UK INSURANCE MARKET OUTLOOK

2015/2016

Landscape Institute
Insurance Services

Administered by the Professional Partnerships
Division of McParland Finn Ltd

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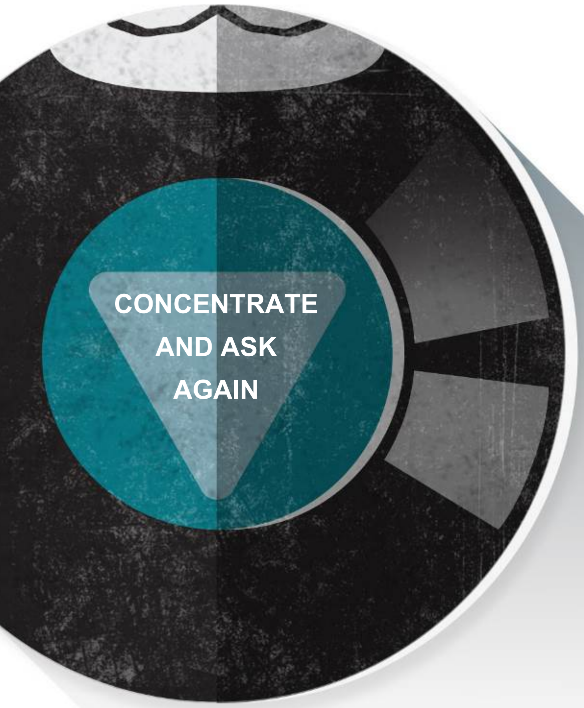


Why does your insurance premium change?

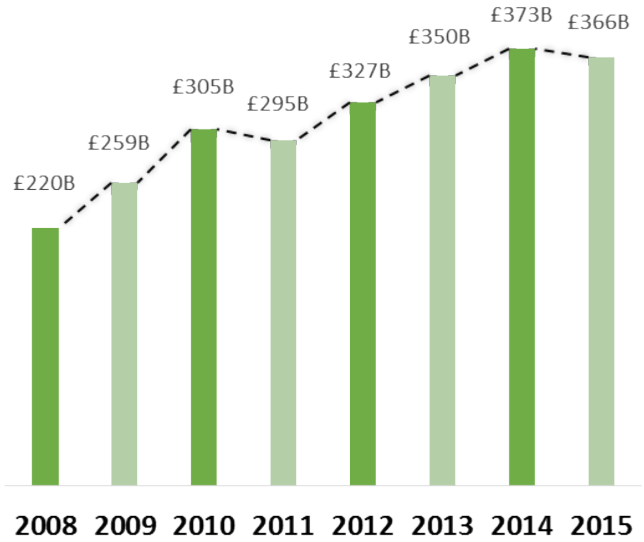
The trickle-down effect of insurance pricing

Insurance premiums are not direct reflections of the risks you insure. While inflation is a good start for anticipating changes in your rate each year, there are still other, more subtle factors you may be unaware of that affect the cost of insurance. Let's start at the top and examine the trickle-down effect that determines your insurance rate.

Reinsurance companies

Insurance pricing begins with reinsurance companies. Reinsurance companies accept risk from insurance companies in exchange for a premium.

Change in global reinsurer capital



Source: Individual company reports,
Aon Benfield Analytics

Factors Impacting Reinsurance

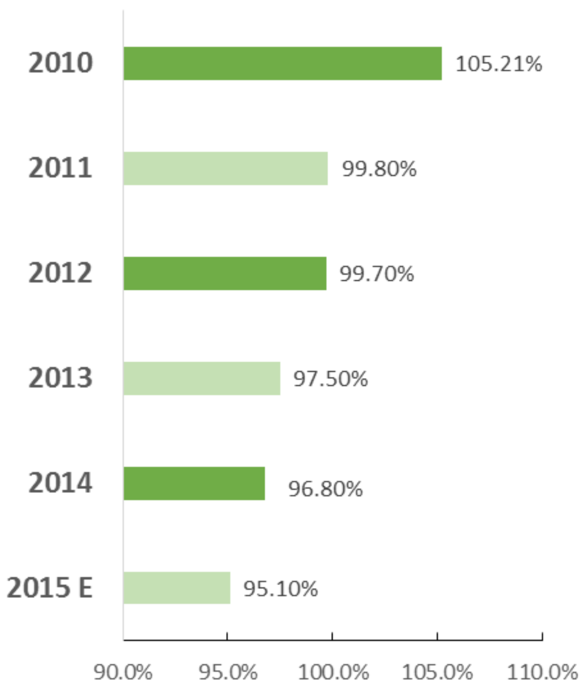
So far 2015 has been a quiet year for catastrophes—below the recent 10-year and 15-year averages—which has boosted profits for reinsurance companies because they paid out fewer and cheaper claims. Additionally, innovative investment options have provided opportunities for reinsurance companies to generate new capital.

Having extra capital on hand means reinsurance companies can insure more people and businesses—raising the competition for customers. As a result, primary insurance companies are paying lower premiums for reinsurance, a savings they can pass along to consumers like you.

Insurance companies

Insurance companies take on risk for you or your company in exchange for premiums. Your premiums are dictated by the amount of risk the insurer accepts on your behalf, as well as by the financial state of the insurer, which is determined by profits or losses in underwriting and investments.

UK General Insurance Industry Combined Ratios



Underwriting Profit

Insurers measure their underwriting profits with their **combined ratios**. A combined ratio is calculated by dividing the sum of incurred losses and operating expenses by premiums. If insurers have a combined ratio of less than 100 per cent, they are making a profit. A combined ratio of more than 100 per cent reflects a loss.

Initial reports summarising the first half of 2015 from UK insurers show that, on average, combined ratios continue to improve. A small number of catastrophic losses for the remainder of 2015, as well as new methods of synthesising and analysing consumer data, will likely lead to reports of improved combined ratios again in Q1 of 2016.

Source: Combined analysis of data from AIG, Aviva, RSA, AXA, and Direct Line Group

Investment Holdings

Another way insurers make money is by investing policyholder surplus and cash reserves in the stock market as well as a variety of other investment vehicles. If investment returns are good, the insurer makes money.

Many UK insurers continue to report dwindling investment yields due to low interest rates, stemming from the United Kingdom's sluggish but persistent economic growth since the 2008 financial crisis. In response, insurers are aiming to shift, grow and diversify their investment portfolios, reflected in the graph below.

Increasing Interest Rates

Interest rates in the United Kingdom have been kept at historic lows since the aftermath of the financial crisis. But as economic recovery gains momentum, analysts are anticipating a rate hike sometime between the first half of 2016 and 2017. Rising interest rates are generally considered a sign of a strong economy, yet opinion remains varied on how rising interest rates will affect financial markets.

Total Long-term and General Insurance Investment Holdings

Source: Association of British Insurers

Insurer Priorities in 2015/16

This is an exciting and challenging time to be an insurance company. The 'old way' of doing business will no longer suffice for insurers, who are being forced to identify new priorities in light of the three big trends below.

Technology Advances

Technology that enables insurers to harness large-scale consumer data in order to make better actuarial predictions is now available. More accurate predictions allow insurers to charge premiums that better reflect risk, which stabilises their income.

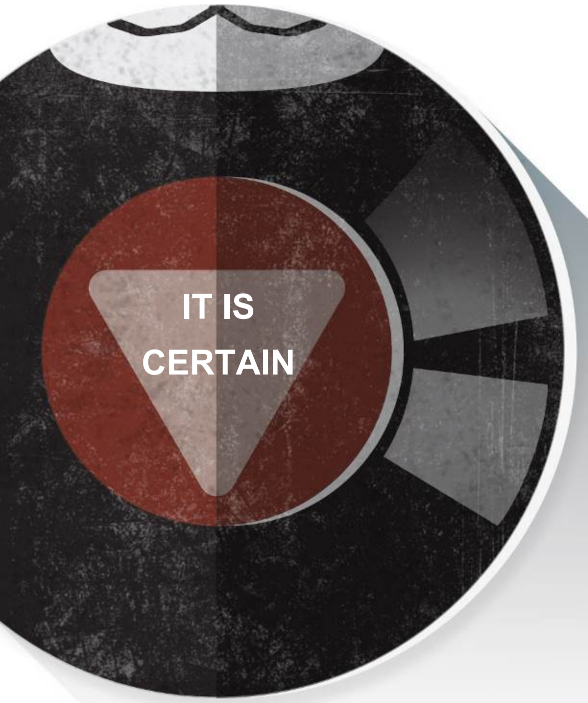
Subpar Investment Returns

Hunger for new business is being tempered by subpar investment returns. Many insurers are becoming increasingly selective about which risks they target, with most preferring to target 'safer' risks. Companies with established safety and risk management programmes in 'safer' industries are more likely to contribute to underwriting profit, and are therefore a more desirable addition to the insurer's book of business. These companies will be targeted heavily in 2016. Lean on your broker to navigate this 'buyer's market' and find the most appropriate balance of premium spend and insurance cover for your company.

Mergers and Acquisitions

Finally, the insurer landscape has been impacted by a number of large mergers, which have triggered competition among insurers even further.

Insurers who respond to these market conditions proactively will find success. In the meantime, consumers will benefit from the added competition among insurance companies through stable or dropping premiums across most lines, increased policy flexibility, and enhanced consumer relationships.



Forces Shaping the 2015/16 Insurance Market

Soft market to continue

As a result of reinsurer and insurer profitability, we are currently experiencing a soft market, which means insurance pricing is relatively stable, or for large companies with negotiating power, perhaps even falling slightly for certain lines. Soft markets have generally predominated in recent decades.

The overall economic climate and the prevalence of natural disasters are perhaps the two most meaningful, leading indicators of future pricing trends, but whether your rates go up or down also depends on the type of cover you need, as well as your geographical location. It is important to keep this in mind when looking at the following macro-level forces shaping the UK insurance market in 2015 and beyond.

Insurance Premium Tax Hike

On 8th July 2015, George Osborne, Chancellor of the Exchequer, delivered his Summer Budget 2015 to Parliament. One of the most controversial and unexpected measures of the Budget was Osborne's 56 per cent increase to the Insurance Premium Tax (IPT), a tax on general insurance premiums. Considered a necessity by the government but a surprise 'stealth' tax by industry insiders, the IPT increase has caused consternation and confusion. Who will absorb the increased tax on insurance, and how will the IPT hike influence premiums?

The IPT increase applies to **some** insurance premiums starting on 1st November 2015 and **all** qualifying premiums on 1st March 2016. The higher rate of 20 per cent, which applies to some policies (such as travel and vehicle insurance) will remain the same. Other policies, such as long-term insurance, insurance for commercial ships and aircraft, and insurance for risks located outside the United Kingdom, are exempt from IPT altogether.

But, retaining the occasional exemption has done nothing to assuage the industry's fears. Although the IPT applies only to insurers, industry insiders allege the increased costs will be passed onto the consumer, resulting in higher premiums, increased pressure on the NHS and more uninsured drivers due to policies such as private medical and motor being priced out of consumers' reach. Indeed, the Association of British Insurers (ABI) estimates that the IPT hike will add £9.48 to the average annual household insurance policy and £12.25 to the average annual comprehensive motor policy. Other estimates have been more liberal, with some experts calculating that the average policyholder will pay an extra £17.50 as a direct result of the IPT hike, and others estimating that private medical insurance premiums will increase by between 7.5 and 15 per cent.

In addition to the anger over the economic impact, some industry insiders feel ambushed by the tax hike since they had no warning. The British Insurance Brokers' Association (BIBA) was 'extremely disappointed' in the IPT hike and labelled it a 'stealth tax'. Industry insiders feel that the IPT hike is especially unexpected given the recent cooperation between the government and insurance industry which resulted in a 3 per cent reduction to home insurance costs and a 2 per cent reduction in motor insurance costs, according to the ABI. The Automobile Association (AA) even went so far as to say the tax hike is 'underhand' and 'unfair'.

And most consumers agree—87 per cent of motorists responding to a recent AA survey believe that the IPT hike is unfair.

The government, however, will not concede. Osborne maintains that the tax hike will only apply to one-fifth of all premiums and that the new IPT rate is still lower than other European countries' rates, such as Germany's 19 per cent IPT and Italy's 21.5 per cent IPT. Osborne is further emboldened by the government's recent crackdown on Britain's 'compensation culture', which has helped to lower premiums across the board, according to the Financial Times. Along with the IPT hike, Osborne pledged to cap charges earned by claims management companies, which insurers say encourage people to make bogus claims and thereby raise premiums for everyone.

Some experts believe that the industry will just have to endure the increase, since soft market conditions should prevent insurers from passing on increased IPT costs to consumers. But, they caution, absorbing such costs without passing them onto the consumer could lead to insurers dropping affected insurance products, thus, reducing competition and subsequently hardening the market.

One thing is for sure—the IPT hike will raise insurance costs in 2016. What remains to be seen is whether the industry will pass these increased costs on to the consumer, and, if so, whether these costs will be negligible.

Vehicle Telematics

Some experts say that vehicle telematics—the use of wireless devices to transmit driver data (such as vehicle speed, braking activity and general driving behaviour) in real time back to an organisation—is poised to move into the mainstream, helping drivers lower premiums and insurers gather valuable data. But not everyone is on board—other experts assert that telematics still has serious hurdles to overcome before widespread, mainstream adoption can occur. How far has vehicle telematics come this year, and how far does it have to go?

Vehicle telematics continued its move into the mainstream this year thanks to lower prices, acquisitions and new legislation.

In January, an insurer with ties to Toyota purchased the telematics provider Insure the Box, opening the door for car manufacturers to potentially gain control of telematics-enabled insurance markets. Insure the Box telematics will now be exclusively fitted to all new Toyota vehicles, but that still leaves an untapped market of millions of existing Toyotas and other vehicles on the road with no pre-existing telematics-insurance ties.

Indeed, the march toward widespread adoption of vehicle telematics is unstoppable—in April, the European Parliament voted in favour of eCall regulation which requires that, starting in April 2018, all new cars be equipped with eCall technology that automatically calls emergency services in the event of an accident. Although eCall technology is not as sophisticated as other telematics devices, it sets a baseline precedent that every UK vehicle will have some sort of telematics capability in less than three years.

And, for good reason, since telematics promises benefits for everyone. It helps insurers rely on real data rather than proxies in order to price insurance premiums, resulting in more accurate prices and risk calculation. It also helps insurers reduce claims costs, enable lower premiums and fight fraud.

Telematics benefits personal lines and commercial insurance customers as well, through reduced motor insurance premiums, fuel savings, value-added services (such as instant emergency services response and young driver monitoring), as well as through the ability to monitor and improve driver safety.

But the road ahead for vehicle telematics is not without hurdles. Insurers must learn how to use and share the data generated by telematics devices while also complying with data protection, privacy and transparency requirements. They must also reshape the public's sceptical perception of telematics as 'Big Brother' and attract the interest of older, lower-risk drivers with already low premiums, since telematics is currently used mostly to drive down premiums among younger, higher-risk drivers.

Due to these factors and telematics' unrelenting march forward, it is no surprise that BIBA reported in May 2015 that there was a 9 per cent increase in the number of telematics motor policies from last year. And, that figure is expected to keep rising. Telematics will likely continue to drive down premiums and reshape the motor insurance sector into 2016—but, only if insurers and brokers learn how to maximise its potential.

Digital Technology: Threat or Opportunity?

Digital technology continues to seep into the insurance sector, disrupting traditional sales channels and unleashing a torrent of potential new revenue streams. So far, the sector has been able stay afloat on the rising tide, but the digital deluge shows no signs of stopping—how long can the sector keep treading water without completely adopting digital? Does digital technology threaten to drown the entire industry as we know it?

Customer adoption of digital technology—which includes mobile phones, social media, cloud computing, data analytics and other digital platforms—continues to outpace the insurance industry's capabilities. But rather than fade into obsolescence, the industry is poised to take advantage of the new opportunities presented by digital technology.

Customers and the technology used to sell and service them are changing. Until now, the industry has survived these ongoing changes by employing quick fixes and patchwork remedies, but it has neglected to overhaul its basic model to allow digital adoption from the ground up.

The result has been an inflexible industry (with several exceptions) unable to quickly adapt to new consumer needs and expectations. Indeed, despite the estimate that 75 per cent of all insurance policies will be sold online by 2020, according to a 2014 global survey commissioned by Google, only 8 out of Europe's top 36 insurers are currently taking a strategic, comprehensive digital approach in responding to customer needs, according to a 2015 survey from research firm, Comprend. Last year, 50 per cent of insurance policies were sold online in the United Kingdom, according to PricewaterhouseCoopers.

Due to digital technology's lightning-fast and global wholesale adoption, doing nothing to adapt is akin to falling behind. In the coming years, the sector must contend with reconciling digital tools and strategies with non-digital legacy systems, ensuring the smooth and safe transfer of customer data, restructuring collapsed sales channels, learning how to use mountains of data effectively and more.

Failure to do so will allow outside-industry forces to poach the most valuable parts of the sector's revenue streams. Research has already begun to quantify the profit at risk—about 30 per cent, according to the Financial Times. Insurers that apply digital technologies across the organisation could add between 31-38 per cent of profit over the next five years, while insurers who only dabble could be losing just as much. Simply tacking on digital solutions to legacy infrastructure is not enough, as it bogs down insurers with additional spending, while new entrants unencumbered with clunky legacy systems use digital technology to sell insurance products at a much more competitive price.

Going forward, the sector must treat the digital deluge as a culture shift rather than a sea change. The sector is still based on solid relationships and buoyed by great customer service—there is no need to move away from this. Instead, the sector should use the opportunities presented by technology to build upon what makes it great—providing necessary products that grant peace of mind and make business happen.

Insurers should use digital technology to make themselves more relevant in the age of instant gratification. Brokers will no longer suffice by just communicating with clients once per year. Adopting digital technology does not mean sacrificing good service—on the contrary, digital tools can help send out regular, personalised communication that clients want. A surprising 38 per cent of UK insurance consumers prefer receiving communications at least semi-annually from their brokers or insurers, while only 23 per cent actually do, according to Ernst and Young's 2014 Global Consumer Insurance Survey. Digital technology promises more customer-centric products, constant and meaningful client communication, tangible benefits, more accurate pricing, improved claims experiences, and more.

Sensible, comprehensive digital adoption should continue lowering premiums for all insurance consumers in 2016 through process automation, more accurate risk calculation and more stringent fraud detection as insurers take the leap and make the investment.

Get in on the Act: Momentous Legislation

In 2015, several pieces of pivotal, far-reaching legislation went into effect, sending ripple effects across the industry that promised to either ease insurers' burdens or increase consumers' premiums. Which pieces of legislation have the power to slash insurers' costs or raise consumers' premiums, and what's on the horizon for 2016?

Insurance Act 2015: The Insurance Act 2015, which will go into effect on 12th August 2016, ushers in a more modern regime for the insurance industry by updating the 100-year-old regulations governing contracts between businesses and insurers. The previous law that the act updated was arguably designed to protect a then-fledgling insurance industry from exploitation—it gave insurers sweeping recourse to avoid honouring insurance policies at any sign of customer misconduct. The act corrects this outdated protection by rebalancing power in the consumer's favour.

Specifically, the act clarifies the pre-contractual duty of disclosure and places some of the onus on insurers to ensure they are collecting enough information to assess risk before beginning a policy, it abolishes 'basis of the contract' clauses which allow insurers to avoid a policy for something as immaterial as a mis-spelt address line, and it provides a set of remedies for dealing with fraudulent claims that are more proportionate.

The act is good news for consumers, who will benefit from increased protections, fewer legal disputes and greater clarity in insurance contracts, which is a common consumer grievance—a May 2015 Consumer Intelligence survey found that 51 per cent of respondents had trouble understanding their cover due to policy jargon. Experts expect The Insurance Act 2015 to empower consumers and potentially lower premiums due to a reduced number of legal disputes.

Deregulation Act 2015: The Deregulation Act 2015, which went into force on 30th June 2015, is a sweeping new law that contains important changes to the Road Traffic Act 1988 regarding the return and recovery of motor insurance certificates. The act amends the Road Traffic Act 1988 in the following three main ways: 1) Motor cover now becomes effective according to the date specified/date on insurance certificates rather than when policyholders receive their certificates; 2) Policyholders will no longer be required to return their certificates following cancellation of their policies and insurers will no longer need to retrieve those certificates to avoid ongoing liability; 3) It is no longer a criminal offence for policyholders not to return their certificates.

These changes are good news for policyholders, since, in the past, failing to return their motor insurance certificates could result in insurers taking legal action. They're also good news for motor insurers, who will no longer need to pay legal costs or be held potentially liable when policyholders neglect to return their insurance certificates.

But there's bad news, too: With more policies definitively cancelled under the new rules, insurers will no longer be liable in ambiguous circumstances, such as the time between a policyholder sending a certificate for cancellation and the insurer receiving it, or, when policyholders neglect to return their certificates after cancellation. This means the Motor Insurers' Bureau (MIB) will pick up the slack in these situations, since the MIB's Uninsured Drivers' Agreement is designed to compensate victims of uninsured drivers. The MIB charges the industry a levy for compensating these victims—a levy which is likely to increase in response to more claims falling under the Uninsured Drivers' Agreement. Whether or not insurers pass these costs onto consumers may depend on whether insurers quickly and completely amend their policy wording and internal processes to reflect the act's changes.

Get in on the Act: Momentous Legislation

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Flood Re: On 14th August 2015, Flood Re, the joint industry- and government-backed scheme designed to provide affordable flood insurance to more than 350,000 flood-vulnerable UK homes, began the 'on-boarding' process which allows industry participants to test the system before it goes live in April 2016. Flood Re is a not-for-profit reinsurance body, run and managed by the insurance industry, which has been in the planning stages since July 2013 when the previous insurance protection for consumers living in flood-prone areas, called the Statement of Principles, expired.

Flood Re is only intended to cover those properties most at risk—stakeholders expect that the market will provide competitive flood insurance rates for those properties not at high flood risk. The Department for Environment, Food and Rural Affairs expects that at least 1-2 per cent of domestic households will benefit from being reinsured through Flood Re. The scheme works by allowing insurers to pass on the flood risk for vulnerable properties to Flood Re. In the event of a flood claim, the insurer pays the policyholder's claim then seeks reimbursement from Flood Re.

Flood Re funding will come from premiums that are capped according to Council Tax bands and a levy paid by all insurers authorised to write home insurance in the United Kingdom according to market share. This will result in every UK home insurance policyholder paying £10.50 on average, which represents the cross-subsidy that already exists between lower and higher flood risk premiums.

Although the scheme's architects are adamant that Flood Re will not set prices for home insurance, home insurance premiums will likely dip, especially for those homeowners who pay higher premiums due to their high flood risk, since insurers can pass flood risk to Flood Re and policyholders can shop around for cover, which may have previously been too expensive, in a more competitive market.

Upcoming Legislation: In 2016, expect LI Insurance Services to keep an eye on any Bills currently before Parliament that have a potential to influence insurance premiums for businesses and individuals or profoundly impact certain industries, including the following:

- **Charities (Protection and Social Investment) Bill 2015-16**: A Bill to amend the Charities Act 2011
- **Energy Bill 2015-16**: A Bill to make provision about the Oil and Gas Authority and its functions; to make provision about fees in respect of activities relating to oil, gas, carbon dioxide and pipelines; to make provision about wind power; and for connected purposes
- **Finance Bill 2015-16**: A Bill to grant certain duties, to alter other duties, and to amend the law relating to the National Debt and the Public Revenue, and to make further provision in connection with finance
- **Health and Safety Executive (Powers) Bill 2015-16**: A Bill to confer further powers on the Health and Safety Executive
- **International Development (Official Development Assistance Target) (Amendment) Bill 2015-16**: A Bill to amend the International Development (Official Development Assistance Target) Act 2015 in order to provide for a five year reporting period instead of an annual reporting period
- **Mesothelioma (Amendment) Bill 2015-16**: A Bill to amend the Mesothelioma Act 2014
- **Working Time Directive (Limitation) Bill 2015-16**: A Bill to limit the application of the EU Working Time Directive; and for connected purposes
- **Riot Compensation Bill 2015-16**

Source: parliament.uk

What can you do?

How you control your insurance rates

Floods, cyber risks, the global economy—it can sometimes seem as if the forces determining your insurance rates are beyond your control. But as an insurance buyer, it's important to know how your premium is calculated, what trends influence the market and what you ***can*** *control to get the best price.*

Your claims history—which you can control—has an enormous impact on whether your rates go up or down. That's where implementing a solid risk management plan will help steer your pricing in a more favourable direction, both now and in future renewal periods.

Manage Cost of Risk, Control Price

Business owners who proactively address risk, control losses and manage exposures will be adequately prepared for changes in the market and will get the most out of each insurance pound spent.

Five key components of a successful risk management strategy:

1. Pinpoint your exposures and cost drivers.
2. Identify the best loss control solutions to address your unique risks.
3. Create a solid business continuity plan to account for disasters and other unpredictable risks.
4. Build a company culture focused on safety.
5. Manage claims efficiently to keep costs down.

The Role of Your Broker

In addition to helping you navigate the insurance market, LI Insurance Services has access to resources to assist in your risk management efforts.

Interested in reviewing your risk management strategies? Contact LI Insurance Services today.