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DEBATE SUMMARY

What is the value to the economy of the finance and insurance sectors and are the right regulatory frameworks in place to protect that value?

Held at Lloyd's of London on 6th July, 2016.

The hash tag for this debate is #fstfinins .
Audio files of the speeches are on www.foundation.org.uk .
A joint meeting with Gresham College - www.gresham.ac.uk .

Chair: **The Earl of Selborne GBE FRS**
Chairman, The Foundation for Science and Technology

Speakers: **Anne Richards CBE CVO FRSE**
Chief Executive, M&G Investments
John Nelson
Chairman, Lloyd's of London
Professor John Kay CBE FRSE FBA
Economist and FT Columnist

ANNE RICHARDS said that it was important to recognise that there was little public understanding of the benefits of the finance sector. Brexit could be seen as a howl of protest against globalisation and the finance industry as its vanguard. Interestingly, banks were more highly respected in countries where less people had access to them or the financial system. But if the industry was unappreciated it had only itself to blame. It had to communicate its benefits more effectively and to respond directly to the post 2008 perception that it could be seen as destroying rather than increasing economic value.

A key value of financial services was their capacity to set as a mechanism of conversion: turning thousands of scattered tiny pots of savings into a deep well of capital which could be made available to industry, commerce and government for growth and wealth creation and jobs. Without this mechanism, for example, fewer houses would be built, roads constructed, or businesses helped to get off the ground. Her Majesty the Queen has recently opened a new wonderful children's hospital in Liverpool. Anne Richards' company, M&G Investments had part funded the project - made possible by using other people's money, combined into a fund which would be made available for large scale investment for the public good.

Finance also helps individuals to spread their risk. The great Victorian invention - the mutual society – was a classic example of this risk pooling. The corporate debt market operated on the same principle. Through a mutual fund, which was just a pool of individual investors, it was possible to offer people with as little as a few hundred pounds the opportunity to lend a small amount not just to one blue chip company, but hundreds of them. The individuals benefited through the interest earned on their holdings and the fact that their exposure to the failure was limited. The company benefited because they had access to funding that might otherwise not be there. And society as a whole benefited through the creation of jobs and greater customer choice.

Recent and rapid improvements in communications and computing power are also making possible a huge range of new financial services for example Apple Pay, Bitcoin, crowdfunding, contactless payment or peer to peer lending. It is uncertain which of these would stand the test of time and prove to have been socially useful, but some certainly would.

Another aspect of financial services vital to the functioning of the wider economy was maturity transformation: turning short term money into long term money. This reduced the cost of providing transactional banking services to customers by putting their money to work, lending their money out to other people who needed to borrow money to buy a house or a car or fund a small business. The ability to balance the needs of both saver and borrower – collectively - was a social good. For example, it had enabled Britain to become a nation of home owners rather than renters.

However, there was a risk – arguably a confidence trick – at the heart of this. If customers of a bank lost confidence in their ability to get their money back when they wanted it, there would be a run on the bank. This was exactly what happened to Northern Rock and was every regulators greatest fear. The disastrous consequences of seeking profit through the creation of more and more complex financial instruments – both in the mortgage market and more widely – were only too evident. Indeed the post 2008 crash demonstrated the risk of reversing that virtuous model of maturity transformation.

That brought her to the second question she and the other speakers had been asked to address: whether the right regulatory frameworks were in place to protect the value of these services to the UK economy. There were no immutable laws here. It would always be an evolving scene: a balance of negotiation and judgment. There was always a risk that regulation was driven by events and therefore perceived as locking the stable door after the horse had bolted. Notwithstanding all the changes to the regulatory framework since 2008, the person in the street was still likely to feel that the system was inequitable, with the financial sector continuing to thrive during a period of austerity for the rest of the economy.

Finance has to operate within broader moral, ethical, legal and ideological parameters set by society. One way to think of this was as a tension between those who supported laissez faire principles - capitalism red in tooth and claw - and those who backed state-sponsored, centralised control. Typically, freedoms were allowed until someone took it too far. Then the pendulum swung the other way. In the heady 1990s building societies had been allowed to jettison their mutual status and embrace the capital markets. But it all turned out horribly wrong. And when the credit crunch came in 2007, the first victims were former building societies. In response regulators introduced a raft of regulations and increased capital requirements. For example, RBS had an equity tier 1 capital ratio – a measure of financial strength - of only 2% at the time of the ABN Amro acquisition. It was now 13% on a tighter definition of risk-weighted assets.

The temptation for all regulators, with one eye on both the consumer and the citizen, is to legislate to remove all risk from the system - by being as prescriptive as possible about the rules, sometimes with unanticipated consequences. There was an obvious danger that attempting to eradicate risk from the financial system would remove any incentive to provide capital for economic growth, wealth creation and jobs. It was a matter of balance - between profitable risk which benefited all and protection of individuals from the unscrupulous.

The financial services industry is, unquestionably more a force for good than the opposite. It plays a vital role in the wider economy in sourcing investment for business, government and other organizations, which in turn creates jobs, more savings and more potential for investment: a virtuous circle. The financial services industry is guilty from time to time of excess and in some cases downright criminality. It has to root it out and to work with regulators and others to do that. The very fact of its intrinsic value to the economic system meant it should be more heavily regulated than other industries; but it would be wrong to attempt to remove all risk from the system. The emphasis should be on seeking a system based on incentives, values and principles and working hard to hold itself to the highest standards against them.

JOHN NELSON set his remarks in the context of the challenges that Lloyd's and the wider insurance market were facing. Lloyd's is the world's only insurance market and a global hub for specialist insurance risks. Over 40% of its business is in the US where it is the number one supplier of specialist insurance – and it does business in over 200 countries, with growing and strategically important positions in the emerging economies of Latin America, the Middle East, South East Asia and China.

The Lloyd's market consisted of over 80 syndicates, each one operating as a separate insurance company. The magnitude of the risks covered is often so large that one single insurer is unable to accept that size of risk on their own, so the syndicates join together to share risks – the so-called subscription model. Should syndicates not be able to pay for any reason, they were backed by Lloyd's central fund – a fund of last resort, which is there to cover any valid unpaid claims. Lloyd's was of course one part of the wider London insurance market, a sector that makes an important contribution to the UK's GDP and a key driver of the economic growth in this country.

The London market generates at present more than 8% of London's GDP. Indirectly, insurance and re-insurance also protected economies, communities and businesses from threats, as business models changed and new economies emerge. And when catastrophes strike, insurers provided capital in the form of claims payments that helped businesses, governments and communities to get back on their feet much more quickly and efficiently than if they had to rely on public money. Insurance and re-insurance, therefore, played a key role not only in the UK economy, but in the wider global economy.

For example, the fast growth of many of the emerging economies, coupled with increasing urbanization, had created more and more specialist risk. The level of under insurance in many of these economies was extremely high, leading to much greater economic vulnerability: an issue increasingly being addressed by governments encouraged by Lloyds. Lloyd's research had shown that a 1% rise in insurance penetration translated into a 13% reduction in uninsured losses, a 22% reduction in the taxpayers' contribution following a major disaster, and increased investment equivalent to 2% of national GDP.

Offshore re-insurance also played a substantial role in diversifying risk out of country. 60% of catastrophe risk in the USA, for example, was re-insured offshore; and the most recent earthquakes in New Zealand and Chile had been mainly re-insured offshore. By contrast in the case of the recent natural catastrophes in Haiti, Pakistan and India, which impacted extremely adversely on the rate of economic recovery, for all practical purposes little insurance or re-insurance had been bought.

The insurance market is, of course, being buffeted by cold macro-economic and geopolitical winds and the London market was under pressure as never before. Brexit is adding to the uncertainty and the consequences for the City of London could be very substantial. Only around 4% of revenues would be directly affected; but there could be collateral damage to London's reputation as an insurance centre. There were other pressures. Sustained low interest rates were driving investors, seeking new types of return, into the insurance market. This additional capital was increasing competition which lowered premium rates and put insurer's bottom lines under severe pressure. A shift in wealth from west to east also meant that companies were increasingly setting up their headquarters in new and emerging markets, changing the type of risks they were underwriting and the nature of the customer base.

The nature of risk was also changing. Research carried out by Lloyd's showed that while natural threats like earthquakes and flooding still posed the largest risk to GDP, an increasing amount was associated with manmade threats such as a cyber-attack, a market crash or an oil price shock. And technology was disrupting traditional insurance business models, allowing tech-savvy companies to sell directly to customers using data analytics to fine tune products to customers' needs.

The extent to which the London insurance market was under pressure from these forces was spelled out in a recent report which concluded that London did not have a strong position in emerging markets and was losing its share in re-insurance; that customers had a preference for buying insurance in their local market, putting 30% to 40% of London premiums at risk of being written locally; and that London had expense ratios higher than its peers. The other challenge the report highlighted, highly relevant to the topic under discussion, was the comparatively high regulatory burden that could further render London less competitive. On this view Brexit, for all its downsides, could be a good opportunity to thoroughly review domestic regulations.

Now is the moment to take stock of the current regulatory regime as we moved away from the agreements we had with Europe. Two key requirements have to be fulfilled: access to a wide talent pool and minimizing unnecessary bureaucracy. The London insurance market draws on a cluster of expertise, producing a responsive set of businesses built around Lloyd's and other operators and brokers. To sustain this, access to the best talent in Europe and indeed the rest of the world will be vital. The current political sensitivities were obvious. But the message that had to be got across was that relatively free movement of people was fundamental to industry, not least the insurance industry where the workforce had to reflect the cultures of the markets it was operating in. The new and emerging markets becoming increasingly important. In the forthcoming negotiations on Brexit the sector will be pushing the Government hard to retain its current access to talent. Otherwise it would need to think hard about alternative arrangements.

One advantage of being in the EU was the passporting rights businesses enjoyed which allowed them to trade in all European countries through a single license. The alternatives were likely to be more costly, time-consuming and bureaucratic, which was why Lloyd's will be lobbying, with other industries, to retain passporting rights.

Domestically, too, excessive red tape could stifle business growth. The implementation of a regulatory regime that struck the right balance between prudential oversight and creating a competitive market that allowed innovation and creativity to flourish was vital. For example, while Lloyd's supported Solvency II as an excellent capital saving mechanism – and fully endorsed the principles behind it – the way in which it has been implemented, in terms of the process and the complexity, was widely seen within the industry as imposing a significant compliance burden.

Other discouraging developments are an increasing trend towards protectionism – sometimes as a result of local regulatory regimes – which should be countered by promoting the idea of more global standardization in terms of regulation - and a worrying trend to try to translate or copy and paste banking regulations across to insurance. The challenge for the Government is to set up regulators to strike the right balance between ensuring a robust, efficient industry while creating an environment in which innovative business development could flourish. As an exemplar it might look to Singapore where the Monetary Authority combined robust regulation with promotion of financial services in a model that had worked well.

The UK insurance industry therefore faces a challenging, competitive environment. But if these two objectives in relation to talent and prudential but less bureaucratic regulation could be achieved, he is confident that the UK will continue to flourish and play its crucial role in the domestic, European and international economies.

PROFESSOR KAY referred to an early – and salutary – experience at Lloyd's when he had queried how much of the then growth in business was attributable to new business coming through the front door and how much to trading within the sector itself. It was telling that the initial reaction to his question had been one of puzzlement. But what was happening then was a microcosm of what was beginning to happen across the sector as it came to trade more and more with itself.

As risk was sold through an increasingly complex instruments, the extent of true risk exposure is concealed – as became apparent in a series of catastrophes such as Piper Alpha where the level of re-insurance with Lloyd's escalated from an initial claim of £1bn to £10bn worth of claims. Parallel developments had taken place in the credit markets from 2003 to 2008 prior to the crash. But still today the volume of financial and insurances services being traded are multiple times greater than the total global value in goods and services. Much of the nominal growth in value of these industries was attributable to inter-industry trade, leaving him to question whether the equivalents of previous crises were still out there and sceptical of numerical claims for the value of the industry.

There was, however, no doubt that the economy needed financial services. The importance of payment systems – arguably going through the most disruptive innovation of any sector, with potentially transformative benefits to customers – could not be underestimated. Wealth management – including the provision of education, employment, health and other benefits and the capacity to pass on wealth to successor generations – is another key function of finance, as were capital allocation and risk mitigation.

The principle of mutualisation as a form of insurance could be seen to have had its origins in Swiss villages where villagers pooled risks and benefits in a model which could still be found in operation in the hugely more sophisticated – and successful – financial systems of Switzerland and South Germany today. The source of the Lloyd's operation on the other hand could be traced back to the tradition of gambling in the coffee houses of the 18th century, where merchants began to see that the gambling they enjoyed could be transformed into a method of laying off risk.

In the 1990s, when the credit default swap was invented the question that had arisen was whether these new contracts were a form of gambling (requiring one of a set of regulations) or insurance (requiring another). The question was avoided and a different legal route found. But the evidence following the inquest into the 2008 crash was revealing. One product had been described by its creator as a "thing" which had "no purpose ….. absolutely conceptual and highly theoretical" and which nobody knew how to price. It was a gamble.

On the question of regulation he was closer to those who favoured less rather than more. It had been possible to exploit differences between bank and insurance regulation; and much of the regulation that had been passed had proved both inefficient and burdensome.

A different regulatory philosophy is required, focusing on structural solutions on the one hand and personal and corporate incentives on the other. He favoured not only the structural separation of retail and investment banking but the separation of different functions within investment banking which could often be in conflict with other, indeed with each one of the others.

But ethical change was also required. No better evidence of this was needed than the Chief Executive of Goldman Sachs, in testimony to a US Senate investigation, describing as "unfortunate to have on e-mail "criticisms made by his employees of outrageous deals made by his company. The famous scene in Casablanca, when Captain Renault could say "I'm shocked, shocked to find that gambling is going on here" while simultaneously pocketing his winnings, came to mind.

In subsequent discussion the value of the finance and insurance industries was widely acknowledged, reinforcing the argument that many of the benefits – such as the role of insurance in responding to catastrophes and the case for further penetration – were under appreciated and under communicated, not least by government. There was, however, further debate around the handling of the market failure and the corresponding case for strengthening the resilience of the industries, the scope of regulation on both technical and ethical issues, and the extent to which that sector could play a stronger role in supporting innovation – particularly in the case of SMEs.

It was suggested that public perception of the finance industry was adversely impacted by the fact that banks were seen to be too big or too important to fail and were, at the last resort, bailed out by the taxpayer. A number of contributors acknowledged the market failure was an essential component of a healthy industry; and that where capacity was sufficient, as in the case of the USA, it did happen. It was also suggested that financial stability was not the role of the regulator. The problem was less that banks were too big to fail – Lehman Brothers was the classic example – but that the system had become so interconnected that failure had multiple effects which were difficult to contain. Arguably, a better response could be to follow the example of other sectors, such as the electricity supply industry, where resilience was built into the structure, with the stress on modularity, not inter-connection. The finance industry might also have something to learn from the insurance industry in terms of improved, more sophisticated methods of risk assessment.

Excessive reliance on regulation to deal with financial stability could also drive consolidation. That inherently was not a bad thing. But the risk of consolidating to bigger and bigger entities, favouring bigger countries and disadvantaging smaller ones, was also observed. Nor, while mutualisation and co-operatives might be currently increasing favoured as an operating model, was it right to over emphasize a single model. That model had its own challenges. Plurality was a good thing.

There were advocates for a greater emphasis on transparency as a counter to the increasing complexity of modern financial instruments and systems. Other participants argued for self-regulation by the industries, subject to suitable safeguards for the public, as the current framework of regulation had responded reactively and inappropriately to recent crises, importing regulation drawn up for one sector to another and adding intolerably to the bureaucratic burden. Others argued that a whole scale return to self-regulation would create mayhem and that prudential, well-constructed regulation could attract business and have export potential in its own right, so long as it was as unbureaucratic as possible and designed in the interests of protecting customers not the regulators themselves.

The difficulty of regulating for moral and ethical behaviour was acknowledged. But it was an unavoidable issue. How could a different set of values from those described by Professor Kay be incentivized? Codification might be helpful; but, finally, the answer lay in getting the right leadership, setting a zero tolerance approach to inappropriate behaviour, which could include strengthening the diversity of teams, and a more systematic approach to ensuring that all teams, at all levels, employed 'devils advocates' to challenge 'group think'.

Ignorance should no longer be regarded as a defence for Boards and senior executives; and legal incentives that encouraged individuals not to know about the actions of their colleagues should be addressed. Nor could the issue of excessive levels of remuneration for salaried employees whose own capital was not at risk be avoided. Here transparency had arguably become a problem: driving up salary levels in a competitive market as executives were benchmarked against each other. Remuneration committees, too, had acted as an accelerator, not a brake, on executive pay. Public incomprehension and dissatisfaction with excessive remuneration had been reflected in the Brexit vote. It was an issue the industry had to address.

Finally, a number of participants questioned the response of the industry to the need for investment in innovation. Examples were cited of cases where innovation in the UK only proceeded on the back of the support of US investors - who put a higher premium on subject expertise and investment potential than UK venture capitalists, whose knowledge base was shallower and whose emphasis was on securing short term return on investment. It was suggested that the UK needed to develop stronger public infrastructure to support small businesses at the very earliest stages of developing an innovation: helping them to build a stronger case for capital investment before the banks and other investors were normally brought in. Changes in the investment model were also noted. Big corporations were largely able to fund their own investments; and the market was in transition from investment dominated by big infrastructure projects to one where start-up businesses were increasingly important. There was a case for seeking to replicate models in Germany and Israel where more locally based funding systems were proving effective.

Concluding the debate, the Earl of Selborne congratulated the participants on a stimulating discussion. The social and economic value of the financial and insurance industry, both here in the UK and globally, had been illuminated. But further reform – particularly in the area of ethical behaviour – and better communication is needed.

Sir Hugh Taylor KCB

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Report:
Financial services: contribution to the UK economy, House of Commons Library, 2015
www.parliament.uk/briefing-papers/sn06193.pdf

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