

# Vision for the insurance industry in 2020

a report from the insurance industry working group





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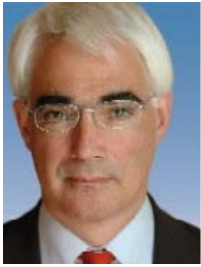
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## Forewords



The Insurance Industry Working Group report sets out a Vision for the insurance industry in 2020.

The Government and the insurance industry already work together to improve outcomes: to reduce floods, crime and road

accidents, for example, and to insure against the risk of inadequate income in retirement through pensions and annuities.

However, there are still more opportunities to work together to improve customer outcomes. Our shared interest in ensuring people have the financial capability to make responsible decisions about their futures is emphasised. We should also seek new ways of cooperation, share data and expertise and collaborate to ensure insurance is more accessible and more widely available.

This report identifies the importance of continuously improving confidence in insurance products. The Government, the Financial Services Authority, as the independent regulator, and the industry as a whole all have parts to play in ensuring that insurance promises are seen to be fairly communicated and appropriately kept.

Much is already in train to make improvements in this area. For example, the FSA's work to embed the principles of Treating Customers Fairly and improve sales processes through the Retail Distribution Review.

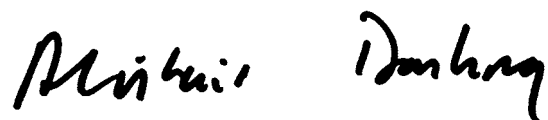
Action by industry will also be an important part of the jigsaw to improve customer outcomes. This report's commitment to improving transparency and simplicity in insurance business is welcome.

Lastly, I am glad that, while this report has been prepared against a background of financial instability, the Group have been able to reflect on the fact that the insurance industry has not experienced the sort of difficulties the banking sector has during the financial crisis.

This is in part because issuing insurance policies presents different risks to accepting deposits, but also because the prudential regulation regime for insurers has so far borne up well. This is a strength we will seek to build on as we work with industry to implement the Solvency II Directive.

This report sets out an agenda for us to work with industry to overcome these challenges and to support the industry in achieving the Vision for 2020.

Insurance is an industry in which Britain has a global lead. Government and industry must work together to build on this advantage to ensure a thriving insurance sector creates skilled jobs all around the country; contributes to exports and growth; and plays an important part in building Britain's future.



Alistair Darling

## Forewords



The great contribution that the insurance industry makes to the nation is largely invisible. The fact that the industry employs over 300,000 people across the UK is there for all to see but the psychological and financial security that is provided by the insurance industry is probably even more important.

Insurance products protect individuals and businesses against a wide range of risks - everything from poor health and terrorist attacks through to provision for a financially more secure future. By reducing the impact of any problems, the insurance industry allows people to bear risks with greater peace of mind. In this way a thriving market for insurance products underpins the everyday lives of private individuals, the transactions of business and the good conduct of government policy.

This is a crucial industry which provides a service to society without which the burden would fall to the individual or the state. The financial crisis has served to heighten consumers' views that the world is a far riskier place and there is a greater need to protect what is valuable to them and provide for those that they hold dearest. Like many other industries, we have not been immune to the financial crisis but although we are in the heart of financial services the insurance industry has weathered the storm well compared to other sectors.

There has been a great deal said and written about regulation across financial sectors, most of it critical. It needs to be said that the prudential regulation of the insurance industry has proved to be successful in a period of extreme volatility in financial markets.

A strong insurance industry provides a welcome, steady hand helping people back onto their feet. It is easy to see the role the industry plays when facing

risks such as the current economic turmoil where families and businesses alike are dealing with greater hardship. In these circumstances, the insurance industry plays a vital and stabilising role in softening the blow. However, it is not just in times of economic turmoil that the industry is needed but for everyday disasters large and small. The 2007 floods are a good example of the positive role the industry can play in maintaining a strong functioning society.

However, the risks we face keep changing shape and in particular we need to keep thinking about the longer term challenges. Long after we have proven our mettle by rising to current economic difficulties, we need to show that we can respond quickly and effectively to rising global competition and more mobile capital flows. In this country we need to show that we can respond proactively and efficiently to the risks posed by an ageing population and climate change. We must ensure that what we deliver continues to build consumer confidence and trust.

With these future challenges at the forefront of our minds, and at the request of the Chancellor of the Exchequer, the Insurance Industry Working Group (IIWG) was formed to make recommendations for the future.

The clear Vision for the insurance industry in 2020 began with an objective that is easy to define but difficult to achieve - to ensure the UK fulfils its potential as the leading global insurance centre with an unsurpassed reputation for excellence, a constructive relationship with its customers and an effective partnership with government.

An underlying theme throughout the report is the need to develop greater consumer trust and confidence in the insurance industry. Specifically, there is a desire for better customer engagement through greater financial education and awareness. In addition exploring opportunities with the

Government where the insurance sector can play a greater role in managing risk in society has the potential to increase savings and protection provision. To support all these aims we must also ensure that the environment in which the industry operates is competitive. This is key to enable the UK industry to attract capital, particularly in a world where capital is extremely mobile.

The industry cannot hope to achieve these objectives alone. Commitment from the Government, from the Financial Services Authority and from a range of other stakeholders will be vital.

Our recommendations should not be broken off and implemented piecemeal. To maximise their effectiveness they should be taken forward as a package. The recommendations complement each other, build on each other's strengths, and together create a virtuous circle. The ultimate objective is a stronger UK insurance industry which competes globally, consumers who are more confident, engaged and informed, and through a combination of these, a Government more able to respond effectively to future social and economic challenges.

The stakes are high and it is important not to lose momentum contained within this report. The Group is committed and determined to follow through and implement these recommendations. They would also benefit from a consensus of all the interested parties. That is the aim. The prize we can secure is great – a contribution to economic stability and growth. More importantly, greater prosperity and peace of mind for the population in the face of the risks we run every day of our lives.



Andrew Moss

# The insurance industry working group

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Rt Hon Alistair Darling MP, Chancellor of the Exchequer

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## Executive summary

The UK insurance industry is the second largest in the world and plays a unique role in helping individuals and businesses protect themselves against the every day risks they face. It employs some 313,000 people in the UK (twice as many as motor manufacturing) and is responsible for investments equivalent to around 25 per cent of the UK's total net worth.

Like many industries, the UK insurance sector has been affected by the financial crisis. However, both the insurance industry and the UK's prudential regulation regime for insurance have so far stood up well to testing economic conditions and the insurance industry continues to provide a vital contribution to the UK economy.

Against this background, the Insurance Industry Working Group (IIWG) was asked by the Chancellor of the Exchequer to consider ways of enhancing the role of the UK insurance industry in view of the medium to long-term challenges and opportunities facing the sector. The IIWG is pleased to provide its views and recommendations on how these challenges and opportunities should be met.

The IIWG has agreed a Vision for the insurance industry in 2020. It wants the UK to be the **leading global insurance centre with an unsurpassed reputation for excellence, a deep and constructive relationship with its customers and a close and effective partnership with the Government.**

This Vision is underpinned by four main themes:

- establishing a more customer-focused approach to increase customers' confidence and trust in the insurance industry, and a greater awareness of their own personal responsibility;
- offering a broad choice of risk management solutions, which are competitively priced and provide customers with the products they need;
- acting in partnership with the Government to explore options to increase savings and protection provision and to help consumers manage financial distress in their daily lives caused by accidents, ill-health or old age; and
- encouraging capital flows into the UK insurance industry by ensuring its competitive position in the global marketplace is maintained and enhanced, and that capital can earn a competitive return.

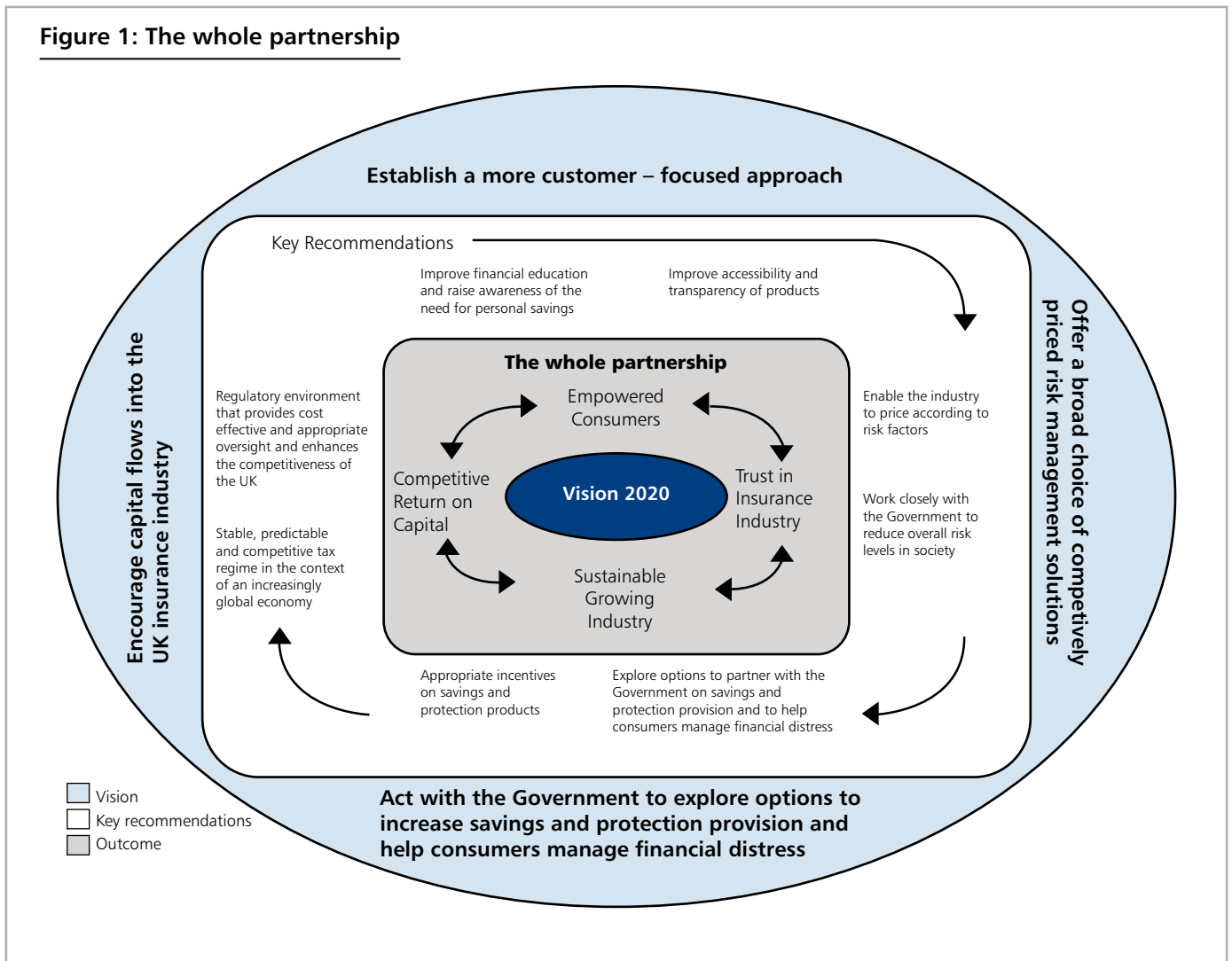
Although the individual recommendations that follow could be implemented on a case-by-case basis, the Group strongly recommends they are considered as a whole to maximise their benefits. They are complementary and form a virtuous circle optimising the benefits for consumers, the UK economy and the insurance industry as shown in Figure 1.

### A more customer-focused approach

Key to the IIWG's Vision for 2020 is the drive for a more customer-focused approach. The aim is to increase customers' confidence and trust in the UK insurance industry, but also foster a greater awareness of their own personal financial responsibility. Improvements in financial awareness are particularly important to address declining savings rates in the UK – the UK household savings ratio declined from over 12 per cent in 1980 to only 2 per cent in 2008.

There are already a number of existing initiatives that have the potential to help achieve this part of the Vision, such as the Financial Services Authority (FSA)'s Treating Customers Fairly initiative, the Retail Distribution Review (RDR) and the Association of British Insurers' (ABI) consumer strategy, as well as educational and informational projects by the Government and the FSA. The Group's key recommendations build on this existing work:

**Figure 1: The whole partnership**



- Improvements in the way financial education and financial literacy initiatives are organised, to maximise their impact.
- Support for the aim of improving accessibility that underpins existing initiatives, such as the Retail Distribution Review. To allow industry and regulators to concentrate on ensuring these initiatives are successful from a consumer perspective, where possible, there should be no further significant change to retail regulation until all the existing initiatives are fully embedded;
- An independent review of the overall effectiveness of all the changes affecting retail distribution, within three to five years of the implementation of the FSA's Retail Distribution Review.

- A commitment by the industry to continue to identify initiatives to make the industry easier to do business with by improving transparency, simplicity and access for consumers, as has already been achieved, for example, by the ABI's work on critical illness disclosure.

### A broad choice of risk management solutions

The second theme of the Vision is the importance of the insurance industry's unique role in offering a broad choice of risk management solutions that are priced competitively, provide customers with the products they need and incentivise good risk management.

It is also important for the industry and the Government to work together where possible to manage the overall level of risk within society. The key recommendations linked to this theme are:

- Ensuring that legislative and/or regulatory changes support the industry's ability to price according to relevant risk factors.
- Partnering with the Government to manage the impact of current, new and evolving risks such as crime and climate change-related flood risk.

The assessment, reduction and pricing of risk is vital to the work of the insurance industry and form an important part of achieving the IIWG's Vision. If the industry is unable to undertake these activities effectively, then consumers and businesses will not be able to buy the risk management tools they need and the UK economy will suffer as a result.

### Partnership with the Government

The third theme of the Vision is the need for industry to act in partnership with the Government to increase savings and protection provision, where appropriate, and help consumers manage financial distress caused by accidents, ill-health or old age.

The Group's analysis shows that the Government currently provides almost 65 per cent of the addressable 'risk management' market for retirement provision, accident, health care and income protection, with the balance underwritten by insurers. The industry is committed to helping the Government address social challenges where commercially viable and is willing to make its considerable expertise available to work with the Government to explore alternative options and models based on closer co-operation between industry and the Government. The key recommendations linked to this theme are:

- There should be further discussion with the Government to assess the scope for a greater industry role in helping people deal with risks such as unemployment and ill-health, as well as

the need for a retirement income or long-term care.

- The need for well-designed incentives to help encourage personal responsibility in respect of savings and protection coverage.

Increasing savings and protection can help people manage their own risks and reduce the burden on the State. Exploring the extent to which the insurance industry can help provide insurance against some of these risks, also has the potential to help reduce pressures on the public purse.

### Encouraging capital flows

The fourth and final theme in the report is to promote a strong industry by encouraging capital flows into the UK insurance industry. Apart from the general economic benefits of attracting capital to the UK, attracting capital would be a prerequisite if the role of private sector insurance in the UK economy was increased. The UK's competitive position in the global marketplace needs to be maintained and enhanced, by ensuring that capital can earn a competitive return. The key recommendations linked to this theme are:

- The industry will work with the Government to deliver a stable, predictable and competitive tax system for the medium to long-term, which is aligned to the Vision for 2020. This must take account of increasing global competition in a world in which capital is flexible and highly mobile.
- The industry will work with the Government and the FSA to promote a stable regulatory regime aligned to the Vision for 2020 and to ensure regulation provides cost effective and appropriate oversight.
- The industry should develop and attract the best talent to ensure there is a deep pool of insurance professionals with the right skills in technical and managerial disciplines.
- The industry will work with the Government to proactively support the UK's insurance business abroad, particularly in emerging markets, as well as within the UK.

The overall impact of these recommendations will depend on whether they are implemented as a whole. Their strength lies in the cohesiveness of the Vision. A financially strong and competitive insurance industry provides much needed protection for consumers from every day risks and enables society to reduce or prevent risks which otherwise would have resulted in financial and emotional burdens. It also provides an essential contribution to the UK economy.

However the industry can only continue to provide these benefits sustainably if it continues to earn an economic return on its activities and to attract international capital. These benefits are also dependent on consumer trust and confidence in the industry and in their own capabilities.

This *Executive summary* provides a high-level overview of the IIWG's findings and should be read alongside the Vision for the insurance industry in 2020 and the recommendations set out in the following chapter. Chapters 1 and 2 give background on the provision of insurance in the UK and the international context in which the UK industry operates. Chapters 3 to 6 are more detailed explorations of the four themes of the Vision and of the associated recommendations.

## Vision for 2020 and recommendations

**The IIWG wants the UK to be the leading global insurance centre with an unsurpassed reputation for excellence; a deep and constructive relationship with its customers; and a close and effective partnership with the Government.**

This Vision will be achieved by:

**Establishing a more customer-focused approach to increase customers' confidence and trust in the insurance industry, and a greater awareness of their own personal responsibility:**

- **Understanding and awareness** – assisting customers to recognise and understand their needs for insurance coverage and to be more informed purchasers of insurance, for example, through financial education.
- **Transparency and simplicity** – facilitating improved accessibility and customer engagement with the insurance market by developing insurance products and services that consumers understand.
- **Access** – widening the distribution of insurance products to allow customers to get the level of help appropriate for their needs at a market rate.
- **Responsibility** – promoting the important role of insurance in helping customers take on personal responsibility for managing risks and for retirement saving.
- **Confidence** – building customer confidence by communicating a positive, consistent message about the valuable and important role played by the insurance industry.

**Offering a broad choice of risk management solutions, which are competitively priced and provide customers with the products they need:**

- **Pricing** – balancing the freedom to price coverage in line with the underlying risk characteristics with protection of individuals' rights.
- **Risk management** – continuing the long term trend of working in partnership with the Government, employers and households to promote effective risk management and reduction in adverse events that can reduce the cost of claims for individuals, companies and society and encourage savings.
- **Evolving risks** – encouraging innovation and reducing constraints in the development of insurance products that meet evolving customer risk management needs.

**Acting in partnership with the Government to explore options to increase savings and protection provision and to help consumers manage financial distress in their daily lives caused by accidents, ill-health or old age:**

- **Incentives** – using a mixture of incentives (both financial and behavioural) and, in selective cases, appropriate and meaningful penalties to enhance risk protection and savings, thereby reducing underinsurance and individuals' dependence on the State for benefits.
- **Savings** – encouraging and monitoring the success of initiatives aimed at increasing savings, such as auto-enrolment into pensions, and work with the Government to develop more effective, innovative solutions.
- **Health coverage** – considering alternative options to cover the cost of health services and long-term care, either to cover core services or top up current provision.

- **Protection gap** – encouraging people to take positive action to protect themselves and their family against risks and examining whether the insurance industry could provide solutions currently provided by the State.

**Encouraging capital flows into the UK insurance industry by ensuring its competitive position in the global marketplace is maintained and enhanced, and that capital can earn a competitive return:**

- **Fiscal and regulatory environment** – ensuring a stable regulatory and competitive tax regime in the UK.
- **International access** – working with the Government to promote open and equal access to international markets that will position the UK insurance industry as a major player in global insurance, including new insurance markets such as China and India.
- **Level playing field** – ensuring a level playing field for insurers within the UK, with competition not distorted by factors such as state ownership of financial institutions, more favourable treatment for certain financial products or the domicile of the insurer.
- **UK skills base** – investing in the UK insurance skills base to maintain leading edge skills in insurance technical and managerial disciplines, such as actuarial and IT.

**Recommendations to achieve the Vision for the insurance industry in 2020.**

Theme	How
<p><b>Establishing a more customer-focused approach to increase customers’ confidence and trust in the insurance industry, and a greater awareness of their own personal responsibility.</b></p>	<p><b>Recommendation 1:</b> Develop a more co-ordinated approach to financial literacy and education and raise awareness of the need for appropriate levels of personal savings and protection amongst consumers. This should build on current initiatives to improve the financial capability of UK consumers and ensure existing resources are used most effectively.</p> <p>As part of this recommendation, consideration should be given to appointing a Financial Education Commissioner to act as the central co-ordinating body for Government. The Commissioner should work with the whole financial services industry to improve all aspects of financial education and literacy, including in the context of the national curriculum, and develop a trusted financial education and information service.</p> <p><b>Recommendation 2:</b> The Group recommends, as far as possible, allowing time for existing initiatives to be implemented and to start having an effect before introducing any further significant new retail regulation initiatives.</p> <p>Over the medium term existing initiatives such as Treating Customers Fairly (TCF) and the Retail Distribution Review (RDR) have the potential to improve customer engagement significantly, by making the industry easier to do business with. The Group supports these aims, which should address some of the main failings of the existing framework in which the industry operates. A period of stability will allow for full implementation of the RDR and time for these changes to start having an effect.</p> <p><b>Recommendation 3:</b> There are currently a considerable number of initiatives that aim to improve consumer engagement. As well as the Retail Distribution Review and Treating Customers Fairly, there are also initiatives on financial education and awareness, on access to advice and to encourage savings. The Group recommends that Government consider an independent review of the overall effectiveness of all these changes, to assess whether in combination they have improved customer outcomes. Such a review should take place around three to five years after the implementation of RDR and Personal Accounts.</p>

Theme	How
<p><b>Establishing a more customer-focused approach to increase customers' confidence and trust in the insurance industry, and a greater awareness of their own personal responsibility.</b></p>	<p><b>Recommendation 4:</b> The industry will continue to identify ways to promote wider take-up of insurance and savings products and to build trust in the industry, by improving transparency, simplicity and access for consumers under the auspices of the Association of British Insurers (ABI). To do this the industry will work with consumer groups and other stakeholders, such as the Financial Services Authority (FSA) and Financial Ombudsman Service (FOS), to identify ways to improve the accessibility and understanding of products, as has already been achieved, for example, by the ABI's work on critical illness disclosure. Initiatives could cover areas such as:</p> <ul style="list-style-type: none"> <li>– conditions of payout, in particular what constitutes a valid claim and what is covered;</li> <li>– transparency around the charges consumers pay and what these charges cover, including distributor charges; and</li> <li>– the degree of investment risk associated with individual funds.</li> </ul> <p>The industry will focus on what it can achieve without regulation. However, where appropriate, the industry will also make suggestions on potential improvements to regulations to ensure these goals can be met.</p>
<p><b>Offering a broad choice of risk management solutions, which are competitively priced and provide customers with the products they need.</b></p>	<p><b>Recommendation 5:</b> The Group recommends that legislative and/or regulatory changes support the industry's ability to price according to risk factors. Insurance, by its nature, pools risk and works most effectively where it can group similar risks together. The industry is sensitive to concerns about which risk factors are used and so, for example, has introduced the Concordat and Moratorium on Genetics and Insurance to deal with specific concerns around genetic testing. However, the ability to price according to risk will help the insurance industry to be able to continue to provide consumers with a broad choice of competitively priced risk management and savings solutions.</p> <p>For example, the industry believes Government should ensure that the Equality Bill and prospective European legislation enables insurers to continue to price risks appropriately. Government is currently consulting on the age discrimination strand of the Equality Bill and will take account of all views, including the insurance industry's, when deciding on legislation.</p> <p><b>Recommendation 6:</b> The Group recommends taking advantage of the scope for a more effective partnership between the insurance industry and Government to reduce risk levels in society and to ensure that effective insurance options exist for new and evolving risks.</p> <p>For example, the insurance industry and Government have data and research findings that can help the collective understanding of the likely impact of different risks, such as flood risk and crime. In some cases, sharing this will help set priorities for public spending on risk reduction; influence whether private insurance is available on a commercial basis at an attractive price for customers; or guide future research. There will be other examples, where industry and Government working together can help people manage their risks better.</p>

Theme	How
<p><b>Acting in partnership with the Government to explore options to increase savings and protection provision and to help consumers manage financial distress in their daily lives caused by accidents, ill-health or old age.</b></p>	<p><b>Recommendation 7:</b> The Group recommends that industry and the Government assess the scope for a greater industry role in helping people deal with risks such as unemployment, ill-health, and the need for a retirement income or long-term care. If in principle partnership is seen as positive, a more detailed plan should be agreed, based on a common understanding of the benefit of involving industry on a commercial basis.</p> <p><b>Recommendation 8:</b> The Group believes that there is an important role for well-designed incentives to help ensure people buy the savings and protection cover they need and to help encourage personal responsibility. It recommends that the Government should maintain existing incentives, including tax relief on pensions, and explore new options, though recognising that affordability is an important constraint.</p> <p>The Government should also continue to seek to maintain stability and certainty, and minimise complexity in savings and pensions taxation where possible. This will be beneficial to consumers, as it will simplify decision-making and enable them to plan more effectively.</p>

Theme	How
<p><b>Encouraging capital flows into the UK insurance industry by ensuring its competitive position in the global marketplace is maintained and enhanced, and that capital can earn a competitive return.</b></p>	<p><b>Recommendation 9:</b> The Group recommends that the Government should continue to work with industry to ensure a stable, predictable and competitive tax system for the medium to long-term, which is aligned to the Vision for 2020 and takes account of increasing global competition in a world in which capital is highly mobile. The Group therefore supports the recommendations on tax competitiveness in the Financial Services Global Competitiveness Group Report and the work of the Business-Government Forum on Tax and Globalisation.</p> <p>The Group believes the Government should take action to prevent loss of UK business to low tax and offshore domiciles and to counter threats to the medium to long-run competitiveness of the UK as a location for insurance business.</p> <p>The Group also believes that it is important that the consultation process around tax changes continues to be enhanced, so that the impact on consumers, the industry and the wider UK economy is understood when making tax decisions.</p>

Theme	How
<p><b>Encouraging capital flows into the UK insurance industry by ensuring its competitive position in the global marketplace is maintained and enhanced, and that capital can earn a competitive return.</b></p>	<p><b>Recommendation 10:</b> The regulatory and legislative framework is key to the success and stability of the UK insurance industry. The Group recommends:</p> <ul style="list-style-type: none"> <li>– Ensuring that the Government, the FSA and the industry work together to promote stable and effective national, international and European regulatory and legislative regimes. The objective should be to support the Vision for 2020 and deliver cost effective and appropriate oversight that helps build trust in the industry and to maintain financial stability. The UK should take account of the economic reality of cross-border activity and ensure a co-ordinated approach to minimise global inconsistency and protectionism.</li> <li>– Ensuring supervisory and regulatory measures taken to respond to the current economic crisis distinguish between, and are proportionate to, the experience of different financial services sectors so that, for example, changes aimed at the banking industry are not automatically applied to the insurance industry.</li> <li>– Ensuring effective and meaningful consultation on new regulation at the earliest possible stage, to allow information-sharing on the likely impact on the industry and consumers. Cost benefit analysis and post implementation reviews are agreed to be extremely important parts of the consultation process.</li> <li>– Continued commitment when transposing EU Directives to the FSA's principles of working with the market and only 'gold plating' measures when there is a strong cost benefit analysis for doing so.</li> <li>– Implementing the Solvency II Directive in a way that ensures the best outcomes for both the industry and UK consumers, for example in relation to annuities.</li> <li>– Avoiding, where possible, retrospective changes affecting long-term savings contracts and long-tail insurance business.</li> </ul> <p>The Group also recommends considering reviewing the funding and operation of the Financial Services Compensation Scheme (FSCS), including the principle of cross-subsidy, taking into account potential changes at a European level.</p> <p>Furthermore, the Group recommends considering whether extending the FSA's mandate, to include a specific objective to encourage financial responsibility, would help ensure an appropriate balance between protecting consumers from potential mis-selling and encouraging them to save.</p>

Theme	How
<p><b>Encouraging capital flows into the UK insurance industry by ensuring its competitive position in the global marketplace is maintained and enhanced, and that capital can earn a competitive return.</b></p>	<p><b>Recommendation 11:</b> The industry should develop and attract the best talent to ensure there is a deep pool of insurance professionals with the right skills in insurance, technical and managerial disciplines.</p> <p>The industry should work with the relevant Government and other interest groups such as the ABI and Chartered Insurance Institute (CII) to support and build on existing initiatives in the market. Consideration should be given to:</p> <ul style="list-style-type: none"> <li>– investigating whether there is a need to establish a central resource to co-ordinate this activity or, preferably, if it can be undertaken by an existing organisation such as CII;</li> <li>– promoting the insurance industry as an attractive career choice and improving the image of the industry within schools and universities;</li> <li>– developing closer links with universities and business schools;</li> <li>– encouraging diversity within the insurance employment market; and</li> <li>– improving the dialogue and communication between industry and the relevant government agencies. This could include, for example, secondments from industry into the Government and vice versa.</li> </ul> <p>In addition, the Group agree with the recommendation in the Financial Services Global Competitiveness Report that the Government should ensure that the immigration points system can attract people with scarce financial services skills, including overseas students keen to pursue financial services careers in the UK after graduation.</p> <p><b>Recommendation 12:</b> The Government should proactively support the UK’s insurance business abroad, particularly in emerging markets, and within the UK.</p> <ul style="list-style-type: none"> <li>– Industry should continue to work with the Government to lift barriers and ensure open and fair access in overseas markets for UK insurers.</li> <li>– The Group supports the recommendation in the Financial Services Global Competitiveness Report, and other recent reports, that the Government, industry and organisations involved in promotional work should consider a process of rationalisation and consolidation to avoid duplication. They should aim to ensure that the promotional resources from the private and public sectors are eventually focused on a single body.</li> <li>– Industry and the Government should consider sponsoring a ‘Risk Summit’ hosted in London emphasizing the UK’s role as the centre of the global risk industry.</li> <li>– The industry, working with respective trade bodies and the Government, will explore opportunities to promote the ‘role of insurance’ and how it helps individuals and business to mitigate and manage every day risks and contributes to the wider UK economy.</li> </ul>

The recommendations made by the insurance industry working group are consistent with and complementary to those of the financial services global competitiveness group report, *UK international financial services – the future*, concentrating on those issues that are particularly important for the UK insurance industry.



# 1 The provision of insurance

The insurance industry is essential to the functioning of a modern economy, protecting people and companies against uncertainty associated with every day events. It covers an extremely wide range of business and consumer needs, from insuring a business or home; preparing for retirement; insuring major catastrophe risks such as earthquakes; or managing flood risks as a result of climate change.<sup>1</sup>

## 1.1 Why have insurance?

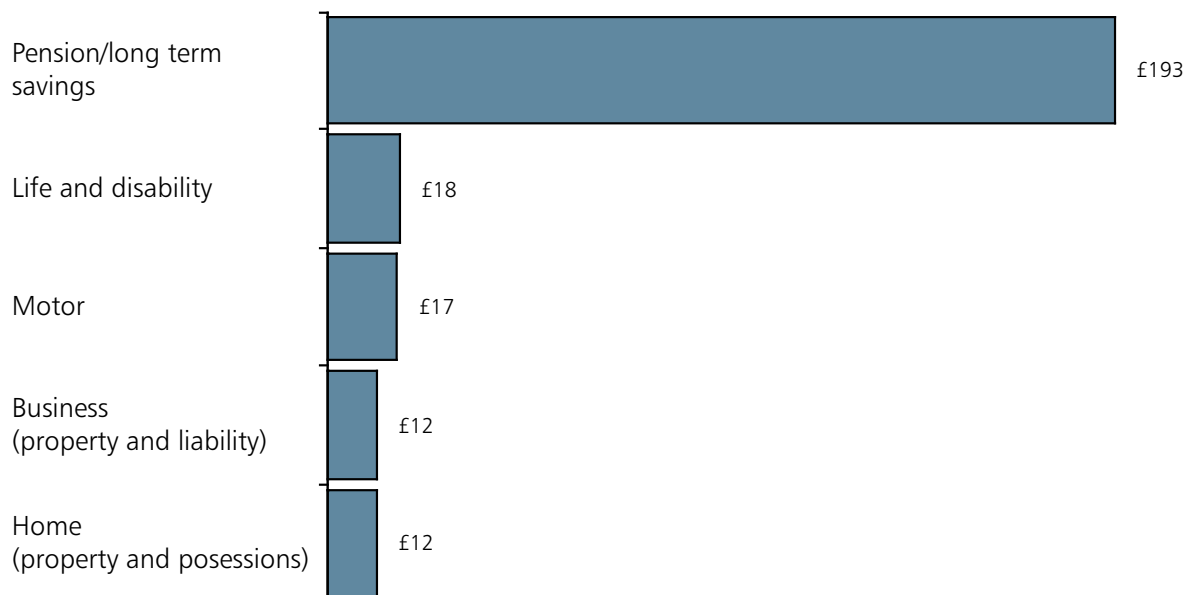
To manage risk an individual generally has one of three options:

- **Personal savings.** These can be used to fund the costs of the risk occurring. In other words, self-insurance. Only a small minority of people are able to rely wholly on self-insurance, particularly where the risk carries a large cost.
- **State assistance.** Although the State will intervene to help alleviate financial hardship for those who are most vulnerable, it will not compensate people for all costs associated with the realised risk.
- **Insurance.** If the risk has been insured, the insurer will help to offset the financial impact.

Although insurance is not the only option available to help people cope with risks, it is often the most effective. In 2007 the UK insurance industry paid out £270 million to customers every day (some key categories of claim are shown in Figure 2).

**Figure 2 – Daily claims paid by insurers to policy holders**

(2007, millions of pounds per day)



Source: ABI (2008a) UK Insurance – Key Facts

<sup>1</sup> See Annex A for a description of the different types of insurance.

The UK insurance industry pays out £211 million per day in pension and life insurance benefits, as well as £59 million a day in general insurance claims. As well as helping individuals, insurance also helps business, paying out almost £6 million a day in 2007 for property damage and over £6 million daily for liability claims such as accidents at work and professional liability.

## 1.2 How do insurers manage risk?

Insurance can help manage risk by pooling the risks of a large number of people. By covering lots of risks, insurers are able to use the premiums from the risks that are not realised to pay the claims of those that are.

In order to provide insurance, insurers need to understand and manage the risks that they are taking on. If they fail to do this effectively, then they risk not having enough money to pay out claims. Managing risks involves many different activities:

- **Risk assessment.** Insurers need to understand the likelihood of different risks occurring. This helps them set a competitive price for taking over a particular risk for a customer. Typically this will involve using data on a high volume of similar policies to assess the probability that claims will be made, for example as a result of motor accidents. However, it also involves assessing the probability that large, but very unusual, events will occur, such as coastal flooding or earthquakes. Insurers need to have enough money set aside to pay out in both cases.
- **Risk reduction.** Insurers also actively work to reduce risks. For example they work with the police to try to reduce crime where they can see patterns emerging that indicate a problem. By taking a risk-based approach they can help focus activity where it is most needed. Similarly, insurers work with the Government to help improve flood risk management.
- **Risk pricing.** By charging riskier customers a higher price, and rewarding good behaviour, insurers also

provide incentives for individuals to reduce the risks they take. For example, no-claims bonuses encourage drivers to drive more carefully. This helps counterbalance the fact that the existence of insurance makes it easier for individuals to take risk.

- **Reserving for risk.** Finally insurers hold reserves to ensure that they have enough money set aside to meet their liabilities. This is particularly important because many insurance products, such as annuities or employers liability insurance, may need to pay out long after the policy was written. This means that the prudential regulatory regime for insurers plays an important role in the health of the industry and its ability to manage risks for customers.

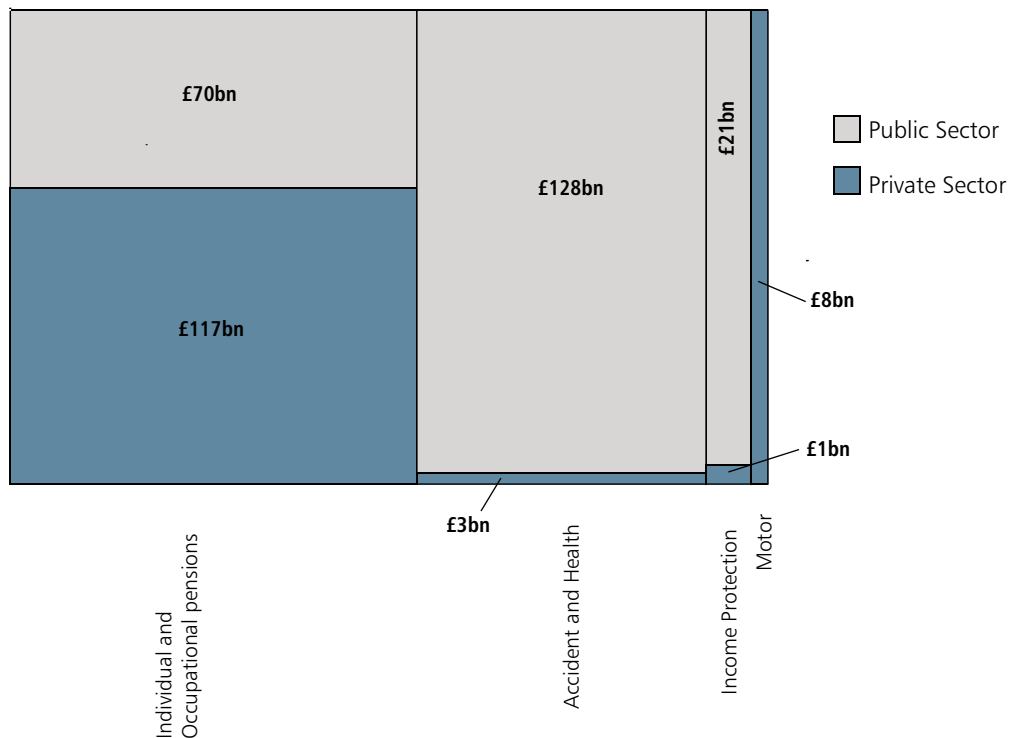
The insurance model relies on risks being predictable and limited. That is why there are some risks, such as terrorism, that are difficult for the private sector to insure without help from the Government, because of their potential scale. It is also why it is potentially very damaging when events happen that increase the number of people who can claim in ways that could not have been foreseen (and therefore reserved against) when the policy was written. Retrospective changes to legislation or regulation are a particularly important example of this type of problem.

## 1.3 The balance between the Government and industry provision

In some areas, such as motor insurance, the private sector provides one hundred percent of individuals' insurance needs – over £8 billion worth in the case of motor. More generally, an individual's decision to take out private insurance will partly depend on the extent of state provision. In particular, there are three main areas where private insurance overlaps with social insurance funded by the tax system: individual and occupational pensions; healthcare and long term care; and income protection. Public and private sector risk management solutions for these three areas (the addressable market) amount to approximately £340 billion.

**Figure 3 – Addressable ‘risk management’ market**

Net premiums/benefits paid (2007)



**Note:** The addressable ‘risk management’ market is defined as those areas of social insurance that are common to both the insurance industry and Government. In 2007, the insurance industry paid around £121 billion in pensions, accident and health and income protection insurance benefits. Over the same period the Government spend on similar ‘risk management’ functions and welfare provision, including pensions, unemployment benefit, statutory sick pay, and healthcare, has been estimated to be around £219 billion per annum. Motor has also been included as an example of other types of insurance – other examples (not shown) include property, liability and warrantees.

Source: ABI and HM Treasury Public Expenditure Statistical Analyses and Deloitte calculations.

The Government currently provides around 64 per cent of the UK’s addressable ‘risk management’ market for individual and occupational pensions, healthcare and long term care and income protection funded through tax and national insurance on a ‘pay as you go’ basis. Over time the challenge of funding these costs will rise, due to a decline in the relative size of the working age population and rising costs in areas such as healthcare. This raises the question of where the optimal balance between private and state provision should lie in the future and how much emphasis should be placed on personal responsibility.

Any shift of the balance from the public to the private sector requires two things to occur:

- greater consumer uptake of cover provided by the private sector; and
- increased capital must be attracted to the industry to fund this growth in the private sector.

If, for example, the private sector increased its share of the addressable risk market by five percentage points, the corresponding saving for public sector risk management could be almost £17 billion per year.

Greater consumer take up of private sector insurance can be achieved in a number of ways, including increased levels of compulsion and co-ordinated efforts to reinforce the benefits of personal cover over state provision. The approach taken would depend on what the goal is: to increase provision across all areas of spend; or focus on a specific category such as top-up healthcare. In any case it would be necessary that any elements transferred to the private sector are economically viable, or can be made economically viable through a partnership between the Government and industry.

The Group estimates that the capital required to support £17 billion in claims paid could be as much as £9.7 billion.<sup>2</sup> This is equivalent to another Prudential or an Aviva entering the market. In practice, determining capital requirements for a life insurance business is complex and depends on the type of business, risks being written, risk policy and maturity of the business. This capital would need to be raised in the context of an increasingly global economy in which capital is flexible and highly mobile.

## 1.4 Are people doing enough to protect themselves?

Even within the current framework, there is a question as to whether individuals are doing enough to protect themselves. Evidence suggests that many are not saving enough to provide for their retirement or to deal with the risks they face in their everyday lives. In addition, many families either do not have insurance at all or do not have enough insurance to protect them against disaster.

For example, many people have no protection in place to provide for themselves and their family should the primary income earner lose their regular income. The percentage of the UK population that

holds life insurance has decreased significantly, from 61 per cent in 1996 to 39 per cent in 2006.<sup>3</sup> Furthermore those who do have a strategy in place often have unrealistic expectations of how they will be able to manage, for example overestimating the level of benefits they would receive from their employer. A recent ABI survey found that 21 per cent of people do not know how they would cope if the main bread winner suffered a long-term illness and 19 per cent do not have a financial plan in the event they lost their job.<sup>4</sup> Recent estimates by Swiss Re suggest that the overall protection gap in the UK could be as high as £2.4 trillion.<sup>5</sup>

Until the current economic crisis, the UK household savings ratio (household savings expressed as a percentage of total resources) had declined from over 12 per cent in 1980 to only 2 per cent in 2008. The result of this decline in savings is a significant disparity in the amount people should be saving to provide for a comfortable retirement and the amount they are currently putting aside. This is particularly true for younger generations, with those under 40 saving significantly less than previous generations at a similar point in their life. It increases the likelihood that people will be retiring on a level of income which is too low to support expected standards of living. Even today, of the annuities sold in the second half of 2008, 83 per cent were bought with pension pots of £40,000 or less, buying an income of under £60 a week.<sup>6</sup>

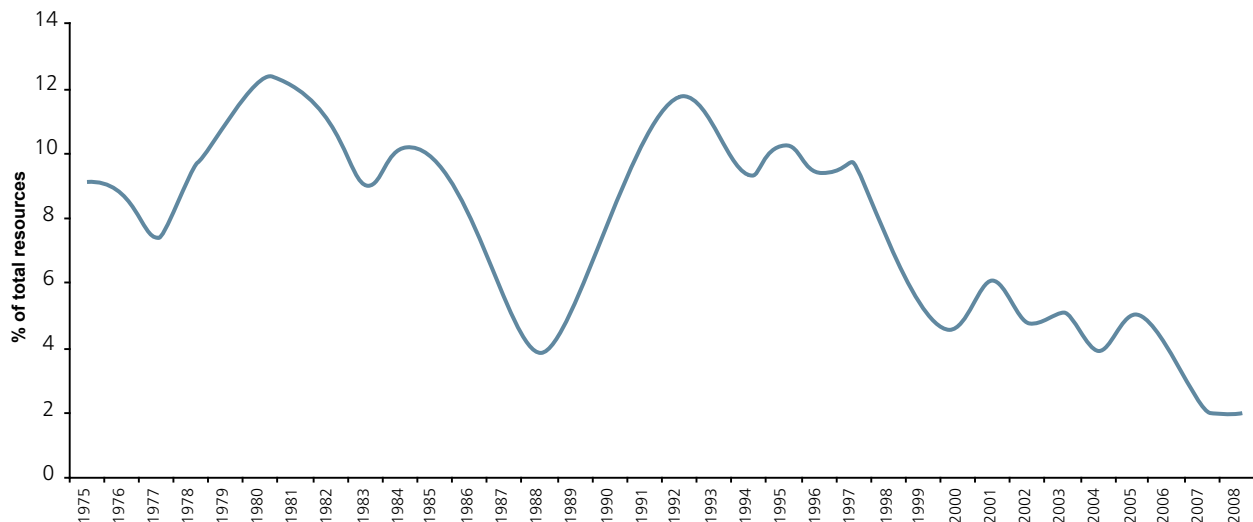
<sup>2</sup> Estimates provided by Aviva and Deloitte's Actuarial and Insurance Services Group, based on the assumption of an 87 per cent payout ratio and that capital could need to be as much as 50 per cent of premiums written per year.

<sup>3</sup> ABI (2008b).

<sup>4</sup> NMG Financial Services Consulting Ltd (2008).

<sup>5</sup> Swiss Re (2009).

<sup>6</sup> Gunawardena and O'Neill (2008).

**Figure 4 – UK household savings ratio**

Source: Office of National Statistics, Economic Trends

A recent ABI study found that 9.6 million people (34 per cent of the workforce) save nothing in a pension, with 3.8 million people (13 per cent of the workforce) saving too little for their anticipated needs. Only 13.3 million people (47 per cent of the workforce) save enough.<sup>7</sup> This issue is partly explained by consumer views on retirement provision, with only 35 per cent of the UK population believing that saving regularly is the best way to provide for their retirement.<sup>8</sup>

One of the reasons for this trend may be that many consumers see it as the duty of the State to provide for people in their old age. A paper published by Aviva in 2008 showed that 61 per cent of UK consumers surveyed agreed that it is the responsibility of the Government to provide for the elderly.<sup>9</sup> In the same survey, only 11 per cent

of respondents agreed that the Government will actually provide retirees with an adequate level of income for retirement.

If the past trend of lower and declining levels of savings continues, it will place an increasing financial burden on the Government by increasing the cost of providing benefits for those who have not adequately saved for retirement. The insurance industry is well positioned to help the Government address this challenge provided it is economically viable to do so and that required capital, as noted above, can be attracted.

<sup>7</sup> Gunawardena and O'Neill (2008).

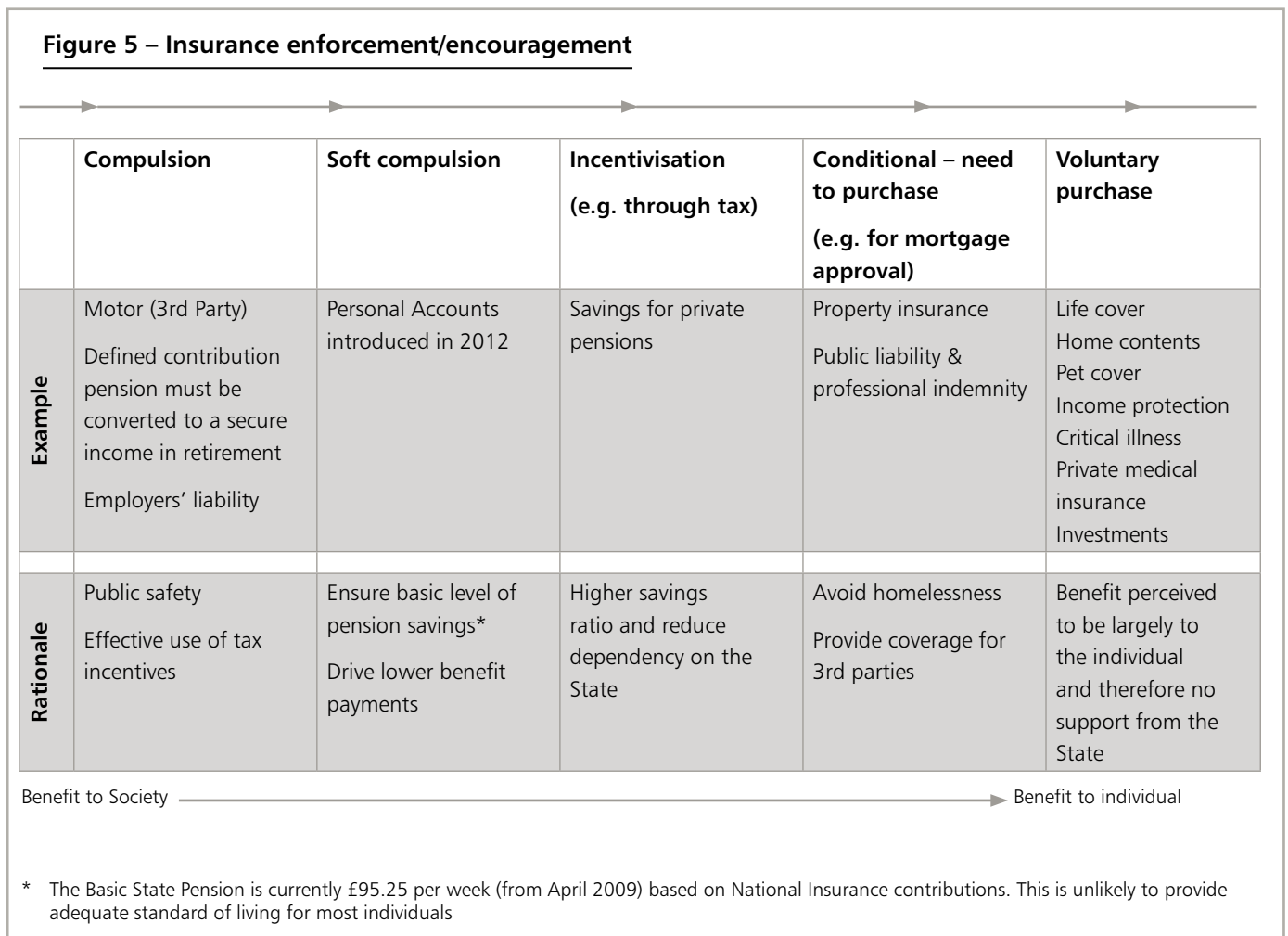
<sup>8</sup> Aviva. 'Understanding consumer attitudes to saving' 2008.

<sup>9</sup> Aviva. 'Understanding consumer attitudes to saving' 2008.

## 1.5 The role of incentives

The uptake and usage of insurance products partly reflects the extent to which the Government currently either enforces or encourages uptake of each product type. While some insurance products are compulsory, such as third party motor insurance, most remain voluntary. Along this spectrum, the Government sets levels of enforcement or encouragement that reflect the relative importance placed on each of these by society. Figure 5 below illustrates the key products and where they fit on this continuum.

Inevitably, it is a question of judgement whether the right incentives are in place to encourage individuals to protect themselves and to reduce the burden on the State. For example, unlike in Ireland, UK mortgage providers cannot demand that people take out life insurance cover when they are purchasing a mortgage. This reduces take up. While for some, especially those without a family to protect, having no life insurance may be the right outcome, for many, particularly those with families, it will not. Getting the balance right is important.



## 1.6 Barriers to uptake of insurance

When insurance products are voluntary, there are sometimes low product penetration rates that can be explained by a range of factors.

### Financial literacy and responsibility

The process of buying insurance, or investing in a savings product, is often seen as too difficult by individual consumers, with the result that even those who know they should do something take no action. Relatively simple changes, such as setting defaults as to what will happen if an individual does not take action, can have a big impact on take-up. It is hoped that the introduction of auto-enrolment for workplace pensions, where the default will be to be in the scheme, will help ensure that more

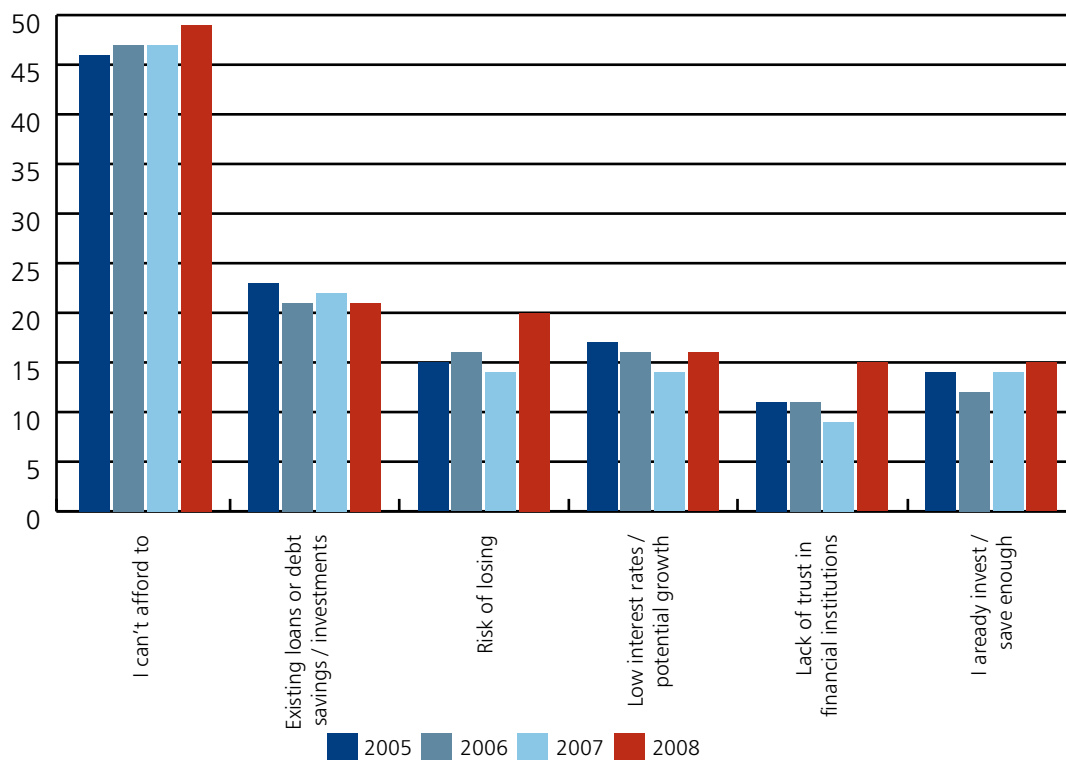
people save for a pension. Financial education is also important, to help individuals understand more about what they need to do and what the impact of taking no action could be.

Despite a number of attempts to improve financial literacy, the average understanding of personal finance issues amongst the UK population remains at a low level. The Group supports the Government’s ongoing efforts to improve financial education and awareness of the need for personal responsibility.

An important part of making this aspect of the Vision for 2020 work will be continued improvements in the simplicity and accessibility of insurance product disclosure documentation, including regulated disclosures, which will need industry and regulators to work collaboratively to promote change.

**Figure 6 – Barriers to uptake of savings products**

Which of the following stop you from saving or investing more money than you do now?



Source: Aviva Consumer Attitudes Survey; 13 countries UK, FRA, GER, ITA, SPA, IRE, NL, POL, CHN, IND, USA, TUR, AUS

## Affordability

As Figure 6 shows, affordability has also been highlighted as a big barrier to take up, particularly for savings. The current economic crisis is forcing consumers to cut back on insurance cover and savings in an effort to meet day to day living costs. A recent study by Sainsbury's Finance found that an estimated one million consumers (946,000) have either cancelled their home contents insurance or reduced the amount of cover they have as a direct consequence of their deteriorating financial situation. Over half a million (532,000) are also estimated to have cancelled their life insurance policy for the same reason.<sup>10</sup> This behaviour will increase the risk that people will not have done enough to meet their needs in retirement, or to cope with risk.

## Access

For many investment and insurance products, consumers need advice in order to help them understand their needs and select the appropriate solution. This is particularly true when complex rules around entitlement for means-tested benefits can lead to uncertainty about the suitability of particular products. However, many consumers lack access to intermediaries, either because they do not understand how and where to find them, or because the intermediary finds it uneconomic to serve the customer. For example, industry sources suggest that a full fact find, which is required as part of the regulated advice process for selling life insurance products, can cost £750 on average, making it unlikely that a customer with little to invest can afford to go through the process.<sup>11</sup>

The Group noted that there is an opportunity that must not be missed to address the issue of accessibility of advice and how advisers are remunerated through the Retail Distribution Review

(RDR). It is hoped that this will not only improve accessibility, but also trust in the industry.<sup>12</sup>

### Case study: Government-industry collaboration to promote financial inclusion

After the Government's Financial Inclusion Taskforce's 2008 Insurance Working Group report, the Association of British Insurers set up an Access to Insurance Working Group (AIWG) to improve social housing tenants' access to home contents insurance, focusing on the role of social landlords in facilitating access.

The programme is aligned with the work of the Government's Financial Inclusion Champions initiative and aims to ensure social housing tenants can access the cover they would need in case of a fire or break-in, for example, at an affordable price.

The Department for Work and Pensions has also commissioned a pilot based on 'Tenant Engagement Groups', who will work with housing associations, promoting the benefits of home contents insurance to tenants and community groups face-to-face and taking the first steps in developing a training tool for housing officers.

The AIWG has identified other issues to consider in due course, including increasing access to insurance for private tenants and ex-offenders.

<sup>10</sup> Harris (2009).

<sup>11</sup> Legal and General and Prudential estimates.

<sup>12</sup> For example, ABI research indicates that the move to adviser charging (previously known as customer agreed remuneration) will help improve trust, see CRA International (2008).

## 2 The strength of the UK insurance industry

**A strong and competitive insurance sector is essential for the UK economy because it helps support economic growth, reduces disparity of outcomes for individuals, and reduces risks. In this section we look at the strength of the UK insurance sector and the key challenges it faces in the medium to long term.**

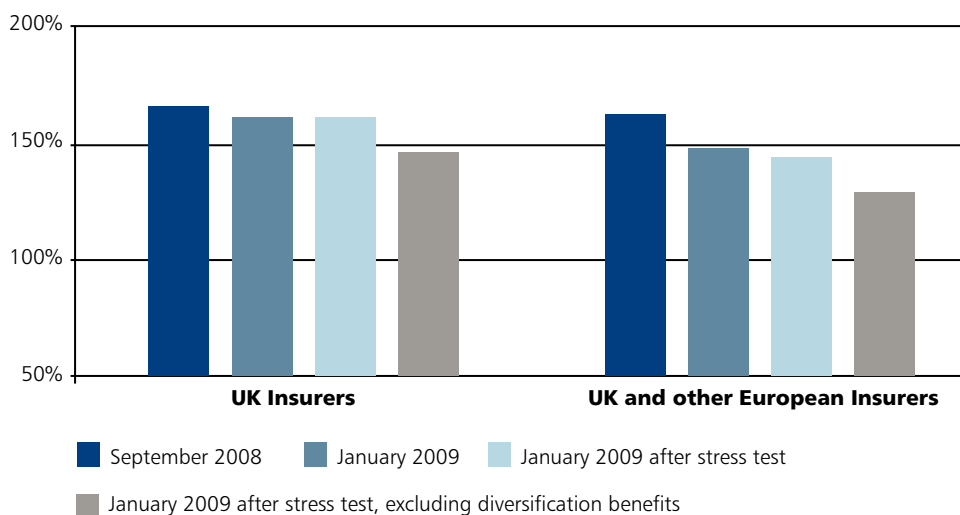
### 2.1 How strong is the UK insurance sector?

The UK insurance sector is one of the most competitive of its kind in the world, and the second largest by premium income. It is characterised by strong innovation, competitive charges and the absence of a single dominant provider. A good

example of this is the UK’s private pensions market, where charges are among the lowest in the world, for example, charges for large group pension schemes are generally between 0.3 per cent and 0.8 per cent. This is competitive in an international context and compares very favourably against similar markets in the US, Australia and New Zealand.<sup>13</sup>

The strength of the industry is also built upon the UK’s role as a renowned centre of excellence and its concentration of underwriting expertise. The Group note that the UK has a number of compelling advantages compared to other financial centres including a deep pool of insurance talent, strong support services and a robust regulatory framework. In particular, in light of the recent banking crisis, many businesses recognise the advantages of operating within a strong financial and regulatory regime.

**Figure 7: Capital strength of European insurers – Total Capital Ratio (TCR)**



**Notes** The Total Capital Ratio is the relationship between the amount of capital held by the business and the amount of capital needed to support the insurer’s business and financial strength rating. A TCR above 100 per cent therefore indicates that the insurer is adequately capitalised. The TCRs allow for diversification benefits unless stated otherwise.

Source: ABI Research based on Morgan Stanley Research. ‘The insurance industry: rebuilding confidence in Europe’, ABI (2009a).

<sup>13</sup> Estimates provided by Standard Life.

## 2.2 The capital position of UK insurers

The UK industry has proved resilient in the wake of the credit crisis. UK insurance companies generally entered the financial crisis with strong capital positions and have been well placed to weather the economic storm despite capital erosion from falls in equity, property and bond values (see Figure 7). For example, it is expected that write-downs directly related to sub-prime mortgage instruments will not exceed around 3.5 per cent of the global insurance and reinsurance industry's capital, or 0.5 per cent of invested assets.<sup>14</sup>

## 2.3 The insurance industry's contribution to the UK economy

A strong and competitive insurance sector is essential for the UK economy, because it helps support economic growth and manage risk. For example, research shows that increased penetration of life and non-life insurance promotes economic growth and that these effects are stronger for high-income countries such as the UK.<sup>15</sup>

Overall, the UK economy benefits from the insurance sector in several ways, for example it:

- is a major contributor to the UK's tax take. In 2006-07 the insurance industry contributed £9.7 billion in taxes including around 6 per cent of corporate tax revenues;
- manages assets worth £1,478 billion, equivalent to a quarter of the UK's total net worth. This includes assets that make up 15 per cent of the investment in the London Stock Exchange;
- employs 313,000 people. This is almost one third of all financial services sector jobs, and twice as many as employed in the motor manufacturing

- sector or in the combined sectors of electricity, gas and water supply; and
- provides net exports of £5.5 billion in 2007, or roughly 0.4 per cent of GDP.<sup>16</sup>

Some of these positive contributions could be eroded in part, if the UK's insurance needs were mostly met by overseas domiciled insurers.

The financial strength and competitiveness of the insurance sector is also important for customers, because it provides greater certainty that insurance will pay out when needed; it keeps the price of insurance low; and it encourages innovation. Private insurance is also able to encourage responsible behaviour, by rewarding those who act to reduce their risks. For example, evidence suggests that motor accidents are significantly lower in jurisdictions where insurers can adjust their premiums to reflect risk factors.<sup>17</sup> Similarly, evidence from the US shows that switching from state provision to private insurance to finance clean-ups from leaks in underground fuel tanks leads to a 20 per cent reduction in leaks, avoiding clean-up costs and environmental harm exceeding \$400 million.<sup>18</sup>

## 2.4 Challenges to the UK insurance sector

Despite its strength the UK insurance industry faces several major challenges as a result of the increasing globalisation of the industry, mobility of capital and changes to society and the environment.

### Attracting capital

While the UK continues to offer many advantages as an attractive location for insurance companies, it is important not to be complacent about this relative advantage. The evidence is that companies continually review countries' overall competitiveness

14 ABI: (2009a) The Insurance Industry: Rebuilding Confidence in Europe.  
15 Arena, M (2006).

16 All statistics drawn from ABI (2008a) 'UK Insurance Key Facts'.

17 See the discussion in Driver, O'Neill and Peppes (2008).

18 Yin, Kunreuther and White (2009).

compared to other locations, including the attractiveness and relative complexity of tax and regulatory regimes, and that companies do relocate when they believe it will be to their advantage. If competitors move, or start-ups are located elsewhere, companies will always need to assess their own position. In addition, even if initially much of the underwriting activity continues to take place in the UK, redomiciling makes it more likely that the advantages of underwriting in the UK will be reviewed in future.

In recent years the insurance sector has seen a trend of redomiciling. This began in 2002 in the personal lines market, with a number of motor insurers, such as Admiral and Zenith, relocating to Gibraltar to take advantage of the more favourable capital and tax regime. More recently, a number of high profile insurers (Beazley and Brit Insurance in 2009, Zurich in 2008, Hardy in 2007, Hiscox in 2006) have also announced their intention to move their headquarters from the UK to redomicile in what they regard as more favourable tax regimes.

Historically, the UK market has also struggled to compete with Bermuda for new capital after market-turning catastrophic losses. This was particularly evident in 2001 (World Trade Centre) and 2005 (Hurricanes Katrina, Rita and Wilma). For example, in 2005 Bermuda attracted US\$8.8 billion compared to approximately US\$1.1 billion received by Lloyd's.<sup>19</sup> The FSA have since announced their intention to fast track applications for authorisations in periods of market pressure and have reduced time taken for authorisation under normal market circumstances. The effectiveness of these changes in attracting capital to the UK will need to be assessed once the sector has experienced what it sees as a market-turning event. It will be important for the FSA to remain responsive.

Although it is positive that the UK's corporation tax rate is the lowest among G7 economies,<sup>20</sup> much

competition for insurance capital comes from elsewhere, including other European countries. Looking towards 2020, the development of new financial centres around the globe in places like Qatar and Dubai, as well as larger emerging centres such as Shanghai and Singapore, present opportunities for UK insurers but also further competition for new capital.

This underlines the need to keep competitiveness under review in order to enhance the medium to long term strength of both the UK insurance industry and the UK economy. The stability, predictability and competitiveness of tax and regulatory regimes, including the relative cost of compliance, will be an important part of this.

### Access to overseas markets

UK insurers should also seek to capitalise on the growing number and magnitude of international opportunities, particularly in emerging markets. In particular China and India with their enormous populations represent huge growth opportunities for insurers. As the wealth of individuals continues to rise in China and India, so too will individuals' demand for insurance.

In some cases accessing overseas markets is straightforward and UK insurers compete on an equal footing with domestic rivals. In other cases, however, access to markets is restricted by overtly or implicitly protectionist measures.

Economic growth in emerging markets presents a significant opportunity for insurers and UK insurers need to be well-positioned to take advantage of this opportunity.

### Dealing with evolving risks

The UK is facing substantial changes to society and its environment, which will impact the level and nature of the risks it faces. Climate change and an ageing population are among the most immediate of these. In terms of climate change, global warming is already

<sup>19</sup> Benfield (2005a) and Benfield (2005b).  
<sup>20</sup> HM Treasury (2009).

increasing the risk of flooding in large areas of the UK today and it has been estimated by the ABI that the potential cost of this risk alone could increase 15-fold between now and 2080, to £22 billion per annum.<sup>21</sup>

It is also projected that the number of workers funding retirement benefits will fall from a ratio of 4:1 currently to 2:1 by 2050.<sup>22</sup> This will create a significant burden on the State, unless benefits are changed, taxes increased, retirement age rises or individuals take more responsibility for funding their old age. Increasing longevity creates its own challenges for insurers as the desire for guaranteed long term income in retirement, via annuities or other vehicles, is difficult to meet due to the capital intensity of annuities and the lack of sufficient suitable long term investment instruments to back annuities policies.

In addition, consumer, demographic, environmental and technology driven changes will result in other new risks that need to be managed, such as the evolving nuclear industry, genetics and nanotechnology. All these issues require a co-ordinated response to ensure consumers and the UK economy are protected against these risks.

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<sup>21</sup> ABI 2005.

<sup>22</sup> Hain (2008).

## 3 Improving customer outcomes

A key part of the IIWG's Vision for the insurance industry in 2020 is establishing a more customer-focused approach in order to increase both customers' confidence and trust in the insurance industry, and their awareness of their own personal responsibility. Achieving this Vision will require both increased levels of financial literacy and improved accessibility, to empower consumers and ensure that everyone who would benefit from insurance is able to do so.

There are already many important initiatives addressing these themes. For example, the industry has worked hard to embed the FSA's Treating Customers Fairly (TCF) initiative. This will help with accessibility, given the requirement, for example, that product literature should be clear, fair and not misleading. Similarly, there are several other initiatives aimed at improving levels of financial capability, such as the introduction of the FSA's MoneyMadeClear website and the Money Guidance initiative.

If implemented effectively, the FSA's Retail Distribution Review (RDR) will also play an important role when it is introduced in 2012. In particular it could help improve the accessibility of advice on simple products via a new streamlined advice regime and reduce the perception of commission bias by introducing adviser charging.

The industry also has its own initiatives to help improve customers' experiences, both at an individual company level and through initiatives such as the ABI's consumer strategy. These aim to address problems at a granular level. Examples of specific issues addressed through the ABI's consumer strategy include: improvements in the 'wake-up letters' that customers receive as they are approaching retirement, making it clear to them what their options are when they need to purchase an annuity to provide them with an income in old age; the improvement in transfer times for

customers exercising their Open Market Option (OMO) at retirement; and a code of practice to deal with disclosure for critical illness policies, which has significantly reduced the number of complaints being taken to the Financial Ombudsman Service.

The IIWG supports these initiatives and believes that combined they have the potential to yield substantial improvements in customer outcomes. To underpin them the Group has made four recommendations:

- Improvements in the way that the financial education and financial literacy initiatives are co-ordinated, to maximise their impact.
- Support for the aim of improving accessibility that underpins existing initiatives, such as the Retail Distribution Review. To allow industry and regulators to concentrate on ensuring these initiatives are successful from a consumer perspective, where possible, there should be no further significant change to retail regulation until all the existing initiatives are fully embedded.
- An independent review of the overall effectiveness of all the changes affecting retail distribution in improving customer outcomes, within three to five years of the implementation of the FSA's Retail Distribution Review.
- A commitment by the industry to continue to identify initiatives to make the industry easier to do business with by improving transparency, simplicity and access for consumers.

### 3.1 Increasing customers' awareness and personal responsibility around insurance and its benefits

Poor financial literacy and low awareness of personal responsibility amongst consumers is recognised as one of the major causes of people not saving

or taking up the protection products they need. Understanding of personal finance issues amongst the UK population remains at too low a level. For example, in 2006 the FSA published *Levels of Financial Capability in the UK: Results of a baseline survey*. This comprehensive report measured UK consumers' abilities to manage and understand personal finances along a number of different dimensions. These dimensions include managing money (further segmented into making ends meet and keeping track), planning ahead, choosing products and staying informed. The results of the FSA report indicate that 42 per cent of UK consumers demonstrate a relative weakness in two or more of these dimensions while 64 per cent demonstrate a relative weakness in at least one dimension.

The Group believes that action must be taken to address these low levels of financial capability and supports the work of the Government, the FSA, industry members, the non-profit sector and others to tackle the issue.

### Financial education in schools

The Group believes that financial education in schools is of vital importance in ensuring that children learn from a young age the importance of taking responsibility for their finances and in laying the groundwork for feeling confident and motivated in dealing with financial affairs in adulthood.

Support for schools teaching about personal finance has included investment of £16 million from the FSA for the 'Learning Money Matters' programme, aimed at secondary schools and delivered by the Personal Finance Education Group (pfeg) since 2006. The Government has also committed £11.5 million to a package of support to embed financial capability in schools. This funds the 'My Money' programme, aimed at schoolchildren from when they start school to the transition to further education or work, which is also delivered by pfeg.

The insurance industry also invests in financial education in schools, for example:

- Prudential's 'Adding up to a Lifetime' – an interactive schools module, developed in partnership with the Specialist Schools and Academies Trust, that aims to show children how decisions made throughout their lives affect their financial security; and
- Aviva's 'Paying for It' – a national programme in conjunction with the Citizenship Foundation that develops "economic literacy" education for ages 14-19. Part of this programme is the 'Chance to be Chancellor' competition, teaching students what economic considerations the Chancellor makes in the run up to the Budget.

The Government has also announced its intention to make financial capability a statutory subject in the secondary curriculum in England – as part of Personal, Health, Social and Economic (PSHE) education – and is currently consulting on plans to implement this.

### Financial capability in adulthood

Support for consumers in making sound financial decisions is also important and the Group supports the range of programmes led by the FSA, the Government and the non-profit sector to improve adults' financial capability. The industry has also promoted and supported a number of financial capability initiatives in recent years. These have included a range of support for Citizens Advice Bureau and other advice agencies, housing associations and other local organisations in delivering financial education in their communities.

The most significant development in support for adults is 'Money Guidance': following the review led by Otto Thoresen of AEGON UK, the Government and the FSA plan to roll out a national generic advice, or 'Money Guidance' service, with national implementation beginning in 2010, provided the pathfinder demonstrates the service's potential to deliver effective outcomes for consumers. The pathfinder builds on the FSA's existing 'Moneymadeclear' website and resources. The insurance industry has actively supported the

development of Money Guidance, which will help to guide people through their options and help them take greater responsibility for their financial affairs.

### Co-ordination and collaboration

The FSA alone, from levy funding, plans to spend £100 million on financial capability between 2006 and 2011. In the same period, the Group estimate that the insurance industry will spend £10-20 million.

The Group supports the significant investment into a wide range of financial education initiatives by the Government, the FSA, the non-profit sector and the industry. However, it is the view of the Group that a more 'joined up approach' is required that better links the different initiatives undertaken by the Government and the regulator, and ensures that support from the industry is better aligned. Through improved co-ordination, greater value could be derived from investment and this could in turn deliver better outcomes for consumers. The Group recommends that the Government considers a single co-ordinating body, which also works in conjunction with the industry to an agreed set of principles and, where possible, a joint approach. Similar bodies have been successful elsewhere, see for example the case study on the New Zealand experience.

**Recommendation 1:** Develop a more co-ordinated approach to financial literacy and education and raise awareness of the need for appropriate levels of personal savings and protection amongst consumers. This should build on current initiatives to improve the financial capability of UK consumers and ensure existing resources are used most effectively.

As part of this recommendation, consideration should be given to appointing a Financial Education Commissioner to act as the central co-ordinating body. The Commissioner should work with the whole financial services industry to improve all aspects of financial education and literacy, including in the context of the national curriculum, and develop a trusted financial education and information service.

### Case Study – New Zealand's Retirement Commission

Any Financial Education Commissioner could usefully draw lessons from the New Zealand Retirement Commission.

In 1993, New Zealand established the Retirement Commission, an autonomous crown entity that, in partnership with industry, helps New Zealanders prepare financially for retirement through education, information and promotion.

The Commission's work contributes towards three elements vital to New Zealanders' confidence and ability to make informed decisions about personal finances throughout their lives:

- maintaining stable effective government policy;
- developing a more trusted financial services sector; and
- creating a financially educated population.

The Commission runs 'Sorted', a consumer website, which was established in 2001 and, since inception, has received over 942,000 unique visitors, 20 per cent of the population. 82 per cent of surveyed users said they would undertake financial planning as a result of visiting 'Sorted'.

The Commission is a central, autonomous body, which has clear objectives and a statutory purpose centred around financial capability, and provides a helpful starting point for thinking about a UK Financial Education Commissioner. In New Zealand, the 'Sorted' website is positioned as a one-stop-shop for impartial information for consumers on financial issues; so, in a similar way, the proposed UK body would be expected to lead the Money Guidance service, offering face-to-face personalised guidance as well as a hub for impartial web-based information. To ensure that initiatives are fully joined up, it should also provide a coordinating role for other parts of the UK's financial education and capability strategy. See O'Connell (2007) and Pensions Policy Institute (2006) for further discussion of New Zealand's Retirement Commission.

## 3.2 Creating consumer trust by making the industry more transparent and easier to work with

Concepts of transparency, simplicity and accessibility for consumers of insurance products and financial services in general have generated much discussion and debate in the UK. The FSA's 'Treating Customers Fairly' (TCF) initiative highlighted the need for improvement in some areas and insurers themselves, both independently and together through the ABI, have made significant ongoing efforts to meet challenges and customer expectations.

For example, recent ABI initiatives on critical illness disclosure and transfer times for customers exercising their Open Market Option at retirement have significantly improved outcomes for customers. Introducing improved critical illness disclosure has led to a sharp fall in the number of complaints going to the FOS,<sup>23</sup> while OMO transfer times for those involved in the Options scheme have fallen from an average of over three weeks to just eight calendar days. Similar initiatives are already on the way on the definitions of total permanent disability and how to explain investment risk to consumers. This type of granular initiative can be extremely effective in improving outcomes, which is why in the recommendations the industry commits to continue to strengthen its interaction with consumers.

The Group recognises that while issues of transparency and simplicity affect consumers of all types of insurance products, including small businesses, it is life and savings products where consumers feel most uncertain. In the recent ABI Customer Impact Study of life and pensions products, although 32 per cent of people felt products were easy to understand, 6 per cent rated products as

poor on this attribute.<sup>24</sup> General insurance and health products are considered simpler to understand by consumers, although some issues related to contestability and payout remain. In contrast life and pension products are inherently more complex due to a number of factors, including their long term nature, the degree of investment choice, the potential interaction with means-tested benefits and the tax regime that governs them. This complexity can make it difficult for consumers to understand savings and protection products and underlines the importance of advice.

The industry has also been hampered by a perception of commission bias in advice, which has meant that some people have been unwilling to entrust their money to protection and investment products. This will be partly addressed by implementation of proposals in the Retail Distribution Review (RDR) on adviser charging (previously known as 'customer agreed remuneration').<sup>25</sup> The Group believes that RDR, combined with TCF, could address many of the current problems with the existing framework, although there are some important details that remain to be agreed.

Given the importance of these initiatives, the Group believes that, as far as possible, it would be helpful to have a period of stability for retail regulation until the RDR is embedded, to allow everyone to concentrate on getting it right. Obviously stability is not always possible, for example because of regulation from Europe, but it is desirable as the pace of regulatory change can be significant.

<sup>23</sup> The most recent Annual Report from the FOS cites the ABI's Code of Practice on long-term protection forms as leading to falls in critical illness complaints. This code was introduced as part of the ABI's Consumer Strategy.

<sup>24</sup> The Customer Impact Study provides an annual extensive and in-depth customer survey to measure how well insurance companies are performing.

<sup>25</sup> CRA International (2008) shows that consumers believe that bias will be reduced under adviser charging.

**Recommendation 2:** The Group recommends, as far as possible, allowing time for existing initiatives to be implemented and to start having an effect before introducing any further significant new retail regulation initiatives.

Over the medium term existing initiatives such as Treating Customers Fairly (TCF) and the Retail Distribution Review (RDR) have the potential to improve customer engagement significantly, by making the industry easier to do business with. The Group supports these aims, which should address some of the main failings of the existing framework in which the industry operates. A period of stability will allow for full implementation of the RDR and time for these changes to start having an effect.

**Recommendation 3:** There are currently a considerable number of initiatives that aim to improve consumer engagement. As well as the Retail Distribution Review and Treating Customers Fairly, there are also initiatives on financial education and awareness, on access to generic advice and to encourage savings. The Group recommends that the Government consider an independent review of the overall effectiveness of all these changes, to assess whether in combination they have improved customer outcomes. Such a review should take place around three to five years after the implementation of RDR and Personal Accounts.

**Recommendation 4:** The industry will continue to identify ways to promote wider take-up of insurance and savings products and to build trust in the industry, by improving transparency, simplicity and access for consumers under the auspices of the Association of British Insurers (ABI). To do this the industry will work with consumer groups and other stakeholders, such as the Financial Services Authority (FSA) and the Financial Ombudsman Service (FOS), to identify ways to improve the accessibility and understanding of products, as has already been achieved, for example, by the ABI's work on critical illness disclosure. Initiatives could cover areas such as:

- conditions of payout, in particular what constitutes a valid claim and what is covered;
- transparency around the charges consumers pay and what these charges cover, including distributor charges; and
- the degree of investment risk associated with individual funds.

The industry will focus on what it can achieve without regulation. However, where appropriate, the industry will also make suggestions on potential improvements to regulations to ensure these goals can be met.

The Retail Distribution Review will not only address concerns around commission bias and improve the professionalism of advice, it also has the potential to facilitate simpler products being made available to a mass market, through the streamlined advice channel. Although this channel will involve advice in some form, the aim should be to create a lighter touch, cheaper process to broaden access to advice to a wider market.

One of the factors that industry and the Financial Ombudsman Service (FOS) will need to work together to clarify when implementing this part

of the Retail Distribution Review is how the FOS will take account of the sales channel when reviewing complaints.

### 3.3 The virtuous circle

The recommendations set out in this chapter underpin one element of the virtuous circle that is needed to ensure the IIWG's Vision is achieved. They address how to improve the customers' experience of the insurance industry. However, implementing just these recommendations, while helpful, will not

be enough. To provide appropriate solutions, the industry needs to be able to price risk effectively and to attract sufficient capital. All this, combined with the appropriate incentives, should help to ensure that by 2020 gaps in coverage have been reduced or eliminated, as consumers understand their protection and savings needs better.

## 4 Risk management solutions

The IIWG's Vision for 2020 is of an insurance industry that helps consumers and businesses by offering a broad range of risk management solutions that are competitively priced, provide customers with the products they need and incentivise good risk management. To achieve this Vision, insurance companies must be free to set prices based on their assessment of appropriate and relevant risk factors, otherwise consumers will face paying higher prices for insurance products that will not be tailored to their needs. In addition the Group believes that it is important for the industry and the Government to work together where possible to manage the overall level of risk within society.

The insurance industry plays a unique role within the economy, by providing a mechanism to allow people to cope when a risk is realised. As Chapter 1 sets out, it does so by:

- assessing the likelihood of risks occurring (to help price insurance fairly);
- working actively to reduce risk (for example by helping the police target crime); and
- pricing risk in a way that provides people with incentives to adjust their behaviour (for example by encouraging high risk drivers to drive more safely).

This helps people and businesses to manage the risks they face.

These activities are all important if the industry is to continue to provide this role, not just with respect to known risks, but also for new and emerging risks. This underpins the Group's recommendations on risk management solutions, which are:

- Ensuring that legislative and/or regulatory changes support the industry's ability to price according to risk factors.

- Partnering with the Government to manage current, new and evolving risks and to incentivise the good management of those risks.

### 4.1 Enabling the industry to price according to risk factors

The insurance industry needs to understand the nature of the risks it is undertaking. This means careful analysis using statistical techniques and data such as age, sex and postcode to enable the industry to appropriately price based on the risk involved. Without this, the risk is either that:

- the industry will not have understood the nature of the risk and will not have sufficient reserves to pay out claims, or that
- customers could face higher prices on average, because charging the same price for everyone reduces individuals' incentives to act responsibly, raising the overall level of risk society faces.

The insurance industry supports efforts to eliminate unfair discrimination, for example due to gender or age. However, the Group believes that underwriting using accepted risk classifications based on proprietary data is not discriminatory, if applied fairly. For example, the average cost of claims from drivers aged over 80 is almost 50 per cent more expensive than that for drivers aged 60-64.<sup>26</sup> Similarly older travellers are more likely to make a claim than younger travellers are. Age can also act as a proxy of other risks, such as health. Using age as a factor in assessing risk therefore also keeps the underwriting process relatively simple and the cost of insurance low. This is beneficial to consumers of all ages and generally ensures that customers pay a fair price for the risk they represent.

<sup>26</sup> CRA International (2009).

There are currently proposals in the UK and at the EU level to prohibit age discrimination in the provision of goods and services. The Government Equalities Office (GEO) on 27 April 2009 brought forward an Equality Bill, which will make discrimination on the basis of age in the provision of goods and services unlawful when the age discrimination provisions are implemented. The Bill provides for differential treatment on the basis of age if it is shown to be “a proportionate means of achieving a legitimate aim”.<sup>27</sup> The Government has committed to introducing an exception to these provisions for financial services, providing differences in treatment are broadly proportionate to changes in risk. Details of this exception will not be defined until after a period of consultation. The Group is keen that the proposed exception is sufficiently clear not to inhibit the provision of appropriately priced insurance.

**Recommendation 5:** The Group recommends that legislative and/or regulatory changes support the industry’s ability to price according to risk factors. Insurance, by its nature, pools risk and works most effectively where it can group similar risks together. The industry is sensitive to concerns about which risk factors are used and so, for example, has introduced the Concordat and Moratorium on Genetics and Insurance to deal with specific concerns around genetic testing. However, the ability to price according to risk will help the insurance industry to be able to continue to provide consumers with a broad choice of competitively priced risk management and savings solutions.

For example, the industry believes the Government should ensure that the Equality Bill and prospective European legislation enables insurers to continue to price risks appropriately. The Government is currently consulting on the age discrimination strand of the Equality Bill and will take account of all views, including the insurance industry’s, when deciding on legislation.

In the longer term, the insurance industry and the Government will also need to work together to address the impact of the increasing availability of genetic information on UK insurance markets.

## 4.2 Effective risk management

The UK is facing substantial changes to society and its environment, which will impact the level and nature of the risks it faces. Climate change is an obvious example, as global warming is increasing the risk of flooding in large areas of the UK. Shifting consumer patterns, as well as demographic, environmental and technology driven changes will also result in new risks that need to be managed, such as the evolving nuclear industry, genetics and nanotechnology.

As well as simply pricing the risk, there is an extremely important role for the insurance industry in both risk prevention and risk reduction. The insurance industry already plays an active role in helping reduce risk, for example by working with police to reduce crime. It does so by identifying patterns and assessing weak spots so, in the case of crime, it helps the police to target their activities effectively. The Group believes that this type of partnership approach between the private and public sector will in many cases be the best way to ensure that both consumers and the UK economy are adequately protected against risk.

Government action to prevent or reduce the impact of primary risks increases the economic viability of insurers providing comprehensive risk management solutions. For example, by investing in flood barriers or preventing development on flood plains the Government can reduce the frequency and severity of flood claims, thereby making it economic for insurers to continue to provide flood coverage. Without such actions, in some areas flood risk could become uninsurable (see case study).

<sup>27</sup> Clause 13.

### Case study: Flood risk in the UK – the role of insurance

Unlike most of Europe, the UK insurance industry generally covers flood risk as a standard part of home insurance. Recent decades have seen increasing flood frequency and intensity, and in the summer of 2007 the UK experienced its most severe weather-related events for decades. The 2007 floods caused losses of around £3 billion and resulted in insurers receiving around 165,000 claims. With the average cost of a property flood claim running at £20,000, it is clear that Britain's homeowners and businesses are benefiting from a unique and valuable service.

The increase in flooding is attributable to a combination of climate change and failures in planning policy. Climate models clearly show that our weather patterns are changing and that sea levels will rise; with a corresponding increase in the frequency and intensity of flood events. As flood risk increases and data relating to at-risk areas improve, areas of the UK will emerge where it is not commercially viable for the insurance industry to provide cover for households using the current model.

To address this issue, the Government must work with the insurance industry and other experts in policy development. This may include reassessing house planning policies, promoting the greater use of resilience and resistance measures, reviewing flood and sea defence programmes and managing drainage issues. The insurance industry and the Government must work together if the universal availability of insurance is to be maintained.

This underlines the importance of the Environment Agency's long-term investment strategy, which provides a strategic England-wide overview of flood risk over the next 25 years. This work will serve as an evidence base to inform future policy and funding decisions.

While industry and the Government currently co-operate on these issues, the Group believes that more should be done to encourage and support further public and private joint working to help the UK confront the impacts of new and evolving risks. Co-operation in addressing new and evolving risks should occur across two main elements: policy setting and strategy development; and risk management (both insurance and prevention).

#### 4.2.1 Policy setting and strategy development

Effective assessment of risk and prioritisation of policy initiatives is a key part of helping society deal with risk. This point can be illustrated using risk arising from climate change.

Climate change is a global phenomenon, which is forecast to have a significant impact on communities throughout the world. Changes to weather patterns are likely to mean increased frequency of 'extreme' weather events, and substantial deviations from expected temperature and precipitation levels. In

addition to more extreme events, climate change is also impacting smaller, more regularly occurring, events by exacerbating their frequency and the amount of damage caused as a result. Although some concerted action is being taken to mitigate greenhouse gas emissions, in the short to medium term society will have no choice other than to adapt to changing climatic conditions.

To set an effective strategy to understand the risk associated with climate change, it is important to have the right sort of information. The Government and industry could have a significant impact by encouraging and supporting relevant public institutions (including Research Councils, the Met Office, Technology Strategy Board, the Department of Energy and Climate Change and universities) to extend their work in assessing issues with risk management implications for the UK. These institutions are significant sources of information and research. If their outputs are tailored to be of practical use to insurers and policy makers, this would be valuable in ensuring that both the

Government and the industry have the best, most relevant information available when setting policy and developing strategy to address evolving risks.

In the case of climate change, the aim of greater co-operation between the Government, the insurance industry and institutions would be to make better predictions of environmental change and its impact (including severe weather, flooding, health impacts, and drought) at regional and local levels. This could be achieved by:

- prioritising high resolution climate models and the need for enhanced super-computing power to be able to make the predictions needed by the industry and society. This is an area of UK leadership that must be maintained, requiring significant investment in super-computer facilities and personnel;
- encouraging and supporting the employment and funding of researchers in universities and public agencies who are directly focused on producing research and outputs which are applied to the risk and insurance industry and can be integrated into the industry's models and systems. This integration is beginning to happen but must be fostered and supported in order to increase levels of activity; and
- improving risk data collection to provide better understanding of what is happening now to both our natural and man-made environment. At present, collection of many key data points is fragmented or non-existent and access to what data does exist can be difficult or cost prohibitive. Observational data is important in effectively testing and calibrating predictive models and lays the foundation for enabling new financial instruments to share the financial risk of extreme events.

#### 4.2.2 Risk management

Once the Government and industry have the best, most relevant information available, it is then possible to establish the best way to address new and evolving risks. In some cases, this may be a combination of investment in infrastructure by the

Government and commitment from industry to deliver the ongoing provision of insurance. In other cases it may mean a direct shift of risk management from the Government to the industry or vice versa.

For example, in the case of climate change, the ABI estimates that at least 80 per cent of the additional costs of climate change could be avoided by taking action now to manage the UK exposure to extreme weather through resilient buildings, flood protection, and controls on development in floodplains. The industry's risk management expertise can then be used in combination with proactive action to shape and inform the Government policy in addressing these issues in the most effective manner.

In the Netherlands and California (see case study) the insurance industry collaborates closely with local and the national Government to understand which risk management solutions will be the lowest cost to society, taking into account cost preventative measures (such as flood protection) and insurance. The Group believes that similar initiatives in the UK could be beneficial.

#### **Case Study: Risk-based design to minimise flood costs in California**

Risk-based design focuses on minimising future costs by taking preventative measures today. Working in partnership with the key interested groups (Government, planners and the insurance industry), the State of California evaluated alternative options as part of a joint approach for managing flood risk. The optimal risk-based design, presenting the minimum total cost to all, was agreed based on an evaluation of alternative risk management solutions.

Public-private joint-working helped in two ways. First, it provided a clear and transparent basis to agree investment in existing flood protection and, second, increased levels of self-insurance cover were taken out as consumers understood their personal responsibility. For example, builders were required to take out homeowners' first year of flood cover to ensure they were aware of the risk associated with living on a flood plain.

The Group note that a joined up approach will be essential to ensure the best outcome for consumers. Without it, there is an increasing risk that areas of the UK have cover withdrawn by the industry as it is no longer economic for them to provide insurance cover in these areas as the risk of flooding will be too high (in other words in areas where, without appropriate flood defences and draining, the risk of flooding is closer to 1 in every 5 years rather than 1 in every 75 years).

Of course climate change is not the only issue where the Government could help insurers manage risk for society and the Group believes that it would be helpful to assess the most effective way of collaborating across a wide range of risks.

Another example where industry and the Government partnership could be beneficial is longevity risk, where one possibility would be for the Government to help manage this risk by issuing longevity bonds. Pension plan liabilities in the UK currently stand at around £1 trillion.<sup>28</sup> As individuals and companies increasingly move to defined contribution pension plans, an efficient annuity market will become increasingly important.

Against this background, the Government could issue longevity bonds to help pension fund and annuity providers hedge the aggregate longevity risks they face, particularly for the long-tail risks associated with people living beyond age 90. The timing of any coupon payments would depend both on the precise type of longevity bond issued and whether longevity increased relative to current predictions. By kick-starting this market, the Government would help provide a market-determined price for longevity risk, which could be used to help establish the optimal level of capital for the Solvency II regime of prudential regulation.

**Recommendation 6:** The Group recommends taking advantage of the scope for a more effective partnership between the insurance industry and Government to reduce risk levels in society and to ensure that effective insurance options exist for new and evolving risks.

For example, the insurance industry and Government have data and research findings that can help the collective understanding of the likely impact of different risks, such as flood risk and crime. In some cases, sharing this will help set priorities for public spending on risk reduction; influence whether private insurance is available on a commercial basis at an attractive price for customers; or guide future research. There will be other examples, where industry and Government working together can help people manage their risks better.

### 4.3 The virtuous circle

Risk assessment, risk reduction and the pricing of risk to provide the right incentives play a vital role in the work of the insurance industry and are an important part of achieving the IIWG's Vision of better customer outcomes. If the industry is unable to undertake these activities effectively, then consumers and businesses will not be able to buy the risk management tools they need and the UK economy will suffer as a result.

The effectiveness of the recommendations on risk management in promoting better outcomes will also depend on elements of the rest of the Vision. The insurance industry can only help manage risk if it is able to earn an economic return on its activities. Take-up of insurance, to allow individuals to benefit from better risk management solutions, will depend on both consumers' understanding of the products and their needs and whether the incentives available are effective.

<sup>28</sup> CBI (2008).



## 5 Partnership with the Government

The third element of the IIWG's Vision is for the insurance industry to act in partnership with the Government to explore options to increase savings provision and to help consumers manage financial distress in their daily lives caused by accidents, ill-health or old age.

As set out in Chapter 1, there is evidence that many people are not saving enough for their needs, particularly in retirement, and do not have sufficient insurance to cover them against the risks they face. Both these trends place a burden on the State, by increasing the need for benefit payments for example.

There already exist some government initiatives to address these challenges. For example, the planned introduction of auto-enrolment into workplace pensions in 2012 should help encourage more people to save for a pension at a basic level.

The Group believes that more could be done and the industry is interested in working in partnership with the Government to achieve this, as well as looking at whether private sector solutions could be helpful in other areas of social insurance.

To achieve improvements in the level of coverage, the Group's recommendations are:

- There should be further discussion between industry and the Government to assess the scope for a greater industry role in helping people deal with risks such as unemployment and ill-health, as well as the need for a retirement income or long-term care.
- The need for well-designed incentives to help encourage personal responsibility in respect of savings and protection coverage.

### 5.1 The balance between industry and the Government

The estimates in Chapter 1 suggest that, for the main areas of social insurance, the Government currently underwrites around 64 per cent of the risks, with the balance being underwritten by insurers. A 5 percentage points shift from the Government to the private sector would require roughly £9.7 billion of capital. For this to happen, it would need to be possible both to earn an economic return on capital that was commensurate with the level of risk and for consumers to be willing to rely on private sector solutions.

Any shift to the private sector would have to be economically viable for insurers and there will always be limitations to the amount of risk the private sector can insure. Across the categories of private and occupational pensions, accident and health and income protection insurance, there are specific challenges on which industry and Government need to work together if a new type of partnership between the public and private sectors is to work. Exactly how to achieve a new partnership, including which segments of consumers and which types of risk the private sector could bear in an economically viable way would require further study.

However, the industry is committed to helping the Government address social challenges, where it is commercially viable, and is willing to make its considerable expertise available to work with the Government to look at alternative options and models based on closer co-operation between the industry and the Government.

The Group believes that it is worth investigating the extent to which this is possible on an on-going basis.

**Recommendation 7:** The Group recommends that industry and the Government assess the scope for a greater industry role in helping people deal with risks such as unemployment, ill-health, and the need for a retirement income or long-term care. If in principle partnership is seen as positive, a more detailed plan should be agreed, based on a common understanding of the benefit of involving industry on a commercial basis.

## 5.2 The role of incentives in facilitating individual responsibility

Incentives play an important role in determining what people do. They can either be financial incentives, such as tax relief, or based more broadly around the design of the system, such as soft-compulsion. The Group believes that using incentives effectively will help encourage people to take personal responsibility for their financial wellbeing.

### 5.2.1 Financial incentives

Throughout the world, governments give tax incentives to encourage long-term savings. They do this for a variety of reasons, including the social benefits of reducing dependency on the state, with the associated benefits for public finances, and the economic benefits of having a pool of savings to fund investment and underpin sustainable growth.

The Group believes that it is important for the Government to follow clear principles around tax incentives, particularly for pension savings. It is important that there is a clear deal for incentives to work effectively. Different forms of savings attract different tax treatment, with the value of incentives differing depending on the tax treatment of: the contributions; the returns; and when savings are withdrawn.<sup>29</sup> In the UK, the two main tax incentivised savings vehicles are pensions and Individual Savings

Accounts (ISAs) and their different tax treatment reflects their different purposes:

- ISAs are designed to encourage people to build up some personal capital to help them manage their financial well-being, but are instant access, so the savings can be consumed whenever they are wanted. Reflecting this instant access, the income that is invested in an ISA is taxed, but the returns and any savings withdrawn are exempt from taxation.
- In contrast, pensions represent a much bigger commitment by individuals, as they are locking up any income they invest until they retire. Therefore the tax incentives linked to pensions are based on deferring tax on income used for pension contributions until the resulting income is taken in retirement.

Effective incentives for pensions and long-term saving require a stable environment that allows both consumers and the industry to plan ahead and minimises complexity and disruption where regimes already in place are working well. It is important for consumers that there is a clear rationale to defer consumption and lock up their savings, so taking personal responsibility for their future. Incentives play a critical role in this. People therefore need:

- a regime that is simple enough to be understood;
- reassurance that the benefits they currently expect are likely to be maintained; and
- confidence that a pension will be a savings vehicle that will be both attractive and fit-for-purpose throughout their working life.

This will reassure consumers that the short term sacrifice associated with entering into long-term savings will be recognised and rewarded, simplify decision-making and enable them to plan more effectively for later in life. These principles therefore underpin the Group's recommendation on incentives.

<sup>29</sup> See Wakefield, M (2009), for a description of the tax treatment of savings.

### 5.2.2 Other forms of incentive

There are of course other forms of incentive that can be used. For example soft compulsion (or auto-enrolment) can be extremely powerful because, by changing the default position, it helps consumers overcome psychological barriers. In the case of pension savings this barrier is either apathy or the fear of making an important, but often difficult, decision. As such, the Group welcome the Government's initiative to introduce auto-enrolment into workplace pensions.

#### Case Study: Examples of additional flexibility around pension savings used elsewhere

In New Zealand, KiwiSaver is a voluntary, work-based savings mechanism to assist people with their long-term saving for retirement. Employees are auto-enrolled into the scheme and choose to save 2 per cent, 4 per cent or 8 per cent of their salary, with a compulsory 2 per cent added by the employer, a \$1,000 starting bonus and up to another \$1,043 per year as tax credit.<sup>30</sup> After being a member for three years it is possible to make a one-off withdrawal to contribute to a deposit for a first home (excluding the bonus and tax relief). This flexibility is used to promote the scheme and encourage retirement saving at an earlier age.

Similarly, in Canada, the Registered Retirement Savings Plan (RRSP) scheme lets first-time home buyers use RRSP savings to buy a house, as well as withdraw money to finance training and education for them or their spouse. RRSP funds used for these purposes must be paid back by the fund holder within a specified time frame or the amounts become subject to tax as income.

The evidence from 401(k) pension schemes in the US also shows that the ability to make either a hardship withdrawal or to borrow against the plan can help increase take up.

**Recommendation 8:** The Group believes that there is an important role for well-designed incentives to help ensure people buy the savings and protection cover they need and to help encourage personal responsibility. It recommends that the Government should maintain existing incentives, including tax relief on pensions, and explore new options, though recognising that affordability is an important constraint.

The Government should also seek to maintain stability and certainty, and minimise complexity in savings and pensions taxation where possible. This will be beneficial to consumers, as it will simplify decision-making and enable them to plan more effectively.

Pensions are provided with more favourable tax treatment, compared to other forms of saving, in recognition that they are less flexible than other savings, and are locked away until retirement. Pension tax relief is provided to support retirement income, not for pre-retirement income, asset accumulation or inheritance.

However, a recent ABI survey shows that the younger generation (34.5 per cent of 18 to 34 year-olds) would be more likely to save more in a pension (or start saving) if they could access part of their pension savings before they retired, for example, in the event of a financial emergency, or for a deposit on their first home. In contrast, increased flexibility would only cause 25.7 per cent of 35 to 54 year olds to increase their pension savings.<sup>31</sup>

Outside the UK, some countries have introduced more flexible savings options, which permit consumers to borrow from their retirement savings in certain situations (see case study). This is often in the context of more limited tax relief on pensions, and there will normally be a trade-off between the extent of tax relief and the flexibility with which savings

<sup>30</sup> [www.sorted.org.nz](http://www.sorted.org.nz), accessed April 2009

<sup>31</sup> Based on the ABI (2009b) Quarterly savings and protection survey, 2009Q1.

can be used. However, for the longer term the Group encourages the Government to continue to consider the effectiveness of current incentives and, if appropriate, to explore practices adopted in overseas markets around providing access to long-term savings. Options such as flexibility should only be introduced only where there is strong evidence that they will increase savings and retirement income.

### **5.3 The virtuous circle**

Effective incentives for savings and protection products help encourage personal responsibility and reduce burdens on the State. In addition, the Group believes that it would be helpful to explore the extent to which the insurance industry can help provide insurance where the Government currently bears the financial risk. It is a potential win for consumers, the UK economy and the insurance industry.

To maximise the benefits of this approach it will also be important to improve consumer engagement through increased financial literacy and greater transparency and to ensure that the regulatory and tax environment promotes the availability of capital.

## 6 Encouraging capital flows

The fourth and final strand of the IIWG's Vision for 2020 is to promote a strong industry by encouraging capital flows into the UK insurance industry by ensuring its competitive position in the global marketplace is maintained and enhanced, and that capital can earn a competitive return. An important part of achieving this will be promoting a stable, predictable and competitive regulatory and tax regime in the UK. However, it will also involve facilitating international access and further enhancing the UK's skills base.

While tax is cited as the most common reason for locating or re-domiciling to an offshore location, the Group recognises that 'levelling down' to reduce the relative disparity with offshore locations may well not be the right answer. The challenge is to deliver a consistently stable, predictable and competitive fiscal and regulatory regime. The Group also notes that in some cases the UK regulatory regime can be a source of competitive advantage for the insurance industry and that effective regulation remains an important element in preserving the ongoing health of the industry.

This logic underpins the key recommendations from this chapter, which are:

- The industry will work with the Government to ensure there is a stable, predictable and competitive tax system for the medium to long-term, which is aligned to the Vision for 2020 and takes account of increasing global competition in a world in which capital is flexible and highly mobile.
- The industry will work with the Government and the FSA to promote a stable regulatory regime aligned to the Vision for 2020 and to ensure regulation provides cost effective and appropriate oversight. It emphasizes the importance of effective implementation of Solvency II.
- The industry should develop and attract the best talent to ensure there is a deep pool of insurance

professionals with the right skills in insurance technical and managerial disciplines.

- The Government should proactively support the UK's insurance business abroad, particularly in emerging markets, and within the UK.

The Group recognises that the recent Financial Services Global Competitiveness Report makes recommendations that in some cases link directly with the IIWG's recommendations, giving rise to the need for co-ordination in implementing both sets of recommendations. While there is a need for co-ordination, the Group believes that the two sets of recommendations are complementary and aligned to achieving similar goals. Specifically, the Group believe there is an opportunity to work together on taxation, consumer financial education and advocacy that promotes the UK as a global centre of excellence in the financial services industry.

### 6.1 A well-designed, stable, predictable and competitive corporation tax system

This report has identified the importance of ensuring that the UK offers an attractive location to bring new capital into the UK. The overall design and operation of the UK tax system is a key factor for companies when deciding where to invest or where to headquarter their companies. The UK's corporation tax rate is lower than those in other G7 economies and recent foreign profits legislation introduced by the Government has enhanced the UK's competitiveness. However, given the mobility of capital, as Chapter 2 shows, this market will always be vulnerable to tax arbitrage relative to the tax rates in other jurisdictions.

A well-designed, predictable, competitive and stable tax system for the insurance industry will be of

critical importance to the industry's ability to realise the IIWG's Vision for 2020, both by encouraging investment by existing players and attracting new start-ups.

The Group recognises that the Government needs to maintain sound public finances. However, for the UK to continue to remain an attractive location for capital, the competitiveness of the tax regime is an area that will need to be subject to constant review.

It is not only the pure corporate tax regime that needs to be stable, predictable and competitive for the UK to remain an attractive location. Regular tax changes that undermine the competitive position of individual products will also make a jurisdiction unattractive to invest in, because it increases both cost and uncertainty. For example, life and pensions products are often structured around tax rules, so when these rules change it can have a negative impact on both the industry and its customers. It is therefore important that this is considered when making tax changes.

The Group believe that more can be done to enhance consultation processes to ensure tax changes are based on the best available information and to prevent unintended impacts on consumers or industry. The recently concluded three-year programme of engagement with industry on simplification of the life tax rules has been a positive and constructive development and shows what can be done in improving dialogue.

**Recommendation 9:** The Group recommends that the Government should continue to work with industry to ensure a stable, predictable and competitive tax system for the medium to long-term, which is aligned to the Vision for 2020 and takes account of increasing global competition in a world in which capital is highly mobile. The Group therefore supports the recommendations on tax competitiveness in the Financial Services Global Competitiveness Group Report and the work of the Business-Government Forum on Tax and Globalisation.

The Group believes the Government should take action to prevent loss of UK business to low tax and offshore domiciles and to counter threats to the medium to long-run competitiveness of the UK as a location for insurance business.

The Group also believes that it is important that the consultation process around tax changes continues to be enhanced, so that the impact on consumers, the industry and the wider UK economy is understood when making tax decisions.

## 6.2 An effective and appropriate regulatory regime

In the competition to win new capital it is important that the UK's regulatory regime provides effective oversight and ensures financial stability without discouraging insurance businesses from basing their operations in this country.

The Group notes that there is much debate at the moment about the need for additional regulation. While they understand the reasons for this, they believe it is important to focus on regulation that is stable, meets the needs of the economy, protects the consumer and is in line with international norms.

The Group also notes that a simple 'read across' from the banking to the insurance sector would not be appropriate, particularly as the existing prudential

regulatory regime for insurance in the UK has so far stood up well to the recent financial turmoil and will be strengthened further by the appropriate implementation of the Solvency II directive.

### 6.2.1 The importance of Solvency II

Prudential regulation plays a vital role in financial services, because it provides the means to ensure that policyholders will receive their money – the ultimate Treating Customers Fairly.

To date, the UK's prudential regime for insurance has coped well during the current crisis and the new EU regime for prudential regulation in insurance, Solvency II, is due to be introduced in 2012.

Members of the IIWG are generally supportive of the new Solvency II directive, and believe that the process of negotiating the directive has been a good example of consultation with industry. However, it is important that it is implemented effectively, and the Group is committed to working with regulators and the Treasury to get this right.

For example, if Solvency II were to be implemented using methodologies tested in the recent QIS4<sup>32</sup> exercise, consumers could end up paying more for certain insurance products, as regulators would require more capital backing for products like annuities. Industry estimates suggest that, under Solvency II, new annuity policyholders will tend to see a decrease in their pension income for a given pension pot. Assessing the appropriate levels of capital needed is therefore crucial.

### 6.2.2 The impact of legislative and regulatory change

The regulatory environment for the insurance sector is experiencing an intense period of change (see case study). In recent years the movement towards a global standardisation of insurance regulation has gained momentum, as the industry itself has become more global. EU policymakers have also proposed significant changes to insurance regulation. The Group supports the need for an appropriate principles-based regulatory framework but agrees the net impact of legislation and regulatory change needs to be managed. Changes implemented since 2005, or currently being considered include:

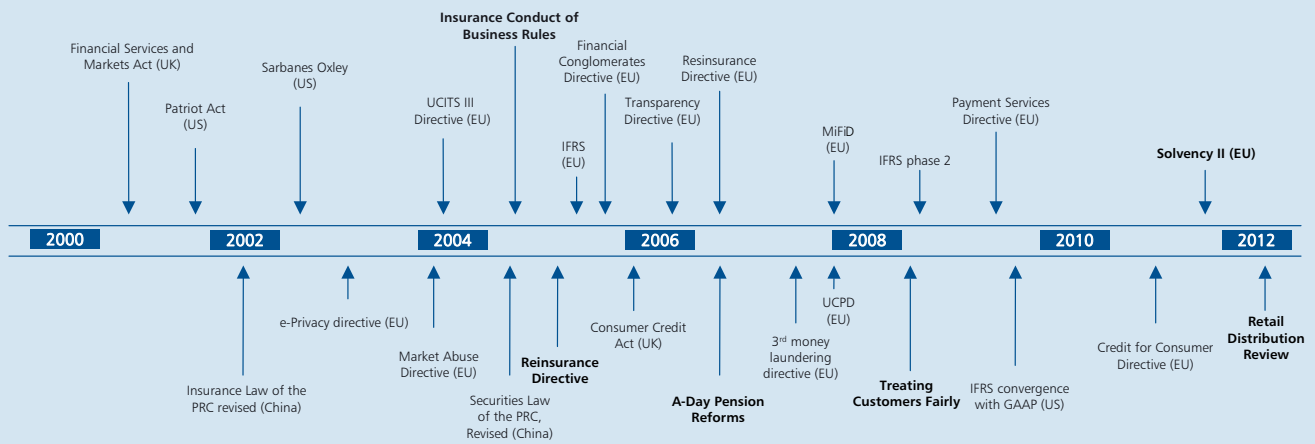
- Treating Customers Fairly (TCF) enforcement.
- The updating of the Conduct of Business (COB) rules to reflect the implementation of the Market in Financial Instruments Directive (MiFiD).
- Pensions Simplification (A-Day).
- Pension Reform, including the proposed introduction of auto-enrolment into workplace pensions.
- Solvency II.
- Retail Distribution Review.
- Insurance Conduct of Business (ICOB) rules, which implemented the Insurance Mediation Directive and the Distance Marketing Directive.

These changes have altered the regulatory environment, particularly for long-term savings business. Many of these changes are helping to address important issues around transparency, simplicity and access. However, in order for the positive effects of regulatory changes to be fully recognised, a period of relative regulatory stability would be beneficial. The Group recognises that regulations must anticipate and respond to economic realities and remains keen to consult with the Government in a timely and meaningful way at the earliest possible stages of the development of any new regulation to ensure the consequences are fully understood.

32 Fourth Quantitative Impact Study.

## Case Study: The Transforming International Regulatory Landscape of the Financial Services Industry

A number of regulations impacting the financial services industry have been introduced over the past few years. Some of these regulations are yet to take effect. This has been the case across markets, geographies and industry sectors.



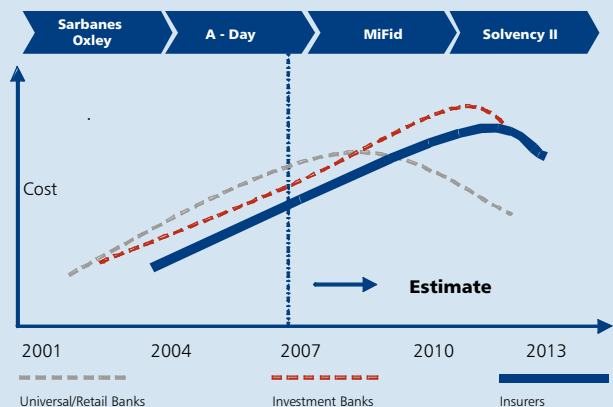
- The regulations included in the above illustration do not form a comprehensive list of regulations influencing the global financial services industry.
- The timeline indicates when a regulation was or is due to be implemented.

In a 2007 study conducted by Deloitte,<sup>33</sup> financial services companies indicated that they do not expect the pace of regulatory and compliance reform to slow even after 2010.

Over half of respondents (53 per cent) do not expect any deceleration of reform in 2010, compared to just 19 per cent who think that reform will slow. This partly reflects the impact of regulations such as Solvency II or International Financial Reporting Standards (IFRS) phase 2 that are not due to take place before 2010, while RDR is still in the midway stages of consultation.

Additionally, the costs associated with implementation will not decrease for some time. This is particularly true for insurers and investment banks. However, there will be divergence within these sectors, some geographic, but also between the best and the worst performers in the financial services industry.

According to this Deloitte research, insurers have seen costs for governance and internal controls rise by around a third from 2003 to 2006 and expect to see larger increases in costs for governance and controls than retail banks until 2010.



Source: Deloitte Research, 2007

33 Deloitte 2007.

## Impact of implementing EU regulation

The EU Life and Non-Life Directives offer insurers a passport to provide insurance in other member states, while the recent Reinsurance Directive allows insurers to domicile their portfolio to a single jurisdiction and pay tax there. While these Directives may lead to some positive outcomes for consumers and industry, they do create significant scope for regulatory arbitrage between EU jurisdictions.

The FSA are committed to working with the market and ensuring that the benefits of regulatory change outweigh costs when transposing EU directives. It is extremely important that these principles are adhered to, to ensure that UK resident insurers are not disadvantaged relative to European peers, reducing the attractiveness of the UK as a domicile for existing or new insurance investment. Of course it will not always be the case that simply implementing the minimum requirement when implementing EU Directives will be the best outcome for UK-based insurers and for the UK insurance market as a whole. The Group notes that the 'precautionary principle' recommendation in the Financial Services Global Competitiveness report is well aligned to achieving this purpose and preventing potential 'gold-plating' and supports the recommendation in principle.

## The impact of retrospective change

One area where legislative change can be particularly harmful is where it involves an element of retrospection. Both life and non-life insurance are long-term industries with liabilities taking many years, or even decades, to crystallise. This means that the industry is vulnerable to sudden legislative change, particularly where there is a retrospective element. Such changes would have a destabilising impact on the UK insurance environment, making fair pricing and the attraction of capital difficult. Where the reserving requirements to deal with the change are substantial, retrospective change can also undermine solvency within the sector.

### Case Study: The impact of retrospection on general insurance claims

In 2007 the ABI and the International Underwriting Association of London published the Fourth UK Bodily Injury Awards Study.<sup>33</sup>

This Study identified 45 major legal developments relating to personal injury claims over the period 1997 to 2007 that had a retrospective impact on insurers because they changed the cost of claims for which premiums had already been collected.

Of these, nearly half the changes related to individual case law, the remainder were mainly as a result of developments in regulations, court procedures and guidelines. The Study highlighted that 26 of the changes had a high financial impact. In the case of the Ogden discount rate change in 1998, the retrospective cost for motor insurance was estimated to be close to £500 million.

The impact of retrospective change on the industry and consumers is substantial and includes:

- future policyholders paying the costs for compensation paid to past policyholders;
- a 'wait and-see-culture' which increases costs for the industry and the Government. Claimants may not want to settle when there is a test case going through the courts that might improve their settlement; and
- a cautious approach to underwriting due to an uncertain future. In particular, this leads to a lack of capacity in areas most prone to retrospective change, for example employers' liability.

This is why, for example, the insurance industry would be concerned about the possibility of any legislation to reintroduce compensation for pleural plaques<sup>35</sup> (which is subject to judicial review in Scotland) and why they believe this would have a

<sup>34</sup> ABI and IUA (2007)

<sup>35</sup> Pleural plaques are a sign of exposure to asbestos, but medical evidence suggests it is not an illness.

significant impact on a number of insurers and could undermine faith in the stability of the UK legislative framework.

### 6.2.3 The Financial Services Compensation Scheme

As the statutory fund of last resort for customers of financial services firms, the Financial Services Compensation Scheme (FSCS) has an important role to play in restoring consumer confidence in financial markets, because it covers policyholders if firms fail. However, a YouGov poll for the ABI conducted between 25 June and 1 July 2008 found that only

34 per cent of people knew that the FSA had increased the FSCS deposit compensation limits to £50,000.

The FSA is responsible for making the rules on FSCS funding. One feature of the FSCS is that it is funded by a levy on firms authorised under the Financial Services and Markets Act 2000, divided into five classes with the potential for those classes to be required to contribute to the compensation costs arising from the default of a firm in another class. The insurance industry believe that the potential for cross-subsidy should be eliminated as the operation of the FSCS is assessed in the light of experience

**Recommendation 10:** The regulatory and legislative framework is key to the success and stability of the UK insurance industry. The Group recommends:

- ensuring that the Government, the FSA and the industry work together to promote stable and effective national, international and European regulatory and legislative regimes. The objective should be to support the Vision for 2020 and deliver cost effective and appropriate oversight that helps build trust in the industry and to maintain financial stability. The UK should take account of the economic reality of cross-border activity and ensure a co-ordinated approach to minimise global inconsistency and protectionism;
- ensuring supervisory and regulatory measures taken to respond to the current economic crisis distinguish between, and are proportionate to, the experience of different financial services sectors so that, for example, changes aimed at the banking industry are not automatically applied to the insurance industry;
- ensuring effective and meaningful consultation on new regulation at the earliest possible stage, to allow information-sharing on the likely impact on the industry and consumers. Cost benefit analysis and post implementation reviews are agreed to be extremely important parts of the consultation process;
- continued commitment when transposing EU Directives to the FSA's principles of working with the market and only 'gold plating' measures when there is a strong cost benefit analysis for doing so;
- implementing the Solvency II Directive in a way that ensures the best outcomes for both the industry and UK consumers, for example in relation to annuities; and
- avoiding, where possible, retrospective changes affecting long-term savings contracts and long-tail insurance business.

The Group also recommends considering reviewing the funding and operation of the Financial Services Compensation Scheme (FSCS), including the principle of cross-subsidy, taking into account potential changes at a European level.

Furthermore, the Group recommends considering whether extending the FSA's mandate, to include a specific objective to encourage financial responsibility, would help ensure an appropriate balance between protecting consumers from potential mis-selling and encouraging them to save.

of the financial crisis and of anticipated European initiatives on compensation schemes.

This is because the cross-subsidy means that costs arising from failures in one sector would be passed on to customers in other sectors, undermining other sectors' brands. It is possible that this would also reduce trust in the industry because consumers do not understand why the price of their insurance rises to cover issues in the banking sector. It also increases the risk of contagion between sectors.

### 6.3 Nurturing and attracting the best skills

The future prosperity of the UK insurance industry, and indeed the financial services industry as a whole, is heavily dependent on its ability to attract, retain and develop high quality people. The availability of a deep pool of highly skilled insurance professionals is a key differentiator for London and the UK insurance industry. A recent City of London survey of *The Competitive Position of London as a Global Financial Centre* suggests that the availability of skilled personnel is the most important consideration for today's financial services companies. Over 90 per cent of those surveyed say that it is very or critically important.

It is widely understood, however, that the insurance industry's attraction as a potential employer is relatively low. In research conducted by Lloyd's with UK captains of industry, insurance is regularly ranked within the bottom few industry sectors in terms of reputation. In the UK, 90 per cent of graduates say they would not consider insurance as a career.<sup>36</sup>

The Chartered Insurance Institute (CII) is dedicated to promoting higher standards of competency and integrity in the industry through the provision of relevant qualifications for insurance employees at all levels across the whole industry. With 93,000 members across 150 countries it is the world's

largest professional body dedicated to this sector. As part of its long term drive to promote greater levels of professionalism and ethical behaviour in insurance it has initiated a series of studies in 2009 looking at the way forward for a modern and progressive profession and the need for continuous learning and development. The Group welcomes and supports this initiative.

**Recommendation 11:** The industry should develop and attract the best talent to ensure there is a deep pool of insurance professionals with the right skills in insurance, technical and managerial disciplines.

The industry should work with the relevant Government and other interest groups such as the ABI and Chartered Insurance Institute (CII) to support and build on existing initiatives in the market. Consideration should be given to:

- investigating whether there is a need to establish a central resource to co-ordinate this activity or, preferably, if it can be undertaken by an existing organisation such as CII;
- promoting the insurance industry as an attractive career choice and improving the image of the industry within schools and universities;
- developing closer links with universities and business schools;
- encouraging diversity within the insurance employment market; and
- improving the dialogue and communication between industry and the relevant government agencies. This could include, for example, secondments from industry into the Government and vice versa.

In addition, the Group agree with the recommendation in the Financial Services Global Competitiveness Report that the Government should ensure that the immigration points system can attract people with scarce financial services skills, including overseas students keen to pursue financial services careers in the UK after graduation.

<sup>36</sup> CII Talent Special Report, June 2006.

The Group believes that developing closer links with business schools and universities such as the Cass Business School, Edinburgh University or Heriot-Watt University will be important to the insurance industry in developing the best talent. For example, Cass Business School is one of Europe's leading providers of business and management education. It is located in the City of London and through its Faculty of Actuarial Science and Insurance provides one of the largest academic actuarial departments in the world, with highly respected degree courses and research. It is also involved in the teaching of undergraduate and postgraduate degrees covering a large proportion of the professional actuarial qualifications.

## 6.4 Promoting and sponsoring the UK insurance industry

As the insurance industry becomes increasingly global it has become more important for UK-based insurers to be capable of readily accessing overseas markets and writing business in local markets. In some cases accessing overseas markets is straightforward and UK insurers compete on an equal footing with domestic rivals. In other cases, however, access to markets is restricted by overtly or implicitly protectionist measures.

India is a good example of an important emerging market that currently restricts access to its market. The insurance industry in India has been growing rapidly in recent years as private insurers have gained market share from incumbent government owned insurers and expanded the market. The Indian Government requires mandatory cession of certain business to a State owned monopoly and limits foreign direct ownership of insurance companies to 26 per cent. Raising this to 49 per cent has been under discussion in political circles for a number of years, although it may now be more likely that the insurance bill to raise foreign direct investment limits in the insurance sector will progress through the legislative process.

A further example is China where the maximum holding for foreign life insurers in a joint venture company is 50 per cent. Although foreign subsidiaries of general insurers in China can be 100 per cent owned, there is a cap of 25 per cent foreign ownership of Chinese non-life insurers. In other markets, there have been recent and positive developments that ease existing restrictions on foreign ownership. In Malaysia, for example, foreign equity participation has recently been raised to a maximum of 70 per cent, with higher equity participation considered on a case-by-case basis.

**Recommendation 12:** The Government should proactively support the UK's insurance business abroad, particularly in emerging markets, and within the UK.

- Industry should continue to work with the Government to lift barriers and ensure open and fair access in overseas markets for UK insurers.
- The Group supports the recommendation in the Financial Services Global Competitiveness Report, and other recent reports, that the Government, industry and organisations involved in promotional work should consider a process of rationalisation and consolidation to avoid duplication. They should aim to ensure that the promotional resources from the private and public sectors are eventually focused on a single body.
- Industry and the Government should consider sponsoring a 'Risk Summit' hosted in London emphasizing the UK's role as the centre of the global risk industry.
- The industry, working with respective trade bodies and the Government, will explore opportunities to promote the 'role of insurance' and how it helps individuals and business to mitigate and manage every day risks and contributes to the wider UK economy.

The Group shares the opinion of the *London: winning in a changing world*<sup>37</sup> report produced for the Mayor of London that it is important to rebuild London's and the UK's reputation for leading global financial regulation and to restore trust in doing business in London. They also recognise the opportunity for linking efforts with those recommended, specifically the proposed promotional body being established by the City of London.

## 6.5 The virtuous circle

Nurturing the competitiveness of the UK insurance industry for the benefit of customers, shareholders and the economy as a whole is the final strand to the IIWG's Vision for 2020. Without a stable and competitive tax regime in particular, it will not be possible for the IIWG's Vision to be realised, as there will be fewer incentives for insurers to invest in the UK to drive better customer outcomes.

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<sup>37</sup> London: winning in a changing world, December 2008, <http://www.london.gov.uk/mayor/economy/london-winning.jsp>



## 7 Implementation

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The work of the IIWG over the last few months has demonstrated the value of a more co-ordinated approach between the industry and the Government on some of the issues raised in this paper. The Group believes that it is important for the insurance industry to continue to be able to do this and has asked the ABI to look at this and suggest an effective solution. This may include, for example, establishing a cross-industry forum that could meet a number of times a year to look at common issues.

Following further discussions with the Treasury on the specific recommendations raised in this paper, consideration will need to be given to the best way to take these recommendations forward over the coming months. The Group believes that the ABI is best placed to take forward many of these recommendations and we suggest an initial meeting with the ABI and Treasury to agree the way ahead.

The Group also feels that it is important for the industry members of IIWG to meet again in 12 to 18 months to assess progress on specific recommendations and discuss if additional work is needed by the Group to achieve the Vision. Initially, it will also be important to engage with a wider group of stakeholders to obtain their buy-in to the Vision and recommendations set out in this report.



# A UK insurance industry overview

## Market overview: in brief

Any risk that can be quantified can potentially be insured. Based on past experience insurance companies assess the risk of, for example, a flooding event happening and calculate the 'premium' that a customer needs to be pay to provide 'cover' against injury or loss. If the insured event happens the insurer pays out the agreed level of 'claim'. There are a number of types of insurance cover available but they all fall within the following main groups.

## Life and pensions

The main products offered by the life and pensions industry are:

- **Life insurance.** Broadly split into term insurance and whole-of-life insurance. Term insurance pays out if the policy-holder dies within a certain period. Whole-of-life insurance pays an agreed sum on death, regardless of when it happens. Some policies also include an investment element.
- **Pensions.** Pensions are tax-efficient long-term investments through which people can save for their retirement, either individually or through a workplace pension scheme. Savings are not accessible until the holder reaches the age of 50 (changing to 55 from 2010), at which point it is possible to take part of the savings pot as a tax-free lump sum and the remainder as an income stream either in the form of an annuity or through a pension income product such as income drawdown.
- **Annuities.** Annuities enable individuals to convert a savings pot into a guaranteed income for life. This insures people against the risk of living for longer than expected. Most annuities (£11 billion in 2007) are purchased as a result of savings in a pension and these are known as pension annuities. However, there is also a market for the voluntary purchase of annuities that are not linked

directly to pension savings. These are known as purchased life annuities and accounted for £47 million of annuity sales in 2007.<sup>38</sup>

- **Savings.** Insurers also offer a range of other savings and investment products, including ISAs, investment bonds, and funds.
- **Bulk buyouts.** This is similar to annuities, but insures firms, rather than individuals, against the risks inherent in their pension obligations.

## Health and protection

The Government provides a level of 'social insurance' to provide protection against socially recognised conditions including poverty, old age, disability and unemployment. Social insurance is provided by the State through, for example, the Health Service and social security, and is funded through the tax system. It provides a safety net to those that have not taken responsibility for providing for themselves or are unable to afford private insurance cover. However, private sector alternatives do exist.

The main products offered by the health and protection sector include:

- **Private medical insurance.** A policy that covers the cost of private medical treatment. It is purchased either by a group or individual consumer, but in each case they pay a premium to help protect against unexpected or high healthcare expenses. Similar benefits are also provided by through the National Health Services and funded by the Government through taxes.
- **Long-term care.** Offers insurance against care needs, such as the cost of nursing homes, particularly for the elderly. The existing long-term care market is mostly point of need.

<sup>38</sup> Gunawardena, Hicks and O'Neill (2008)

- **Critical illness.** A policy that pays a lump sum to the insured if they are diagnosed with specific critical illnesses during the term of the policy.
- **Income protection.** Income protection insurance pays an income as long as the policy holder is unable to work due to accident or sickness. The policy usually lasts until retirement.
- **Accident and health.** Personal accident insurance pays either a lump sum or weekly benefits in the event of accidental death or a specified injury.
- **Payment protection insurance.** Covers the policy holder against inability to meet debt repayments in the event of accident, sickness or unemployment.

## General insurance

General insurance products provide insurance for companies or individuals against unwelcome future events. Such risks are typically shorter-term, and include covering everyday risks, such as the risk of a motor accident, theft, or damage to property. The main products offered by the non-life sector include:

- **Motor.** Motor insurance covers the legal liabilities arising from the use of a motor vehicle, including private cars, motorcycles and commercial vehicles. Cover can either be third-party (the legal minimum, which only provides compensation to others involved in accidents) or comprehensive, which also covers damage to the vehicle.
- **Property.** Property insurance covers property against damage or destruction from fire, storm, subsidence or theft. Property insurance can cover either the structure itself, or the contents, or both.
- **General liability.** General liability insurance covers a policyholder's legal liability for injury, property damage or financial loss caused to others.
- **Other.** The insurance products also provide a range of further products that insurance against a variety of risks that consumers may wish to insure against. These include: travel insurance, identity theft protection, pet insurance, landlord insurance, heating cover, and others.

General insurance also provides important risk management services to all types of business enabling them to manage uncertainty. Public Liability, Employers' Liability and Professional Indemnity cover are normally the core cover of business insurance cover but additional types of cover can be added.

## Wholesale insurance markets

Wholesale insurance insures large commercial risks, such as those incurred by large corporations. Writing wholesale insurance involves specialist brokers who have expert knowledge of the market and access to reinsurance underwriters on behalf of their clients. It is a market where transactions are undertaken between professional counterparties.

Lloyd's of London is an important part of the UK's wholesale insurance market. The insurance market at Lloyd's is organised into syndicates, which underwrite most types of policy. It is the world's leading specialist insurance market. Together the syndicates underwriting at Lloyd's form one of the world's largest commercial insurers and a leading reinsurer.

Lloyd's of London insures 88 per cent of FTSE 100 companies, 97 per cent of Dow Jones listed companies and 70 per cent of Fortune 500 listed companies.<sup>39</sup> Furthermore, 18 of the world's top 20 reinsurers have representation in London. Lloyd's also has a unique niche in unusual, specialist business such as kidnap and ransom insurance, fine art insurance, aviation insurance, and marine insurance.

## Reinsurance

Reinsurance, effectively insurance for insurers, is the mechanism by which insurers can transfer risk to other insurers or reinsurers. It is a specialist form of wholesale insurance. A contract of reinsurance is between the insurer and reinsurer only; legally there is no direct link between the original insured and any reinsurer. The original insurer is still the one who must

<sup>39</sup> Lloyd's Key Facts (2008)

pay any claim from the insured the insurer must then make its own separate claim against the reinsurer.

Reinsurance is important for a number of reasons:

- **To protect against large claims.** For example, in the case of a fire in a large oil refinery or a large city hit by an earthquake, insurers will spread the risk by reinsuring part of what they have agreed to insure with other reinsurers so that the loss is not so severe for any one insurer.
- **To avoid undue fluctuations in underwriting results.** Insurers want to ensure a balanced set of results each year without peaks and troughs. They therefore use reinsurance to cover them against any unusually large losses. This keeps a cap on the claims the insurer is exposed to having to pay for itself.
- **To obtain an international spread of risk.** This is important when a country is vulnerable to natural disasters and an insurer is heavily committed in that country. Insurance may be reinsured to spread the risk outside the country.
- **To increase the capacity of the direct insurer.** Sometimes insurers want to insure a risk but are not able to do so on their own. By using reinsurance, the insurer is able to accept the risk by insuring the whole risk and then reinsuring the part it cannot keep for itself to other reinsurers.

## Market facts and figures

The UK is the largest insurance industry in Europe and the second largest insurance sector in the world, accounting for 11 per cent of total worldwide premium income in 2007.<sup>40</sup> The insurance sector therefore makes an important contribution to the UK economy:

- In 2007 total worldwide net written premium (written premium less reinsurance premiums paid by the insurer) for general insurance was £52.7 billion, of which about £35.5 billion was

for UK risks. Gross written premiums were £66.7 billion in 2007.<sup>41</sup>

- Total net premiums for life and pensions business in 2007 were £194 billion. Total net written premium on long-term protection policies in 2007 was £2.1 billion, of which 70 per cent was accounted for by income protection policies.<sup>42</sup>
- At the end of 2007, UK long-term insurers were managing assets worth £1,478 billion, equivalent to a quarter of the UK's total net worth. These assets include equity holdings that account for 15 per cent of the investment in the London Stock Exchange.<sup>43</sup>
- The insurance sector employs 313,000 people. This is almost one third of all financial services sector jobs, and twice as many as employed in both the motor manufacturing sector or in the combined sectors of electricity, gas and water supply.<sup>44</sup>
- There are around 1,100 insurance companies operating in the UK market. Of these there are 209 companies that carry out life and pension business only and 46 that carry out both general and life insurance business.<sup>45</sup>
- Net exports of the UK insurance industry were £5.5 billion in 2007, or roughly 0.4 per cent of GDP.<sup>46</sup> This compares to a current account deficit of £39.5 billion for the economy as a whole. Therefore, without the contribution of insurance, the UK's current account deficit would widen by 14 per cent.
- The insurance sector is a major contributor to the UK's tax take. In 2006-07 the insurance industry contributed £9.7 billion in taxes, including £2.3 billion in Insurance Premium Tax and £2.9 billion in corporation tax. In the case of corporation tax, the insurance sector accounts for around 6 per cent of corporate tax revenues.<sup>47</sup>

40 ABI (2008a). Swiss Re, Sigma No 3/2008.

41 ABI statistics.

42 ABI statistics.

43 ABI (2008a).

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47 ABI (2008a). 2007 Total Tax Contribution survey conducted by PWC for the ABI.



## B Acknowledgements

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