Association of British Insurers

Identifying the Challenges of a CHANGING WORLD

THE TRENDS FACING INSURERS TOWARDS THE 2020s

CHAPTER FOUR

Insurers and the Economy

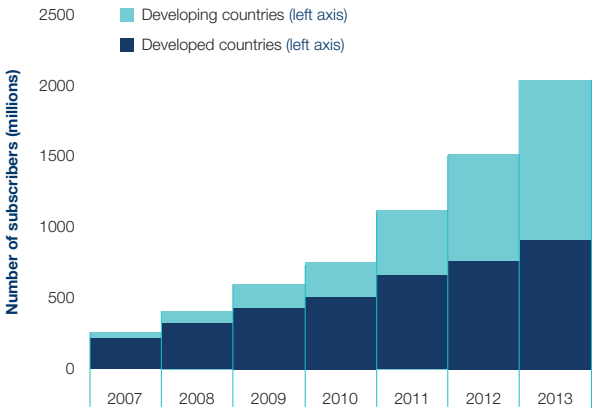
The development of the modern insurance industry is indivisible from the major economic trends that have shaped the last 300 years of human history. It has grown out of the commercial and human needs of industrialisation; the enabling of trade, the protection of property and the provision of basic welfare. In doing so, the industry has built a scale and stake in modern economies that have made it vitally important in its own right as an owner and protector of assets, a major employer, tax contributor and source of macro-economic stability. Now, at a time of unparalleled global economic change, the questions for the future are what role insurers can most usefully play in the mature economies of the West and the fast-growing economies of the East, Latin American and parts of Africa, whether political and regulatory expectations are reasonable and how insurers can place themselves at the heart of the next period in human history.

Among the five over-arching trends likely to shape the next 20 years of economic development are:

- **Growth of the global consumer classes.** Global economic convergence, the ongoing effects of the liberalisation of the Chinese and Indian economies, the relative absence of global conflict and the growth of internet-enabled education will all see the consuming class grow to an estimated 53% of the world's population by 2025[5].

- **Connectivity.** By 2025 the majority of the world's population could have access to a hand held device connected to the world's information sources[10]. This will mean fewer economic units built around a single location (although centres of excellence and places of critical market mass should always prosper) and more complex supply chains connected through the internet, rather than geographic proximity.

Figure 13: Number of mobile broadband subscriptions in developing / developed countries, 2007 - 2013



Source: International Telecommunication Union Statistics.

- **Robotics and 3D printing.** We will see increased use of devices such as robots for basic tasks both at home and work. This will reduce the number of people required to perform these tasks but should free the remaining employees to undertake more productive and innovative work. With 3D printing, the ability to print-manufacture physical objects will offer new economic opportunities for both developing countries where basic needs will be available without lengthy supply chain delays and in advanced economies where it will enable product offerings to be increasingly sophisticated and personalised at lower cost.

[10] The New Digital Age, Eric Schmidt & Jared Cohen, John Murray, 2013. P4/5. See also Figure 13.

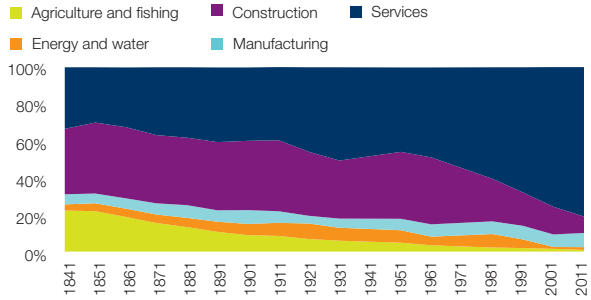
"As insurers, we need to be prouder of our social purpose and become more proactive, especially as the key providers of long-term capital to the economy. We have the answers to many of the challenges of the future and we need to tackle our own tendency to be too defensive and inward-looking".

Nigel Wilson, Group CEO, Legal & General

- **Post-financial crisis recovery.** This will continue to be slow and tough with many obstacles to face. In the UK, the unwinding of the £375bn of Quantitative Easing will require both luck and judgement if economic leaders are to avoid an inflation problem and prolonged market instability. More broadly, the lack of growth in the subdued debt-laden economies of the West could easily continue to loop into a vicious circle of high welfare bills, low tax revenues and a sub-capacity labour market.

- **Under-employment & supply-side challenges.** As global economic forces continue to shift manufacturing labour to emerging economies and to automated devices, labour markets in the West will continue to struggle with the reduction of jobs in manufacturing and agricultural sectors as well as potentially the lower end of the professional occupations (see Figure 14). This will probably continue to affect the young and certain regions disproportionately.

Figure 14: Percentage of employees by industry group, 1841 - 2011



Source: ONS (2013) "170 Years of Industrial Change across England and Wales.
Note: Data for 1941 and 1971 are interpolated. For 1841-1911 percentages are GB-based; for 1921 onwards percentages are based on England and Wales

What then, do these trends and challenges mean for the insurance sector?

There are five areas where the insurance sector's role will be most important:

i. Provision of capital
ii. Funding of infrastructure
iii. Exercising of stewardship and stabilisation of the economy
iv. Protection of assets
v. Maximisation of export strength

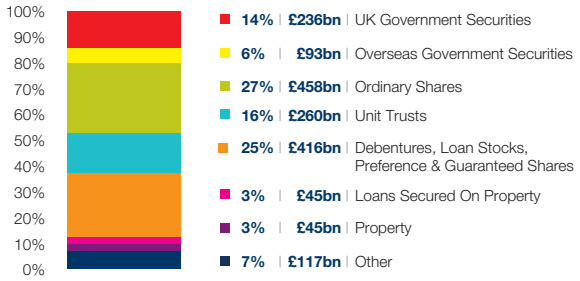
Provision of capital

Insurers remain **core providers of long-term** capital to the economy and also an increasing source of short-term capital as banks are forced to meet higher capital requirements by 2019 (see Figure 15).

Both types of capital will be needed, and not just for infrastructure which is covered below. As a high-speed connected world unlocks the entrepreneurial capacity of every corner of the globe, the need for investment capital by businesses will be profound.

The challenges to unlock and fully utilise the value of capital will be both regulatory and political.

Figure 15: Investment holdings of ABI members by asset type, 2011



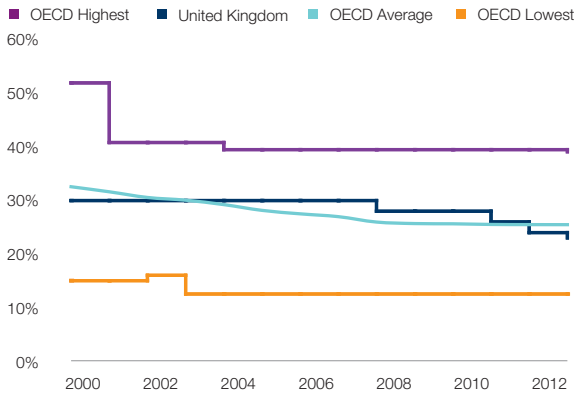
Source: ABI Statistics

For regulators, the focus on investment in supposedly 'safe' **sovereign debt** must be recalibrated to recognise the stability of other asset classes such as corporate bonds and equity. While in the UK the prudential regulatory framework devised in the aftermath of the dot-com and 9/11 shocks proved its resilience in 2008/9, the pendulum has arguably swung too far in favour of sovereign debt that is now more systemically insecure than the equity of cash-rich large corporates. If prudential regulators get this wrong, they could create new sources of systemic risk by building too heavy a concentration in certain asset classes. A similar, currently unresolved, challenge lies in bank debt which has become increasingly unattractive for insurers at the very moment when regulators need them to invest in it. There is an inherent tension between devising resolution regimes for banks so they never again collapse with such calamitous impact on the public purse and enhancing their attractiveness to insurers whose investment capital is

needed in order to meet ever more stringent international capital requirements. Until this tension is more adequately resolved in favour of the insurer, it is difficult to see how the future capital needs of banks can be met fully.

For politicians, the challenge is to continue to create the political, legal, regulatory and tax framework which makes the UK a genuinely attractive place for capital to flow into so that this country can share the benefits of global capital flows. In this, there is some way to go. While the downward trend of headline Corporation Tax has sent a positive signal to international markets (see Figure 16), the mood music created by politically populist attacks on top rate tax and corporate tax structures (however justified in individual cases) has sent a conflicting message about a country not entirely comfortable with the workings of global capitalism. With the establishment of new regulatory authorities in the UK and continued debate about the remit and mission of the European Supervisory Agencies across the EU, the UK faces a significant challenge to demonstrate to global investors that the country remains a location of choice from which to operate.

Figure 16: UK and OECD corporate tax rates, 2000 - 2012



Source: OECD Tax Database
Notes: "OECD Lowest" is Ireland at 12.5% since 2002; OECD highest is United States at 39%, previously Japan at 40% / 41% for 2001 - 2012

Funding of infrastructure

Nowhere are the opportunities for insurers to contribute to economic growth more visible than with physical infrastructure such as roads, bridges, factories and commercial real estate. Across the West in particular, there is a painful apparent mismatch between investment finance being heavily skewed into short-term government debt while the same governments desperately need it to be channelled into infrastructure projects to boost short-term growth and develop long-term productive capacity.

A seminal Group of Thirty report[12] recently identified four major barriers to the provision of long-term finance; *regulatory & mandate constraints on investors such as insurance companies; too narrow a range of financial instruments including limited bond supply and securitisation in emerging markets; excessively volatile and short-term global capital flows and supply constraints such as bank recapitalisation, debt reduction and the investment consequences of an ageing population*. Formidable as these barriers are, the clarity of the analysis offers a way forward for insurers who are keen to invest in a way that combine good long-term returns for their policyholders with contribution to economic growth, boost equity markets and corporate returns.

For infrastructure finance to work at its best several factors are key:

Greater state involvement is critical, including to provide some levels of state-backed guarantee to underpin major projects. Although instinctively resisted by the treasuries of many Western governments, such guarantees are increasingly necessary to secure highly prized capital in a market where it can either go into lucrative short-term investments or to Far Eastern markets where the government, central bank and regulators are prepared to put their backing behind the security of the investment. This is particularly true of construction risk but is also relevant to the debt financing; without the guarantee of a fixed return above RPI, many investors will continue to view UK infrastructure financing as too risky, especially when the unwind of QE poses a medium term inflation risk. The creation of state-backed investment banks (such as the UK's Green Investment Bank) and public-private partnerships both provide mechanisms to achieve some of these aims but they need to be pursued with vigour and ambition if they are to make a difference. Secondly, politicians need to be bold about infrastructure decisions and determined in securing cross-party backing for them to maximise the political stability of the projects with a clear medium to long-term horizon. For politicians this poses difficulties; taking bold infrastructure decisions invariably causes a local backlash in the area affected (although the recommissioning of nuclear power stations is often an exception to this rule) and securing cross-party backing requires patience and courage on both sides. Taking major infrastructure decisions out of the hands of politicians and giving it to an independent commission may be one way forward and was legislated for by the last government in 2010 before being scrapped by its successors but ultimately political support will always be a necessary component of major state infrastructure, not least because even when an independent commission can take a decision, Parliament would still be required to legislate for a major project. In some of the developing economies where the political will clearly does exist to encourage such investment, the challenge is to develop the legal and regulatory framework to ensure investor rights are protected and high standards of transparency and auditing are followed. Finally, the Government has a key role in providing clear regular communication on infrastructure projects to provide insurers and all potential investors a sense of continuity and stability in delivery of long-term projects.

As noted above, **regulators also have a key role** here if their capital rules for both insurers and banks are to facilitate

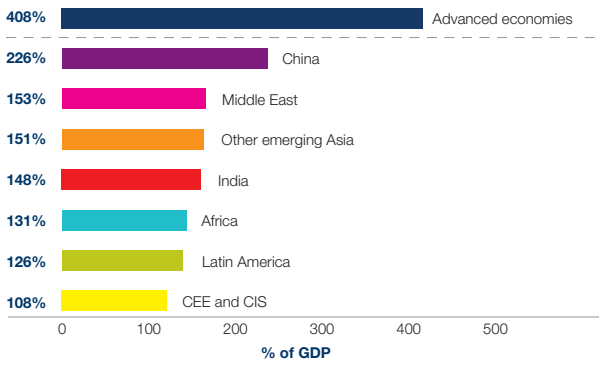
[12] Group of Thirty (2013) "Long-term Finance and Economic Growth".

"The insurance industry in Europe faces two big future uncertainties; regulation and investment yield. Insurers have a key role to play in tackling the economic challenges we face, especially if we build customer support with greater simplification, transparency and claims service."

Clement B. Booth, Chairman, Allianz UK

investment. The evidence of the last five years is clear; the more debates about capital adequacy and resolution are conducted by central bankers and regulators in isolation from elected finance ministers, the less likely it will be that a holistic view is taken about how to regulate risk management and investment in a way that encourages growth. As the Group of Thirty report notes, failure to do so could result in profound systemic consequences further down the line. Another key task for regulators is to tackle the unblocking of the capital markets which remain undeveloped and constrained in many economies (see Figure 17). This is particularly true of the use of corporate bonds which have been significantly under-utilised in relation to bank financing in many countries. Similarly the lack of securitisation markets since 2008, especially for the distribution of long-term debt, unnecessarily constrains the potential supply of investment. Tackling these problems will require the engagement of a range of bodies and governments; without this, it is hard to see how the pipelines will exist to facilitate the necessary flow of investment.

Figure 17: Ratio of debt and equities to GDP for world economies, 2012 Q2



Source: McKinsey Global Institute (2013) "Financial globalisation: Retreat or reset?"

Insurers have a role to play here too; they need to be proactive and vocal in flagging what needs to be done, not waiting passively for everyone else to figure it out. Insurers need to be brave enough to be honest with ministers about the limits of their appetites and work collectively to maximise the investable capital and demonstrate the value of insurance as a sector. This also requires continuing being proactive and engaged in trying to shape vital regulation such as Solvency II, rather than simply criticising from the sidelines.

Exercising of stewardship and stabilisation of the economy

In an increasingly short-termist and high speed world, insurers also have a vital economic role to play as stabilisers in the economy, providing the long-term asset management, corporate stewardship and bank investment which will also be critical to economic development.

Long-term asset management. Over the next two decades the long-term investment horizon of insurers as institutional investors (along with sovereign wealth funds, pension funds and charitable foundations) will stand in increasingly marked contrast to the computer-driven hyper-trading of daily capital markets activity. To a certain extent it already does. At a time when an exchange transaction can be completed in 124 millionths of a second and when company success is measured in quarterly reports, the existence of insurers reliably investing for a period of between 5-25 years will be critical to the economic foundations companies need to build, grow and maximise their productive potential. To achieve this, in addition to the regulatory licence described above, investors need to be allowed by their clients to rise above the day to day and quarterly chatter about performance and focus on genuinely long-term goals. With UK auto-enrolment predicted to lead to a growth in Defined Contribution Assets Under Management of as much as £50-60 billion by 2022[13], it is clear the industry's activities represent a significant stabilising force for the UK economy at a time when levels of personal and government debt remain high.

Stewardship. The scrutiny of major corporates carried out by institutional investors will also remain a key stabilising factor in the economy, albeit hopefully a better understood one. These asset managers are acting on behalf of the insurers who own the assets, who have an important role in defining the standards of stewardship that they expect their managers to meet. Contrary to popular myth (and some political rhetoric), stewardship is not primarily about over-riding Board governance on areas such as corporate strategy, executive remuneration and succession planning, but instead exists to act as a check against complacent practice, a challenge function to group-think and as a watchdog against the capture by the executive management of a company of the independent non-executive directors who represent shareholders.

[13] ABI Internal Modelling

Worryingly for the future, campaigners and some legislators have sought to load investors with broader stewardship responsibilities beyond those that are part of the financial health of the company and into the realm of politically-driven ambitions, such as linking executive pay to average pay ratios. While the UK's Enterprise and Regulatory Reform Bill has stayed just the right side of this line, if the future political direction of travel is to load stewardship responsibilities further with statutory duties, it will act as a disincentive for insurers to continue to handle these responsibilities directly or indeed to invest as heavily in equity markets in the first place.

Protection of assets

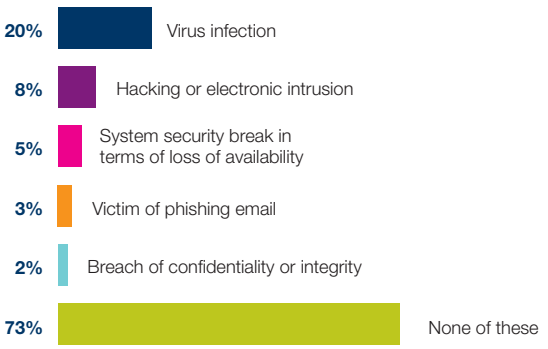
While insurers are commonly referred to as risk managers, an equally valid way to view their economic function is as protectors of assets.

The growth of the **global middle class** as part of a fast-growing world economy will continue to reinforce the value of insurers as essential risk managers and asset protectors. With most of this growth coming from Asia, it would be wrong to assume that consumption patterns will necessarily mimic Western middle class patterns. While the middle classes of the West – especially in the UK – prioritise the accumulation of property and household assets and the insurance necessary to protect them, the middle classes of the East are more likely to protect themselves against ill-health, economic misfortune and the inability to afford education. This is not a binary split, however. With the societies of the West rapidly ageing, the insurance industry is being tasked by governments to help provide retirees with the means of protecting themselves against unaffordable future care costs and drawing down equity from their property assets. At the other end of the age spectrum, the popularity of the latest technology in the East, especially among younger demographics, also feeds a general insurance market in protecting expensive consumer items.

Whether East or West, the future will increasingly see **identity and reputation** valued as assets in their own right and requiring greater protection in a data-centric, constantly connected world. As individuals are increasingly characterised by their online statements, preferences and interactions, the capacity for reputations to be destroyed either by accident or deliberately will be a real threat to a professional's most tangible economic and social asset. In this way, insurance against the misuse of individual data and online presence may soon join the existing insurance need for identity theft protection.

Allied to the threat to individuals from **cyber-misuse** will come the threat to major commercial and public institutions from major cyber failure, caused by either hackers, terrorists or systems malfunction (see Figure 18). In an economy that is based so wholeheartedly on connectivity, the disruption and panic caused by a major cyber failure could easily echo the consequences of major acts of physical terrorism in recent decades. Just as insurers were essential to repair the physical destruction caused by the 1906 San Francisco earthquake, the 2001 World Trade Centre attacks and the 2011 Japanese earthquake and tsunami, so the insurers of the future will increasingly be compensating for the supply chain failures caused by major cyber breakdown, a major underwriting challenge given the complexity of the liabilities that could ensue.

Figure 18: Percentage of small businesses aware of having experienced online crime, 2012



Source: Federation of Small Businesses "Cyber Security and Fraud: The impact on small businesses"
Notes: Sample consisted of 2,667 small businesses. Respondents could select multiple options (excluding "None of these").

"The UK economy faces a major challenge to unwind QE over the next decade. Infrastructure offers a big opportunity to utilise insurer capital for the wider economic good but this requires an active government role and clearly defined yields above inflation as well as appropriate regulatory treatment."

Robert Talbut, Chief Investment Officer, Royal London

Maximisation of export strength

Finally, insurers have a key role to play as exporters, particularly from the UK with its position as the third largest market in the world and home to London, the global insurance capital. As future UK governments continue to struggle with the balance of payments, imbalances created in part by our reliance on Chinese manufacturing capacity, the insurance industry offers a means to promote one of the UK's globally-leading sectors into markets which remain a long way behind its sophistication and expertise. Key to this is Government support in trade negotiations and a broadly supportive regulatory approach.

Several risks stand in the way of achieving this ambition fully. The first is that protectionist attitudes remain entrenched in markets such as India and China, resulting in excessive advance transfer of UK knowledge and expertise as down payments on market opportunities that fail to fully materialise. The second is that domestic governments fail to fully support insurers compared to more glamorous and obviously job creating programmes such as weapons manufacture. Thirdly, any exit of the UK from the EU single market, whatever its democratic legitimacy, would have the potential to impact the UK's ability to maximise its trading potential in a world made up of major trading blocks.

abi.org.uk/jointhedebate

Join the debate

How can the UK maximise its attractiveness as a home for globally mobile capital?

What exactly can Western governments do to attract insurer capital into infrastructure investment?

How can investment arms of insurers retain a focus on core stewardship responsibilities in the face of political pressure to widen their scope?

How can insurers avoid the trap of transferring so much specialist expertise to emerging markets without getting full access to the market in return?

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