Association of British Insurers

Identifying the Challenges of a CHANGING WORLD

THE TRENDS FACING INSURERS TOWARDS THE 2020s

Chairman's message

Tidjane Thiam
ABI Chairman
Group Chief Executive,
Prudential plc

Insurance is one of Britain's business success stories. We provide security and protection to our customers. We are one of the largest sectors in the UK in terms of jobs. We remain one of the UK's most important export earners.

We fund much of the long-term investment which is key to the competitiveness of the UK economy and ultimately drives growth or, in other words, our future prosperity.

As an industry that makes long-term commitments to its customers, we have to focus on and think about the long-term. The nature of our activity means that we have a key role to play to help solve many of today's long-term concerns, from the need to invest in the renewal of our ageing infrastructure to the challenges to traditional social protection models caused by demographic shifts here in the UK and around the world.

We need to continue bringing our distinct skills and experience in understanding and managing risk to bear in working in close partnership with government and regulators to find creative solutions to the challenges facing our customers and society at large.

This important publication sets out how the world is changing around us and what these changes mean for our customers and for our industry. I hope it helps to stimulate debate and ideas about how we as an industry can make a positive difference.

Foreword

Otto Thoresen
Director General, ABI

This is a critical year for looking ahead and considering the challenges our society, economy and industry may face in the years to come. Twin peaks regulation is now in place, we face uncertainty in our relationship with the EU and the economy continues to struggle. We are less than two years away from a general election and the choices are tough, whatever colour your politics.

For the insurance industry, it is easy to be so engaged with tackling the challenges we face today that it can be hard to find the space to consider 'what's next?'

This document represents the ABI 'thinking out loud', discussing what impacts national and global trends could have on our customers, economy and industry. We share some of our thoughts about the challenges we will all be grappling with and how some of this plays out in regulatory, commercial and economic terms.

Our industry has the opportunity to play an even more active role in many public policy areas, but the thinking about how to shape our contribution needs to start now.

I hope you find this document thought-provoking and join us in debating not only what may happen, but also what action we should be taking to ensure we cope with, and take advantage of, the huge changes we all face.

About the author

Huw Evans
Director of Operations,
Association of British Insurers

Huw Evans is the Operations Director at the ABI where he has worked on a range of policy areas since he joined in 2008.

He was previously in the Group Strategy team at the Royal Bank of Scotland Group. Before that, he worked as a Special Adviser to the Prime Minister, The Rt Hon Tony Blair from 2005 to 2006 and to the Home Secretary, The Rt Hon David Blunkett MP, from 2001 to 2004.

Contents

abi.org.uk/jointhedebate

@BritishInsurers #ABIdebate

Follow us on Linkedin

Introduction

We are living through a period of significant and profound change. Global economic and demographic forces are reshaping geopolitics, the distribution of wealth and the future prospects of billions of people. A digital revolution of mind-boggling speed and significance is connecting our entire world in the course of a generation, constantly shifting the parameters within which we live and work, and re-framing the power balance between information-rich consumers and the providers of their services. The financial crisis which erupted in 2007 has been of historic magnitude, shaking every aspect of the norms which governed the relationship in the West between financial services, government, regulators and central banks and potentially shaping economic performance and governmental structures for decades to come.

Insurance is at the fore front of our changing world, almost uniquely affected as an industry by public policy. Insurance is silently woven into the fabric of our daily lives providing cover against the risks inherent in all aspects of human activity; owning homes; possessions and cars; running businesses from the multi-national to the micro; providing for life after work; protection against illness or death; the freedom to travel and a vast array of risks ranging from the threat of kidnap to the preservation of beauty. The management of risk provides an essential invisible foundation to the sophisticated economies and societies we enjoy today, while also reflecting back to us the realities of the world we live in and the consequences of the choices we make.

Insurers face challenges and uncertainties of their own in this world. As providers of risk management to wider society and the economy, they are all too aware of the volatility and difficulty of their own commercial operating environments in which investment yields are difficult to achieve and where the outcome of systemic issues like the Eurozone crisis remain uncertain.

In the following pages, we will analyse how the insurance industry has responded to the changing environment and how insurers can play a more proactive and engaged role in public policy than the sector has traditionally felt comfortable with. In greater detail, it looks at the future issues in relation to the economy, the affordability & availability of insurance products, paying for life after work and changing patterns of regulation.

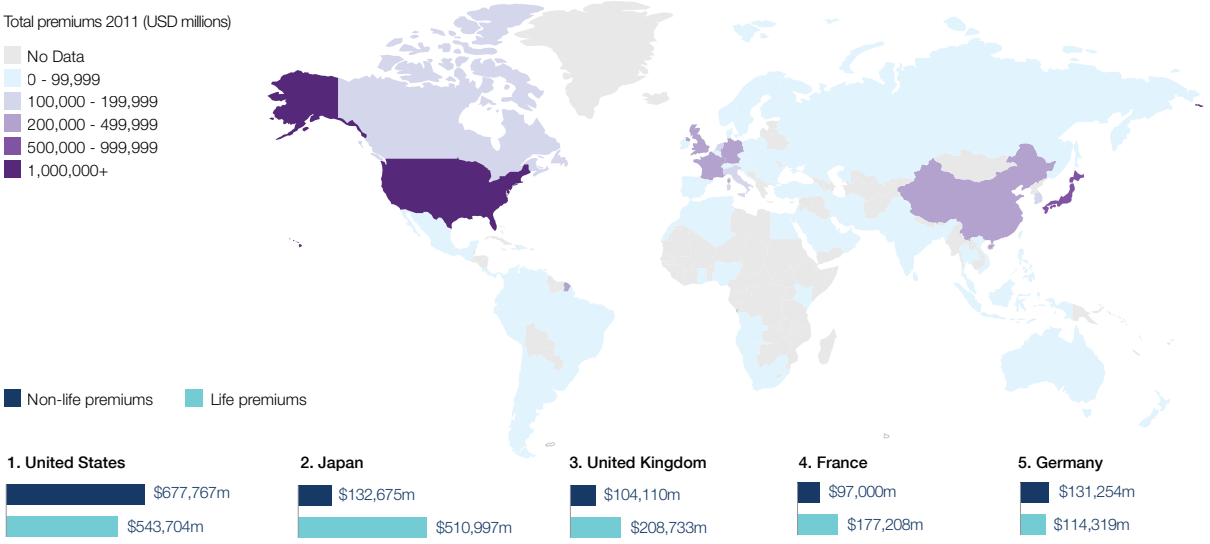
In many respects, insurers in the UK are well-equipped for the future. The UK insurance industry is the third largest in the world and London is the undisputed global capital of insurance and a clearing house for global risk (see Figure 1). Insurers' traditional (and occasionally stereotypical) virtues of prudence, regulatory compliance, industry cohesion and sense of social purpose are back in fashion as the hangover from the boom years persists. Meanwhile, some of the industry's well-documented problems with mis-selling and solvency concerns are further in the rear view mirror than many of the similar problems which affected the banking sector in a much larger way.

This document seeks to understand the developing environment and identify how the world is likely to change between now and 2030, thinking aloud about the issues this presents for the industry.

However, these relative advantages will count for little if insurers misjudge the future. **The insurance industry has a chance to take a more proactive role in shaping what is to come, asserting its relevance and importance to our changing world.** With this more public role could come greater status, recognition and better relationships with its customers. But it would also pose demands; balancing reputation against profits more starkly, greater self-regulation and partnership with regulators and an ongoing commitment to working with governments of every persuasion to find common solutions to major problems, however frustrating the process.

In seeking to explain what the future may hold and think aloud about how insurers may respond, this document aims to stimulate debate within the industry and with its customers and wider stakeholders. It is a debate for which the time has come.

Figure 1: Global insurance premiums 2011, $millions



Source: Swiss Re Sigma (2012) "World insurance in 2011"

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

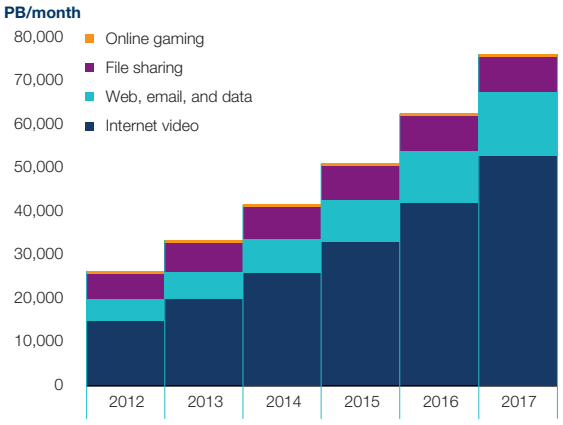
vii. The continued impact of climate change on our environment

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.

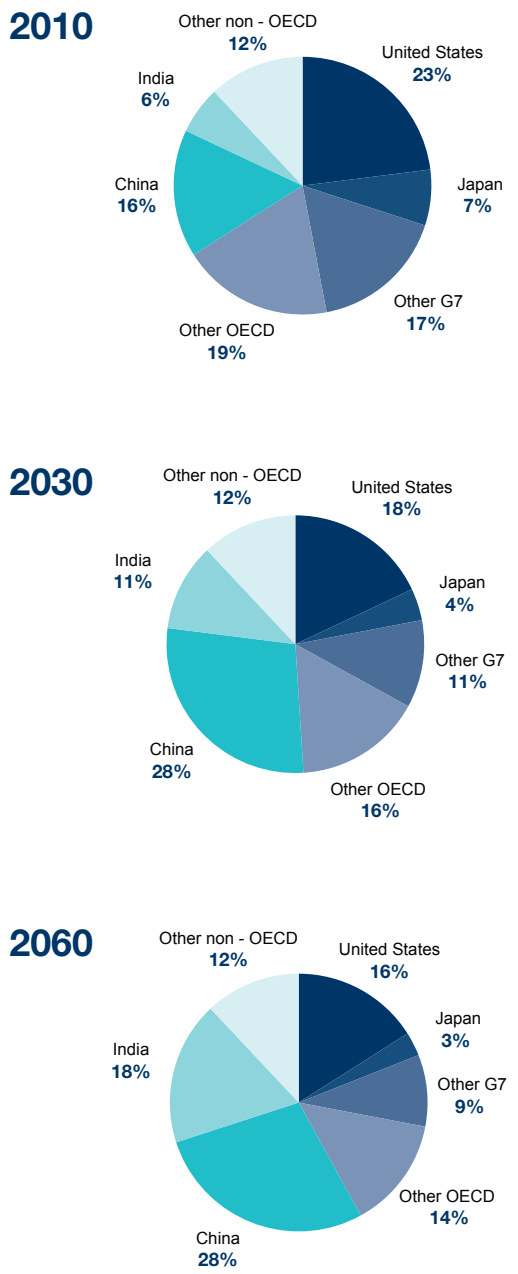
Global convergence; the increasingly inter-connected and balanced global economy

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.

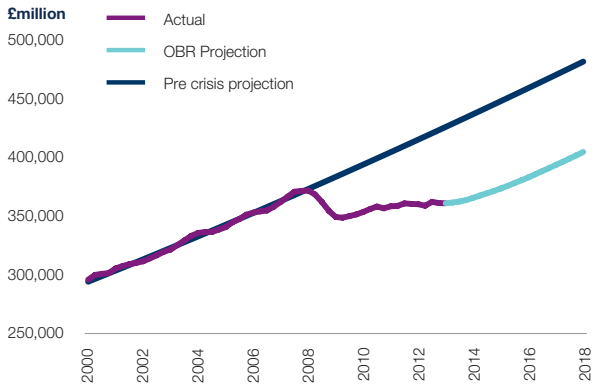
Finally, a converging global economy will need stable energy supplies to meet its consumption needs. This will continue to drive the market for **energy innovation**, maximising the benefits of shale and carbon capture technologies and reinforcing the role of nuclear power too, all needing to be underpinned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

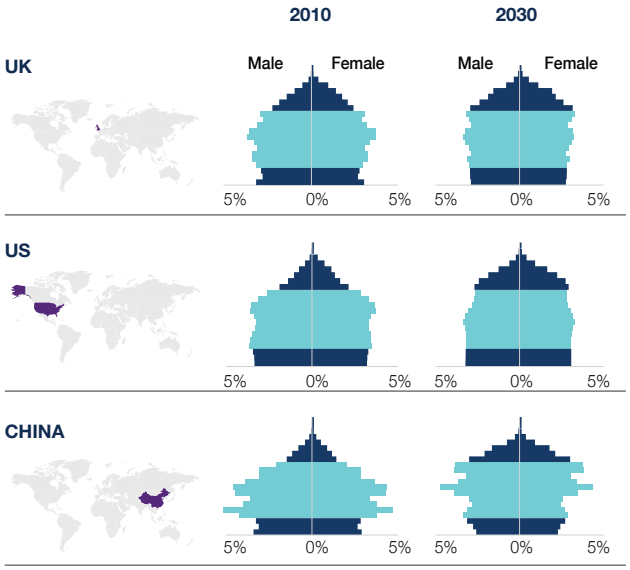
Income decile	Median annual Income	Households with NO insurance	Percentage of households WITH insurance expenditure, and average annual expenditure of these households: Home Contents		Motor		Life	
1st	£6,660	38%	44%	£148	33%	£387	11%	£261
2nd	£10,560	21%	61%	£124	45%	£382	15%	£168
3rd	£14,355	15%	70%	£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

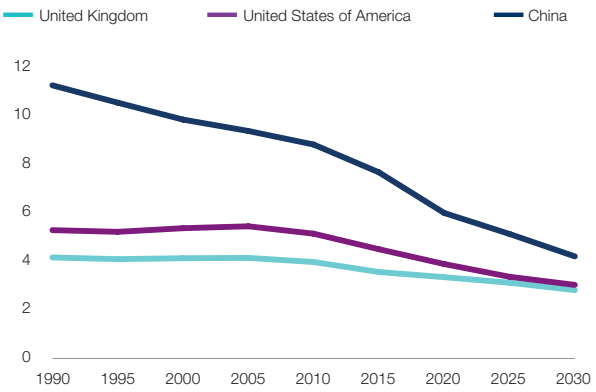
While the world's population will continue to grow dramatically over the next two decades, our own society is ageing and our ratio of workers to retirees is falling (see Figure 6 and Figure 7). This makes the current pensions system increasingly unaffordable. But ageing also brings with it wider challenges 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.

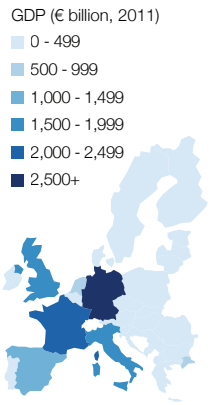
Within the UK, the structural foundations of the United Kingdom will probably have evolved, irrespective of whether Scotland has voted to leave the Union either in 2014 or in a subsequent plebiscite. Structurally, the trend will continue towards increased devolution towards the constituent parts of the 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.

abi.org.uk/jointhedebate

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?

@BritishInsurers #ABIdebate

Follow us on Linkedin

[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.

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.

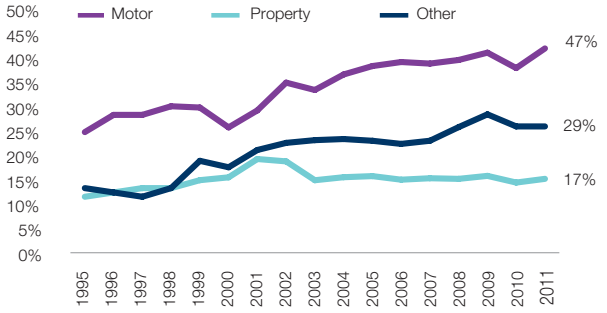
At the heart of customer-centric businesses are **products that meet customer needs and expectations**, a proposition more easily aspired to than delivered. Some products may be required by customers but be uneconomic to provide, particularly at a time of increased regulatory focus on capital resilience. 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."

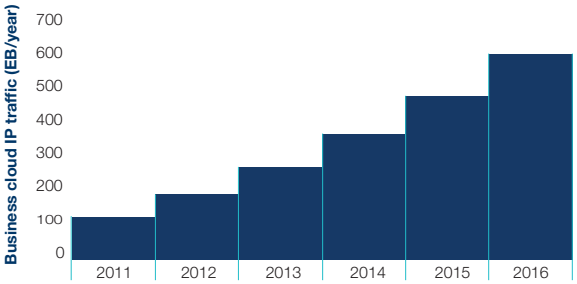
Adrian Grace, Chief Executive, Aegon UK

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.

abi.org.uk/jointhedebate

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?

@BritishInsurers #ABIdebate

Follow us on Linkedin

CHAPTER THREE

Changing Consumer

The industry's relationship with its customers has already undergone significant change over the last 25 years. In General Insurance, the emergence of direct sales and more recently the comparison websites has reframed the customer relationship and undoubtedly driven greater commoditisation. In the Life and long-term savings markets, there have been similar tidal waves of change with the development of personal pensions in the 1980s, the growth of the IFA market, the development of platforms, the recent partial removal of commission-based sales and advice and the implementation of pension reform. Against this backdrop, predicting further change to follow over the next two decades seems more like a statement of the obvious than analysis. Nevertheless consumers are continuing to change in a way that demands analysis.

Five over-arching trends broadly summarise how the consumer-insurer relationship is changing:

i. Greater demands of customer service and complaint resolution

ii. Expectation that regulators will provide greater protection

iii. More engagement in data use and risk pricing

iv. More segmented targeting by insurers

v. Multi-channel relationship, driven by the digital revolution.

Greater demands of customer service and complaint resolution

No insurer sets out to build a system with poor customer service, yet at a time when consumer expectations of product delivery and service are undoubtedly increasing and the digital revolution makes the insurer-customer relationship more public when things go wrong, insurers face the challenges of matching other sectors with higher satisfaction ratings and adapting to a new dynamic where customer communication is even more important.

Paying claims. No insurer in the future is going to meet the expectations of consumers or enhance its reputation and brand without paying legitimate claims in a prompt and customer-centric manner that is fully open and transparent. Insurers will still have to scrutinise claims for organised fraud, customer exaggeration or misrepresentation and compliance with Terms & Conditions but they will increasingly have to do so in a way that is fully open to public scrutiny and compliant with newly established permissions from their customers. The old media handling line of 'We don't discuss individual cases' will seem as obsolete as a dial-up modem in a world where the customer's experience is played out in public among online communities. A greater standardisation of the scope for what a claim covers and how service is delivered will also have to be renegotiated, almost certainly through a combination of conduct regulated and ombudsman established practice and the competitive dynamics of the market place. In an increasingly personalised world, customers may want more flexibility about how their claim is settled although speed is likely to be a standard requirement in a world where so much is transacted instantly. Rules and standard practice will only go so far and the human interaction will remain key; people making insurance claims will still be people dealing with an unwelcome or traumatic event, with their emotions heightened and an instinctive impulse to try and rectify the

"Customers will increasingly expect to feed back on their insurance experience and rate it online just as they do their hotel or entertainment experience."

Paul Evans, Group CEO, AXA UK & Ireland

situation as soon as possible. Insurers who succeed in their customer service in this world will continue to value and invest in meeting the human aspects of an insurance claim, while operating by a set of public practices that can command a broader level of tacit support from their wider customer base, regulators and media. Publication of pay-out data and customer rating of insurers will be the norm with 'Trip-Advisor' style feedback from customers either on the product provider's website or on a separate insurance review site.

Speedy complaints resolution will be almost as critical as claims payment. In a contract-based, volume business where service delivery is dependent on the supply of highly accurate information and the exercising of good judgement, it is a cost of doing business that sometimes both or either of these critical factors will go wrong, even if the product sold was the correct one and the insurance company is acting in good faith in declining a claim either in full or in part. This makes the complaint process for insurers a vital part of 'future-proofing' their business so they can review contentious decisions promptly, benchmark against similar cases externally as well as internally, empower employees to a greater degree to resolve disputes and ensure, where appropriate, senior-level judgement can be exercised swiftly about how to tackle a significant complaint. This is not to say that insurers will have to agree with every complainant in order to maintain acceptable overall levels of consumer trust, **but complaints will have to be rejected on grounds that are evidently fair and consistent to the wider world with whom the process is likely to be shared through social media**. Complaints data will also have to be routinely subject to root cause analysis to convert the original complaints into long-term improvements in service. The danger for insurers may come increasingly – as it does sometimes at the moment – when they hold up the mirror to society on issues that it does not want to acknowledge, as when travel insurers are publicly blamed for the potential high cost of US health care for holidaymakers travelling with a serious pre-existing condition.
Customer needs, of course, are not limited to the claims experience, particularly in the life and long-term savings markets where it is the choice of product which can define the outcome, rather than the claim. Here, we will see an interesting blend of conduct regulation, technology shaped sales processes and insurer behaviour change the way sales are executed and commercial strategies are formed.

Expectation that regulators will provide greater protection

Conduct regulation will play a much more formative role over the next two decades in shaping customer relationships for the long-term savings, protection and general insurance sectors. Ironically this is because customers have high expectations of how far regulators will protect them even though they wield greater power in relation to their insurance company than they ever have given the accessibility of information and the relative ease of moving provider.

For the immediate future, regulatory focus will be on the avoidance of detriment; ensuring customers are not buying unsuitable products, informed sales processes and good product performance, with the underlying analysis increasingly driven by behavioural economics and competition models. Underpinning this however, in the UK conduct regulatory space, is a determination to have a more profound understanding of regulated companies' commercial strategies to be comfortable that sales and profit are being achieved in ways that are 'healthy' and fair and that the market overall is operating in a competitive way. While hard to argue with in principle, it is difficult to predict how this philosophy will be enacted over time. It could easily lead to an alternative – although not desirable - model of regulated 'utility' in which the approval, pricing, sales and performance of products are all scrutinised against regulatory benchmarks. This could drive unnecessary commoditisation and leave customers with a less innovative and responsive market as a result.

More engagement in data use and risk pricing

In a world where our **personal identity data** is more multi-faceted and publicly available, the means by which a customer agrees with the insurer who owns that data and how that data can be used to source and price a product will be vital. Vital to the insurer because it will be impossible to risk price effectively, fairly and competitively without access to all relevant 'public' information, but also important to the customer to ensure they are getting a product which is fully matched to their needs and priced appropriately. This is true whether the product is an annuity, a retail investment product, a critical illness policy or a home insurance policy. Insurers will increasingly have to establish permission levels about what data they need, how

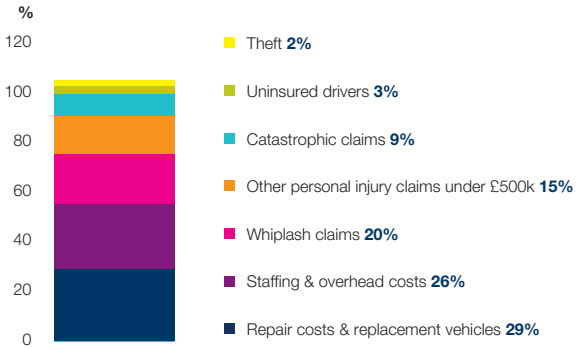
they are going to use it to risk price and how they will protect it. This will require a much more engaged process with customers working through the variety of channels which a customer will use to buy or renew a policy. Future dynamics around risk pricing are explored more fully later but the principle of 'informed consent' will be essential to the functioning of the market and to the likely future framework of data protection at an EU, national and international level. This is a framework which will have to reflect individuals' more permissive and fluid use of their data and to avoid reputational minefields around data permission.

More segmented targeting by insurers, offering a more personalised service

Insurer behaviour is also changing as they increasingly 'segment' the markets available to them to pursue customers who offer the best risk profile for their business model, using technology such as predictive underwriting. **Segmentation** has always been a feature of insurance, particularly in the highly sophisticated UK market where competitive advantage is sought and achieved through detailed risk assessments of potential customers. Because risk appetites will vary, as will business models and capital management strategies, the existing level of segmentation is usually only apparent to customers when those with specialist risk requirements such as high-risk flood properties try to use comparator websites. But with the future volume and granularity of data that will be available to feed computer models, the reality for most underwriters will be the use of segmentation at a level of sophistication hard to imagine now. The extent to which this increased use of segmentation is welcomed or criticised by customers will depend to a certain extent how far it is matched with greater personalisation of risk judgement and how competitive the UK market remains overall. For insurers dealing with the customers of tomorrow in a world where identity will be more defined and more public than ever before, it should be acceptable and expected for insurers to be much more explicit about which group of customers they aim to serve.

With more transparency over the customer base will come greater **visibility on pricing and projection** factors, consistent with constraints imposed by competition law and insurer relationships with third party suppliers. Connected to the world's information sources as never before, consumers in 2030, whether aged 17 or 70, will expect to understand how financial products are priced and expected to perform. In a product like insurance where the blend of risk factors will have a variable impact on the eventual price, this will be especially true. The old maxim that purchasers of such products should leave the engine unexamined to work under the car bonnet will feel outdated and commercially non-viable, whether it applies to fund management strategy, total charges and costs in a pension or the components of a total price for a motor insurance policy. The emergence of this trend is already apparent in the recent ABI industry agreement on charges and costs in pension products or indeed in the motor insurers' breakdown of the component parts of an average motor premium as part of the ABI campaign on whiplash costs (see Figure 11). It will also become apparent as regulators and insurers consider the best ways to engage customers with disclosure for retail investment products, which is likely to result in a broader mix of projection presentation and simpler descriptions of the potential outcomes.

Figure 11: Breakdown of average UK motor insurance premium, 2011



Source: ABI (2013) "Lifting the bonnet on car insurance -what are the real costs?"
Notes: Percentages relate to the amount *paid out* by insurers, relative to an average motor premium of £440 in 2011.

Those customers who have been successfully sold a product should see a greater industry focus on the **retention of existing customers** than has been the case in recent years in the general insurance market (see Figure 12). This will be especially true given the future challenges of amassing all the relevant data and the increasing pressure to pay claims to customers' full satisfaction; the more service levels increase and are the focus of investment, the more commercial sense it makes to retain an occasional claimant and cross-sell to them. Retention will not be easy given the ease with which instant connectivity will allow customers to be tempted to rival providers, some broker antipathy to cross selling to 'their' customers and the current pricing dynamics of the general insurance market which can see insurers discounting the price for new customers heavily at the expense of existing customers. Over time, these pricing practices may have to change if they are not to incur increasing levels of political and regulatory scrutiny and prove counter-productive to insurers' own commercial imperatives to retain customers who fit their business model and risk appetite.

Multi-channel relationships driven by the digital revolution.

Cross-selling will be made much more straightforward by the **connectedness** of the future. Most customers will have a relationship with their insurers through a variety of channels, including online, through brokers and the mobile telephone.

"To significantly improve insurers' reputation, we need to consistently do the right thing between now and 2025, focusing on the long-term benefit to customers of an insurance industry they can fully trust. We have to navigate short-termism and take difficult decisions now before future challenges become insurmountable."

Stephen Lewis, CEO General Insurance, Zurich UK

Figure 12: Percentage of customers remaining with same motor / home insurer at renewal, 2012

Source: ABI Consumer Survey 2012.
Note: "Home" based on 8309 respondents, "Motor" based on 7754 respondents.

Customers will expect to be able to move seamlessly between these channels, including on the same transaction, demanding sales and claims processes that are not dictated by the means of distribution and with technology that is genuinely customer-friendly not just more efficient in the back office.

For platform based businesses, the demands of customers are likely to increase to a more interactive and real-time update service, which may not sit easily with the investment dynamics of a long-term portfolio. For insurers using comparators, the increase in connectedness could help tackle the current 'hollowing out' problem where important differentials get squeezed out of the sales process by constraints on space and functionality.

The trade-offs for both insurers and customers here will be the cost of providing this type of service in the face of cash-conscious consumers who would ideally like ever-more sophisticated, personalised and digitally-enabled service while paying lower prices. One approach may be to codify service levels and charge accordingly, a principle which works well in the transport sector and is practiced to a certain extent with packaged accounts in the banking sector. Another approach may be to segment so relentlessly that better customer service can be provided for a smaller number of customers without impacting profit.

Another outcome may be the happiest of all; that the cost of new IT systems is offset by higher productivity enabling investment to be maintained in customer-facing staff and competitively low prices. In the long-term savings market, however, average costs of a new workplace pension are already at 0.52% with larger schemes going as low as 0.30%[9] so there is a limit to how much lower these prices could conceivably go and still be economic for the provider with good service levels for the customer.

abi.org.uk/jointhedebate

How far will insurers have to adapt current claims and complaint practices to meet changing consumer expectations?

Is the insurance industry sufficiently focused on the future data ownership and protection aspects of its customer relationships?

How will increased use of segmentation feel to customers?

How quickly can the industry prepare for a fully multi-channel future?

@BritishInsurers #ABIdebate

Follow us on Linkedin

[9] ABI (2012) "Time to Act: Tackling our Savings Problem and Building our Future"

CHAPTER FOUR

Insurers and the Economy

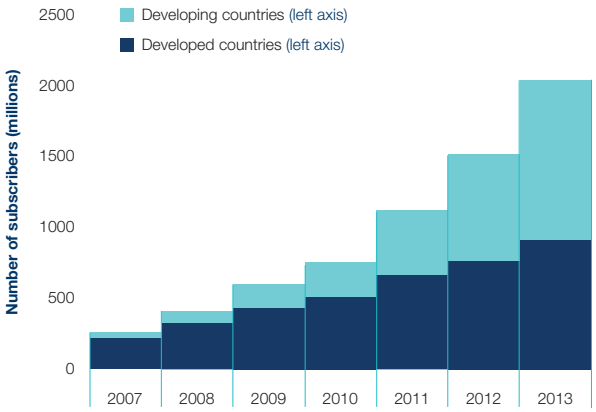
The development of the modern insurance industry is indivisible from the major economic trends that have shaped the last 300 years of human history. It has grown out of the commercial and human needs of industrialisation; the enabling of trade, the protection of property and the provision of basic welfare. 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.

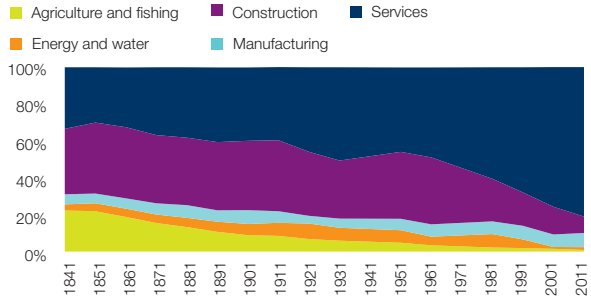
"As insurers, we need to be prouder of our social purpose and become more proactive, especially as the key providers of long-term capital to the economy. We have the answers to many of the challenges of the future and we need to tackle our own tendency to be too defensive and inward-looking".

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

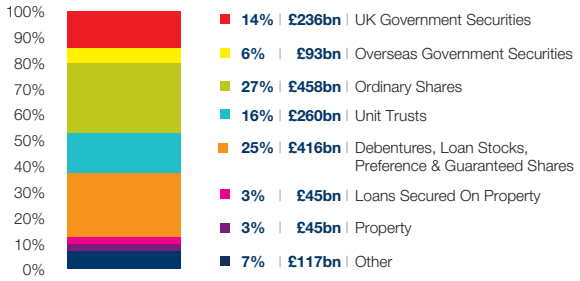
Provision of capital

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



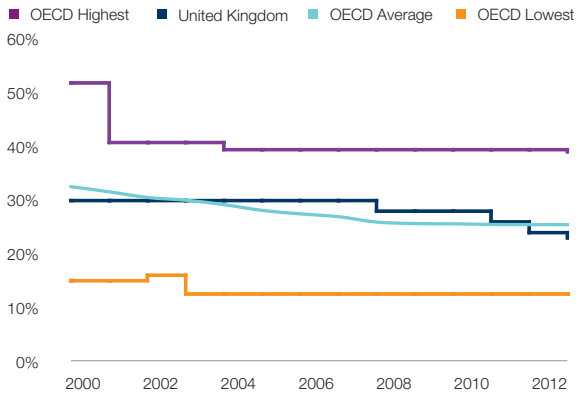
Source: ABI Statistics

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

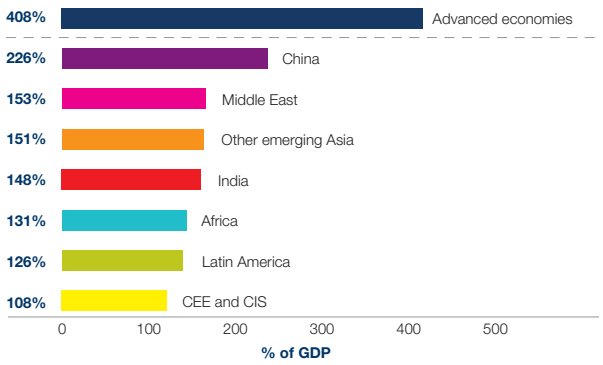
[12] Group of Thirty (2013) "Long-term Finance and Economic Growth".

"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

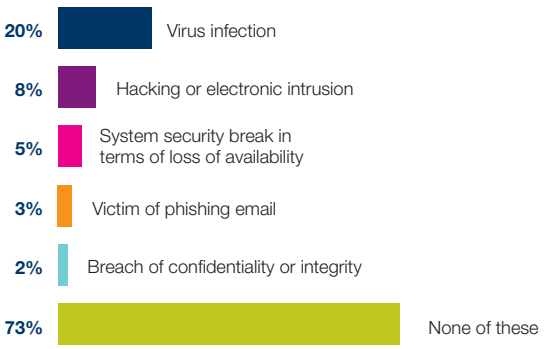
While insurers are commonly referred to as risk managers, an equally valid way to view their economic function is as protectors of assets.

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?

@BritishInsurers #ABIdebate

Follow us on Linkedin

CHAPTER FIVE

Insurers, Risk Assessment and the Availability of Insurance

Insurance companies exist to serve society by managing its risk, yet the way in which insurers assess risk and the consequences of those judgements are under increasing scrutiny and challenge. For general and protection insurers, the weighting and pricing of risk is at the commercial heart of their business. The science of doing so is core to the industry's professional standing and is an integral component of commercial success, especially in an era of low investment returns.

This section looks at the over-arching trends that are shaping the future and some key issues the industry will need to wrestle with if it is to serve customers effectively while preserving its key operating principles and enhancing its reputation.

For high quality risk assessment to remain at the heart of UK insurance, insurers will need to choose a greater degree of proactivity over defensiveness. Insurers will need to be increasingly open and transparent about how they use risk assessment to deliver products that best meet customer needs and price limits.

The issues facing insurers in this area are formidable but they are not unwinnable battles. With sustained IT investment, greater openness with customers, close relationship with regulators and an ongoing willingness to act collectively to tackle problems, the future offers more opportunity than challenge.

Trends shaping the future are:

i. Risk assessment and pricing increasingly under scrutiny

ii. Increased sensitivity to insurance exclusion

iii. Multi-channel access

iv. Increasing segmentation of customers driven by analytics and renewed focus on underwriting profit

Risk assessment and pricing increasingly under scrutiny

There is no single reason why risk assessment and pricing is under more scrutiny than ever before. In part, it reflects the dynamics of the information-rich and increasingly transparent era we live in; this encourages customers, the media and consumer groups to 'demystify' aspects of financial services they do not understand. The advances of science have also played a part, such as in the development of genetics. Many insurers have responded to this trend, seeking to explain more fully what risk factors they use and how these can impact on the availability and cost of an insurance product. Linked to this **search for information** has been less consent from some customers about risk assessment decisions, empowered by the internet and social media to challenge the specific application of risk factors, their accuracy or relevance to the individual or their overall consequences. This has been most notable in the debates around young drivers, flood insurance and annuity pricing where customers have increasingly expressed strong views about how they feel risk factors should impact on the product and its cost. It has also been reflected in challenges about the use of postcodes and how far insurers should be able to reflect differences within postcode bandings.

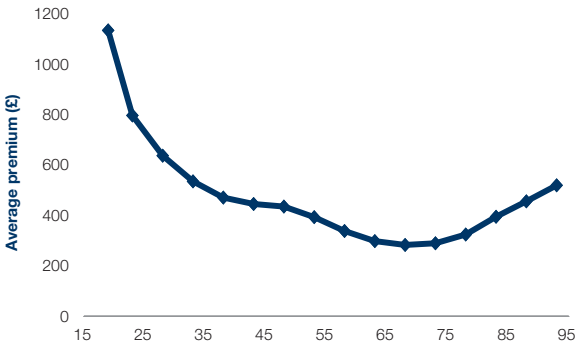
Parallel to this has been **increasing challenge** from both UK and EU politicians and stakeholders to the use of risk-pricing. During the passage of the 2010 Equality Act, many UK parliamentarians called for the banning of the use of age risk factors for travel insurance, while the Belgian consumer group, Test Achats, was ultimately successful in 2011 in persuading the European Court of Justice to ban the use of gender in insurance pricing after it had originally been excluded from the EU's Gender Directive. Interestingly, this decision was widely criticised in the UK by consumers as well as politicians with strong support expressed for the principle of insurers being able to recognise the lower accident rate of younger female motorists.

Insurers too have been continually refining the use of risk factors within their own models, in part because of the renewed focus on **underwriting performance** required by the lower investment returns available when markets are depressed. Some customers have seen a change to the risk they are considered by insurers to pose, which, in turn, has led to greater scrutiny of the factors contributing to this assessment.

Increased sensitivity to insurance exclusion

The biggest area of scrutiny, however, has come in areas where risk assessment has led to **exclusion** from insurance products either because of lack of availability of the product or because the cost is unaffordable for the customer. This has partly come to the fore because particular sub-groups of customers have found the risk-related price for their needs too high, especially young drivers and high flood-risk households (see Figure 19). In both cases, prices have undoubtedly gone up in recent years as the respective costs of compensating the victims of road accidents and the incidences of flood claims have risen.

Figure 19: Market average premiums for motor insurance by age group, 2011



Sources: ABI (2013) "Age and insurance".
Note: Values represent market average premium at centre of each age category.

The recessionary climate has also had an impact; with household incomes down from their 2008 levels and utility bills and food costs rising, higher risk customers have been less willing or able to absorb price increases.

The regional aspect of insurance risk has also became more pronounced, especially in relation to motor insurance. With whiplash claims alone now accounting for £90 of the average motor insurance premium of £440 (see Figure 11), insurers have been focusing relentlessly on assessing those parts of the country where claims management companies are most active and where the greatest number of suspicious claims has been made. When this has pointed clearly to higher risk in regions and neighbourhoods within the UK, prices have been increased to reflect both the higher risk to insurers and the limited industry appetite to take it on. This has led to complaints from local MPs that their constituents are being excluded from the insurance market.

Multi-channel access

However, for the vast majority of customers, the future will be about ever-greater **choice** in how to buy insurance, rather than exclusion. Customers will expect to buy, amend and claim through a full range of channels, including the ability to move between them, in the same way many customers now take it for granted they can set their digital TV box to record a programme via their mobile phone.

This level of interaction will also provide opportunities to encourage personal risk management, offering customers the opportunity to see what their premium would be if they gave up smoking, installed a burglar alarm or a telematics box, a point considered more fully below. This is a variant of the **'nudge'** behavioural economics approach which is increasingly demonstrating its worth in the public policy arena, although the FCA is potentially taking a different view of its utility.

Increasing segmentation of customers driven by analytics and renewed focus on underwriting profit

The huge potential future volumes of data and use of highly sophisticated analytics and predictive underwriting will also be reinforcing and refining insurers' segmentation of their markets, driving a relentless focus on which types of customer a company wishes to serve and designing the product and price accordingly. This is not new; insurers have never wanted to insure every potential customer against every potential risk; taking on too much bad risk can wreck profitability and ultimately solvency. However, as segmentation becomes ever more refined, customers and stakeholders may resent any sense that insurers are picking them rather than the other way round and increasingly argue that insurance is a utility product and should therefore perform accordingly, especially if the product is compulsory like Motor insurance or Employer Liability insurance. Insurers will need to be increasingly up front with their customers about which group they serve and market accordingly, watching other sectors closely, especially the retail sector, to see how they navigate similar terrain.

Key Issues facing Insurers in the future:

As well as responding to these overall trends, insurers face the challenge of some specific industry issues, many of which are familiar, that are thrown into particular relief by the likely dynamics of the future world:

i. How to set renewal pricing that is accepted as fair

ii. How to ensure future products are accessible and fit for purpose

iii. How to balance the use of predictors versus experience in risk assessment

How to set renewal pricing that is accepted as fair

Long-term relationships between businesses and customers are regarded as a positive thing for both parties. However, in certain circumstances, long-term customers of general insurance firms can find themselves disadvantaged by price compared to new customers making the same purchase.

This is not an easy problem to solve. With high numbers of household customers shopping around on price for their annual property insurance, both challenger brands and existing providers looking to re-profile their book of customers will seek to attract new customers by offering initial price discounts. This is normal behaviour in the retail sector and is also apparent in the service sector where an 'introductory' offer will be in place to encourage membership of a gym or golf club where an annual fee is subsequently payable. In the general insurance market, this practice is also fuelled by the presence of the comparator websites with their heavy emphasis on price and by the over-supply of some parts of the market which can lead to too many insurers chasing after too few customers.

The least preferable long-term answer may be a regulatory one, forcing insurers to demonstrate at point of sale the impact of the first year discounted price, so it is clear what the potential impact at renewal will be. A market-driven option would be if an insurer were to seek competitive advantage on the stated basis they did not increase at renewal beyond indexation with the aim of maximising premium income over a five year horizon. An alternative would be complete transparency from insurers to customers that the first year premium included a new customer discount. This could potentially increase churn still further but would limit the chances of the customer being misled about future premium costs. Greater cross-selling may also have a part to play in making the economics of customer retention work, although this would be more complicated when a broker is involved. Without some of these changes or different reforms, it seems hard to see how the current pricing system, however understandable its origins, will survive the challenges of consumers, media, politicians and regulators in the years ahead.

How to ensure future products are accessible and fit for purpose?

The challenges posed by **financial illiteracy** will continue to pose problems of accessibility. As insurers respond to their information hungry customers by delivering more interactive means of assessing policies, the difficulties for those with poor understanding of financial products may grow. The relatively sophisticated judgements involved in buying an insurance or investment product still require a foundation of understanding of concepts such as risk, return compounding and coverage requirements. In order to avoid inaccessibility – or worse, mis-selling – to these customers in future, it may be necessary for insurers themselves to increasingly offer their own online educational tools to help ensure potential customers know what they are buying, in addition to the financial education provided by the State and through bodies such as the Money Advice Service and the Citizens Advice Bureau. This will be particularly necessary because of the failure of the RDR reforms to ensure some form of simplified advice to the mass market.

Many of those with lower levels of financial knowledge will also be those most at risk of struggling with **affordability** of insurance cover, particularly given the likely 'hourglass' shape of UK wealth distribution in the 2020s which could see the lowest 10-20% of the population suffering from considerable economic exclusion, relative to the rest of society. For this group, access to insurance, like all modern day necessities will be a huge challenge on low wages and basic benefits. Given how many people already exist in this bracket, the temptation will be for the market to consider this a permanent, unfixable problem – or at the very least, a

"The digital revolution is changing the balance of power between companies and their customers, making the insurance industry more customer-centric and increasingly reliant on analytics. Harnessing these trends will be an increasingly critical source of competitive advantage."

Paul Geddes, CEO, Direct Line Group

challenge for the politicians running the welfare state to consider. This may be to understate the risks for the industry of this disadvantaged group becoming a lightning rod for political dissatisfaction with insurers who are portrayed – correctly or otherwise – as being uncaring about those unable to afford their product, especially when there are visible concentrations of these people in urban parliamentary constituencies and where high levels of localised crime, fraud or PI claims may create a vicious circle of relatively expensive insurance products for those in society least able to afford them.

Affordability issues are not exclusive to those in the lowest income brackets. However, with levels of disposable income in 2030 predicted to be lower than in 2008[6], insurers will have to build and maintain customer, political and regulatory support for price levels and potentially engage in an almost permanent supply of information to keep customers briefed about how prices are arrived at, the broader risk factors that have contributed and to demonstrate that cost is being managed efficiently to keep prices as low as possible. This is a changed dynamic from now where efficiency metrics are the preserves of analysts, not customers and stakeholders. But if a sizeable chunk of the 'squeezed middle' are finding insurance – or any other consumer necessity – unaffordable in 2030, the digital power at their fingertips via social media will make it very easy for them to focus attention on anything they could argue constituted wasteful or inefficient costs by an insurer which was keeping premiums artificially high, including executive remuneration. Insurers can harness social media as well to have a more open discussion with their customers about the risk factors which lead to unnecessarily high premiums, such as marginal PI claims, fraud and the risks of bad driving. This is more common in commercial lines than in general insurance. The test will be whether affordability issues can be seen as a shared problem between society and insurers rather than something for which the industry is to blame and is expected to fix.

Harnessing **distribution** will also be critical. Without efficient distribution channels, the industry potentially may face a future where it offers good, understandable products at appropriate prices but it lacks the ability to reach potential customers:

- The ability of the **workplace** to offer a trusted environment in which to plan financially and purchase products will offer a major opportunity to make the successful introduction of auto-enrolment the beginning of a major new channel of communication between employee and financial services provider.
- **Brokers** will also have a role, most obviously at the large corporate end but also in helping retail and small commercial customers to bundle together policies effectively and to ensure specialist requirements are catered for in a cost-efficient manner. They too will face challenges over transparency of client relationships and cost.
- **Collective purchasing communities** may also increasingly open up a channel which assists accessibility. This 'collaborative consumption' such as village oil syndicates, the resurgence of interest in credit unions and in online services such as the home-holidaymaker service, AirBnB, could be an essential way for people to group together to minimise the cost of essentials as well as leisure items, with the potential for insurers to use the opportunity of a collective framework to reach customers who would otherwise lack access to the insurance market.

New products will also be important to ensure insurance is meeting the needs of people and business, especially products protecting against reputational damage/data misuse and cyber crime. More subtle will be customers' different requirements of familiar products; **home content insurance will focus increasingly on the value of the data stored in gadgets that are central to the running of the individual's life, rather than on commoditised products like televisions and furniture.** The biggest component of a commercial lines business interruption policy in a decade's time may be the risk of connectivity failure meaning supply chain loss of capacity, rather than physical damage to an office or local infrastructure. In a future where mental health problems are predicted to continue to rise, the most expensive element of an EL or PMI policy may be the cost of mental rehabilitation rather than physical repair following a slip & trip accident. Innovation to meet customer need will have to focus as much on developing existing products as on creating new ones.

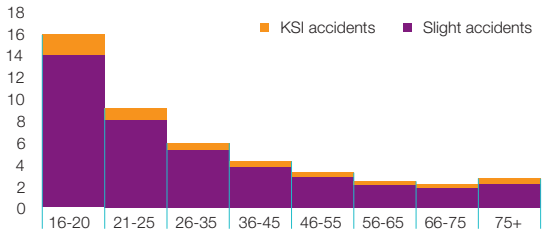
[6] Which? Consumers in 2030 Report

How to balance the use of predictors v experience in risk assessment?

A final – and fundamental – challenge facing insurers over this period will be resolving some of the tensions of how data is actually used to shape risk weighting and the tension between risk assessing on the basis of past evidence and so called 'predictor' factors. In a future likely to be dominated by use of data and analytics, it may be vital to get customer permission for the way in which predictor data, in particular, is used.

The challenge here is the **mismatch between insurer and customer outlooks**. Customers broadly, if wearily, accept that past behaviour affects insurance risk assessment; a penalty notice for speeding will increase motor premiums, as will an at-fault accident. A property premium is likely to go up after an expensive house fire or flood, especially if the causes remain an area of risk. These are also areas where customers are likely to feel a level of control about how they manage their own risks in the future. **Insurers' use of predictor data, however accurate, upsets this dynamic; customers will view their marital status, age and postcode as being facts of life, not proxies for risk** (see Figure 20). They are likely to be particularly unhappy if the postcode on their motor policy is used as a predictor for how likely it is they will be innocently involved in a staged accident where other parties will claim for extensive whiplash injuries. This upsets their notion of fair play and individual responsibility, as well as their belief in the integrity of risk assessment based on proven facts, not educated guesswork.

Figure 20: Accidents per 1000 driving licence holders by age and severity, 2011



Sources: Department for Transport STATS19 Data, DVLA Licence Holder statistics
Notes: Figures show the number of accidents involving a driver in the relevant age band per 1000 driving licence holders in that age band. KSI = Killed or Seriously Injured.

There are no easy answers to this challenge but insurers will gain nothing in the future by avoiding the discussion except the ever more real threats of statutory intervention from MPs representing those most affected. **Insurers will need to be increasingly open and transparent about the predictor factors they use**, the evidence base on which they are founded and any mitigating measures customers can take to dilute their impact. This will mean predictor factors which hitherto have been actuarial curiosities will need to pass more of a public credibility test. The use of postcodes as predictor factors for staged accident risk is partly based on density of claims management companies – this is a fact consumers can understand, even if they resent the impact on them. The more insurers publicise the evidence on which they base their risk assessment, the greater the chance of developing public acceptance which will be a bulwark against political or regulatory interference. Where commoditised systems can be adjusted to offer greater refinement of data, for example sub-post code data, there will also be a neutralising effect.

Most exciting is the extent to which the insurer and insured customer will increasing have a dynamic relationship to assessing risk on the basis of an ongoing supply of data through the extension of telematics to areas such as health and property insurance and annuity assessments. By replacing a static annual data supply with a more engaged process, facilitated by the processing power of modern technology, the customer could feel a greater sense of individual ownership of risk and allow the insurer to rely less on proxies, predictors and other underwriting tools.

abi.org.uk/jointhedebate

Join the debate

How can insurers tackle the increased sensitivity of those excluded from insurance?

What can general insurers do to establish renewal pricing that is accepted as fair?

How can insurers do more to help those most at risk of not understanding or being able to afford insurance products?

How can insurers strike the best balance in risk assessment between experience and prediction?

@BritishInsurers #ABIdebate

Follow us on Linkedin

CHAPTER SIX

Insurers and Paying for Life after Work

In the 70 years since the full establishment of state-provided welfare, the question of how to pay for life after work has been relatively simple to answer with a combination of occupational pension and state-provided support ensuring a respectable standard of life for employees, and the self-employed relying largely on a private pension. Within this framework, the state, the pensions industry, employers and individuals broadly knew their respective roles and accepted them, even as specific aspects of the regime changed.

It has been apparent for some time that this settlement is patently unfit for the next 70 years not least because of the terminal decline of Defined Benefit (DB) occupational pensions, rendered unaffordable by spiralling life expectancy, unfavourable tax treatments, declining(or negative) investment returns and the burden on employers of such generous benefits. A combination of Defined Contribution (DC) pension provision supplementing DB benefits and increasingly generous state provision of pensioner tax credits, benefits, winter fuel payments and free bus travel have kept the current framework staggering on, but few would pretend it is built to last.

Trends shaping future life after work provision are:

i) The need to save more

In the UK, we have long stopped saving enough as a working population to provide the level of retirement most of us wish to enjoy; some rates of saving into DC pensions are half of those normal in DB pension schemes. Just rehearsing some of the barriers to saving - behavioural economics (especially 'present bias'), lower employer contributions, too much personal debt, relatively poor industry reputation after mis-selling scandals, lack of understanding of the product, limited access to products – is enough to demonstrate that no magic bullet can fix the future. Auto-enrolment is an excellent and vital reform to ensure there is a foundation of workplace-based saving on which to build, but not even its most enthusiastic advocates would pretend it could provide an entire solution for the future and it faces its own challenges to ensure persistency, maximum employer and employee contributions, employee confidence in charging and ensuring optimal fund management performance.

ii) Changed economic circumstances

Our economic circumstances have changed for the worse. The foreseeable future will be one in which our economy continues to adjust to the post-crisis 'new normal,' as QE is unwound alongside higher taxes, less government spending and less disposable income for average households. This means more pressure on investment performance, continued stress on savings rates and ongoing uncertainty about the affordability and distributional benefits of the current tax incentivisation system for pension saving. Even when the UK successfully closes the output gap, its wealth relative to the other global powers will continue to decline, albeit to an uncertain extent and with it still remaining one of the wealthiest countries in the world.

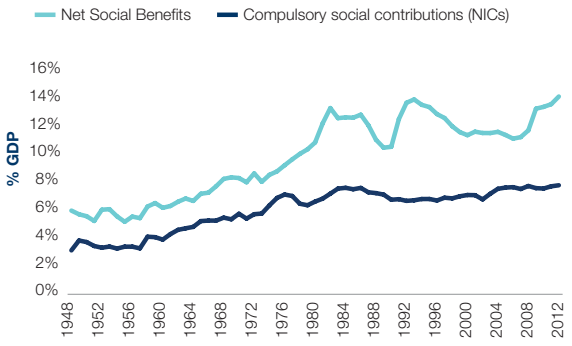
iii) An ageing society

Along with much of Western Europe and even some parts of Asia, our population is ageing and our ratio of workers to retirees is falling, making our current pensions system increasingly unaffordable. But ageing also brings with it other 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 later life care either at home or in residential and nursing facilities.

iv) A welfare state requiring radical reform

The Beveridge reforms of 70 years ago envisioned a basic safety net for all with additional benefits for those who contributed to them during their lifetime. Yet the contributory element has diminished over time while the level of overall state support has increased, resulting in the incentives for people to provide for their future being reduced and misaligned in an overly complex system (see Figure 21). While the proposed single state pension is a step back in the right direction, it is only the first step required.

Figure 21: Net social benefits and compulsory social contributions as a percentage of GDP, 1948 - 2012



Sources: ONS "Quarterly National Accounts Dataset", ONS "Public Sector Finances Dataset"

v) The very significant changes within the traditional life and savings industry
The provider base of the long-term savings market is changing fast too, with traditional life insurers, ranging across a spectrum including platform-based providers, specialist protection and annuity companies, pension buyout specialists and closed book companies. With a mix of ownership models underpinning this wide span of providers, the sophistication of the market poses a challenge for those looking to work with 'the industry' to construct a new framework for future provision.

Key Issues for insurers to address are:

i. How to develop a new framework for accumulation

ii. How to adjust to semi-retirement

iii. How to protect ourselves and pay for care

iv. How to reform our welfare framework

v. How to achieve the political and regulatory consensus necessary for insurers to deliver

How to develop a new framework for accumulation

Auto-enrolment has to remain the foundation for increasing savings between now and 2030. Built with cross-party support after a detailed independent review and EU state aid approval for NEST, auto-enrolment is the most ambitious state-sponsored intervention in retirement provision since Beveridge. If implementation continues to proceed smoothly between now and 2018, meeting the next set of challenges it will face are critical to it making a long-term difference. Firstly, people have to stay enrolled; high persistency levels are vital if the social outcomes are to be reached and for the economics of the low charge to work. This will be made more likely if employee and employer contribution levels continue to rise above the statutory minima, requiring an ongoing political and social pressure to do so. **Auto-enrolment must not turn into a 'done and move on' project for the political classes but instead represent a key part of the future welfare framework** particularly if auto-escalation schemes can become the norm. Behavioural economics has a role here too, particularly in ensuring the right conversation with workplace savers if they are considering dropping out. Studies in the US have demonstrated that conversations focused on eventual retirement income are far more effective in maintaining persistency than dialogue centred on contribution levels or fund management performance, so the more the auto-enrolment offer evolves with higher employer contributions and other benefits such as life assurance, the easier it will be to meet this challenge.

Resolving the future level of **tax relief incentivisation** of saving will also be important to setting pension saving levels over the next 20 years. While the principle of tax incentivising the deferral of income for retirement will remain important in overcoming an employee's natural bias to present day consumption, and in rewarding people for 'doing the right thing'. The likely future cost and distribution of an unchanged framework could be increasingly hard to justify for politicians in the 2020s, providing the industry with a challenge to suggest a more sustainable model that distributes tax relief more evenly and at lower cost to the Exchequer. Such a model could aim to be simpler for savers to understand and could potentially also incentivise insurance for other long-term needs such as later-life protection cover although employers would almost certainly need incentives of their own such as NICS rebate to offer such cover in a widespread way.

For such incentives to be effective, future dialogue with customers will need to focus increasingly on **desired outcomes**, not just contribution levels, especially in a DC environment, where savers need to focus on what they want their saving to achieve rather than view it through a retail saving mindset where short-term performance is important. This can help overcome the instinctive tendency towards present bias and inertia which can impair customer judgement. In particular employees need to focus on the income in retirement that their savings will generate which is often the best and only way to persuade people to save more. The online access to an holistic view of savings that platforms offer should help here and be an increasingly important part of the future.

Some politicians believe that an outcomes focus could be delivered through the increased provision of **targeted-outcome pension products**, such as the UK Government's 'Defined Ambition' suggestion which would seek to offer targeted outcomes in return for specified and persistent contribution levels from an employee and their employer. While such products have the benefit of apparent simplicity to the employee, they also face formidable obstacles. If the intention is to reassure an employee that year-on-year contribution levels will always increase the fund in its early years, it will dictate an investment strategy that will probably be too risk averse to achieve the desired end result. Even without this pressure, delivering a guaranteed product is always more expensive, raising the issue of whether customers are prepared to pay the premium required. Even if they are, such products face significant regulatory headwinds as conduct regulators focus intensely on the avoidance of policyholder detriment as a guiding principle of post-crisis insurance regulation and as prudential regulators worry about the solvency strains in parts of the continental European market created by guaranteed products operating in low interest rate environments. In the UK, the scepticism demonstrated towards 'With Profits' structures from both the new regulators is a reminder of the regulatory unease about savings frameworks where customers have limited power or access to the fund management techniques and structures being employed on their behalf.

Low charges for workplace savings schemes will also be important in an economic environment expected to be characterised by low interest rates, challenging investment

returns and suppressed wage growth. Both the level and construction of fees and charges will become increasingly transparent as long-term savings providers implement the ABI's Agreement on Fees and Charges and as platforms and comparator style websites emerge to compare charges and break down their component parts. Transparency will also shine a spotlight on the levels of cross subsidy which exist in DC schemes between those with low accumulated pots and those with large pot sizes. It is likely that new pricing frameworks will emerge which more accurately reflect administration and investment costs of individual pots differentiating between the fixed costs, which are incurred for every individual, and the variable costs this will reflect the wide range of customers the industry is serving.

The extent to which employers and individuals make **increased use of platforms** may be key to whether the 2020s see people saving more or just saving differently. If platforms can fulfil their potential to attract a wide base of customers to online consolidated saving practices, they could stimulate greater saving and help bridge the uncertainties surrounding moving from accumulation to decumulation which can deter people from pension saving in the first place.

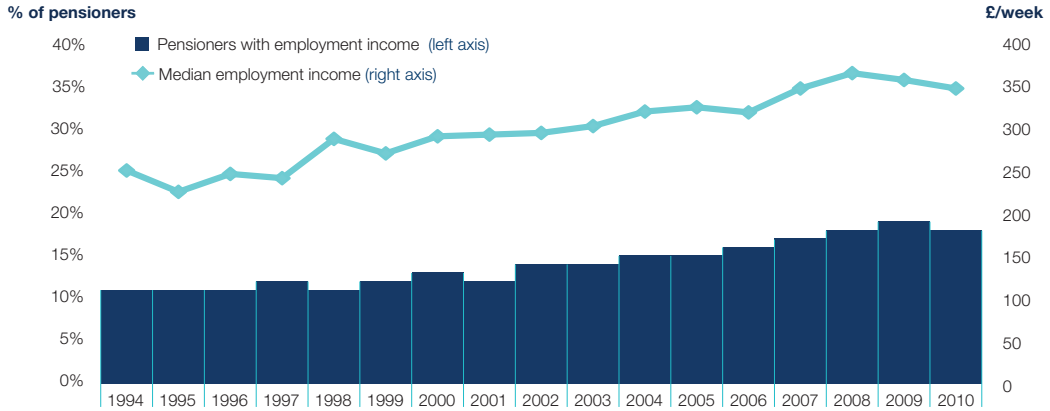
Finally, customers' future needs will also require **simple mass market savings and protection products** that can facilitate short-term saving and basic protection needs for those lacking either the capability or appetite to seek out more complex products. The groundwork for this has been laid with the Government's recent Simple Products taskforce. While such products would attract low initial deposit and premium levels for providers, they could encourage good habits, build and protect assets and underline the wider importance of insurance to a healthy society. In a future where advice may be only the preserve of the upper end of the mass affluent group and above, simple products will also be a necessity, although to be fully successful they may require a degree of regulatory approval that will be difficult to secure in the initial phases of the new conduct regulatory regime. Whether the Simple Products initiative delivers a new suite of products or not, it seems likely that in a world characterised by information overload and complexity, there will be a market for starter products on a mass market non-advised basis.

How to adjust to 'semi-retirement'

As a society we are still just about clinging on to the concept of a fixed universal retirement age acting as the gateway to a life of non-work, it will seem increasingly meaningless in the 2020s.

By 2010, 18% of people drawing a pension also had a paying job of some sort; a trend badged as **'semi-retirement'** by KPMG (see Figure 22). This makes economic sense for pensioners who may not have benefited from the generous occupational schemes otherwise typical of the working lives of their generation. But it also reflects the better health of these retirees in their early years and the growing belief that full sudden retirement can be bad for physical and mental well-being[14]. Over the next 20 years as the retirement demographic takes on those who typically had a mix of pension provision involving lower employer contributions, society will need to adjust more profoundly for this group of semi-retired people. The welfare system will need to encourage their continued working by avoiding benefits or tax traps that negate the value of post-retirement employment, while a labour market needs to continue to evolve that can utilise the potential supply. In an ageing society, we will all need to get more comfortable with the idea that certain types of work are done by the semi-retired, just as we now accept as commonplace how much of the civic volunteering fabric of our communities is provided by pensioners.
A similar shift in attitude may also be needed in our approach to **property equity**. Culturally, the British are more likely to trust the value of our bricks and mortar than

Figure 22: Percentage of pensioners with employment income, and their median employment income, 1994 - 2010



Source: DWP "The Pensioners' Income Series 2010-11".
Note: A pensioner is defined as an individual over state pension age, or a couple with one or more individuals over state pension age.

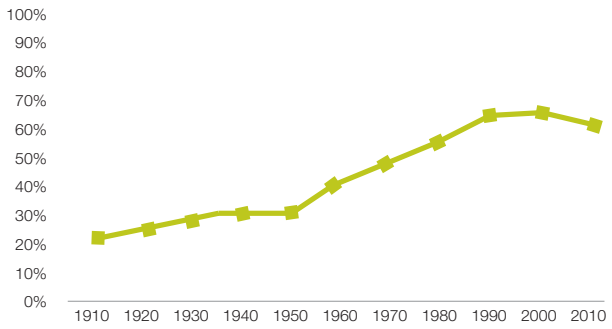
[14] 'Work Longer, Live Healthier' Report, Institute of Economic Affairs, 2013.

"We face significant challenges, not least an ageing population, the decline of Defined Benefit pensions, a reducing state pension and a low growth/low interest rate environment. The core social purpose of retirement and protection products will remain but we will have to adapt our product offering, investment strategies and standards of transparency if we are to deliver fully for customers and maximise returns."

Andy Briggs, Group CEO, Friends Life Group

we are to instinctively trust the assets invested with our banks, our governments or our pension providers. The home is often instinctively viewed as an illiquid asset, often maintained with a view to inheritance for the next generation rather than to be utilised for ourselves (see Figure 23). For many, this could be an unsustainable position in the decades ahead. If people are to continue to live longer but save less, they will need to adjust to a view of the home as a critical asset that may have to be partially realised at the appropriate time in our retirement to ensure the level of care (residential or otherwise) and income we would wish. For those who wish to avoid this route at all costs, it needs to be explicit that they must make greater savings provision before retiring, work during retirement or have the means to purchase at-need protection products to avoid a forced sale of their home when long-term care is required. Insurers will also have a key role to play in this, needing to produce products with the flexibility to offer people a range of options for realising value from their property assets and which are affordable and accessible to customers while not overly capital intensive. Regulatory attitudes will be critical. With property owner patterns also changing as high deposits and significant levels of student debt see increasing numbers of first time buyers in their mid-late 30s, this will remain a difficult, albeit necessary, area for the market to serve.

Figure 23: Percentage of owner-occupied households in England and Wales, 1910 - 2010



Source: ONS (2013) "A Century of Home Ownership and Renting in England and Wales"

The **annuity market** will also face challenges in a world with more 'semi-retirees' as the retirement trigger point and decision become more complex to judge. A more flexible decumulation regime seems inevitable, driven by customer demand and by the impact of platforms on behaviour. Meeting these challenges may be difficult as providers of enhanced, partial and deferred annuities are forced to regularly adjust their measurement of the norm in the face of increased demand, especially as public requirements of annuity options grow.

Outcomes-focused products, whether guaranteed or not, may also be a bigger part of the market as people without any component of DB pension seek to establish a degree of certainty in their retirement provision. With regulators sceptical, outcomes-focused products may come to encapsulate a new paradigm that having moved away from a world in which long-term savings products were designed around tax and IT systems, long-term savings products instead have to be built around conduct regulatory permissions.

How to protect ourselves and pay for care

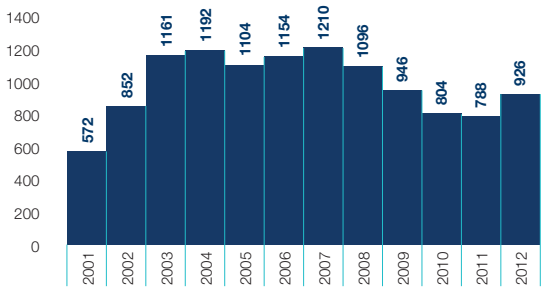
The change in attitudes needed towards budgeting for care is already underway as some of today's pensioners deal with the challenges of their own parents' ageing and as the NHS struggles to cope with the impact of dementia-related conditions on its primary care capacity. These pressures helped lead to the setting up of the Dilnot Commission on **Long Term Care** with the principal recommendation of a fixed cap on private provision for care costs (but not residential costs) accepted by the Government in February 2013. The Dilnot framework is potentially a promising one; accepting some (although not all) long-tail liability for the State and offering the industry the opportunity to develop products that can help customers meet their liabilities of paying up to the cap and accommodation costs. While a modestly sized immediate needs annuity market exists at the moment, the challenge here is to see if social attitudes can change enough to persuade people of the validity of paying for a protection product over a period of years that could offer them some financial cover should they end up needing residential care in later life. **This is a major**

challenge in a society as rooted in consumer spending as we are and where many people carry an exaggerated sense of what the State will provide for them in old age. On the other hand, people do buy such products to protect their income and living standards from critical illness which may never happen (albeit to potentially cover a present need such as a mortgage) and the more people become familiar with the care system through personal experiences with their older generations, the more possible it is that such products could connect with customers. For wider levels of self-provision to be developed in the 2020s, customer engagement with the trade-offs involved will need to become more profound; how far will people expect to be sure of receiving any benefit from a protection-based insurance policy and how far in advance will they consider purchasing one? What will be the trigger points in the life cycle that will act as 'prompts' for action and how can appropriate advice be given prior to purchase? How sufficient would their expected level of retirement income be to cope with care costs? These will be significant questions to answer, and they will increasingly overlap with the broader policy and public dialogue around savings.

Distribution will also be critical here. For some, protection benefits are already provided by the employer as part of **the employment package** and devising a more formalised system to bundle with auto-enrolment could well be the most successful way to build coverage to meet society's future liability. One way to promote and develop such products could be with a voluntary employer contribution and tax relief, like a pension scheme, so that employees had a clear incentive to prepare for the future. However funded, employers could be critical to any significant renewed provision of savings and protection products in the future for reasons of scale, trust levels and ability to provide basic advice.

Equity Release clearly has a role to play too, as noted earlier. The mis-selling and mispricing of the late 1980s market has long been replaced by a smaller, functioning and profitable market, successfully self-regulated with an ABI code (see Figure 24). However, it remains small and some social stigma remains to the concept of not passing on a home intact as an inheritance. Critical to the successful development of a future market would be the regulatory environment. If Solvency II is finalised in a way that proves difficult for annuity providers, it will potentially restrict capital availability for the market to develop or scale up Equity Release products. From a conduct perspective, the sales process for a significant mass market proposition would need to be clearly agreed and understood with regulators to avoid any increase in the market supply being met with a blizzard of avoidable concerns. Developing products with greater flexibility such as partial release will also be important.

Figure 24: Total value of advances in the UK equity release market, 2001 - 2012, £million



Source: Equity Release Council statistics

Developing product **understanding and performance** will also be vital to build a broader protection market. This means insurers would continue to standardise and self-regulate on issues such as non-disclosure and changed circumstances which have bedevilled the reputation of many protection products, fairly or unfairly for many years. With publication of pay-out data becoming the norm too, it should be easier for protection insurers to build greater confidence in the value of their product and better understanding about the range of circumstances covered, especially if in the context of a reformed welfare state.

How to reform our welfare framework

It is hard to look far into the future and see the current welfare framework surviving unchanged into the 2020s. Three aspects of a revised welfare framework seem likely.

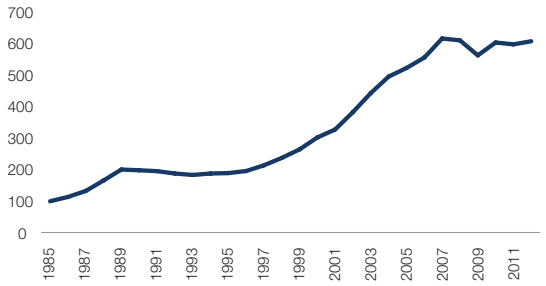
The first is an increased focus on the **poor and the vulnerable** which may be forced on society rather than chosen by it. In contrast to the cultural norms in many of the emerging economies, the British state and wider society has sought to provide some form of basic welfare safety net since the Elizabethan era. **If distribution of wealth in the UK continues to develop into an 'hourglass' shape, the scale of economic problems facing the bottom 20%** and their relative lack of opportunity to escape them will have its own momentum and require a significant focus of welfare provision to prevent social breakdown and destitution and uphold the standards of protection for children and vulnerable people we now expect as a society. These problems will continue to become more expensive for the state as the cumulative effects of multi-generational unemployment and social exclusion build further and the barriers to work and economic productivity therefore grow ever higher.

We are also likely to see a revival of the **contributory principle** as politicians are confronted with the rising cost of an unreformed welfare state and seek to minimise the other options of increasing general taxation or significant benefit cuts. The contributory principle was one of the

foundations of Beveridge's vision for the British welfare system, built on the concept that the state pays out most to those who pay in the most. For it to succeed in the future, it will need to regain the support of the middle classes by offering confidence and clarity to those contributing. In practice, this would mean no more blurry use of NICs to pay for services such as the NHS and the continuing removal of universalism, tackling non-means tested benefits such as the Winter Fuel Allowance and free bus passes for pensioners, which will be politically controversial.

The extent of **wealth transfer** within the current welfare framework will also come under scrutiny; our system now enshrines an unprecedented level of wealth transfer from the under-35 working population and the self-employed towards those in retirement, many of whom have already benefited from a significant uplift in their net wealth thanks to the relative rise in house prices over the 25 year period to 2008 (see Figure 25). While this transfer initially helped tackle the very real problem of pensioner poverty, it is hard to see how this is sustainable for the 2020s, especially if the burden on the working population is increased further by more increases in general taxation to fill the projected gap in public finances in the 2015-20 Parliament and with the added impact on the under-35s of saving for higher mortgage deposits and paying back higher education debt.

Figure 25: House price inflation 1985 - 2011 (1985 = 100)



Source: ONS House Price Index Table 33.

Welfare reform may come in small, grudging steps rather than through grand plans but change is inevitable. For as long as the old quip remains relevant that the British want Scandinavian standards of welfare provision with American levels of personal taxation, the challenge will be formidable to reform a welfare system that is increasingly strained by the tensions within it.

How to achieve the political and regulatory consensus necessary for insurers to deliver

For insurers to play a full part in meeting these social challenges, the gap between political appetites for solutions and what **regulators** are prepared to countenance will be increasingly important to bridge. Although they are reluctant at the moment, regulators will need to become increasingly involved in these debates about how products needed to equip future generations for life after work can be made to work, engaging with the trade-offs necessary to marry together political, social and regulatory imperatives.

No less challenging will be attaining a measure of **political stability and consensus** among political decision-makers and their opponents. Providers of long-term savings and protection products are natural partners of governments, but much greater cross-party consensus on the big issues of the future will be essential to achieve meaningful change, just as it was key to the establishment of auto-enrolment. This will require a more proactive industry which is bolder in its thinking, setting a compelling but politically neutral agenda which politicians can engage with and which feels inclusive of the needs of society as a whole. This will never be easy to accomplish but it is a vital task for the future to achieve reforms the industry can support and work with.

abi.org.uk/jointhedebate

How can we build on auto-enrolment so it becomes the foundation for healthier saving and protection levels?

What steps can insurers take to be ready to meet the needs of the semi-retired?

How can the industry build on the new Long Term Care framework to meet customer and political expectations?

What welfare reforms are most needed to ensure the best alignment with the provision available from the private sector?

@BritishInsurers #ABIdebate

Follow us on Linkedin

CHAPTER SEVEN

Insurers and Changing Regulation

Financial services regulators were heavily blamed for their part in the financial crisis and changes to their structures, institutions and leadership were implemented quickly from 2009 onwards in the UK, EU and USA.

This swift reaction of political decision-makers was a reminder of the huge reliance political leaders have on regulators' performance in managing the risks of sophisticated, interconnected and highly complex financial markets, the size of which easily overshadow national economies. Failures in regulation contributed towards the collapse of significant financial institutions in the UK, USA and continental Europe, costing billions to these economies in lost shareholder value, output failure, credit shortages, low tax returns and higher welfare costs.

With the creation of the European Supervisory Authority for insurance comprising the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) in the EU, the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA) and Financial Policy Committee (FPC) in the UK and the Federal Insurance Office (FIO) and Financial Stability Oversight Council (FSOC) in the USA, the main structural changes have been completed for the time being with new leadership teams established. This chapter explores the extent to which trends have emerged which the UK and EU institutions will follow and explores the key issues likely to shape their future development. While the UK regulatory system is now based around two separate prudential and conduct regulators, their establishment at the same time and in the wake of the worst UK financial crisis in 80 years has led to a very similar initial outlook across both bodies.

Trends shaping the future for UK regulation of insurance are:

i. A focus on judgement and outcomes

ii. Early intervention in a low-trust environment

iii. Customer-centricity, repositioning the customer/insurer balance of responsibility

iv. Better understanding of the big companies and market dynamic

v. Emphasis on the culture of insurers and self-regulation

A focus on judgement and outcomes

The new UK regulators have been tireless in proclaiming their adherence to a new focus on judgement-based regulation, centred around outcomes, not principles. This is unsurprising but may not prove as big a change as it sounds, given the limited degree to which the FSA lived up to its proclaimed ethos of principles-based regulation.

A key challenge will be to to establish a greater degree of certainty about what regulators consider 'appropriate' outcomes actually mean in given circumstances, including the extent to which such outcomes are solely a matter between the regulator and the regulated company or whether in practice they take into account the wider impact on society. The initial caginess of regulators to talk specifics should give way over time to recognised best practice emerging, whether regulators intend it to happen or not.

Where regulators have not been cagey is in their insistence that they do not see their job as being to prevent failure of regulated companies, merely to ensure orderly resolution which protects the broader financial system as well as the interests of customers. This is unsurprising, given the reputational risks for the new regulatory institutions of being perceived to have failed when a regulated company collapses, but it remains to be seen how practical the proposed resolution regimes would be in the event of a major failure and whether the new regulators could really escape the reputational risk such a failure would bring.

Early intervention in a low-trust environment

Early intervention as a core method of operating is now explicitly stated as being central to the approach of both prudential and conduct regulators when conditions demand. This is partly borne from the PPI scandal but it also reflects an explicit lack of trust as the starting point for supervision and regulatory engagement; companies will have to prove, not assert, their overall health and the performance of their product suite and expect early intervention if they fail to convince regulators. Even so, a judgement-based approach does not necessarily mean that such judgements can be reached more quickly; early intervention may prove to be more of a threat than a routine and will always carry risks for regulators.

Customer-centricity, repositioning the customer/ insurer balance of responsibility

Being responsible for customers is not just a conduct issue; it is central to the statutory objectives of both the PRA and the FCA and top of EIOPA's stated priorities. In practice this means is a repositioning of the balance of responsibility between insurer and customer; the customer is now viewed as being less responsible for their own decisions and needing greater protection from insurers. Given their differing timescales this will be easier to rebalance in practice for the FCA than for the PRA.

Better understanding of the big companies and the market dynamic

Both regulators place explicit credence on the importance of fully understanding the business model of a large regulated company and analysing the competitive dynamics of the market. For a company, this is an approach which seeks to work upwards from the bottom line to identify core profit drivers, scrutinise the resilience of current product offering and future strategy and understand the strengths and weaknesses of the business. It is also reflected in the FCA's move away from the Arrow system to greater face to face meetings, the focus on issues and products and greater use of thematic reviews and Section 166 powers. The downside of this approach may be cost to the industry, especially if regulators rely heavily on consultants for commercial expertise. More broadly, the focus on competitive dynamics requires a different way of thinking from both regulator and regulated, raising challenges about the extent to which a market overall is working for the benefit of customers rather than the sole focus on compliance that many firms have become used to. This raises an interesting dynamic for an industry that is continuing to think collectively about issues of market dynamics and raise them proactively with regulators as has happened increasingly with motor insurers' engagement with the OFT and Competition Commission inquiries.

Emphasis on the culture of insurers and self-regulation

Again, regulators have been clear in their emphasis that regulated firms having the right internal culture is a 'must-have' with a leadership team from Board downwards that aims to do the right thing for customers and which prioritises the long-term health of the business above short-term considerations. This means companies being increasingly challenged to view regulatory standards as a minimum they should operate above, rather than play strictly to the rules and find ways to game them. However, it is unclear how wide the spectrum of permitted behaviour will be and the extent to which firms want to be invited to judge this for themselves rather than being given a set of rules and operating by them. This could potentially impact the appetite of the industry to self-regulate. Particularly problematic will be requests to operate 'within the spirit' of regulations in the absence of hard guidance from the regulator especially when the FCA has begun to articulate a more negative view of the role of behavioural economics than has been in evidence in the auto-enrolment debate.

Key regulatory issues for insurers to address are:

i. How do regulators manage 'post-crisis bias'
ii. How to ensure regulators balance domestic responsibilities with international focus and perspective
iii. How to develop and contribute to regulatory thinking on the customer
iv. How regulators should manage the increased visibility and public profile they now hold
v. How can regulators ensure the most productive relationship with the politicians to whom they are ultimately accountable

How do regulators manage 'post-crisis bias'

A key challenge facing the new institutions will be avoiding 'post-crisis bias' with regulators becoming overly institutionalised in thinking that is shaped by the events that led to their creation, rather than focusing on future risk. This is partly demonstrated in the priority given to **resolution arrangements** over the prevention of failure. While it is hard to argue with regulators revising an agreed set of resolution processes, the key future challenge will be the prevention of avoidable failure by taking rational and clear-sighted judgements on what constitutes a fundamentally healthy company. As the 2007-8 market failures demonstrated, when crisis hit it was the swift co-ordination of decisive action by governments, central banks and industry leaders that mattered more than orderly resolution regimes, not least because it is hard for any resolution regime to be quicker than the markets. A similar challenge exists for prudential regulators in relation to asset allocation; if regulators' views are too influenced by the last crisis, they risk creating new sources of systemic risk.

The other area where 'past-bias' may be too evident is in **conduct risk**. While more analytical on the drivers of detriment and over-arching risks, the FCA's recent 'Risk Outlook 2013' document still highlighted over 60 pages some 40 areas of individual conduct risk, exploring every conceivable angle of potential detriment. In this, the ghosts of the FSA's handling of the PPI scandal are all too evident in seeking to ensure that no future risk could possibly emerge that has not been publicly flagged.
While the scale and reach of the PPI scandal make it an obvious starting point for a new conduct regulator, the danger is that this single scandal is relied on too much by regulators to inform a future in which entirely new products will increasingly be sold using multi-channels, the workplace and specialist brokers. While both the PPI and Libor scandals demonstrated lamentable practice within the financial services industry from which lessons must be

learned, both relied on long established operational practices rather than being automatically relevant to a future world which could operate very differently.

How to ensure regulators balance domestic responsibilities with international focus and perspective

Equally challenging is the extent to which the new UK regulators understand and are equipped for the future international regulatory framework.

Having failed to address relationships outside the UK in their early pronouncements, both the FCA's and PRA's main recent policy documents[15] have now stated the importance of engaging early and proactively with **EU and international regulatory institutions** to ensure the formulation of high quality regulatory policy that is consistent with UK practices and markets. It is also encouraging that the new UK regulators have already demonstrated a degree of flexibility in interpreting complex EU legislation such as MiFID passporting rights for AIFM firms. Both are vital; UK regulatory leaders have been noticeably insular in recent years with only a few honourable exceptions. Exercising leadership effectively outside our national borders will only become more important in the 2020s to regulators who will have to form ever more sophisticated judgements about how economic and regulatory inter-connections can be managed. Equally importantly, UK and EU regulators will have to be mindful of the regulatory approaches taken in increasingly important Asian markets if EU-based insurers are not to suffer from relative over-regulation.

Even without these globalisation challenges, UK regulators face the challenges of an **uncertain political environment** with the 2014 Scottish independence referendum, the proposed EU referendum in 2017 and the proposed Banking Union for Eurozone member states. The regulators who succeed in this environment will be those who keep their focus outwards to understand the changing world, influence it and navigate its difficult terrain.

How to develop and contribute to regulatory thinking on the customer

The emerging thinking of both UK regulators looks likely to reframe the relationship between the customer and insurer over the period ahead with the long-standing principle of **'caveat emptor'** (buyer beware) which has underpinned much of English consumer law being **diluted** significantly in favour of the insurer taking primary responsibility for the product from its design through the sales process and into its life after purchase. Although the recent Consumer Insurance Act 2012 also rebalanced the burden onto insurers, the UK regulatory approach goes further, viewing the customer as a fundamentally weak counterparty capable, whatever the purchase, of being hoodwinked during the sales process or inadequately protected by a long-dated product.

Although insurers have supported consumer legal reforms and understand the regulatory climate, it is questionable whether this view of such a weak consumer is fully future-proof. Thanks to the internet revolution, the consumer has significantly more power in their relationship with an insurer because of the correction of much of the **information asymmetry** that traditionally made the relationship so unequal. It is true customers may not understand much of their new-found information either because it is too complicated or their transactions are too infrequent to build understanding. But nonetheless, given the scale of connectivity that is going to happen over the next 15 years and the inexorable rise of public customer ratings and feedback mechanisms, there is a danger that at the very time when customers are better informed and empowered than at any time in recent history, they are being wrapped in compliance-driven regulation which dumbs down their relationship with a product provider.

A similar question mark must exist about the extent to which regulators can deny any responsibility for wider **socio-economic outcomes** that frame the society in which customers live and which they are conditioned by. This is critical for insurers whose products hold up a mirror to the realities of society. In establishing the FCA, its leaders have been very quick to assert they are not responsible for wider socio-economic outcomes and are limited to the implementation of their statutory objectives. While strictly true, it is hard to see this approach surviving far into the future. This is because ministers, who are paid to worry about socio-economic issues, will always apply pressure, subtle or otherwise, for regulators to take account of government policy in choosing how they implement their statutory objectives. Secondly, if regulators are to be genuinely focused on what is best for customers, it is difficult to divorce this from the fast-changing wider society in which these customers will be buying and using insurance products.

A broader challenge for both the regulators and the industry will be how to differentiate appropriately between the interests of different groups of customers. This is particularly relevant to insurance which relies on the principle of pooling risk and a degree of educated consent by the customer to the content of the insurance contract.

How regulators manage their increased visibility and public profile

The future public profile of the new regulators and its impact on how they operate is also a fascinating future dynamic. Both the new CEOs of the new UK regulators and the Chairman and the CEO of EIOPA have adopted relatively high profiles, accepting that the environment in which the new bodies have been created is one in which these powerful regulators will expect to be more publicly accountable for their organisations and more willing to speak out on issues of public concern.

[15] The Prudential Regulation Authority's approach to insurance supervision, April 2013, Journey to the FCA, October 2012.

"The biggest consumer challenge we face is how to provide advice to the mass market. Regulators, politicians, financial advisers and insurers need to find a way forward if we are to meet the needs of customers and employers."

Phil Loney, Group CEO, Royal London Group

On the whole, this is a healthy development; anonymity has sometimes allowed mediocrity to flourish. It is also inevitable given the digital revolution and the premium placed within our information-rich world on leadership views and official sources of information. The challenge for the future will be the extent to which this **high profile, public leadership** interferes with the relationship of trust and engagement that also has to exist between regulators and the CEOs of the major companies they oversee. In the past, the critique of such relationships was that they could be insufficiently robust and too close. Clarity of communication will be essential to ensure that regulatory leaders can be both credible public figures with the political accountability and media scrutiny that brings, without sacrificing some of the balanced judgement and understanding of complexity that will give them credibility with the CEOs they interact with.

This reflects a broader future tension between visibility and effectiveness. Given the circumstances of their establishment, the new regulators will be under significant and ongoing media pressure to demonstrate their value with **public criticism of industry practices** as well as high profile enforcement action. Indeed, the FCA lists among its three-year metrics for the period to 2016 that it aims to have 'successfully intervened to ensure customer benefit' as well as to have used its early intervention power. Setting targets to use intervention powers is potentially at odds with the stated aim of a framework in which firms exceed regulatory minimums and minimising conduct risk is inculcated throughout customer-facing activities. Insurers will expect to find their new regulators staffed with high quality professionals who are capable of meeting the challenges of the future and whose skills levels justify the fees increases. Indeed, if fees continue to rise without tacit industry consent, it will do much to damage the relationship. While at this stage, public targets about intervention may just reflect the trade-off necessary to establish credibility, the tension for regulators between building professional and meaningful relationships with regulated firms and using the soapbox of public visibility to maintain licence to operate and leadership credibility will be a permanent dynamic in the future.

How regulators can ensure a productive relationship with the politicians to whom they are ultimately accountable

Managing the tension with politicians between **public policy and regulatory requirements**, will also prove a challenge, especially in the early days when regulators will be keen to demonstrate their statutory independence from political pressure. The challenges are real however as the Government's recent enthusiasm for Defined Ambition (DA) pension schemes has demonstrated when guaranteed retirement schemes, such as the mooted DA model, are increasingly out of favour with both conduct and prudential regulators in Europe and the US because of their risk to insurer capital, the difficulties of resolution and the risk of consumer detriment. Ministers will need to be increasingly aware of the need to engage with regulators in developing public policy ideas, while regulators will find themselves being asked to health check policy proposals in a way they may find uncomfortable.

More broadly as the debate on stimulating economic growth dominates ministerial thinking in all the major capitals of the West, regulators will increasingly find their major projects scrutinised against its impact on growth, such as the challenges to Solvency II over its potential effects on infrastructure financing. In a future world where tighter more intrusive regulation is the norm and can emerge from a range of international forums as well domestic institutions, ministers and regulators will find it impossible to operate in separate silos and will need to establish better protocols to frame their relationship.

Join the debate

abi.org.uk/jointhedebate

How significant is the danger that the UK and EU over-regulate in relation to Asian competitor markets?

How can the industry help our national regulators operate effectively and proactively at EU and international level in the future?

How can insurers increasingly help illustrate to regulators the need to analyse socio-economic factors in judging consumer outcomes?

What can the industry do to bridge the gap between political and regulatory imperatives and how best can it avoid being stuck in the middle between them?

@BritishInsurers #ABIdebate

Follow us on Linkedin

"In simple terms, our task is to help people have confidence about their future money. With automatic enrolment, we have an opportunity to vastly improve the quality of later life for millions of people in the years ahead and embed the savings habit. This will help build a more financially resilient and inclusive society for current and future generations alike."

David Nish, Group CEO, Standard Life

Conclusions

Identifying the challenges of a changing world for the UK insurance industry is a reminder of its unique range, depth and sophistication. Insurers therefore have more at stake than most in judging the implications in the future for its customers, business and reputation.

Several themes have run consistently through this document:

1. The pace and scale of change in today's world. This is an extraordinary time in human history with momentous forces interacting in a way that raises considerable uncertainty about how our economies, societies and quality of life will develop. For insurers, all these changes matter whether demographic, economic, climate-related or driven by the ever-changing technology landscape which shapes our lives.

2. These challenges will continue to have a major impact on an industry that is already changing very significantly. Whether because of customer demands, technology, regulation, reputation or capital demands, the notion of a single insurance industry will continue to be stretched by a wide array of business models.

3. Consumers are changing rapidly too, as their needs become more sophisticated and their expectations of service providers are shaped increasingly by technology and a sense of information-driven empowerment. Future customer attitudes to data will be one of the most challenging areas for insurers to gauge in the decades ahead.

4. Insurers will have a vital part to play in the significant economic challenges facing both West and East in the years to come. As with many other areas of its relationships with governments and regulators, this will require the industry to be more proactive and visible in its approach to public policy than it has traditionally been comfortable with.

5. Core insurance approaches will be under challenge in the years ahead from governments, regulators and customers. Insurers will need to defend their use of risk, continue to address problems of exclusion and engage with customers in new ways to assess risk and develop confidence in investment outcomes.

6. The challenge of paying for life after work will also be a critical test for the industry with high stakes for its reputation, the customers it serves and the shareholders it is accountable to.

7. The regulatory road ahead will represent a huge adjustment for insurers to make at a UK, EU and international level. Regulation will form an even bigger and more complex part of insurers' operations than at present, with the potential to redefine not just operational norms but available markets and customer liabilities.

Do you agree with these conclusions?

How should the insurance industry prepare for the 2020s?

Join the debate

Let us know what you think

abi.org.uk/jointhedebate

@BritishInsurers #ABIdebate

Follow us on Linkedin

Acknowledgements

All members of the ABI Board for their generous contributions to this document; Tidjane Thiam, Paul Evans, David Nish, Andy Briggs, Simon Lee, Robert Talbut, Nigel Wilson, Stephen Lewis, Clement B. Booth, Bronek Masojada, Paul Geddes, Phil Loney, Toby Strauss, Adrian Grace, Jackie Hunt.

Also thanks to Trevor Matthews, Rob Devey, Bill Cooper, Nick Pearce, Ian Mulheirn, Andrew Haldenby, Matt Cavanagh, Sean McGovern, Steven Cameron, Which?, Andrew Dunn, Otto Thoresen and the Executive Team & colleagues at the ABI, especially Louise Hanson, Lorna Wiltshire and Kelly Ostler-Coyle. Special thanks to Katharine Evans.

The charts and fact-finding for this document were done by Dan Sadler, the ABI's Economist whose contribution has been invaluable.

Designed by iloveclive.co.uk

Association of British Insurers

For more information
Association of British Insurers
51 Gresham Street,
London EC2V 7HQ

020 7600 3333