747	UK	62.5	UK	235	France	261
4.	Italy	1,578	Italy	60.6	Belgium	228	Belgium	246
5.	Spain	1,063	Spain	46.2	Italy	216	Italy	211
6.	Netherlands	602	Poland	38.5	Netherlands	199	UK	182
7.	Sweden	388	Romania	21.4	Spain	154	Spain	147
8.	Poland	371	Netherlands	16.7	Poland	106	Poland	106
9.	Belgium	370	Greece	11.3	Austria	106	Czech Republic	97
10.	Austria	301	Belgium	11.0	Sweden	87	Austria	90

Source: EuroStat

Interventionist regulation

The financial services regulators of the 2020s will be the second generation of high profile regulatory leaders since the financial crisis, operating through some of the international and regional frameworks we can begin to see emerge today as they attempt to manage the risk of financial services companies operating at intense speed in an interconnected global economy.

International frameworks and co-operation. 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 the structures work and on designing and agreeing practical fixes to problems as they emerge. The 'weakest link in the chain' principle will be paramount here; regulators could easily spend as much time monitoring each others' markets for signs of risk as they could supervising their own. This means that 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. A key challenge for EU and UK regulators will be to avoid over-regulation that disadvantages the West compared to Asia in the battle for capital and domiciled companies.

Early Intervention. For both international and domestic reasons, early intervention will have been established as a regulatory principle; given the speed of information flows and the organisation of online communities, it will be virtually impossible for regulators not to intervene to tackle possible detriment. However, if the avoidance of detriment is not to trump other legitimate priorities of regulators, their public position on customer responsibilities will have to be fully understood and constantly communicated. High profile public intervention will remain politically risky, especially given the fast-changing consumer relationship with technology.

Public Performance. In exercising these duties, regulatory leaders will become well established public figures during the 2020s, subject to high profile political and media scrutiny. This will have introduced its own dynamic to their relationship with the companies they supervise and may be a greater barrier to private dialogue than it is at present. It will also lead to an interesting dynamic with ministers who may find themselves at loggerheads more publicly with regulators when their policies come into conflict with regulatory policy or orthodoxies. It will certainly lead to greater pressure on regulatory leaders to help deliver desirable socio-economic outcomes.

The continued impact of climate change

Debate on the scale and impact of climate change will be at the forefront of the 2020s, in particular whether **4°C warming** will be reached by the end of the century instead of the predicted 2°C. The 2020s would be the last chance for sustained global action to prevent this 4°C rise, as irreversible tipping points[7] are potentially reached in areas such as the Greenland ice sheet and Amazonian rain forests. More broadly, insurers will increasingly be coping with the consequences of **greater volume of heat waves, drought and major floods** which will accompany the climate change that is already certain to happen. In aggregate, this will have wide-ranging effects on property, agriculture and mortality rates but such losses will continue to be heavily skewed towards certain geographies and climates with greater risk of hurricanes in North America and flooding in Europe and parts of Asia being key areas of concern for UK-based insurers.

These changes will be just as relevant for insurers' **asset management** activities as their underwriting operations. If political leaders take sustained action to try and prevent 4°C warming, it would almost certainly lead to further restrictions on fossil fuels, reducing the value of reserves held by major energy companies in which insurers will be heavily invested. Meanwhile greater natural resource constraints, driven by both climate change and population growth could not just limit economic growth but, at worst, impact pension funds as assets deliver lower returns and costs rise against a backdrop of consistently rising commodity costs[8]. A particular challenge for insurers will be to identify and react quickly enough to long-term trends, rather than adjust behaviour on an annual basis that may not be enough in aggregate to manage medium-term risk exposure.

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Do insurers fully understand the scale of the changes that will be driven by the digital revolution over the next 15 years?

How can insurers help our economy and society navigate the prolonged effects of the financial crisis?

As a long-term industry, how can we help tackle short-termism in political decision making?

Is the insurance industry looking far enough ahead to understand the possible consequences of even greater global warming?

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[7] 'Major Tipping Points in the Earth's Climate System and Consequences for Insurers, Tyndall Centre for Climate Change Research, supported by Allianz and WWF. 2009
[8] 'Resource constraints; Implications of Limits to Growth for the Actuarial profession, The Institute and Faculty of Actuaries, January 2013.