Insurance in a changing financial services industry

The ***Governor***[1] *discusses the current tide of change in the financial services industry and ways it may affect insurance broking. He says:*

- *'It is fast becoming a truism that in many cases the insurance broker has more in common with other intermediaries in the savings industry than with what is conventionally thought of as insurance'.*
- *'The direct and indirect conflicts of interest inherent in the plurality of functions to which financial institutions aspire are so manifold that the investor cannot be left wholly to look after himself'.*
- *'. . . the authorities . . . have to consider how best to respond to proposals to develop new forms of financial institutions encompassing previously separated activities. In all probability we will have to devise new safeguards to cope with new structures'.*
- *'I judge that the radical changes that we are witnessing at the moment, with the Stock Exchange at their centre, will in retrospect be seen as at least as important as we currently perceive them to be. They pose challenges but also present opportunities to us all'.*

Both banking and insurance have a number of important features in common and they are in some respects growing closer together. They are of course both basically risk-taking activities, although not in the same way. The banker parts with his money first and gets it back later. The insurer, on the other hand, does not part with his money until the risk has, so to speak, come home to roost. Viewed in that perspective, the banker appears as an optimist and the insurer as a realist. However, like all generalisations this contrast represents a considerable oversimplification. Insurers may make loans in much the same way as a bank does and, when a bank gives a guarantee for a fee, it is very little different from an insurer underwriting a risk for a premium. In any event, both banking and insurance have long since embraced activities going well beyond simply making loans and accepting risks, and both now represent highly diversified and to some extent overlapping activities forming part of an increasingly sophisticated financial services industry.

Another major characteristic that insurance shares with banking is that both activities have a very important international content. The record demonstrates your continuing success in international markets. In 1982 the net contribution of the insurance industry to our invisible earnings amounted to £1.2 billion. But the more relevant question is whether UK insurers have been maintaining or losing share in world business. There is no very reliable series of statistics, but the Chairman of Marsh & MacLennan has suggested that there has been a growth in worldwide non-life business from around \$100 billion in 1972 to around \$300 billion in 1982. This represents a compound annual growth rate of over 11%. In the same period the combined non-life premium income of members of the British Insurance Association and of Lloyd's, converted into dollars, grew by 10% per annum. Too much weight should not, however, be placed on this comparison because of the influence on it of exchange rate changes, and of probable differences in definition. The main conclusion must be that both world business and that part of it gained by UK insurers have both grown very rapidly. Nevertheless the estimates do raise a suspicion that the United Kingdom may have slightly lost ground. That would not be surprising given, for instance, the particularly fast growth over the same period in European business, and our relative lack of penetration of that market which, of course, is still not as open to our insurers as we would like it to be.

In some respects general insurance business appears to have followed a parallel path to banking business over the last decade. Both have been fast-growing internationally as well as nationally. This has encouraged new entrants and intensified competition. Pricing has been excessively keen and the quality of underwriting, like that of loan portfolios, has declined to a point where efforts have been needed to repair the damage done to balance sheets. Notwithstanding these pressures, our major insurance companies and Lloyd's underwriters, like our major banks, have prevented any really serious

(1) In a speech at the British Insurance Brokers' Association annual conference in Bristol on 27 April.

erosion of their capital bases, so that they remain at levels which compare favourably with those of overseas competitors.

Success in maintaining solvency ratios has, however, largely resulted from strong investment performance. Most other trends visible in the statistics have been distinctly unfavourable. Underwriting losses of members of the British Insurance Association, for instance, have been increasing, and operating ratios worsening. Recent moves to set premiums at higher, more realistic rates in most classes of general insurance and reinsurance business appear to recognise that this process has to be reversed. Moreover, the general decline in interest rates over the last two years has exposed more clearly the limits upon the extent to which investment income can be relied upon to offset underwriting losses.

Competitive pressures will determine the extent to which increases in premium rates can be extended and sustained, but a strengthened financial position will enhance the long-run growth prospects for UK insurance companies. In saying this, I am simply underlining the self-evident but vital lesson that, to compete successfully, financial institutions—even more than industrial or commercial companies—must not only be responsive to the needs of the markets they serve but must also demonstrably operate on a foundation of financial strength.

That means in the first instance the fulfilment of essential prudential requirements—the maintenance of adequate reserves and the judicious assessment of risks and their pricing. But confidence and trust in financial intermediaries rest on more than balance sheets alone. As a matter of enlightened self-interest, those engaged in the provision of financial services need to observe the highest ethical standards. Moreover, since individual lapses from those standards tend to undermine faith in the collective probity of the wider group to which they belong—and ultimately of the City as a whole—it follows that there is a consequent need for the construction and enforcement of a robust regulatory framework.

This will doubtless sound like rather tired conventional wisdom—the sort of thing any of my predecessors might have said to any of yours, had one in fact had the privilege of appearing before them. Indeed, it would not have been a new thought even in the mouth of the first Governor of the Bank of England. In 1673, twenty-one years before the Bank was founded, Parliament passed an 'Act for the regulation of brokers upon the Royal Exchange'. The stated purpose of that Act, incidentally, was to prevent 'all usurious contracts and bargains, false chevesance and other corrupt devices and crafty deceits'. In view of its purpose, I cannot believe that it was in fact directed against insurance brokers.

Change in the financial services industry

Ancient though the need for regulation may be, it has a particular topicality, urgency even, today, because of the tide of change which is sweeping through the City and which affects not only banking and insurance but the whole of the financial services industry. Let me now then turn to that wider scene, and focus in particular on developments since the last annual conference of this Association.

I would like to refer first to the agreement reached at the end of July last year between the Stock Exchange and the Secretary of State for Trade and Industry. The prospective fruits of that agreement in terms of market structure and membership are now to be seen in the discussion document which the Stock Exchange issued two weeks ago. May I in passing emphasise that this forward-looking document is essentially consultative in purpose and, in my view, presents an admirable foundation for well-informed debate about issues which are both complex and important.

A second major development, altogether different in kind but in a way given much greater significance by prospective changes at the Stock Exchange, was the publication of Professor Gower's report on investor protection. He will be addressing you later today and it is not for me to steal his thunder, but perhaps I may be allowed a preliminary rumble. For most of the time that Professor Gower was working on his report, it was, I think, just about possible to assemble a credible case in favour of an avowedly *caveat emptor* approach to the problems that he was addressing—as opposed, that is, to a deliberate strengthening of arrangements for investor protection. It would not have been a case that I personally would have espoused, but that is by the way. By November last year, however, various financial institutions were beginning to react to what they believed would be the inevitable ultimate consequences of the Stock Exchange agreement, namely the disappearance of single capacity and more open access to membership. And as these institutions began to make their dispositions, such persuasiveness as the *caveat emptor* case might have had, began to evaporate. It was in November that the link between Citicorp and Vickers da Costa was announced. Before the end of the year, two more moves involving banking interests and stock exchange firms were announced—Warburgs was to form a link with Ackroyd & Smithers and Rothschilds with Smith Brothers. The new year brought more announcements of alliances between other major players and leading stock exchange firms—Charter Consolidated with Rowe & Pitman; Natwest with Bisgood Bishop; Samuel Montagu with Greenwells; Barclays with both Wedd Durlacher and de Zoete & Bevan; Morgan Grenfell with Pinchin Denny and so on. Other London institutions were also known to be in the field—EXCO, the world's largest money broker, and Mercantile House, a leading international financial service group, and from the United States the giant Prudential Insurance Corporation, already allied with Bache.

All of these moves were of course directly attributable to the stock exchange agreement, but that agreement also heralded the start of a process of change which is by no means narrowly confined to the Stock Exchange or even to the securities industry at large; and the breadth of the tide of change which is now running can be gauged by the proposal announced two weeks ago to merge Charterhouse J Rothschild with Hambro Life. Bankers, securities dealers, brokers in various fields, insurers, investment managers, investment advisers—all are joining together with other providers of financial and related services hoping to move into the same unified playing field. The game, I scarcely need tell you, is the provision through one organisation of a comprehensive range of financial services to both the corporate client and the private individual. How in these circumstances can the full blooded *caveat emptor* case retain any credibility? The direct and indirect conflicts of interest inherent in the plurality of functions to which financial institutions aspire are so manifold that the investor cannot be left wholly to look after himself. This is not to deny that *caveat emptor* has a part to play, and I echo Professor Gower's words in saying that no-one can hope to protect a fool from his own folly but there has to be adequate regulation to prevent him being made a fool of by others.

Self-regulation

In short, whatever view one took of the adequacy of arrangements for investor protection and for coping with conflicts of interest before the process of change began in the Stock Exchange, that process of change itself calls for new measures, approaches and procedures now. But in saying this, I want to emphasise equally strongly that I would resist any style of regulation which needlessly frustrated innovation, impeded the flow of funds to those raising new capital, or stifled the capacity of the financial services industry quickly to respond to competitive and technological challenge. We must never forget that it is the activity itself and not the regulation of it which generates wealth. Regulation in the highly sophisticated and fast changing world of financial services must be expert and must be flexible. For that reason I welcome Professor Gower's advocacy of self-regulation. Much of course will need to be done before we can claim to have a self-regulatory structure apt to the purpose in hand. But self-regulation properly structured can, I believe, offer the best chance of combining a vigorous, expanding and innovative financial services industry with a proper degree of protection for the user.

I said that much remains to be done, and one of the early tasks is to ensure that we have an appropriate family of self-regulatory agencies. A great deal of thought is being given to the question of whether they are better based on trade associations or whether they should not rather be organised on a functional basis. This is an area where your own experience will be valuable. You of course have a separate regulatory body, functioning under statute, sponsored by your Association and with its jurisdiction limited to those who style themselves insurance brokers. I know that many of you feel that the formula you have adopted has not been wholly successful. Matters were not improved when it became apparent that the activities of your members might fall within the ambit of the Prevention of Fraud (Investments) Act and that registration with the Insurance Brokers' Registration Council afforded no exemption. Clearly you will need now to review the role of the IBRC and its relationship to the rest of the regulatory structure. I do not doubt this is already well in hand. I for my part have no ready made prescription to offer. Indeed I doubt whether it is sensible to suppose that any one model of regulatory agency will suit all the activities included within the financial services industry and the wide diversity of its participants. At the end of the day, what matters is not whether the agency conforms to some preconceived blueprint but whether it is effective in the ways I have described.

One sector of the insurance industry which has long operated a self-regulatory system within a statutory framework is of course the Lloyd's market. Before the Lloyd's Act of 1982 came into effect at the beginning of 1983, a need had been demonstrated for more effective ways of maintaining market standards. This had largely come about as a result of practices which had developed over a number of years and which called into question whether certain underwriters were acting in the best interests of the syndicates' members. There was, of course, no question that the interests of the assured were in any way prejudiced. It is to the restoration of confidence in the relationship between the underwriting agencies and the names that the Council of Lloyd's is devoting its energy. I do not doubt you will hear of this in detail in tomorrow's speech from the Chief Executive of Lloyd's but I would like to commend the vigour, dedication and courage with which the Council and permanent staff of Lloyd's have tackled problems of great inherent difficulty.

Structure of the insurance market

It is, of course, in many respects easier to develop an appropriate regulatory structure within the framework of a coherent market organisation. It is also manifestly the case that in such circumstances regulatory functions can readily be combined with professional and representational activities. However, the insurance industry is perhaps unusual, in that it has an organised market, namely Lloyd's, and, in addition, a great number of separate insurance companies, both general and specialised, some very large, whose business is not conducted through that market. The organised market is essentially a broked market. Insurance business outside the market is also conducted very largely through brokers and other intermediaries but it does not have to be; and, of course, there can be considerable variety in the nature of the relationship between the broker or other intermediary and the insurer. As a consequence, there is a wide diversity of both function and participant in the industry and often divergencies of interest. This doubtless helps to explain what is, I must confess, to the outside observer a somewhat bewildering variety of representative associations and authorities. In saying that, I am not suggesting that the real world can always be made to conform with the ideal structures of the tidy-minded theorist. Its size and diversity make it difficult for the insurance industry to speak with a single, uniform voice, though it would greatly gain in authority if it could.

Decisions about appropriate groupings, whether representational or regulatory, are all the more difficult in a period when different specialisations are tending to come together within the same company or group. Many of your members already offer broking and advice in respect of investment in unit trusts and in pension provision as well as in life assurance policies. Insurance brokers, whether locally based or employees of a national group, are also well placed to take advantage of the opportunities which deregulation and diversification will open up in the retail side of the securities industry. It is fast becoming a truism that in many cases the insurance broker has more in common with other intermediaries in the savings industry than with what is conventionally thought of as insurance.

This may become more openly recognised with the withdrawal of tax relief on new life assurance premiums, since many insurance brokers will doubtless wish to offer potential savers a wider choice of investment alternatives. For the same reason, there will be an enhanced requirement for professionalism in the giving of well-informed and disinterested personal investment advice. I know that this is a cause to which your Chairman attaches great importance and I wish to endorse wholeheartedly his and your efforts to devise a scheme of professional qualification for your members. It is small comfort to the investor to know that he was adequately protected when making his investment, if he finds that, through bad advice, what he has invested in is totally inappropriate to his needs and circumstances.

Consideration of professional competence leads one inevitably to the vexed question of differential commissions. I know that your Association has strong reservations about the Registry of Life Assurance Commissions (ROLAC), because it applies fixed maximum scales of remuneration for intermediaries but does not restrict the remuneration of tied salesmen, and because those scales, in your view, do not give adequate differentials in favour of degrees of professional expertise. Without prejudice to the merits of these arguments, they illustrate again the problems of achieving comprehensive regulation in the insurance industry. I would only comment that, while the fixing of maximum commissions does not necessarily provide a complete answer to the sort of problems that can arise from differential commissions, ROLAC appears to offer the only orderly solution in sight to the risk of unbridled competition in the payment of ever more generous commissions. I was also interested to see that the life offices supporting ROLAC were to give further thought to making use of public disclosure as a complement to the ROLAC rules in certain circumstances. Where problems of direct regulation prove intractable, public disclosure of all relevant information is very often the only alternative.

With regard to your Association's concern about tied salesmen, may I offer the thought, which you may find comforting, that the ability of independent brokers to choose between a wide variety of products gives them a by no means negligible competitive advantage over salesmen who may be tied to the products of one company, though I concede that the comfort is diminished when the tied salesmen are not limited in that way. More generally, I would like to think that independent insurance brokers were better able to offer impartial advice to meet the client's needs and I urge you not to lose sight of the fact that competition in providing a range of services offering value for money ought always to take priority over competition in obtaining commission from insurers.

Opportunities and challenges of change

I wish to turn now to some other aspects of the breakdown of barriers between institutions, which is currently proceeding at such a pace. I have referred already to the overlapping between insurance brokers and securities dealers, and the obvious possibilities for new combinations in that area. Another area of direct interest to you where the number of linkages and the extent of overlapping has increased and is increasing further is between banking and insurance. These arise in two forms—connections between banks and insurance brokers, and connections between banks and insurance companies.

Just as the location of their offices gives insurance brokers opportunities for diversification into security dealing and investment management, so the clearing banks' network of branches gives them opportunities to sell other services including insurance. Provided that they have adequate managerial and technical expertise and that where they act as principals, their exposure is confined within appropriate limits, this is a legitimate form of diversification on their part which adds to the choices available to the consumer. But the competition offered by banks and other credit institutions such as building societies must, of course, be fair. There is, I understand, a concern in this country, just as there is in the United States, that a bank which is also involved in insurance may take advantage of its position as a lender to require the borrower to place such insurance as he requires with or through the bank in question. I must say that I never encountered such a practice when I was a commercial banker. I would have condemned it then as an anti-competitive restrictive practice and have no hesitation in doing so now.

This concern relates to one sort of problem which may arise for the customer when one institution provides a variety of financial services, but linkages between banks and insurance companies also present a major problem for the supervisory authorities—that is the Bank of England and the Department of Trade and Industry respectively. In the past, such linkages have almost all been between institutions differing greatly in size, and this has meant that, in practice, the degree of additional risk taken on by the parent institution—whether a bank or an insurance company—has been acceptably small. The core of the problem is that both kinds of institution are highly geared in the sense that their capital is low in relation to their other liabilities: both (though especially insurance companies) are vulnerable to changes in asset valuations, which are, moreover, quite likely to occur at the same stage of the economic cycle: and both (though especially banks) depend on maintaining the confidence of their investors, which could be put in jeopardy by any failure in the related company. Consequently both are required by their separate supervisory authorities to maintain adequate capital and other solvency ratios. If these fall or threaten to fall below acceptable levels, the most likely response of the authorities is to seek a capital injection from the shareholders. In some circumstances this could not be done without creating similar difficulties in meeting the requirements, which may be statutory, imposed by the other supervisor. There were indeed cases during the secondary banking crisis in the mid-seventies where connected banks and insurance companies both ran into difficulty, and one or two cases where a crisis in one part of the group was aggravated by the need to meet the solvency requirements of the other—though the more fundamental cause of the problem, of course, was the double exposure to similar imprudent commitments in property.

I describe this problem not so much to rule out any flexibility on the part of the authorities as to demonstrate that we, too, have to consider how best to respond to proposals to develop new forms of financial institutions encompassing previously separated activities. In all probability we will have to devise new safeguards to cope with new structures. We will have to consider such controls as the retention of corporate distinctions between the different parts of a new group, the preservation of the independence of the separate managements, and the erection of barriers preventing cross-infection through exposure to the same risks. Where there is more than one supervisory authority, as with banking and insurance, this will clearly require co-operation and co-ordination between the officials concerned. There is a fine balance to be struck between encouraging competition and maintaining a proper degree of prudential security, analogous to the balance which has to be struck between, on the one hand, an innovative, expansionist response by financial institutions to new competitive and technological challenges, and, on the other, the maintenance or construction of regulatory procedures which are manifestly seen to protect the interests of users.

I have had much to say today about change and the prospect of change. Every decade, of course, brings events which to those who live through them seem at the time to be major landmarks. The lengthening perspective of the passing years then cuts them down to size. But I judge that the radical changes that we are witnessing at the moment, with the Stock Exchange at their centre, will in retrospect be seen as at least as important as we currently perceive them to be. They pose challenges but also present opportunities to all of us.