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The Contemporary British Insurance Economy

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Résumé de l'article

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The Contemporary British Insurance Economy[1]

by

Michael A. Butt[2]

La société d'assurances Eagle Star Insurance Company, *que dirige l'auteur, M. Michael A. Butt, a bien voulu accepter notre invitation à publier ici une réflexion sur la place de l'assurance dans l'économie britannique, présentée à l'occasion de la vingt-quatrième réunion annuelle de l'*International Insurance Society (I.I.S.).

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(1)Presentation prepared for the International Insurance Society's annual meeting held in London on July 11, 1988.

(2)Mr. Michael Butt is Chairman and Chief Executive of Eagle Star Insurance Company Limited, London.

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It is my pleasant duty and privilege to open the twenty-fourth annual meeting of the International Insurance Society, which takes
510 place this year in London. I would like to thank the Board for giving me the opportunity to set the scene for this meeting. I regard it as a significant event for this worldwide organization, which plays such a leading role in our industry. We shall shortly be turning our attention to specific subjects, but I shall concentrate on a broad view of the contemporary British insurance economy, taking London as my starting point.

There are many views of this city of many parts. Robert Southey said it was "the single spot whereon were crowded more wealth, more splendor, more ingenuity, more worldly wisdom, and alas ! more worldly blindness, poverty, depravity, dishonesty and wretchedness, than upon any other spot in the whole habitable earth." Alternatively, according to Samuel Rogers, "to a thinking mind London is incomparably the most delightful subject for contemplation."

So, here we are in this colossal emporium of men, wealth, arts and intellectual power, this city of refuge, the mansion house of liberty, this flower of cities, this clearing house of the world, which aspires to be the financial center, as well as the largest continuously built-up area of Europe.

The attraction of one third of Britain's population to its orbit is a recent achievement, but London has long dominated economy and society. Apparently, in the seventeenth century London was better known overseas than Britain, so that some people thought that London was the country, and Britain a city in it. The fortunes of the city and the country are inextricable.

The Economy

It is fortunate indeed that the International Insurance Society's visit to London coincides with interesting times here.

In this country we have collectively raised self-deprecation to the status of an art form. We have an unequalled capacity to make light of our victories and dwell on our defeats. You must forgive me if I don't indulge this national character defect today, nor rise to euphoria, but try to look levelly at our position in 1988 and our prospects for the 1990s.

In the 1970s we had a bad case of what came to be called the British disease. We were not alone in losing an empire, but the British economy fared worse in the aftermath than other countries'. Between 1950 and 1980, GNP grew by less than 2 percent, compared with 3.5 percent in France and more than 4.5 percent in Germany.

We were afflicted by poor management, poor labor relations, poor design and poor quality. Attitudes had worsened to the point that distributing wealth was becoming identified with good, while creating wealth was becoming identified with evil. The state was stultifying the efforts of individuals. Wages and prices rose pointlessly without relation to underlying conditions. There was a feeling that when it is three o'clock in New York, it is still 1938 in London.

During the past decade there has been if not quite a reversal of these conditions, at least a sharp turn for the better. Between 1982 and 1986, real GNP growth averaged 3.2 percent in Britain, against 2.4 percent in West Germany, while last year Britain grew more quickly, at 4.8 percent, than West Germany, the United States or even Japan, which could manage only 3.5 percent. British productivity growth is also outstripping the other leading industrial countries. Company profits and growth in capital investment are both well up from the past year. Britain's government is comfortably in surplus.

The strength of the economy has been fully reflected in the affluence of the personal sector. Unemployment has fallen to its lowest point since 1981 – 8.8 percent of the work force, down from 10.8 percent a year ago. This compares with 8.9 percent in West Germany, 10.3 percent in France and 15.6 percent in Italy. A rise in incomes has made it possible for income taxes to be reduced while maintaining or increasing government revenue. Retail price inflation is below 4 percent. Interest rates are lower than for some time. The Treasury recently revealed that the real earnings of an average couple after tax this year are 29.4 percent higher than ten years ago.

Growth in Insurance

Thanks to economic growth, there has been healthy growth in general insurance. But this pales by comparison with the growth of life assurance and personal financial services. The same is true of other European countries.

If we look at the five large European markets, between 1982 and 1985, non-life business grew at between 2.5 and 5 percent in all but Spain, where it grew at less than 2.5 percent. This was respectable ; but it was slow compared with non-life business, which grew less than 5 percent only in West Germany. In Spain, it grew at between 5 and 10 percent. In the United Kingdom, France and Italy, it grew at more than 10 percent. The demand for life insurance and savings products should continue to increase by more than twice real GDP growth in the United Kingdom.

It has become impossible in this country to consider the insurance industry without reference to the other financial services. The slowly changing financial markets of a few years ago, which were separated by specialization, are becoming a single financial market in which most participants are free to engage if they wish in most of the activities.

From managing premium income and life funds, insurance companies have gone on to managing other investment vehicles – unit trusts, investment trusts, pension plans, public and private sector pension funds and new products such as personal equity plans.

Barriers between activities like managing funds, investment analysis, stock trading, market making, owning intermediaries, marketing investments to individuals and so on, which used to be regarded as quite separate, are falling away. Insurance companies have long been both insurance underwriters and investment managers, with a range of supporting services. So we are well used to running the twin businesses of insurance underwriting and investment management, and the diversification of insurance companies into pensions, unit trusts and other investment products has been a logical development.

All the different financial services had individual origins, and different types of organizations arose to specialize in them. Now in the United Kingdom, a unit trust, for example, might be launched by a bank, a building society, a stockbroker, a fund manager, an investment intermediary or by an insurance company, domestic or foreign.

The addition of investment to the traditional element of protection in life insurance, although hardly recent, is modern in character. It has enabled insurance companies to win a growing share of personal savings. From 1982 to September 1987, the financial assets of the personal sector in the United Kingdom grew from 403 billion to 927 billion, an average growth rate of 16.5 percent a year. Within these figures, life and pension funds grew from 156 billion to 413 billion in five years, an average rate of 20.6 percent. The much smaller unit trust sector, much of which is controlled by insurance companies, grew even more quickly, from only 4.6 billion in 1982 to 25.5 billion in September 1987, though unit trusts have suffered most from the October fall in share prices.

The explosion of personal financial services in the United Kingdom is attributable to three factors :

1. The expansion of the economy, which has resulted in increasing disposable incomes for most people ;
2. A growing interest in financial matters, which was encouraged by the bull market in equities ; and
3. Government action.

These factors do not operate only in the United Kingdom, and similar developments should occur in certain other countries. But the relative dynamism of the British economy and financial services in particular makes it a good subject for study and gives us an edge for the expected opening of the European market in 1992.

As we look ahead to 1992, it is worth noting the point here that the London market is very different in its makeup from the other European markets. This is partly because we have the unique institution of Lloyd's, which now has 33,600 members and can accept total premiums this year of 11.2 billion. The British domestic market for insurance is of course relatively small, but British insurers have long looked to the whole world for business. Indeed most of the business in London, both for Lloyd's and for other London-based underwriters, is international business. Lloyd's alone contributes more than 1 billion in foreign earnings to the British economy each year. The London market offers a flexibility in underwriting, continuity, financial integrity and depth of supporting skills unmatched anywhere in the world.

514 Let me now sketch the regulatory changes which have caused drastic changes to our markets and will undoubtedly cause further changes in the 1990s.

Financial Services Act

First of all, the government introduced the Financial Services Act to regulate the personal finance industry, including life assurance, in the name of investor protection. Regulation operates through a system of autonomous self-regulating organizations for different types of business under the supervision of a Securities and Investments Board.

Among the plethora of rules the most significant is that anyone running any kind of investment business in the United Kingdom has to be authorized to do so. And according to the concept of polarization, each financial firm, from the largest insurance company to the one person small-town insurance broker, has to choose between selling the products of one company exclusively and impartially distributing the products of all.

Insurers have had to consider how their distribution methods should be changed to meet a polarized environment. Over the past few months, other financial institutions have gradually been announcing their decision between tied distribution and sales through independent intermediaries.

Anyone selling investments must give the best possible advice. For the tied agent, this means providing the most appropriate product the company sells. For the independent intermediary, it means selecting the best product available from any company. The other mandatory maxim is "know your customer." An agent or intermediary must have reason to believe a product suits the customer's circumstances. There are limits to these injunctions. They do not extend to execution – only business or to experienced investors.

While the concept of investor protection is indispensable, there is naturally apprehension about the effects of new rules on the industry, which may be onerous. The adjustments required to operate within the Act require major changes to insurance industry methods, as well as introducing uncertainty as to how different ways of organizing the business will work out in practice. The Act has also increased costs, to such an extent that the combined bill for our industry must run into the hundreds of millions of pounds. The United Kingdom has bought a deluxe model of regulation, when a cheaper one might stay the course better.

Polarization has thrown the spotlight on to methods of distribution. Whereas at one time each financial service had a settled distribution method, now mortgages are sold long distance, insurance and shares are sold in department stores, estate agents sell houses and everything else, and so on. There is no single best way to distribute. Each company must make its own choice between having a tied sales force and supporting a network of intermediaries, or a mixture of both.

Polarization does not affect a company's ability to sell products through its own branches or through direct sales techniques. It is expected that direct marketing will grow rapidly, as in the USA, where direct marketing of personal lines and life is much more prevalent than in the United Kingdom.

Insurance companies have several advantages as competitors in personal financial services. Staff are experienced and know the sophisticated products they are handling, while other organizations have many staff who are totally inexperienced in selling their new products. Insurance companies are comparatively well-capitalized and stable, and we can build on established distribution systems.

An unexpected difficulty was presented at the last minute by the introduction of new commission rules by the Life Assurance and Unit Trust Regulatory Organization. From 1990, sales people will have to disclose the amount of commission paid in life assurance premiums. This apparently justified rule is unfortunate because consumers have a very poor understanding of how life products work.

Disclosure will discriminate against intermediaries, whose only source of income in the United Kingdom at present is commission. The change threatens far-reaching effects on the structure of the industry, for which there has been no time to prepare.

Pensions

As if the Financial Services Act were not enough, the United Kingdom's major restructuring of pensions, which are an increasingly important business for insurance companies, has been timed to coincide with the implementation of the Act.

In common with most other countries, the United Kingdom has faced an aging population with inadequate financial provision. The solution chosen is the partial privatization of pensions. Under the new pensions regime, individuals will take the primary responsibility for making their own pension arrangements, either through their employers or by taking out a personal pension plan.

The advent of personal pensions is welcome, because the new arrangements offer flexibility for customers. Individuals will decide the level of their contributions and what happens to their contributions. Individuals – customers – will benefit from the competition for their pensions. In saying this I do not suggest that company pension funds have necessarily done a bad job, but simply that the ultimate result of competition must be a better product with a keener price for the customer.

Giving individuals the responsibility for their own pension plans, either through company schemes or through schemes of their choice provided directly by insurance companies and others, offers insurance companies the chance to sell a large number of personal pensions in a short period. Insurance companies should enjoy the lion's share of personal pensions. Other providers will face serious problems in training staff, designing contracts, administration and marketing ; and they will mainly rely on insurance companies to provide their pension products.

It is not expected that millions of people will suddenly desert their existing pension arrangements for insurance company personal pensions. But there is a decisive and long term shift from the public sector to the private sector in pensions. This trend is worldwide. It presages not a nine-day wonder boom but a steady surge of pensions business in many countries for many years.

Europe

The internationalization of financial services is gradually producing a more open, global marketplace, not only in securities, but throughout the financial services. For the insurance industry, our immediate arena for international competition is the European Community.

The purpose of the Community since its inception has been to establish a free market for goods and services throughout the member states. Legislation is now in progress aimed at removing most barriers to business between the countries of the Community.

In Europe, the conduct of the insurance business varies widely from country to country because of the differences in regulations. Insurance and insurers are controlled by numerous laws, introduced at different times, by a range of regulatory bodies, with all kinds of rules affecting authorization procedures, accounting policies, solvency requirements and taxation.

When the barriers fall, the insurers of each European country will have the opportunity to enter any of the other national markets on equal terms. I believe that this is a tremendous opportunity for the insurance industry in the United Kingdom, because while alone each country offers a small market, the European Community together offers up to a quarter of the world market. London's longstanding international orientation makes this a particularly promising development from our point of view.

Many points about the single European market still have to be settled, not least concerning insurance. It will require 300 separate pieces of legislation to come into effect, of which less than 70 have so far been completed. Harmonizing insurance regulation in a way that will meet the practical requirements of the insurance business and be fair to the insurers and insureds of each country will be difficult. But the end result, whether in 1992, as hoped, or later, will be open competition in life and non-life insurance throughout the Community.

The internationalization of financial services is welcomed, but one must not underestimate the competitive threat which results. Tough competition for the United Kingdom insurance industry from insurers based in other European countries is expected. They will be able to operate in the United Kingdom on the same terms as in their domestic markets. There will also be competition from overseas insurers, for whom Europe will become a single and therefore much more attractive market.

In particular, one could expect at some point greater interest from Japan, where, at the end of 1986, the eight largest life companies had combined assets of Y44,650 billion, or $282 billion, and premium income of Y12,400 billion, or more than $78 billion. The savings of the average Japanese household were no less than $46,000, of which 25 percent was in life insurance.

Restructuring the Financial Sector

Changes in the past decade have caused modifications to the structure of the financial sector which will take some time to work through. We saw the desertion, almost overnight, of the Stock Exchange trading floor in favor of electronics. In the run-up to Big Bang, brokers made arrangements with other institutions so that there is now only one independent stockbroker of any size in London ; and, since October, there have been a number of closures, shrinkages and withdrawals.

The United Kingdom insurance industry operates in a volatile, competitive environment, where it is felt a company needs to do one or both of two things. The first is to obtain the resources to compete effectively in a market. The second is to develop the expertise to offer a particular service in a particular market superbly well. However, this author does not see a polarization between financial supermarkets at one extreme, which offer every financial product imaginable, and niche players or boutiques at the other extreme. While there are obvious advantages in being able to offer related products to the same customers, there is still room for a broad spread of institutions.

There will be supermarkets, but the supermarkets will not contain all goods, whatever their promoters may think now. Pride alone cannot sustain an organization which participates in a market where it cannot make a profit.

There is a diversification of banks, building societies and others into new financial services, including insurance. But it is fair to ask whether some financial institutions boast ambitions beyond their means, in insurance as well as in securities and in merchant banking. It is an understandable but probably unattainable goal for many institutions to provide a full service on their own.

Because of the capital-intensive nature of underwriting, European insurers must have capital bases of roughly equal proportions to those of American and Japanese insurers to be able to compete worldwide. Unless it intends to operate only on a small scale, to succeed in the 1990s an insurer will need resources. How it gets resources is less important than having them.

An increasing number of financial institutions are supported by the resources of a conglomerate. An alternative route, which is especially attractive looking forward to 1992 is to link up with a European partner. There have already been movements towards European alliances in insurance.

Conclusion

These are some of the challenges the United Kingdom insurance industry faces today – competition from overseas and in overseas markets, regulation and deregulation of the *personal financial services* and the blurring of boundaries between different forms of financial activity.

Our fundamental role remains unchanging and unchallenged. Without insurance cover, technological and commercial progress would be halted. Without insurance cover, individuals would continually be threatened by catastrophic losses. By protecting customers against risks, *we create security* in the midst of volatility. We are also investment managers, *maximizing the return on our premium income*, providing life assurance and other savings products, and funding industry and commerce.