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Public Interest versus Private Profits Transcript

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Introduction

There might not be much that a trader from Rhodes in 1000BC would recognise if he appeared here today - but he would recognise an insurance contract to protect him against the loss of cargo. For it was in Rhodes in the first millennium before Christ, that traders came together to pay a premium knowing that if their cargo was lost in transit they would be compensated for their loss. What would surprise those traders is the role insurance can play to deliver public policy. Compulsory third party motor insurance ensures that the innocent victim of an accident will be compensated for their loss regardless of the means of the driver at fault. The evolution of insurer funded fire brigades into a comprehensive publically funded fire service is a sign of how the boundaries between private profit and public interest shift.

How is the public interest reflected in insurance?

The public interest in insurance has a number of different expressions. Prudential regulation of insurers provides customers with reassurance that an insurer will pay out in the event of a loss. Conduct regulation protects the insured whilst the legal framework around disclosures when taking out a policy ensures the insurer has a full picture of the risk they are insuring. The risk transfer between the insured and the insurer avoids a situation where a consumer looks to the state to compensate them for a loss. The private sector provision of flood cover minimises the risk of the state having to compensate people for flood loss. The complex inter-play of public and private provision of protection against the financial consequences of sickness, accidents and death also seek to balance personal responsibility, private profit and public interest.

So whilst an insurance contract is inherently a private contract, there is a strong public interest in the effective functioning of that market.

Where that market doesn't function effectively, then the state can and does intervene to rebalance public interest and private profit: restoring the equilibrium between the insurer and the insured.

Flood Re is a product of the need to re-balance the equilibrium between householder, insurer and government. At one level, Flood Re is simply a monoline reinsurer; reinsuring just one peril UK flood but it is also a product of market changes which led to people being priced out of insurance or having to accept five figure excesses.

Whilst the structure and funding of Flood Re is unique, its role in rebalancing personal responsibility, private profit and public interest is the latest of a number of reiterations of insurance over several centuries.

Pensions - public interest and private profit and personal responsibility

I want to explore two areas where that balance between public interest and private profit is vital and where the dynamics have changed - one is obviously flood insurance - the second which I will kick off with the welfare state - particularly - insuring against the cost of old age - or pensions!

There has been a long standing public policy goal to provide pensions for older people. Indeed, it was the provision of a state pension that started the welfare state. Bismarck established state pensions in 1889 as part of his policy of securing power in the face of a more articulate and politically powerful working class. Lloyd George followed suit in 1908. His scheme was expanded in 1911 to encompass a wider range of benefits funded through National Insurance Contributions.

The state pension insured you against longevity: providing an income if you live beyond the end of your usual working age. The state pension was never going to be enough to provide an adequate replacement income in retirement so many supplemented it with a defined benefit pension scheme. Insurance against longevity with the employer bearing longevity and investment risk.

The demise of the DB scheme disturbed the equilibrium between the individual and their employer; to put in more familiar terms or the insured and their insurer. The changed equilibrium created a situation where the proportion of the workforce saving fell and the amount those that did save for retirement fell too.

Given that there is a public policy goal of ensuring that people have an adequate income for their retirement, it would be hard for the state to stand by and allow the continuing degradation of private pension provision. Having seen the equilibrium in pension saving disturbed and recognising that it is a public policy priority to reverse this, the Government implemented the Turner Commission's proposals for auto-enrolment.

Whilst the demise of DB schemes disturbed the equilibrium for the accumulation phase - when people build up their pension savings, the 2014 Budget disturbed the equilibrium in the decumulation phase when people convert their savings into a retirement income. The Government's pension freedoms - ending compulsory annuitisation for all - people were no longer required to buy insurance against longevity - i.e. an annuity.

Running through the pension policy from Bismarck and Lloyd George to today, is a thread about balancing the responsibilities of state, business and individual to deliver the public policy objective of delivering an adequate income in retirement. As that debate shifts because of economic, social and demographic trends the balance between state, business and individual shifts - altering the boundaries between private profit and public interest.

Flood RE

Let me return to Flood Re as a further illustration of those shifting boundaries. At the heart of the challenge around the accessibility and affordability of flood insurance is the understanding of the probability and size of loss. Changes in weather patterns, increased density of building and modern farming techniques were all factors that have increased the probability, severity and cost of flooding. The increased level of losses would, all other things being equal, simply lead to increase in the overall level of premiums as risks would be shared across the population as a whole. The equilibrium between private profit and public interest would remain unchanged. But the increase in the level of losses has been coupled with a better understanding of where those losses are likely to be. The granularity of data means that an insurer can discriminate on grounds of risk and therefore price between neighbours not just communities.

Increased incidence and cost of flooding together with better and more tailored data leads has led to higher premiums and five figure excesses for those most at risk.

It became a matter of public policy to address accessibility and affordability and Flood Re was born.

Flood Re is a privately funded scheme - no taxpayers' money is involved and -unlike Pool Re - there is no Government backstop or reinsurance. Flood Re will have a reinsurance cover in place up to £2.1bn.

There are two sources of income for Flood Re: a levy on household insurers of £180m per year and a premium for each policy ceded to us which is capped by council tax band.

The relationship between insurer and customer remains unchanged. It is insurers who will set the premium, it is insurers who will assess losses and it is insurers who will pay the claim.

As I mentioned earlier, Flood Re has a finite life of 25 years at which point we will return to risk reflective pricing. Implicit in this is that the price of flood insurance will be affordable as well as risk reflective. To do this, there are a series of steps to be taken to cut the cost of flood damage. By making individual properties more resilient you can reduce the cost of flood damage. By strengthening flood defences, you can reduce the incidence of flooding and when it does happen reduce its severity. By only granting planning permission to developments that don't add to flood risk or, even better, reduce flood risk through design and imaginative use of s106 agreements, you reduce the risk of flooding.

So Flood Re has been designed to deliver one of the Government's public policy objectives – the provision of affordable flood cover within household insurance policies; in a way which creates no burden on the public purse and that does not, through time limiting Flood Re, remove the incentive to minimise the cost of flood damage.

Some lessons for insurers and the State

So my central thesis is this that insurance has changed from being a private contract between the insured and the insurer to a socially useful vehicle for allocating risk between the insured, the insurer and government. Government – in the widest possible sense to include regulators – has a stake in the effective functioning of that relationship. Where that relationship is strong, then the role of the state to intervene is and should be limited. Where the balance tilts in favour of the insurer, then government will intervene to rebalance that relationship to deliver the social policy outcomes by taking out cost for either or both the insured and insurer. For example, in the Government's reforms to motor insurance, lower costs for insurers were passed through to customer premiums.

Sitting as I do as chair of a public body with a past in government and a future in industry what are the conclusions I would draw.

The equilibrium between individual responsibility, private profit and public interest is dynamic. As I have demonstrated already, it can be a delicate equilibrium which can be easily disrupted. Restoring that equilibrium can create tensions between government and insurers which a successful relationship requires them to navigate.

Let me explore some of those tensions and how they can evolve.

One of the drivers of Flood Re is the increasing ability of insurers to tailor pricing to individual circumstances. The use of data enables insurer to price according to risk characteristics specific to that person or house -moving away from pricing for a group to pricing for an individuals. From an insurer's perspective, this is simply a continuation of a centuries long process of refining data to improve knowledge of risk, the likelihood and scale of losses and fine-tune pricing. This has broadly been good news for customers - it has stimulated disruption in the market and greater competition. Greater segmentation of insureds is good news if you are a winner. But what happens if this refinement of data means that people either have to pay materially more for their insurance or are excluded from the peace of mind that insurance offers? Flood Re is in part a response to a process that risks creating a pool of uninsured. But what happens when this process is applied more broadly and more and more people are unable to afford or access insurance?

Flood Re points the way to one route to resolve this – the creation of a special purpose vehicle to offset the impact of higher prices. But there are other routes available. Insurers could simply be told by the government to offer that insurance at a price – guaranteeing both affordability and accessibility – with the insurer picking up the cost. Or the State could subsidise premiums or act as insurer of last resort with the taxpayer picking up the cost.

In a time of austerity with significant pressures on public spending – this is not a great outcome.

I am concerned that further developments in the application of big data will create further tensions between insurers and government where important public policy goals are at risk. That will lead to government and insurers working how best to re-provide insurance to those who would otherwise be uninsurable.

Secondly, insurers and government need a better understanding of the pressures each faces. I remember as a minister praising the competitive nature of the motor insurance market and seeing insurance industry executives wincing as they reflected on the paper thin margins they were earning on that business...and that was if they were lucky. A better understanding of those pressures can lead to good outcomes. The work led by the ABI and motor insurers with ministers to cut the cost of motor claims - tackling referral fees etc - helped drive down the cost of doing business and this flowed through to premiums. Flood Re is another good example of that collaborative approach. But it does come at a price for insurers. As I said earlier, Flood Re is part funded by a levy on insurers – but who ultimately picks up this levy. Is it absorbed by insurers and their shareholders or passed on to customers through higher premiums?

Now the current economics of household insurance suggest that insurers will have to absorb some or all of the levy at the same time as they are faced with an increase in IPT.

In trying to rebalance the equilibrium, government need to understand better the economics of insurance so they can gauge the pressures they are facing and the capacity they have to bear higher costs. But insurers also need to remember that the government is not hugely interested in profit maximisation. Ministers will not support risk reflective pricing when this excludes people from insurance. Yes they want to see a thriving, growing and financially viable sector but not when that comes at a cost borne by voters. A closer partnership between government and insurers in recognising how to tackle changing market practices and pressures will create mutual benefit - but getting a good outcome isn't the same as sharing the same values or goals.

To achieve public policy goals, governments can legislate to require people to have particular insurance policies.

I mentioned motor insurance earlier where there is a legal duty on drivers to buy motor insurance – creating a market for insurance. As a consequence the main thrust of motor insurance marketing is price, brand and creating attractive animal characters whether bulldogs or meerkats and not on creating demand. This interaction between public interest and private profit clearly benefits insurers. But relying on government to create a market creates a business risk too as annuity providers found after last year's Budget. In the absence of a government requirement to buy an annuity, insurers will need to think how they design products that meet consumer's aspirations rather than sitting back and waiting for the fruits of someone's defined contribution scheme to default into an annuity. So my warning to insurers is this – just because consumers are forced to buy a particular product today because of the diktats of public policy, it might not always be like that. Indeed, the more it appears that the product is failing to meet customer needs, the greater this risk that government will decide to make its purchase voluntary.

The final point I want to make is directed at my former profession. If we want insurers to help deliver a public policy priority, then we need a coherent policy framework. Insurance can help supplement state welfare provision and but to do so there has to be clarity and certainty about a citizen's entitlement to state benefits to create the demand from consumers for new products from insurers.

I have lost count of the number of conversations I have had about whether there is a suitable insurance policy to cover care costs. I think one of the barriers to this was the lack of clarity around state provision for the residential and nursing costs of care. Contrast that the clarity of the framework around auto-enrolment where we saw the pension sector develop good low cost products when there was a great deal of scepticism about the industry's appetite to go beyond their core market of selling pensions to better paid management rather than the staff on the shop floor.

But it goes beyond this as it requires government to link up policy across areas. The successful insurance and cross-government initiative on motor insurance is an example of how this can work. But it isn't always like this. Government sees insurers' assets under management as a potential source of investment in infrastructure projects as well as the wider economy through equities and non-bank debt. One of my key priorities when negotiating Solvency 2 was to ensure that the rules around the matching adjustment facilitated this - a priority we delivered on. But investment in long term assets requires an insurer to have long term liabilities to match them against. Whilst it is too early to see the full effects of the end of compulsory annuitisation, over time insurers could have a reduced appetite for long term infrastructure investment leaving government with the need to look elsewhere for funding. Joined up policy across government will help align public interests, private profits and personal responsibility.

Conclusion

Insurance has moved from a private transaction in 1000BC to a socially useful means of achieving goals for the insured, insurer and government. Balancing the interests of these three parties requires a common understanding of the threats to that balance and a clear way to restore equilibrium when it is disturbed. Achieving that balance has driven insurers and government closer together, developing a degree of interdependency which helps create equilibrium by marrying public interest and private profit. But economic, social and demographic change can disrupt that equilibrium, requiring a recalibration that needs sophisticated and insightful leadership on both sides to implement.