Association of British Insurers

Identifying the Challenges of a CHANGING WORLD

THE TRENDS FACING INSURERS TOWARDS THE 2020s

CHAPTER TWO

Changing Insurance Industry

Across nearly every sphere of its focus, the insurance industry is changing too by continuing to evolve a very broad spectrum of 'insurance' business models, particularly in the traditional 'Life' section of the market.

The drivers behind these market changes are many; commercial realities, optimal use of capital, focus on cost control and cash generation, regulatory imperatives, political and economic forces and evolving social and consumer needs. But a further change is also being driven from within the industry, by a new generation of industry leaders who have taken on executive responsibility in the immediate aftermath of the financial crisis and who have an appetite for insurance to play a more central and public role in the societies and economies it serves.

Four over-arching trends help explain how insurers are preparing themselves for the future:

i. Improving reputation and providing solutions to society's problems
ii. Increasing customer-centricity driven by changing distribution
iii. Impact of the digital revolution on business model and operational capacity
iv. Developing a closer more effective relationship with regulators

Improving reputation and providing solutions to society's problems

Tackling the reputation of the insurance industry is a key priority for the CEOs of the major UK insurers. No single factor holds the key but several matter.

Insurers will continue to suffer from the **collateral damage** inflicted on the entire financial services sector by the banking crisis, a crisis in which insurers as investors played a contributing role and, in some cases, were linked by common ownership or banking activities. This association is impossible to avoid and will not fully dissipate until the economy has recovered but the asset management arms of insurers have been at the heart of post-crisis governance reforms and insurers have had some success in establishing their distinctiveness in the eyes of key stakeholders.

A second factor is the industry's **reputation with consumers.** This is explored in more detail elsewhere in this document but insurers recognise that good customer experiences and swift resolution of avoidable complaints will increasingly have to form the bedrock of any improvement to insurer reputation.

More difficult to change is the relative unpopularity of the core insurance product; a necessary but unglamorous so-called 'grudge-buy' in an age where the zeitgeist is set by exciting technical innovation in the entertainment and leisure sector and where household incomes are squeezed. Compared to insurance products providing security against the financial consequences of a risk a customer never hopes to confront, insurance is always going to struggle, especially given the normal bias of people towards near-term gratification.

> "The reputation of the insurance industry will be its biggest future challenge. Our underlying performance is good but we need to step up our engagement with customers, especially in a more challenging regulatory environment."

Simon Lee, Group CEO, RSA Insurance Group

Insurers know the answer will partly come from providing undeniable value when the product is required; **the bar for meeting customer expectations will always be higher for insurers precisely because the product may not be needed very often or because customers have paid in for many years to get the benefit of it.** Given the anxiety which often accompanies a general insurance claim, the opportunity to change perceptions by offering first class service is an increasing area of focus for industry leaders.

None of these issues can be tackled in a vacuum which is why **tackling broader social problems** as well as those of individual customers will also be critical to changing reputation over the medium term. Insurers' traditional reticence to engage heavily with public policy in a high profile way has come at a cost of politicians, journalists, stakeholders and the public neither understanding nor appreciating the value of insurance. This reticence is now being challenged by a new generation of insurance leaders (many of whom began their careers outside the sector) who believe that an insurance sector that is better respected and understood by key policy makers and valued by its customers will have a fuller licence to operate.

For insurers, a more conscious but considered move into the public policy domain to offer options and analysis on the issues on which the industry has a locus could be more than an exercise in punditry. Identifying the challenges we all face is central to what insurers can do; holding up a mirror to society to offer an unflinching data-rich view of its strengths and weaknesses. Insurance-generated data has an important part to play in a very wide spectrum of public policy ranging from: the licencing regime for young drivers; pensions policy; flooding; the operation of our civil justice system; criminal fraud and executive pay, to name just a few. Equally, as a both UK and global leading sector, insurers have a clarity of perspective on how public and regulatory policy is decided across a range of cultures, continents and political systems.

There are some clear risks to taking a higher profile and more engaged stance in the decades ahead. Analysis, however neutrally presented, can always be attacked for bias by those who do not like the results. More importantly, as an industry identifying problems and suggesting possible solutions, insurers risk always being asked to pay for and lead those solutions. At a time of constrained public finances, this is a material risk which could increasingly take UK insurers into the dangerous and unprecedented position of not just being expected to help manage the risks of society but to pay to help prevent them in the first place. As all insurer capital comes from shareholders and customers, at its crudest this type of approach represents an additional form of tax on those who buy from and invest in insurance companies which would rapidly damage the market if it became the norm.

Where insurers do engage in helping provide a solution, as in its proposed Flood Re model to tackle the problem of unaffordable and unavailable domestic property insurance for high risk households, it will have to be on the basis of a more equal partnership with government to bind politicians and insurers together more closely in the management and mitigation of risk to the benefit of the customer. Even then working with governments will always bring with it frustrations and constraints, however important the partnership for politicians.

While the risks will always need to be closely managed by executives, for an industry operating in such a rapidly changing world, insurers will increasingly need to be at the table for the critical decisions that affect it. This will not come as an automatic entitlement in the modern political environment but be earned by sustained and patient engagement with politicians and governments to find and implement solutions to public policy challenges.

Increasingly customer-centricity

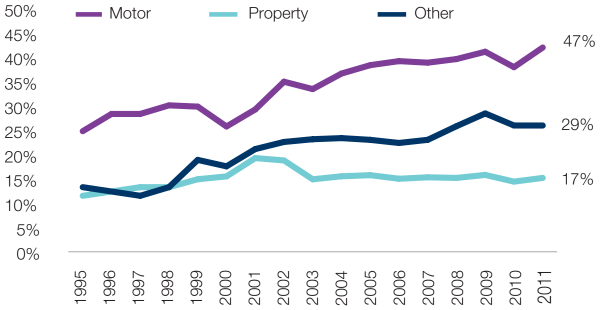
The relationship between insurers and their customers has undergone major changes in recent years and will be increasingly shaped in the future by a combination of product needs, distribution regimes and the impact of digital technology on the insurer-customer proposition.

At the heart of customer-centric businesses are **products that meet customer needs and expectations**, a proposition more easily aspired to than delivered. Some products may be required by customers but be uneconomic to provide, particularly at a time of increased regulatory focus on capital resilience. Other products may be popular with customers but considered too much at risk of causing customer detriment by conduct regulators. Others may be popular with customers but difficult to sustain in particular economic climates; the challenges facing guaranteed life products at a time of very low interest rates are a clear example of this. One area where insurers are increasingly likely to cater to changing customer attitudes is in the appetite for greater **simplicity in products**, especially in the long-term savings, life and protection markets. These so-called 'vanilla' products aim for a simpler product offering with add-ons stripped away and the potential for misunderstanding or mis-selling minimised. The growth of such products will be a recognition of the changing conduct regulation dynamic and political/consumer lobby pressure that products should 'do what they say on the tin' as well as the opportunities provided by internet-based sales channels. Challenges will include the complexity of the design and operation of products sold under the 'vanilla' wrapper and regulatory reluctance to endorse such products in a way that will help build consumer confidence. Mirroring this is also increasing simplicity in service and processes as the industry focuses on stripping out unnecessary complexity to ensure better front-end service to the customer.

How **distribution and advice regimes** develop will be critical to this. In the UK long-term savings market, the Retail Distribution Review (RDR) reforms have severed the long-standing provider-distributor model of selling advised investment products to customers. While this has been driven by the need to ensure customer needs and value are primary, it remains highly uncertain how the long-term market will develop, with the real risk that those most needing access to advice are unable to get it. One possibility is that platforms increasingly take over the gap between the non-advised mass market and the products they may be interested in being sold. Equally possible is that advised retail investment products become the sole preserve of the wealthy who buy independent advice, while mass market customers stick to pensions and ISAs through familiar non-advised channels or very basic fund supermarkets. This is perhaps more likely in the UK context with its poor levels of financial literacy.

In the UK general insurance market which has a more mature blend of direct and intermediated sales (see Figure 9), any future GI version of RDR would have a very uneven effect on the market. The GI market also has its own challenges to ensure broker-based sales always offer good value to customers and underwriters. A challenge already apparent now is how profoundly the internet-based, aggregator sales channels will continue to affect the product being offered with their emphasis on price over value and limited customer engagement on insurance requirements.

Figure 9: Direct sales as a percentage of motor, property and other personal lines general insurance gross written premiums, 1995-2011



Source: ABI Statistics

None of these developments is without risk to customers, especially if the life and savings sector becomes too commoditised as customers prioritise ease of access over a fuller judgement of their financial needs. However in responding to public fears about complexity and in the absence of advice, insurers especially in the long-term savings market are seeking to provide the products customers increasingly want and reverse the traditional perception that it designs products around the taxation system before it has identified a customer need.

The other area in which the industry is increasingly seeking to serve customers is through **workplace provision**. With mass market advice not available, levels of financial literacy low and household incomes under strain in a low growth environment, attention will increasingly turn to the workplace beyond the phasing-in of auto-enrolment to explore the extent to which it can be used to allow for a broader offering of insurance and other financial products, particularly for some of the protection products which complement pension saving.

The workplace is well-placed for this because it can be a convenient market place for employees to buy products they need from a supplier already used by their employer. With platform technology becoming ever more commonplace, employees may increasingly be able to access and transact with retail investment products through an employer-provided scheme. If the sales process needs to be advised, it can either be done through the platform or on an employer group rate, making it more affordable. Either way, in an uncertain world with near-infinite sources of information and frightening consequences for those who take the wrong decisions, the role of the workplace as a 'safer' environment in which to plan and execute important financial decisions seems certain to develop, although not necessarily with the enthusiasm of all employers.

It will be in the interests of policy makers to encourage such innovation as they increasingly search out insurance-based solutions for some of the more intractable problems they face. Policy maker interest will not, in itself, generate product development but it can be an important ingredient in the mix, especially if combined with regulatory engagement. This is apparent at the moment in ministerial approval of the Simple Products initiative and it will be a vital component of any development of a market for a range of Long Term Care products.

Embracing the digital revolution and future role of IT

Testing this ability to innovate will be some formidable headwinds in the face of IT innovation. Capital constraints, regulatory uncertainty, price-driven commoditisation in the GI market, cumbersome and inflexible legacy IT system and subdued consumer consumption in a low-growth UK environment will all have the potential to impact insurers.

"Platforms are fundamentally changing the pension world, potentially reshaping the DC pension market for millions of customers alongside pension reform and the Retail Distribution Review. A brave new world is emerging where customers, their employer, advisers and providers are increasingly working together online."

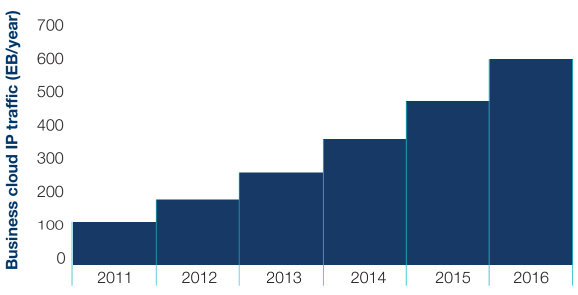
Adrian Grace, Chief Executive, Aegon UK

Nonetheless, insurers understand the implications of the digital revolution and are positive about the capacity of future technology solutions to serve customers better.

Among the opportunities are:

- Increased usage of more cost efficient computing capacity, such as cloud-based infrastructure to analyse, segment and filter the ever-increasing volume of data (see Figure 10).
- Increasing use of platforms to provide long-term savings products to customers in a holistic and modern way.
- Increased connectivity with the customer, both in speed and regularity, allowing greater engagement, more in-depth communication and information sharing and a greater opportunity to develop personal relationships at scale.
- Large and more diverse sources of underwriting data, including social media, telematics and more in-depth claims data.
- Significantly greater distribution opportunities for insurers who are able to set up genuine multi-channel capacity.

Figure 10: Projected volume of business cloud computing, 2011 - 2016



Source: Cisco "Global Cloud Index Forecast and Methodology, 2011–2016"
Note: 1EB = 1 Exabyte, or 1.07 billion gigabytes, or ~43 million blu-ray disks

An important aspect of this investment will be to develop 'built for change' systems that can evolve to meet changing customer, insurer and regulatory requirements in a fast-moving world. For general insurers these will be systems powerful enough to deliver transactional excellence, in volume, while potentially allowing for the greater personalisation of commoditised products that may be required by consumers. For long-term savings providers, these will be systems that allow greater online and real-time access to funds under management, in some cases through platforms. To succeed fully, the delivery of such systems will need to be at the core of strategic priorities within insurance companies.

Developing a closer more effective relationship with regulators

Given that we are entering into a period of regulatory interventionism, a closer more effective relationship with the industry's regulators will not only be commercially necessary but vital for a sector that wishes to enhance its reputation and build stronger customer relationships.

Compliance is not inherently problematic for insurers. As risk managers who match price to risk and assets to liabilities in a measured way within established frameworks, insurers as a profession instinctively comply with rules and respect the importance of high compliance standards even when individual rules are unpopular or considered disproportionate. More broadly, insurers also recognise that to improve the industry's reputation and build the level of private dialogue with regulators necessary to ensure informed regulatory judgements, **they will need to continue to adapt to a world of more powerful, intrusive and risk-averse regulators than many of them have dealt with professionally up to now**. In conduct regulation for example, this will mean accepting the greater onus on avoiding customer detriment as the significance of *caveat emptor* is downgraded and the role of distributor is diminished, with regulatory focus increased on barriers to competition and the function of the market. This will be particularly marked for GI companies that were relatively lightly regulated in the conduct space by the FSA and which will see significantly increased EU-led conduct regulation as well. In prudential regulation, much of the challenge will come from the interplay of international, EU and domestic players as the hard questions of systemic risk, regulatory capital requirements, and global capital standards are thrashed out.

"We face some formidable challenges as an industry; making auto-enrolment work, engaging on long-term care and providing insurance for high flood risk households to name but a few. It is vital we focus on long-term answers to these issues, working collectively to deliver the best outcome for our customers and the UK economy"

Toby Strauss, Group Director, Insurance, Lloyds Banking Group

Adapting to these changing dynamics will demand discipline and patience, not least to avoid anything forcing politicians and regulators into an ever closer public alliance against the industry. But this does not mean the industry will or should adopt a supine approach to its regulatory dealings, simply pulling its punches and resigning itself to decades of regulatory oppression. Insurers will need to actively redefine the relationship themselves, behaving as a partner where opportunities allow, investing in high quality private dialogue and seeking to understand further, (if not always agreeing with) the drivers affecting regulatory behaviour. There will still be occasions when regulators take decisions which the industry will want to challenge legally or publicly. Nonetheless, a closer approach overall offers the potential for insurers to establish a way of working with its regulators that will display public alignment on issues such as company culture, transparency and trustworthiness, while giving themselves some traction when things go wrong.

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Join the debate

What will be the most significant factors for industry reputation in our changing world?

How much will changing distribution models affect provision and design of products?

What will insurers need from their IT systems to serve customers' future needs?

How can the industry adapt to a world of more powerful and risk averse regulators?

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