McKinsey&Company

Global Insurance Pools, fourth edition, 2014

Global Insurance Industry Insights

An in-depth perspective

North America edition

Foreword

This is the fourth edition of McKinsey's annual in-depth analysis of the global insurance industry, based on our proprietary Global Insurance Pools (GIP) database. It will interest those who make decisions about allocating resources globally and those seeking to deepen their understanding of the drivers of insurance growth and profitability in all regions.

The report begins by summarizing the most important developments of 2012 and 2013. These two years were very eventful ones for the industry, as profitability recovered but growth was volatile and remained subdued in life insurance.

The report then outlines the key long-term trends for each of the industry's two primary lines of business: life insurance and property-casualty (P&C) insurance.[1] How has life insurance fared against other savings vehicles, and is the industry making progress in de-risking its business model? Which product categories and geographies are still growing in P&C, and what impact has the underwriting cycle had on profitability? Finally, the report briefly outlines strategies that can help insurers outperform expectations on growth and profitability.

A note on methodology: In general, our analysis focuses on data through 2012. We have selective data available for 2013 based on preliminary reports. The forecasting tools developed as part of McKinsey's GIP initiative were used to assess how the insurance industry might respond over the next decade to global macroeconomic shifts. Our "consensus scenario" assumes a recovery of GDP growth in the coming years in addition to steadily increasing interest rates. The results detailed in this report reflect the output of this model.

---

1 The global version of this report includes data and perspectives on health insurance markets globally. This version, prepared for a North American readership, does not include health insurance, as it is largely a separate market with different competitors in the U.S.

Global Insurance Industry Insights

An in-depth perspective

Contents

Executive summary 2

Recent developments in the global insurance industry 6

A perspective on life insurance 10

A perspective on P&C insurance 18

Appendix 26

Executive summary

The years 2012 and 2013 were eventful for the insurance industry. Profitability recovered sharply in both life and property-casualty (P&C) insurance. However, the growth pattern of the previous several years was sustained, which is to say that insurance was shrinking relative to nominal GDP growth. McKinsey's preliminary estimates for 2013 show that overall growth in the global insurance industry continued to trail nominal GDP growth (3.4 versus 4.3 percent), largely due to lower life insurance growth rates. P&C insurance grew in line with GDP, helped by the favorable cycle.

The underperformance against nominal GDP is driven by mature markets, which in 2013 still accounted for 84 percent of premiums, but less than half (45 percent) of the global premium growth. The high contribution of emerging markets to growth represents a structural shift that is driven by both the growing economic importance of emerging markets, and by a faster rate of insurance penetration compared to mature markets.

In contrast to this mixed growth pattern, profitability came back powerfully and somewhat unexpectedly in 2012. The reversals of 2011 were erased and profits above cost of capital were again realized in global life and P&C insurance markets. The recovery can be partly accounted for by particular events within individual countries, including the United States, Spain, and Italy. Yet even taking these factors into account, the level of profitability was surprising, especially for life insurance, given the persistently challenging interest-rate environment in mature markets.

LIFE INSURANCE

Life insurance has lost some ground globally to alternative savings vehicles in the last few years, and we expect this trend to continue. The pattern is driven by mature markets, where growth has been extremely volatile and weighed down by the low interest-rate environment, and by regulatory challenges (such as commission bans) and erratic performance of bancassurance volumes in some European markets. Emerging markets have been performing better. However, the rebound in life insurance penetration rates – as measured by the share of life insurance in personal financial assets (PFA) – seems to have ground to a (potentially temporary) halt in some regions, such as Emerging Asia.[2]

A clear shift of the product mix towards variable products has recently emerged. Although it is too early to tell if this shift is structural or cyclical and caused by the favorable recent equity market development, we believe the shift represents at least in part the efforts of the industry to de-risk its business model in light of risk capital regulation.

Life insurance profits recovered well in 2012, helped by the strong rebound of global equity markets. The picture remains very volatile year-on-year, and over time the life insurance industry on average has not been earning more than the cost of capital.

Our outlook is for a continued relative decline (growth above inflation but below GDP) due to lack of momentum in mature markets and adverse regulations on distribution. Global growth will be driven by the BRIC (Brazil, Russia, India, and China) markets. The implications for carriers can be summarized in three points:

[2] Includes China, India, Indonesia, Malaysia, Philippines, Thailand, Vietnam and the Middle East.

- Given the extremely high volatility and the difficulty in forecasting particular regulatory developments, there seems to be value in geographical diversification

- Regulation is a key influence on growth (either way)

- The push towards variable and biometric risk coverages needs to be intensified

The strategic implications of geographical growth patterns is less clear – while emerging markets appear more attractive on the face of it, many insurers have faced substantial difficulties both entering these markets and carving out a profitable position.

PROPERTY-CASUALTY

In P&C, premium growth has been roughly in line with nominal GDP. In emerging markets, auto insurance has been the growth engine, both as a result of rapid vehicle growth and a rise in the average value of new cars. In mature markets recent growth has been helped by a positive cycle, but is under pressure structurally. Auto insurance in mature markets has been declining relative to nominal GDP growth; premiums have been falling due to lower accident frequency, and growth in other lines has not made up for the decrease, leading to a decline in the broader market.

Our profit pool database suggests the direct/remote channel is not growing as quickly as expected at a global level, particularly in emerging markets.

Profitability in P&C is nearly as volatile as it is in life insurance. It also rebounded strongly in 2012, partly due to the cycle, which is still apparent and relatively aligned across regions. Given that investment income remains structurally under pressure due to low interest rates, the industry is rightfully putting more emphasis on underwriting discipline. In emerging markets, the return on equity (ROE) is higher due to superior technical profitability and the higher share of "short-tail" business, which requires less capital.

The outlook for P&C is for growth to trail GDP growth slightly, with mature markets having reached saturation, and new types of risk coverage unable to compensate for the decline in auto. There are several implications for P&C insurers:

- As market momentum continues to be the most important driver of growth, insurers will need to take a granular approach to growth, assessing markets, products, and segments in detail to identify the most attractive cells

- Continue to push operational and underwriting performance

- Start preparing for a gradual downturn in mature markets, given that technological advances will likely accelerate the decline in auto insurance.

WHY THIS MATTERS FOR NORTH AMERICAN CARRIERS

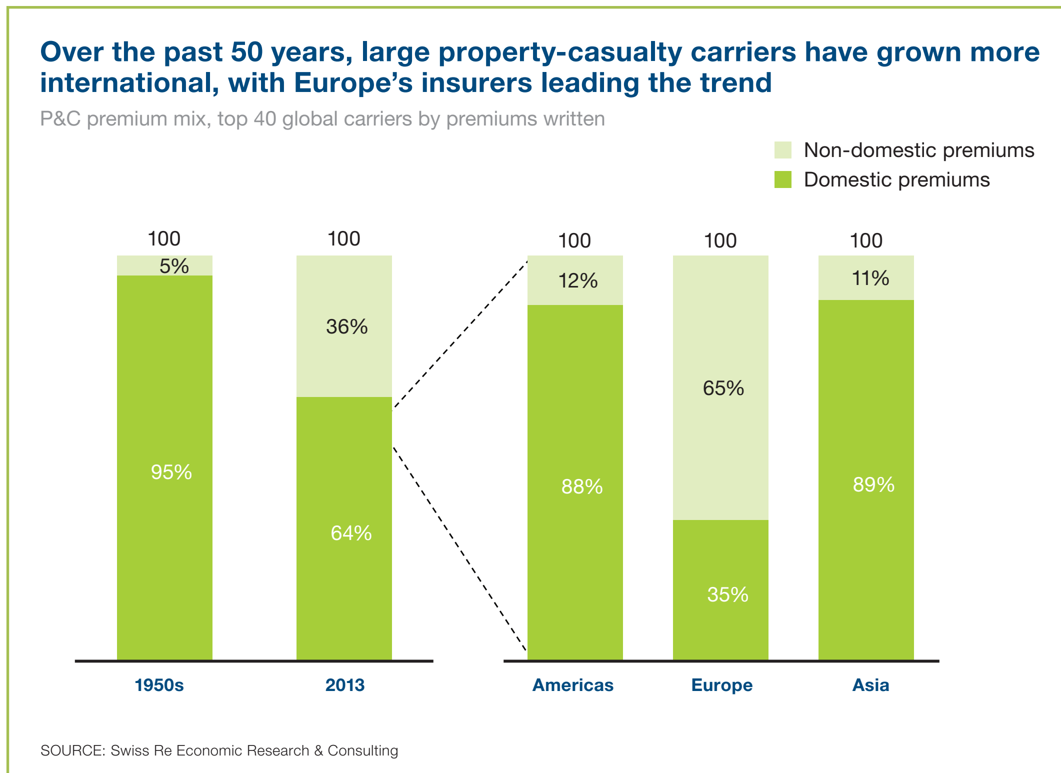
Over the longer term, the insurance industry has become more global. In the mid-1950s, the 40 largest property-casualty global carriers drew 95 percent of revenues from their home country; in 2013 domestic revenues for the top 40 decreased to 64 percent (Exhibit 1, page 4). Carriers with a diverse global mix have also been shown to perform better: between 2004 and 2012, the combined ratio of the largest carriers with a more global footprint was three points lower than that of the largest carriers

with a less global footprint. Global insurers benefit from diversification, increased staff mobility, more leverage with distribution partners and other advantages.

Most of the globalization of the 40 largest property-casualty insurers has been driven by European carriers, with some notable exceptions (AIG and Liberty Mutual in the U.S., for instance). However, most U.S. property-casualty carriers remain primarily focused on domestic markets. This is understandable, as the U.S. property-casualty market is still five times larger than the next largest markets (Japan, Germany). And, while other developing markets and emerging markets today comprise the majority of global premiums, this was not the case from the 1960s to the 1980s, when the U.S. accounted for 75 percent of global property-casualty premiums. These same patterns apply broadly to life insurance, where only a few U.S. carriers have made significant forays into international markets.

Times are changing, as our latest profit pools demonstrate. In both property-casualty and life insurance, global markets (outside of the U.S.) continue to gain share, particularly due to fast growth in emerging markets. This, combined with the fact that the U.S. insurance market remains among the world's most mature and competitive, suggests that it is only a matter of time before more U.S. carriers seek a larger presence outside their borders

Exhibit 1



About McKinsey's Global Insurance Pool database

McKinsey's GIP is a proprietary database containing over 150,000 data points covering the largest 60 countries worldwide and 99 percent of global insurance premiums. The database includes key financial indicators for every market, starting from 2000, and projections to 2020. The forecasts in this paper are based on extensive regression modeling that incorporates a set of macroeconomic parameters as input variables, including interest rates, equity market performance and nominal GDP growth. These parameters make it possible to develop scenario-based forecasts portraying the impact of specific macroeconomic events or situations.

Our forecasts are derived from a combination of quantitative regression analysis and the informed judgment of experts. They are the outcome of a consensus macroeconomic scenario that is based on Oxford Economics' macroeconomic forecasts. The Oxford forecasts assume average global nominal GDP growth of 6.2 percent for 2013–2020 (compared to 5.3 percent for 2002–2012) and a gradual increase in interest rates. The scenario does not include potential macroeconomic and regulatory threats (for further methodological details, please refer to the Appendix).

McKinsey's Global Insurance Pools provide actionable data along several dimensions. GIP's "Granularity of Growth" analysis can identify a company's specific drivers of growth; the tool can also benchmark a carrier's growth and profitability against market performance and competitors, and identify the impact of different macroeconomic scenarios on growth and future market share. McKinsey offers a subscription to this proprietary database giving unlimited access to all data points.

New additions to GIP

GIP is currently expanding its core offering of market data to include individual insurer data. This data will be offered as performance benchmarking and as databases for global and local insurer data.

Performance benchmarking. GIP now offers tailored performance benchmarking in which an insurance company can be compared to its competitive peers. This in-depth analysis covers capital markets performance, financial performance for total business and life insurance and non-life insurance, and country-level performance. A complete performance benchmarking report is available upon request and takes less than 48 hours to compile.

Individual insurer databases. GIP is extending its databases by integrating data on the largest insurers globally and locally. The databases include:

- *Global insurer data:* provides key financial statement information for 80 major global insurers, including a split for life insurance and non-life insurance.
- *Local insurer data:* provides key financial indicators for the 25 largest local insurers in the top 15 global insurance markets. In addition, it includes premium-level data for the 10 largest insurers for more than 30 countries globally.

More detailed information on the GIP initiative can be found in the Appendix.

Recent developments in the global insurance industry

The last two years were eventful for the global insurance market. Profitability returned strongly in both life and P&C insurance, but growth in both lines still trails GDP and individual lines of business continue to be beset by extreme volatility.

INDUSTRY GROWTH TRAILS NOMINAL GDP GROWTH

In 2012, the global insurance industry grew 4.4 percent, continuing the pattern observed in the past few years of growth in insurance lagging slightly behind nominal GDP growth (4.6 percent). Preliminary reports estimate that in 2013 industry growth is again behind GDP growth, posting 3.4 percent against GDP of 4.3 percent. The trend means that on a relative scale, insurance as an industry has been experiencing mild shrinkage. As demonstrated in the following discussion of the development of individual lines in 2012 and 2013, the trend is largely driven by poor performance in life insurance in mature markets (Exhibit 2).

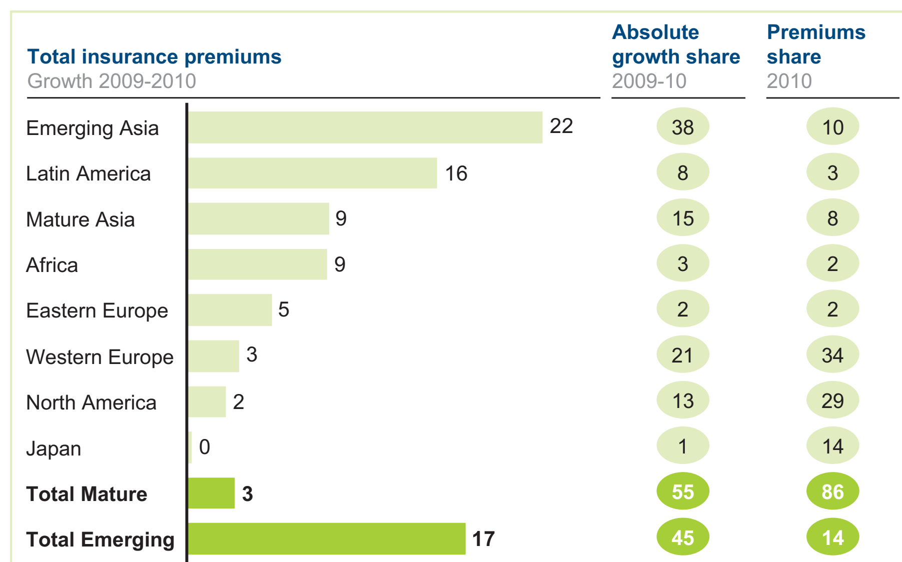
Life insurance

In 2012, most mature markets faced low interest rates and tightening regulation. This caused customers to move away from life insurance products and into other financial assets, such as short-term deposit products. Growth in emerging markets has not completely offset the pattern seen in mature markets. In 2012 and 2013, global life insurance has been a volatile line, both year to year and region by region. Overall, life insurance grew at 4 percent in 2012. In 2013, growth was much lower, at 0.4 percent. In previous years, annual growth in life insurance has been around 2 percent, well below GDP growth.

Exhibit 2

Emerging markets drove overall premium growth in 2010, in particular Emerging Asia

Percent



SOURCE: McKinsey Global Insurance Pools

P&C insurance

Compared to life insurance, P&C premiums developed more positively in the last five years, helped by a positive cycle in mature markets and strong growth in emerging markets. P&C premiums grew steadily in 2013, at 5.4 percent, slightly higher than GDP growth and 2012 premium growth (4.8 percent). Still, P&C premiums grew slightly more slowly than did nominal GDP in most mature markets, reflecting a continuing trend. This trend mostly relates to the performance of auto insurance products, where declining premiums reflects falling accident frequency. In emerging markets, where the number of cars and auto insurance policies is on the rise, premium growth outpaced GDP growth. Penetration in emerging markets, however, will not approach mature-market levels any time soon.

INDUSTRY PROFITS RETURN

Profitability has made a sharp recovery and is now above the cost of capital. Profits in 2012 reached their highest level in five years. The ROE for global life insurance was 12 percent in 2012, double the 2011 level. The ROE in the P&C business was slightly lower but at 9 percent still represented a powerful uptick from 2011 (6 percent). Such strong profitability, especially in life insurance, surprised some analysts, given the persistently low interest rate environment in mature markets. In 2013, profitability appears to have remained strong.

The recovery in profitability can be explained by four factors.

- **Strong equity market performance in 2012.** The return to shareholders for the world's equity markets was a strong contributing factor to both life insurance and P&C profitability. Total return to shareholders (TRS) of the Global Capital Market index in 2012 was 15 percent versus -9 percent in 2011. A sensitivity analysis in our GIP life insurance profit forecasting model suggests that roughly half of the ROE delta in life insurance is driven by an increase in investment income and a reduction of revaluations and impairments. Equity markets and credit spreads have played a major role in that.

- **Continued price increases and a favorable cycle in P&C.** This holds particularly true in mature markets such as the U.S.

- **Fewer natural disasters.** Profitability improved in P&C with fewer disasters. The earthquake in Japan and destructive storms in the U.S. made 2011 a difficult year with depressed profitability.

- **Reversal of anomalous effects.** In 2011 the industry experienced a number of unusually low ROE rates, which came back strong in 2012. Primarily this was driven by performance in the U.S., where life insurance industry ROE rose from 3 percent in 2011 to 13 percent in 2012. Similar increases were observed in Portugal, Spain and Italy, mostly due to instant book gains on reinsurance deals and improving government bond spreads.

EMERGING MARKETS HAVE INCREASED THEIR STRUCTURAL GROWTH SHARE

Growth in emerging markets has been outpacing that of mature markets by 10 percentage points. In all mature regions, growth has been lower than nominal GDP

Exhibit 3

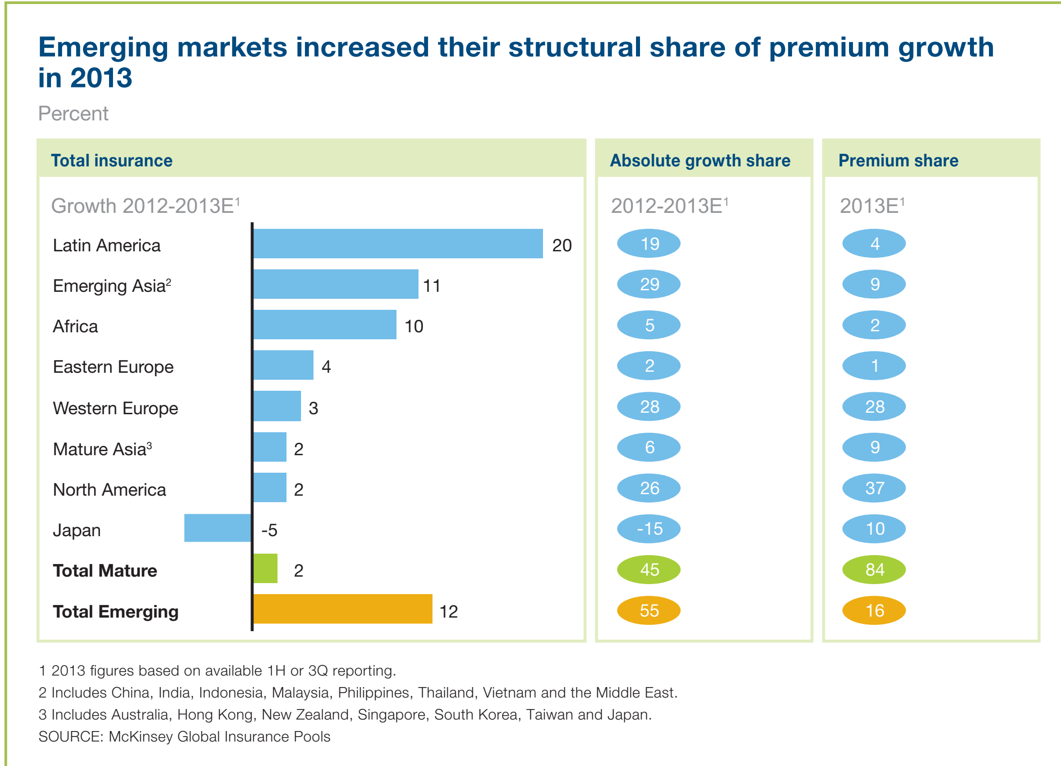
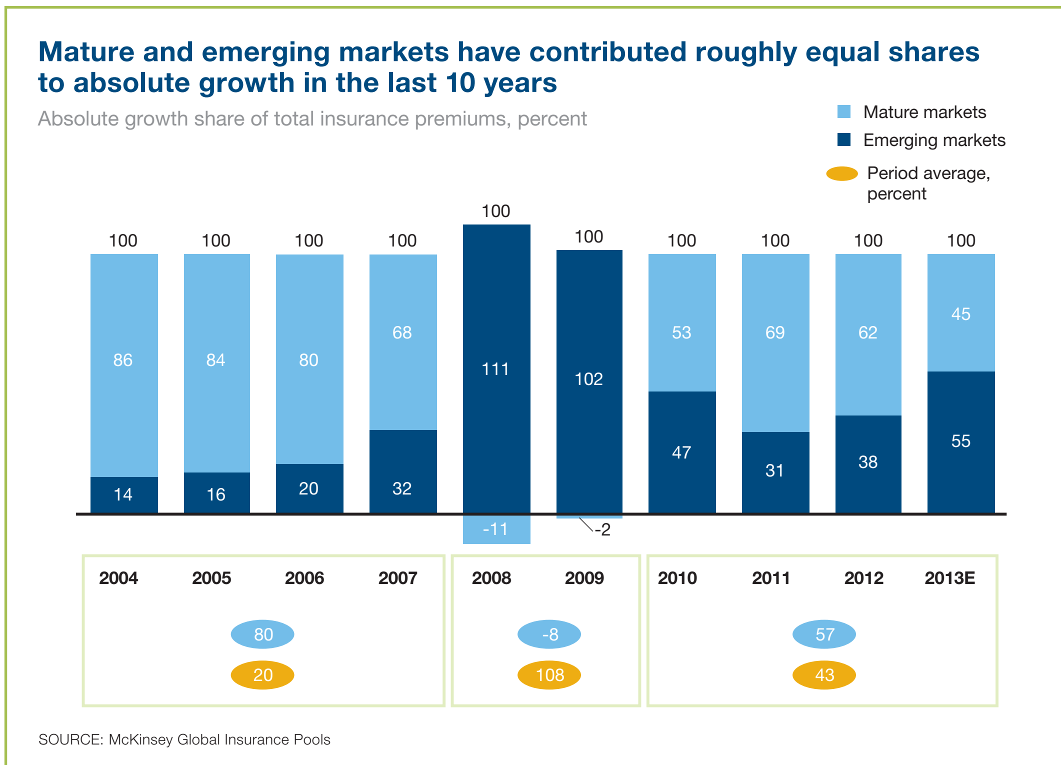


Exhibit 4



growth; despite this, mature markets taken together still account for 84 percent of total premiums globally (Exhibit 3).

In 2013, Emerging Asia was the main contributor to insurance growth, accounting for 29 percent of all global growth. This reveals a shift in growth distribution between emerging and mature markets over the past decade. Before the 2008-09 financial crisis, mature markets accounted for roughly 80 percent of absolute growth; since the crisis (which froze growth at zero in mature markets) emerging markets have had a nearly equal share of global premium growth (Exhibit 4).

The structural shift in premium growth contribution mirrors an underlying shift in GDP growth, and is most likely permanent due to this basis effect. Specifically, emerging markets' share of world GDP has more than doubled, from 16 percent in 2003 to 34 percent in 2013. Accordingly, emerging markets' contribution to absolute GDP growth has increased by more than 50 percent—from 42 percent for 2004-07 to 64 percent for 2009-13. Mature markets are expected to recover, with GDP growth of 4.1 percent going forward (versus 2.8 percent in the last four years), while emerging markets are expected to slow slightly, to GDP growth of 9.7 percent (versus 12.4 percent in the last four years). Still, the emerging market contribution to absolute GDP growth is expected to remain at around 60 percent, much higher structurally than it ever was.

A perspective on life insurance

Historically, the life insurance environment has been strongly influenced by macroeconomic developments, local regulations and tax laws. In the long run, the environment should benefit from positive fundamentals. Demand is up in mature markets due to the retiree pension gap and in emerging markets from a growing middle class. In the short term, however, these factors have yet to be reflected in the numbers, and it remains to be seen if insurers will be the ones capturing these opportunities.

HIGHLY VOLATILE GROWTH, WITH STRONG REGIONAL VARIATIONS

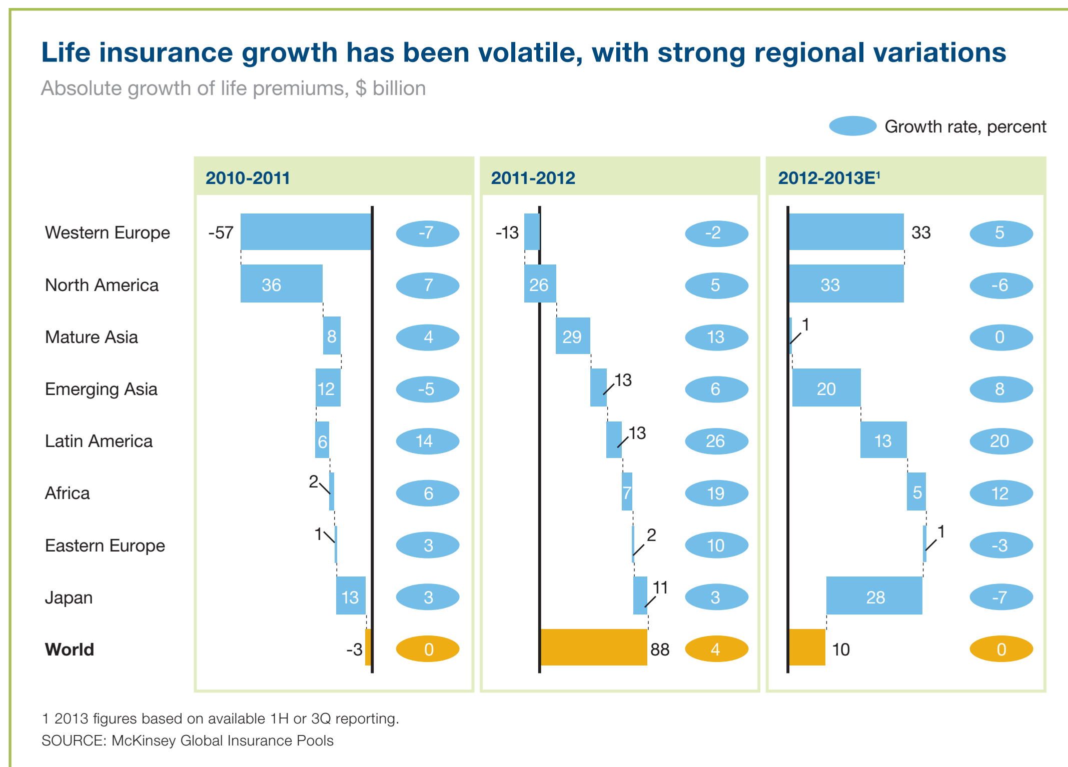
Life insurance premium growth has proven to be volatile over time, as it is very sensitive to regulation and capital market performance. Growth in global life insurance declined to 0.4 percent in 2013 from 4 percent in 2012, mostly due to negative growth in two big markets: Japan (-7 percent) and the U.S. (-6 percent) (Exhibit 5).

Strong regional variations in life insurance growth are typical. For example, in our previous report, the outlook was negative in Europe, due to declines in bancassurance markets in southern Europe. Premium growth in these markets is historically volatile, since sales largely depend on the appetite of banks to sell life insurance products over banking products. Fortunately for the industry, bancassurance in most markets recovered strongly in 2013.

Western Europe recovers; U.S. and Japan stall

Overall, Western Europe premium growth is back on track, rebounding from -2 percent in 2012 to 5 percent in 2013. It is a region of country-to-country variations, how-

Exhibit 5



1 2013 figures based on available 1H or 3Q reporting.
SOURCE: McKinsey Global Insurance Pools

ever, and unique trends. The recovery has been largely powered by improvements in France and Italy; markets that accounted for most of the decline in 2011 and 2012. In the United Kingdom and the Netherlands, on the other hand, the decline appears to be structural and continues with ongoing regulatory pressure. The regulations adopted by these countries also loom for the rest of Europe, with more and more countries writing rules around distribution cost transparency and commissions (including total bans). Finally, Greece and some other countries are still suffering from poor economic conditions.

The remaining mature markets. In the U.S., Japan and other mature Asian countries, premium growth declined in 2013 compared to 2012. In 2011 the U.S. still had the highest absolute premium growth worldwide, but it experienced a 6 percent decline in premiums in 2013. This decline is largely a result of a restructuring of the variable annuity business of local insurers and a normalization effect in group life as insurers took over pension plans from non-insurers in 2012. In Japan, a premium decline of 7 percent was set off by a lowering of the guaranteed rate from 1.5 to 1 percent in 2013. Japan now accounts for approximately 15 percent of global life insurance premiums, down from approximately 30 percent in 2000. Finally, after 13 percent growth in 2012, premium growth slowed to zero in the remaining mature Asian markets.

Emerging Asia surges ahead

In the emerging Asian markets premium growth has continued to rebound, reaching 6 percent in 2012 and 8 percent in 2013, after a decline in 2011 (-5 percent). This decline was due to changing regulation, especially accounting rules, in some core markets such as China and India.

In the rest of the emerging world, premium growth varied widely by region and country. In Eastern Europe, premiums declined by 3 percent due to weak economic conditions. The Polish market was deeply affected, with life insurance premiums declining by 18 percent in the first half of 2013. This sharp decrease was mainly caused by the government's attempt to discontinue a specific short-term product that is exempt from capital gains tax. Latin America and Africa are the only two regions to show consistently high premium growth over the last three years.

LIFE INSURANCE PENETRATION STAGNATING

The share of life insurance as a percentage of personal financial assets (PFA) varies strongly between regions, due to differences in country-specific regulation and customer demand. In mature markets life insurance generally claims a higher share of PFA, as people start long-term savings regimes only after having reached a certain income level. Countries with the highest life insurance share of PFA are generally those, such as France, that provide specific tax incentives. In the U.S., life insurance has a low PFA share, as the life insurance industry missed out for a number of reasons on the growth in 401(k) plans. These plans began in the late 1970s and have heavily contributed to the growth of the asset management industry.

In 2012, the overall share of life insurance in PFA fell, as penetration in emerging markets, which seemed to be accelerating, came to a halt. Life insurance penetration is now characterized by a wide variation globally and a pattern of stagnation in several regions (Exhibit 6, page 12).

Exhibit 6

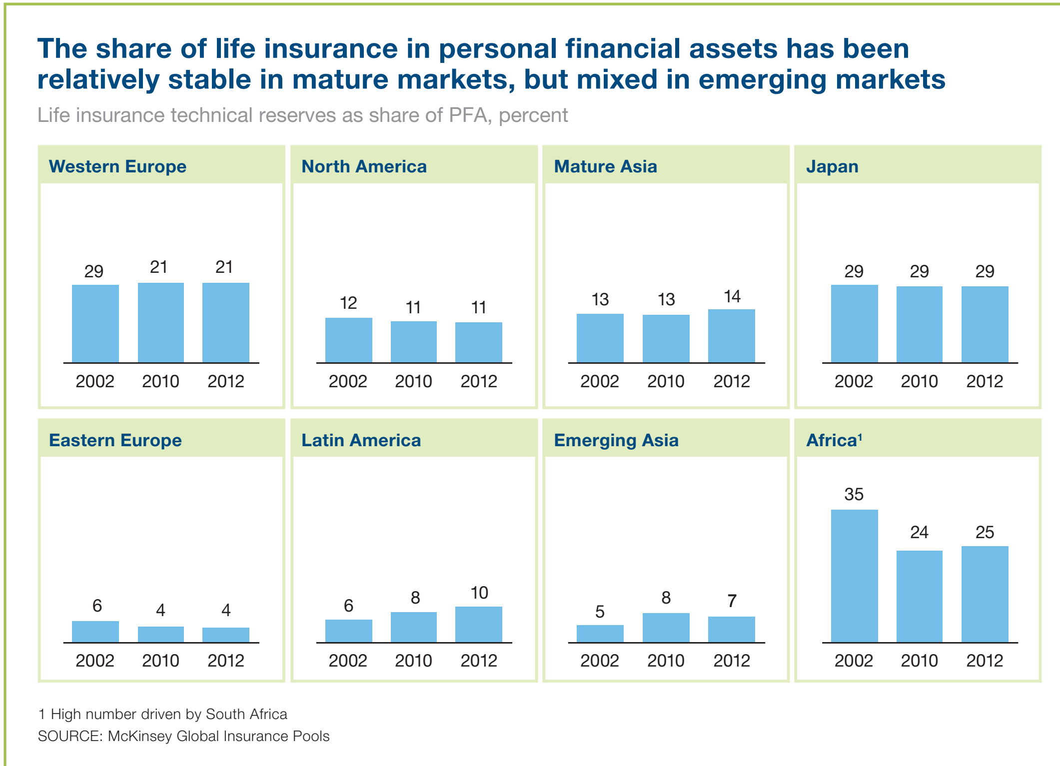
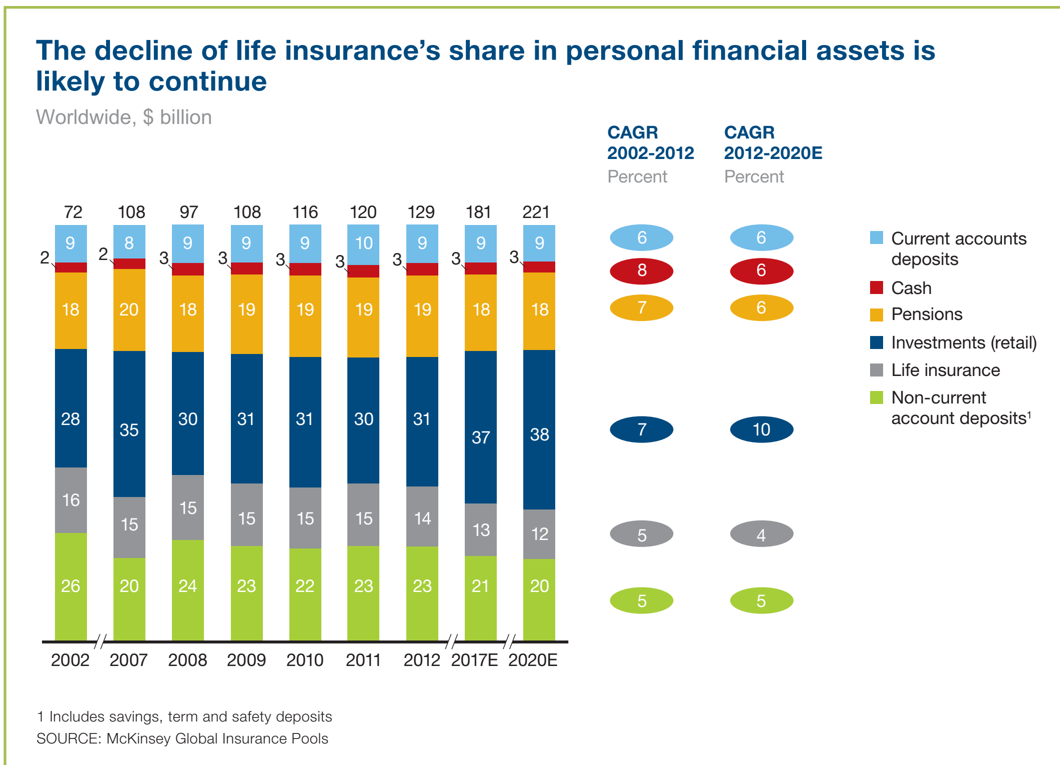


Exhibit 7



In the first decade of the millennium across emerging markets, the life insurance share of PFA rose notably. In Latin America, penetration increased by 33 percent, from 6 percent in 2002 to 8 percent in 2010. In Emerging Asia the rise was 60 percent, from 5 percent in 2002 to 8 percent in 2010. Since 2010, however, this growth has slowed in Latin America and stopped entirely in Emerging Asia.

In most mature markets the life insurance share of PFA has remained stable over the years. In North America the share has lately edged down from 12 to 11 percent; in Western Europe and Japan it has remained stable at approximately 20 percent, and in Mature Asia it has increased slightly from 13 to 14 percent.

A number of factors are influencing life insurance penetration in Western Europe. In the United Kingdom, discretionary pensions and investments grew at the expense of life insurance's PFA share, which was 22 percent in 2007 and 18 percent in 2012. The likely causes of this gradual decline are regulatory changes. On the other hand, the share of life insurance increased at the expense of investment products in France, Sweden and Norway. In France, the continued favorable tax treatment for life insurance products was likely the main cause of the increase; in Sweden and Norway a large group life business with typically very stable inflows makes life insurance less sensitive to short-term market fluctuations.

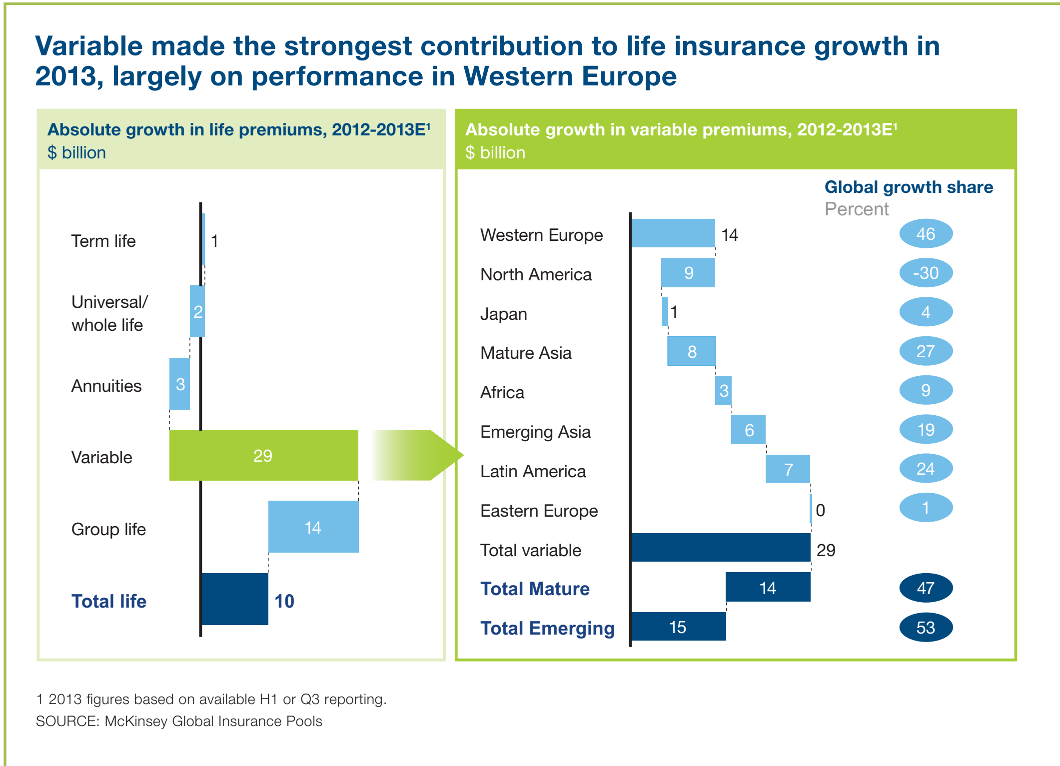
McKinsey expects life insurance's PFA share globally to decline further (Exhibit 7). The forecasted annual asset growth of life insurance to 2020 is 4 percent, the lowest among the product categories analyzed. Investments, for example, are expected to grow at 10 percent annually and bank deposits at 5 percent. The reasons for the lower growth are several: first, economic uncertainty and the low interest-rate environment are causing people to prefer short-term savings and cash in mature markets; second, from a tax-advantage standpoint, countries have begun to level the playing field for savings products, and thus life insurance has lost its unique benefits as a tax-exempt product in many countries; third, traditional products with guarantees and hence a lower asset appreciation compared to investment products continue to dominate over variable products.

Emerging markets are a different story. The share of current-account deposits and cash is expected to decrease as financial systems mature and consumer confidence increases. Furthermore, long-term tax-efficient savings will continue to be promoted by most Asian governments, in a way that would favor insurers. However, these developments will not fully compensate for the declining penetration in mature markets, in McKinsey's view.

VISIBLE SHIFT TO VARIABLE LIFE AND ANNUITIES: DE-RISKING FINALLY SEEMS TO HAVE AN EFFECT

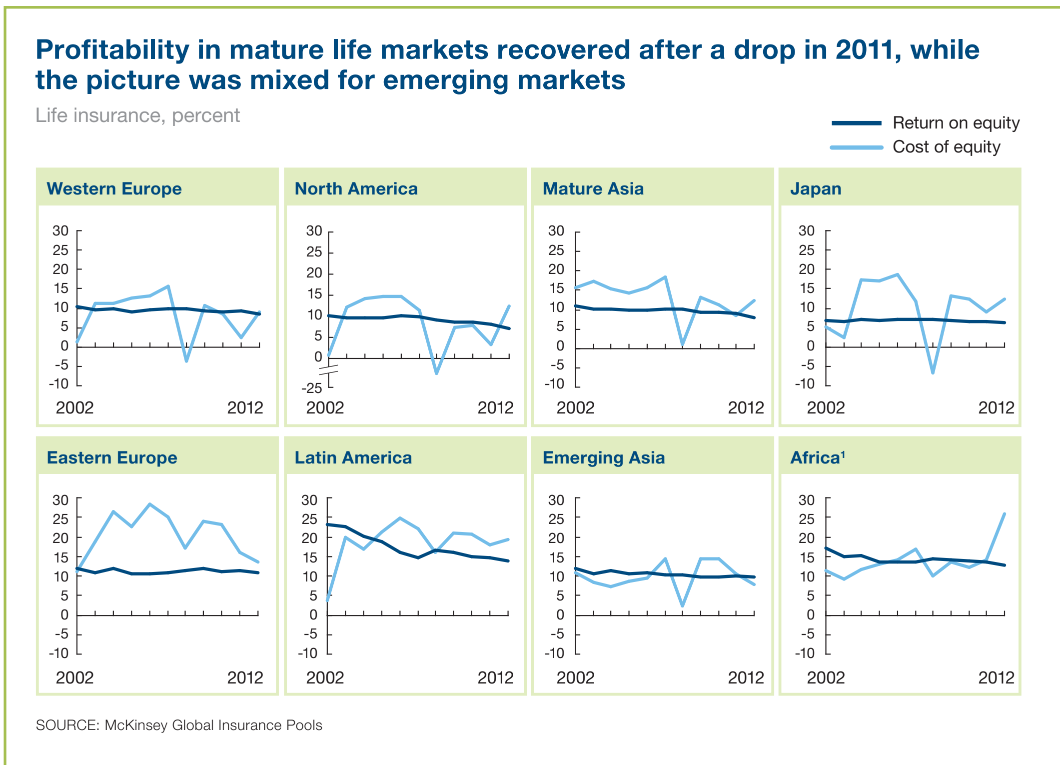
Variable life insurance products (in Europe, *unit-linked*) have developed cyclically; premium growth depends heavily on capital market conditions. Between 2004 and 2007, variable products grew 16 percent per year on average. Between 2008 and 2010 contraction set in, at a rate of -9 percent annually. Finally, since 2011 growth has returned, though at a modest annual rate of 4 percent. By comparison annual growth for traditional life products was 3, 6 and 2 percent respectively for these three periods. In 2013, variable was the product category with the strongest absolute growth by far, especially in Western Europe (Exhibit 8, page 14).

Exhibit 8



1 2013 figures based on available H1 or Q3 reporting.
SOURCE: McKinsey Global Insurance Pools

Exhibit 9



SOURCE: McKinsey Global Insurance Pools

While it is too early to tell if the shift to variable is structural or again purely cyclical, the industry's recent wave of product innovations has had an impact (e.g., alternative guarantee concepts within a variable product, aiming at maximizing both the product's upside potential and the insured's need for downside protection).

PROFITS RECOVERED TO ABOVE COST OF CAPITAL DESPITE A HEAVILY CHALLENGING ENVIRONMENT

Life insurance has been remarkably resilient despite a difficult interest rate environment and general economic challenges.

Clearly, 2011–12 was a highly volatile period for life insurance, with the outlook flipping from somewhat negative in 2011 to positive in 2012. Global ROE moved from 6 percent in 2011 to 12 percent in 2012, with about half the lift attributable to improved capital market performance (2012 global TRS was 15 percent versus -9 percent in 2011). The result was an after-tax increase in global life insurance profits of $69 billion. More than one-third of this total was captured in the U.S., where ROE rose from 3 percent in 2011 to 13 percent in 2013. And most of this increase was achieved by five or six of the largest insurers. These carriers saw enhanced investment performance and made several profitable transactions in pensions (group) and reinsurance (individual). These actions led to reserve releases, which positively affected ROE.

Other significant drivers of profit growth were one-off effects and economic conditions in some southern European countries. Improving government spreads in Italy contributed strongly to an overall ROE growth leap from -9 to 15 percent. The one-time gains captured by offloading individual life insurance books to reinsurers helped lift the ROE in Portugal from -3 to 25 percent and in Spain from 13 to 19 percent.

In emerging markets, the picture was more mixed. Africa continued its decade-long upward trend, while in Latin America the high-profitability plateau was reached in 2003. In a trend opposite to that of the mature markets, Emerging Asia's 2012 profitability was down in 2012 compared to 2011. The trend reflects a weak stock market, which declined 13 percent in 2012 (Exhibit 9).

LONG-TERM OUTLOOK SUBDUED DUE TO PERSISTENT CHALLENGES IN MATURE MARKETS

Even under a mildly optimistic economic scenario, life insurance growth will likely lag behind GDP growth for the foreseeable future. McKinsey does have a positive view of long-term fundamentals, based on demographics and the growing middle class in emerging markets. However, we expect growth momentum to remain subdued in the next five years for a number of reasons.

The upswing in the equity markets helped improve industry performance in 2013, but life insurance is still suffering from a low interest rate environment that is expected to continue in certain mature markets. The consensus scenario (based on macro forecasts from Oxford Economics) foresees life insurance premiums growing by 4 percent annually between 2013 and 2020, while nominal GDP grows at 6 percent annually.

Given capital regulations and low interest rates, a further shift from traditional guarantees to variable products is likely, but this will not fully offset the decline in traditional products. In line with historical trends, McKinsey expects term life and group life insur-

ance to show the most stable development in the future, with variable continuing to be volatile. An increasing level of scrutiny of commissions could boost direct channels, including salaried sales forces and multi-access propositions, but this effect is not fully visible yet.

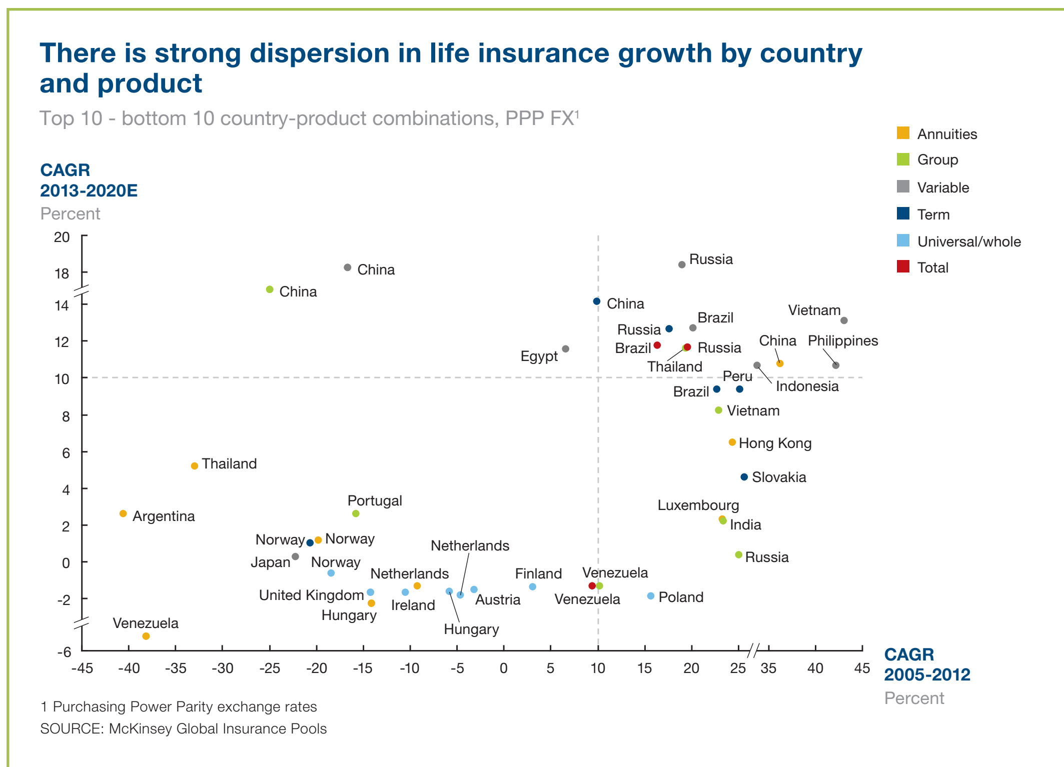
More specifically, for mature markets, premiums are forecast to grow 2 percent, in line with growth over the past decade, but above the average of 1 percent seen in the last four years. This improvement reflects the expectation of a continuing macroeconomic recovery. However, this growth is still well below the forecast of 4 percent GDP growth, and so the trend of declining penetration begun in 2007 is expected to continue.

For emerging markets, premiums are forecast to grow 10 percent, below the growth of the last decade (14 percent) but ahead of the average for the last four years (9 percent). The growth expectation reflects a recovery in China and India, which have been negatively affected by regulatory developments of late. However, the strong growth of the last decade will likely not be reached, a result of less powerful macroeconomic momentum (10 percent GDP growth forecast, versus 14 percent in the last decade).

When historical development is linked to expected growth in the life insurance industry, three groups of countries stand out (Exhibit 10):

- Of the BRIC countries, Brazil, Russia and China stand out in terms of both historical and forecast growth. China and Russia show expected growth rates of over 10 per-

Exhibit 10



There is strong dispersion in life insurance growth by country and product

Top 10 - bottom 10 country-product combinations, PPP FX[1]

1 Purchasing Power Parity exchange rates

SOURCE: McKinsey Global Insurance Pools

cent. Positive growth is also expected for India, but at a slower rate of 8 percent, not necessarily outpacing GDP growth.

- Countries affected by regulation such as the Netherlands and the United Kingdom face poorer expectations. Other country effects can also be noted, such as in Hungary, where nationalization of parts of the pension system have contributed to negative growth.

- Finally, countries facing new or lingering financial crises showed negative growth numbers and are expected to continue to decline.

IMPLICATIONS FOR INSURERS

While the environment is challenging, especially in mature markets, individual insurers can make adjustments to improve their growth performance. Previous editions of this paper have suggested that carriers should pursue growth by carefully identifying and choosing to compete in the most attractive market segments, based on the observation that market growth is the best way to achieve market share gain. The approach is based on a highly detailed or “granular” analysis of the most promising combinations of countries, products, channels and customer segments. Based on the latest global life insurance market data and analysis, as covered in this chapter, the granular approach can be slightly adjusted.

McKinsey sees three important levers for life insurers:

1. Geographic diversity: Given the increasing volatility of growth in life insurance across markets, the value of diversification has increased. The individual country (including its geopolitical, economic and regulatory environment) remains the dominant growth driver, overwhelmingly more important than products or channels. For this reason, effective diversification essentially means geographical diversification. At the same time, insurers need to carefully consider the associated risks and challenges, including fragmentation of management attention, overpayment for acquisitions, or entry into regions where they have no credible competitive advantage.

2. Regulatory strategy: The impact of regulation on growth can be clearly seen in a number of countries. This impact can of course be positive (favorable tax treatment of life insurance leading to high PFA share) or negative (regulation of sales commissions triggering market declines). For insurers, working with regulators toward a goal of fair regulatory treatment can be a valuable part of overall growth strategy. The aim should be to arrive at a fact-based evaluation of risks and a level playing field with banks and asset managers. The most positive potential effects of regulation could be a privatization of pension systems in certain markets.

3. De-risking of the business model: Further de-risking, including growth in biometric or variable product categories, would be beneficial for capital ratios and would also mitigate volatility of profitability. While some progress has been made in this direction, the life insurance industry needs to intensify its efforts in both product categories.

A perspective on P&C insurance

Growth in the P&C industry is a good deal less turbulent than in the life insurance industry and trends are not as volatile from year to year. Yet, profitability is dependent on both the cycle and capital markets, and the latter caused an uptick in global P&C profits in 2012.

CONSISTENT PREMIUM GROWTH

Premium growth has been much more consistent in P&C insurance than in life insurance, yet here too growth trails GDP. Average annual global growth has been 5 percent since 2009, compared to 6 percent nominal GDP growth.

The highest premium growth rates in 2013 were recorded in Emerging Asia (15 percent) and Latin America (19 percent). Almost all of this growth was in auto insurance. Overall, real growth in P&C in emerging markets was flat, however, at about the rate of inflation.

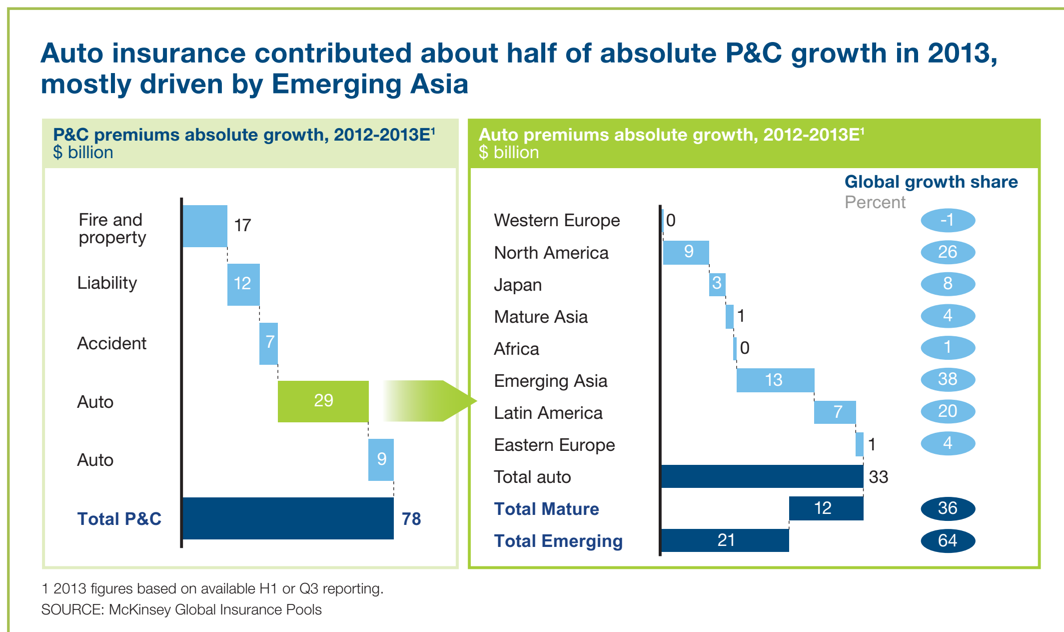
Mature markets have basically reached a saturation point and growth has begun to decline slightly in relative terms. The slide is partly due to fewer and less severe auto accidents in some markets, causing auto premiums to remain flat in absolute terms, despite an increase in the value per car.

Other P&C product lines have not compensated for the decline in auto. The most significant exception is an increase in fire and property insurance in the U.S., which has been driven by a favorable pricing cycle. On a global scale, new risk coverage offerings have so far failed to make a significant impact.

Auto insurance: Up in emerging markets, down in mature markets

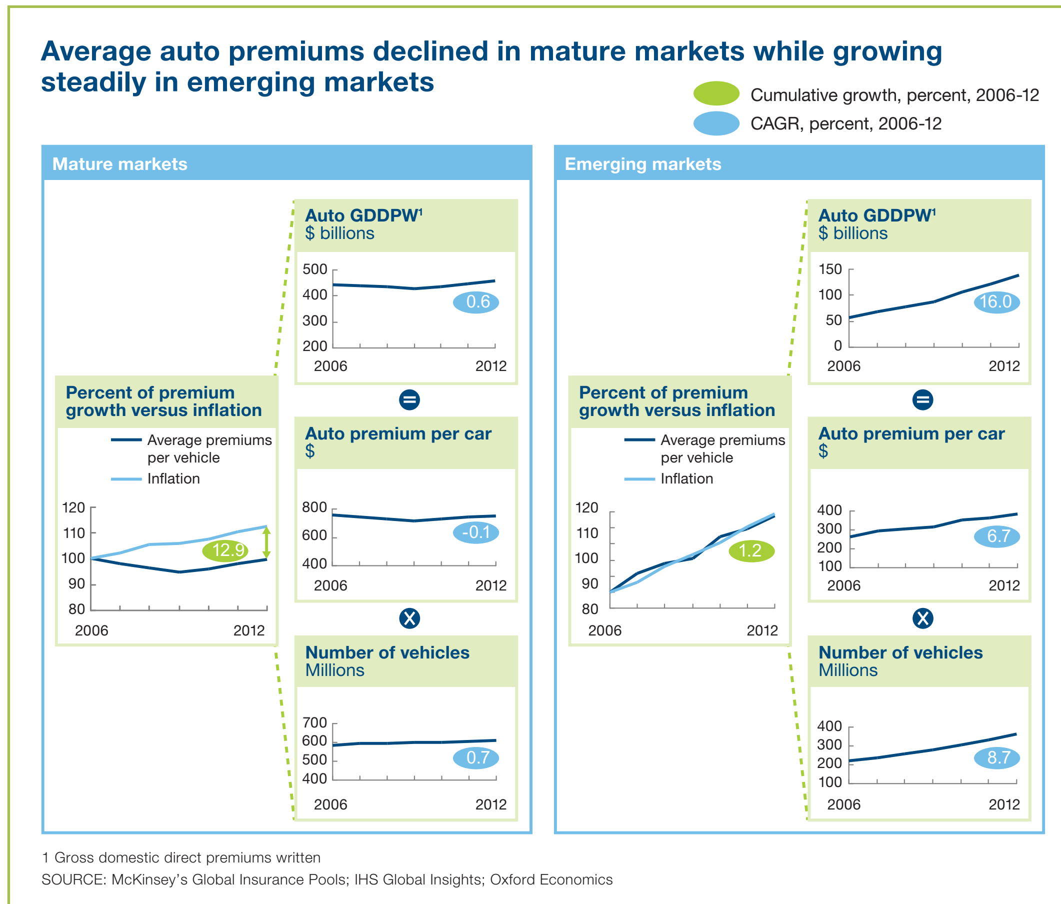
The global market for auto insurance expanded by $33 billion in 2013, with most growth coming from emerging markets—Emerging Asia captured 38 percent and emerging markets as a whole captured 64 percent (Exhibit 11). In some mature markets, prices have been dropping due to fewer accidents and increased competition from direct channels.

Exhibit 11



1 2013 figures based on available H1 or Q3 reporting.
SOURCE: McKinsey Global Insurance Pools

Exhibit 12



In emerging markets growth was driven by a continuing surge in car ownership, which has risen by nearly 9 percent annually since 2006 (Exhibit 12). Prices also contributed, rising 6.7 percent annually during this period, reflecting the higher value per car insured. The growing economies of China and other emerging markets have contributed to the significant increase in premiums.[3] The pattern will continue as the middle class—and with it, car sales—continues to expand on a parabola that seems to have no end in sight.

In mature markets, growth in auto insurance was stagnant between 2006 and 2012. Prices have been flat, apart from slight swings over time due to the cycle. This stagnant growth reflects a long-term trend that has been driven largely by technological improvement: fewer and less severe accidents thanks to increasingly sophisticated safety technology for cars, such as ABS brakes, airbags, electronic stability control and autonomous emergency braking systems. Apart from cyclical price fluctuations, growth has thus been dependent on the increase in the number of vehicles, which has been close to flat at 0.7 percent per annum.

As a consequence of these diverging patterns, the share of auto insurance in overall P&C premiums in mature markets has declined from 43 percent in 2002 to 39 percent in

[3] "Seizing the world's largest P&C opportunity: The Chinese auto insurance market," McKinsey & Company, 2012.

2012, while in emerging markets auto insurance share rose from 48 to 56 percent of the whole.

Penetration in other P&C lines has been stable but has not compensated for the decline in auto

The slow decline in auto insurance in most mature markets has been ongoing for a long time. Many industry observers have held the view that other product lines such as liability or new risk coverages (such as cybersecurity or energy-related coverage) could compensate for this decline. This has unfortunately not been the case. Overall penetration in mature markets for personal and commercial lines has declined slightly in the last decade, although helped recently by the cycle. Fire and property is the only line with a slight increase in penetration over the decade (Exhibit 13).

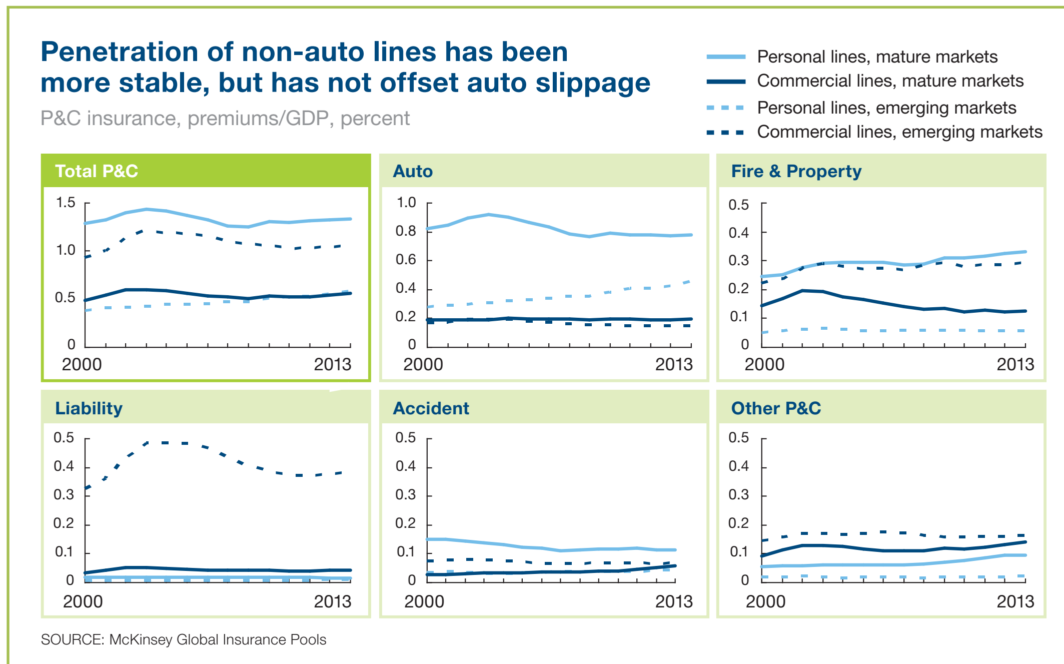
PROFITABILITY REMAINS HIGHLY CYCLICAL ACROSS REGIONS

As one would expect in a textbook example of a mature industry, P&C profitability typically fluctuates around the cost of capital. Profitability in P&C insurance is dependent on the capital market environment, as investment income continues to account for a much larger portion of overall profit than technical profitability in mature markets (Exhibit 14). (The underwriting cycle, of course, is the other driver of P&C profitability.)

ROE for P&C insurance in 2012 roughly equaled the cost of capital, after having declined sharply in 2011. This improvement was driven by both investment income and technical profitability: investment income increased thanks to the rebound of equity markets; and the net combined ratio improved from 102 percent in 2011 to 99 percent in 2012.

The ROE recovery can be partly explained by a decline in the number and severity of natural catastrophes in 2012, but the industry also seems to have exercised more pricing discipline in 2012. Despite the rebound in equity markets, investment income in mature

Exhibit 13



SOURCE: McKinsey Global Insurance Pools

markets has remained relatively low compared to historical averages. As a result, the industry has put even greater emphasis on technical profitability and has increased prices and tightened underwriting standards.

Profit mechanics continue to differ between mature and emerging markets. In emerging markets, technical profitability accounts for a much higher share of profits, owing to a lower claims ratio and much lower reserve levels. (Whether lower reserves are warranted in a business that tends more to the short tail, or whether they are potentially inadequate, is an open question.)

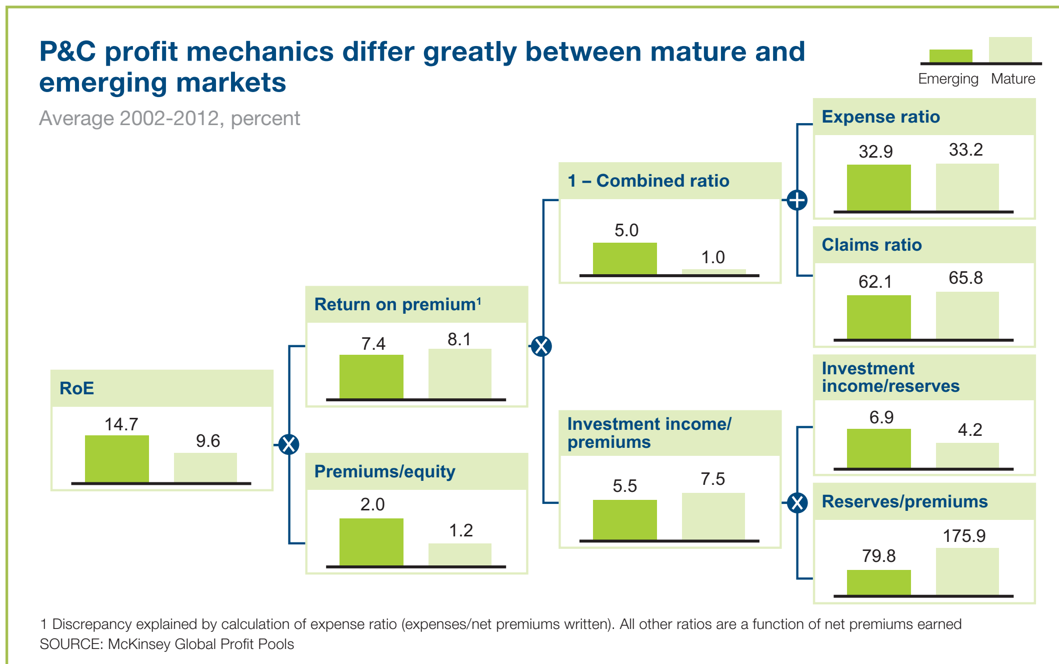
Strong profits in most regions and products

Cyclical effects were observed from region to region (Exhibit 15 page 22). In 2012, P&C profitability in all regions, with the exception of Japan, reached levels close to or above cost of capital, an improvement over 2011.

Technical profitability played a strong role in this recovery (Exhibit 16 page 23). In the recent past, 2011 was the worst year in terms of net combined ratio. The cycle differs in magnitude from region to region—it is most pronounced in North America and least pronounced in Western Europe—but it is generally aligned across regions.

In North America, the cycle is largely driven by commercial lines. Overall combined ratio has ranged in recent years from a high of 115 percent in 2001 to a low of 92 percent in 2006. It is trending downward to 102 percent in 2012 as a result of price increases. In Western Europe and mature Asian markets, the combined ratio has been less volatile. To a limited extent, this effect is caused by the aggregation of multiple countries with imperfectly aligned cycles into one regional average. However, a stronger factor driving volatility in the U.S. is the higher relative weight of commercial business—with its more pronounced cyclicality—and the greater impact of natural catastrophes. The net com-

Exhibit 14



1 Discrepancy explained by calculation of expense ratio (expenses/net premiums written). All other ratios are a function of net premiums earned

SOURCE: McKinsey Global Profit Pools

bined ratio in Western Europe has been below the 100 percent bar for the last eight years, a trend that McKinsey expects will continue into the foreseeable future. In mature Asian markets, the combined ratio exceeded 100 percent in 2011 but dropped back to levels closer to Western Europe in 2012.

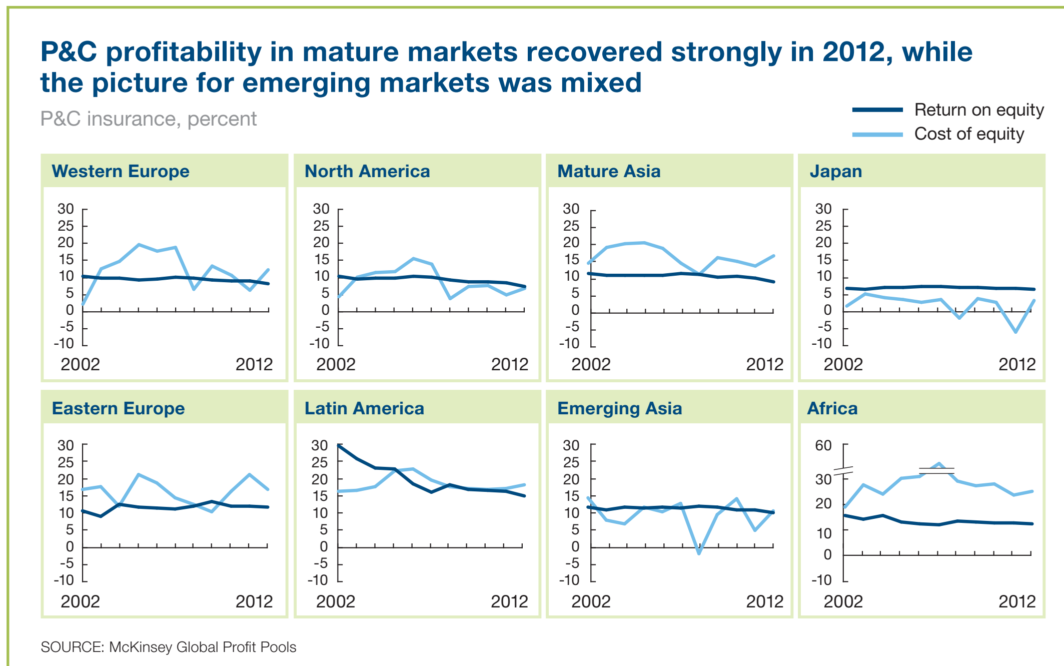
Emerging Asia presents a slightly different story. Before the financial crisis, P&C insurance in the region seemed to follow its own cycle; in recent years the industry has become somewhat more aligned with the cycle seen in other regions. In 2007, the combined ratio in Emerging Asia was wholly tied to developments in China. The year was marked by price wars, lawsuits over illegal commissions, and other negative factors. In response, there was a wave of regulation requiring insurance companies to improve internal controls, reduce commissions, shift away from price-war strategies, and streamline claims procedures. The Chinese market has consequently become more stable. Excluding China, the net combined ratio in emerging markets followed a relatively stable development path over the past decade.

DISTRIBUTION MIX SHOWS MODEST SHIFT TO REMOTE AND ONLINE CHANNELS

The global average for the distribution mix in P&C has been stable over time, with no apparent big shifts. The share of direct/remote distribution in P&C insurance globally is still relatively low at 9 percent, and the channel has risen only slightly compared to captive agents (31 percent of the market) and brokers (50 percent).

There is, however, divergence in distribution mix among different countries. Remote distribution has achieved shares of only 2 and 5 percent for P&C insurance in France and Italy respectively, while taking a 22 percent share in Canada and the Netherlands. Also, in some emerging markets, such as China and the Czech Republic, remote distribution

Exhibit 15



SOURCE: McKinsey Global Profit Pools

has made more headway than it has in some mature countries (Exhibit 17, page 24). This illustrates that there is no universal channel evolution pattern, but that distribution mix is influenced by factors beyond simple market maturity — for instance, local customer preferences and the regulatory environment.

LONG-TERM OUTLOOK STARKLY DIFFERENT FOR EMERGING AND MATURE MARKETS

McKinsey expects growth in the P&C industry to remain stable for the foreseeable future at 5 percent annually, slightly lower than GDP. Profitability should continue to hover around the cost of capital. In some areas, the historical decline in growth relative to GDP may accelerate, presenting a danger to insurers. The largest business line in P&C insurance is auto in mature markets, where technological innovations such as highway monitoring or even self-driving cars could drastically reduce the number of accidents over the long term, leading to lower premiums.

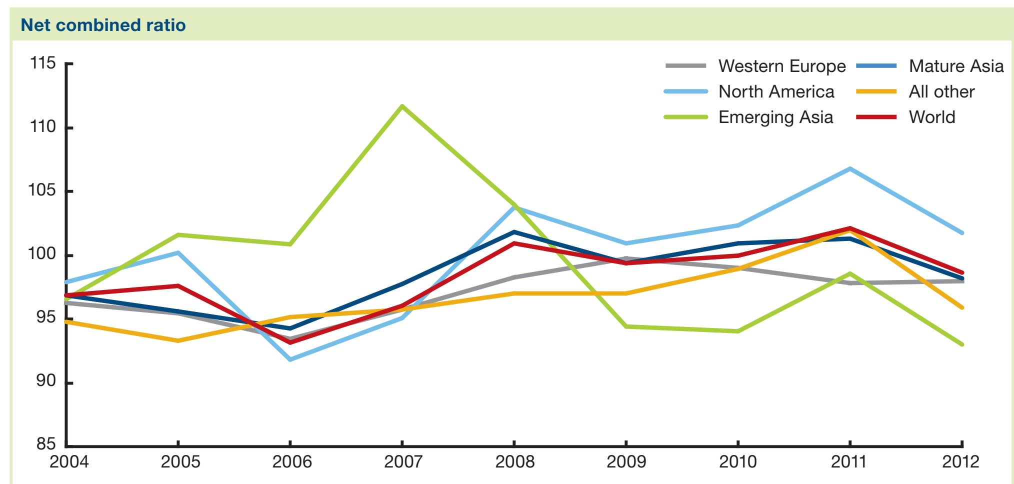
A number of new P&C products have been introduced but have so far done little to offset market shrinkage. Cybersecurity products have not yet significantly expanded the market and are unlikely to do so in the foreseeable future. The same can be said of new energy products and commercial liability products such as business interruption insurance (which actually may have unrealized potential, as the severity of claims has become much larger in the past two decades).

In conclusion, McKinsey forecasts that premiums in mature markets will grow 3 percent yearly between 2013 and 2020, as they have over the last four years—which is significantly better than the 2 percent growth over the last decade. This projection reflects, on the one hand, the counterbalance of the macroeconomic recovery expected in the coming years, and on the other the expected negative cycle. Overall, P&C penetration is expected to decline in line with historical trends, though growth levels will still outpace inflation.

Exhibit 16

Emerging Asia and North America have seen large variation in net combined ratio; Western Europe has been below 100% since 2004

P&C insurance, percent



SOURCE: McKinsey Global Profit Pools

Continued strong growth is expected in emerging markets, mostly as a result of the expanding middle class. As people become richer, they buy more cars and more property, and thus more auto, home and liability insurance.

McKinsey forecasts premium growth in emerging markets of 11 percent, a drop from 14 percent over the last decade and 15 percent in the last four years. This slowdown is expected despite the positive environment we have described, and reflects both slowing economies in emerging markets as well as an expected negative cycle.

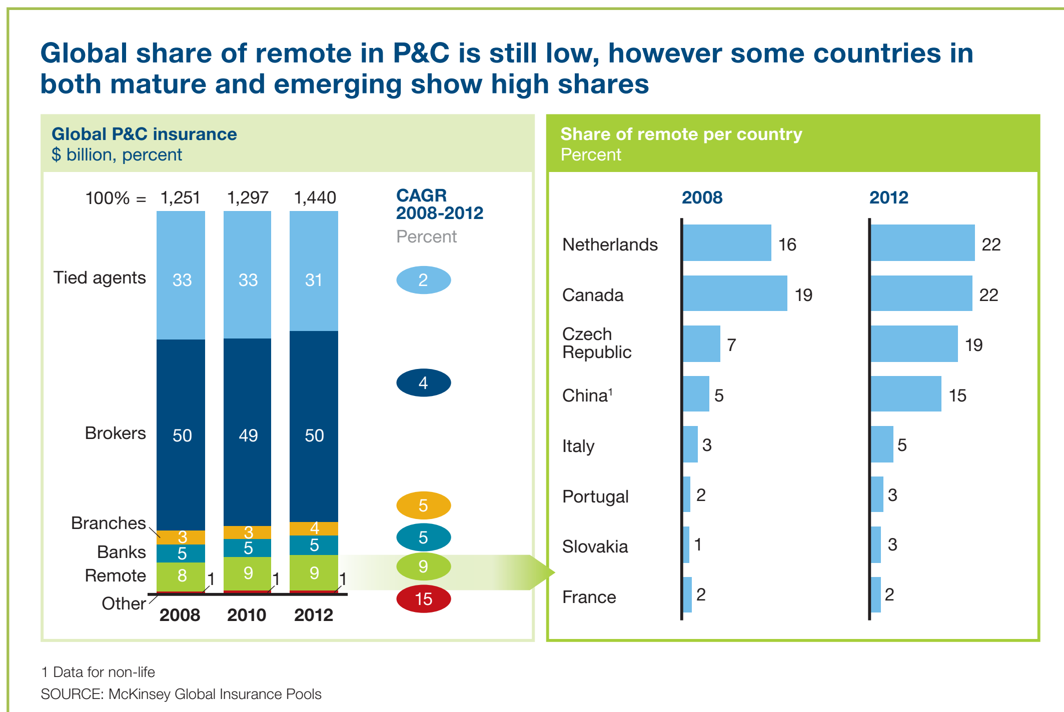
IMPLICATIONS FOR INSURERS

Insurers can prepare for the future by addressing three dimensions of their business:

1. Continuing validity of the "granular growth" model. The best path for P&C insurers is to focus on the right markets and the right segments—the "granularity of growth" approach. Over time, P&C profits are expected to be relatively stable at the global level, while the industry contracts slightly relative to GDP. To stay competitive, insurers must concentrate their resources on the segments and regions that offer the most potential for high growth, such as big cities in emerging markets. Of course, some of these high-growth markets, especially in Emerging Asia, and most of all in China, are extremely competitive, and do not always provide foreign players with high returns.

2. Operational performance. As is well known, success in the P&C industry strongly depends on operational performance. P&C is a mature industry that struggles to maintain profitability. McKinsey argues that insurers should continue to emphasize technical excellence, which time and again has proven to be the most important driver of performance differences among insurers. Insurers can continue to focus on traditional levers such as

Exhibit 17



claims, pricing and underwriting. At the same time innovative avenues are opening up for improving these capabilities with big data and advanced analytics (e.g., the use of social network data in underwriting). Early movers in these areas have been able to establish a competitive advantage.

3. Prepare for a downturn in mature markets. As growth continues to trail GDP in mature markets, the relative size of the P&C industry will slowly but steadily diminish. As it seems that a saturation point has been reached, a gradual decline relative to GDP (but above inflation) can be expected in the next 20 to 40 years. To counter this trend, the industry will need to do two things. First, it will need to develop new coverages that have a real impact on premiums, beyond small niches. Second, individual insurers will need to focus on thriving as organizations, continuously reducing operating expenses while staying an attractive employer in a period of long-term decline.

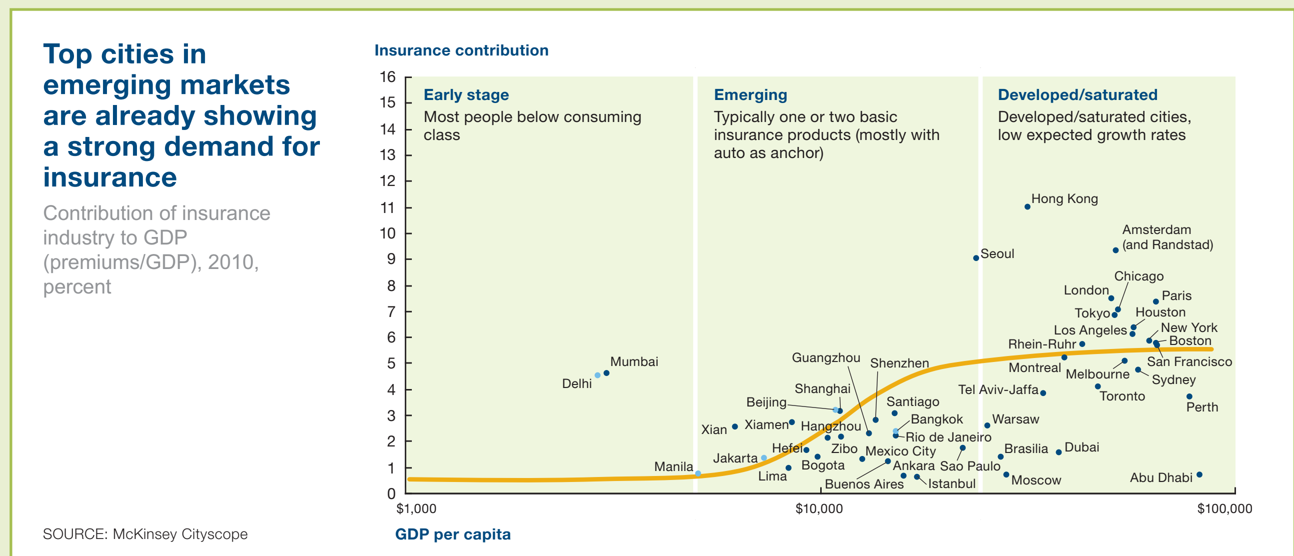
Forecasting city-specific insurance growth by combining Cityscope with GIP

This year, Global Insurance Pools piloted a new tool that incorporates McKinsey's Cityscope. This new combination tool can generate city-specific forecasts for insurance growth, and help identify the most attractive urban markets. Cityscope is a proprietary McKinsey database of macroeconomic forecast variables at a city level. It includes data for over 2,000 cities worldwide in 148 countries and can render growth forecasts out to 2025.

Snapshot of the Cityscope application

The rationale behind GIP-Cityscope is that the relationship between GDP and premium growth is not a one-to-one ratio, but depends on the level of maturity in the city. For example, as up-and-coming cities in emerging markets develop, GDP might rise significantly, but premiums might remain flat, because the population is still relatively poor and insurance penetration is low. However, as the middle class takes off, premiums can be expected to outpace GDP. In cities in developed markets, on the other hand, the economy can still grow but insurance penetration might decline due to market saturation. (Exhibit A provides an example of GIP-Cityscope data).

Exhibit A



SOURCE: McKinsey Cityscope

Appendix

MCKINSEY'S GLOBAL INSURANCE POOLS

McKinsey's Global Insurance Pools (GIP) initiative uses a bottom-up approach to size insurance markets. GIP comprises the 60 largest insurance markets, covering more than 99 percent of total global premiums.

The granularity of the data in our GIP database varies from market to market. For the less advanced markets, the data might include gross premiums written, technical reserves and profits. For the more advanced markets, GIP includes complete sets of financial indicators for each product line, including the mix of distribution channels. Historical data covers the period 2000–2012, with estimates for 2013 based on 1H or 3Q reporting, and forecasts run until 2020. Historical data are available in local currency as well as in euros and U.S. dollars (average and year-end). In the present report, we express the historical data and forecasts in U.S. dollars using 2012 fixed exchange rates.

GIP distinguishes five product groups in life insurance, based on European terminology: term life, endowments, annuities, unit-linked (variable in this report) and group (see below for detailed descriptions). P&C includes five product groups: auto, homeowners, liability, accident and other (e.g., travel).

The distribution mix is available for the 35 largest countries. The channel categories include: captive agents, brokers/IFAs, bancassurance, branches, remote and other (such as retailers and car dealers).

The GIP model was built country by country by collecting and analyzing public data (such as national insurance regulators' data and industry association publications) and drawing on the insights of our global network of local experts. We mapped the local product types and distribution channels to the standard globally accepted definitions.

LIFE INSURANCE PRODUCT DEFINITIONS

Term life: all types of protection products with purely biometric risk coverage.

Permanent life: all individual life-savings products that provide a guaranteed credited-rate component and a lump-sum payout. Examples include universal life insurance and whole life insurance.

Annuities: individual life-savings products (both single and regular premium) that provide a guaranteed credited-rate component and a payout in the form of an annuity (i.e., regular monthly payment streams either for a fixed duration or for life).

Variable: individual life-savings products (both single and regular premium) for which the policyholder bears the investment risk and that provide a lump-sum payout. Examples include variable life, variable universal life and variable annuities.

Group life: includes group protection, group variable and group annuities; the largest segment is corporate pensions.

FORECASTING METHODOLOGY

Our *volumes forecasting model* is based on a series of historical multivariate regression models that use both macroeconomic drivers and momentum as explanatory variables for premium growth.

We run panel regressions with random effects at both country and product-category levels. For life insurance and P&C, we split countries into two or three subgroups based primarily on each country's level of maturity. We then run separate regressions for the subgroups at the country and product-category levels, with particular equation specifications for each product.

Among the macro drivers we have considered are GDP growth (nominal and real), long-term and short-term interest rates, penetration and equity market returns.

For our *profit forecasting model* we also developed separate methodologies for life and P&C.

For P&C, we take a driver-based approach in which we forecast separately all of the components of profit (claims, costs and investment income). For each profit component, we test various specifications, combining macroeconomic variables (such as GDP growth, interest rates and inflation) and time-series variables (such as momentum effects and mean-reversion effects). The approach for life insurance was similar; however, because life insurance profits are highly sensitive to capital market and regulatory conditions, any profit forecast is valid only under the assumption of stability on both these fronts.

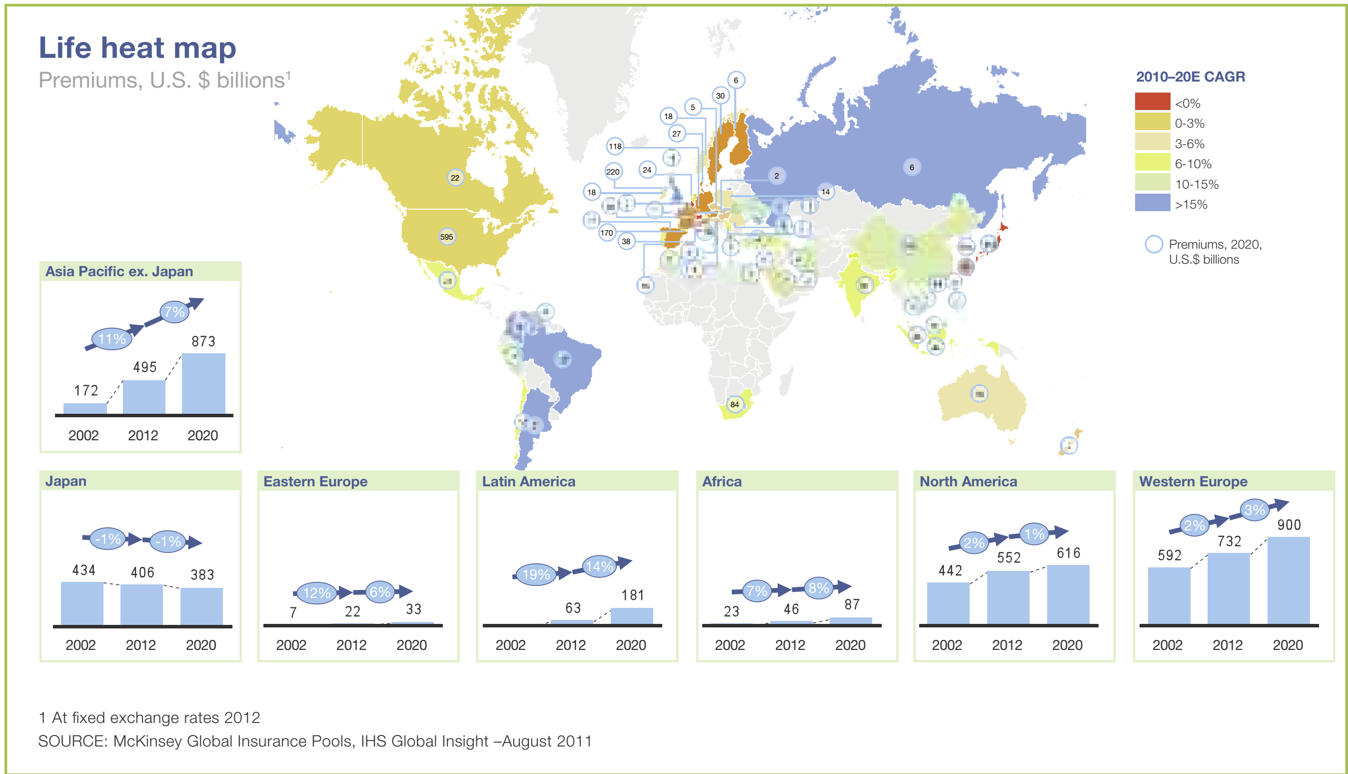
For both P&C and life insurance we ran panel regressions grouping similar countries. Overall, the regressions have generated superior results, with strong R^2 values, good stability and reasonable back-testing behavior.

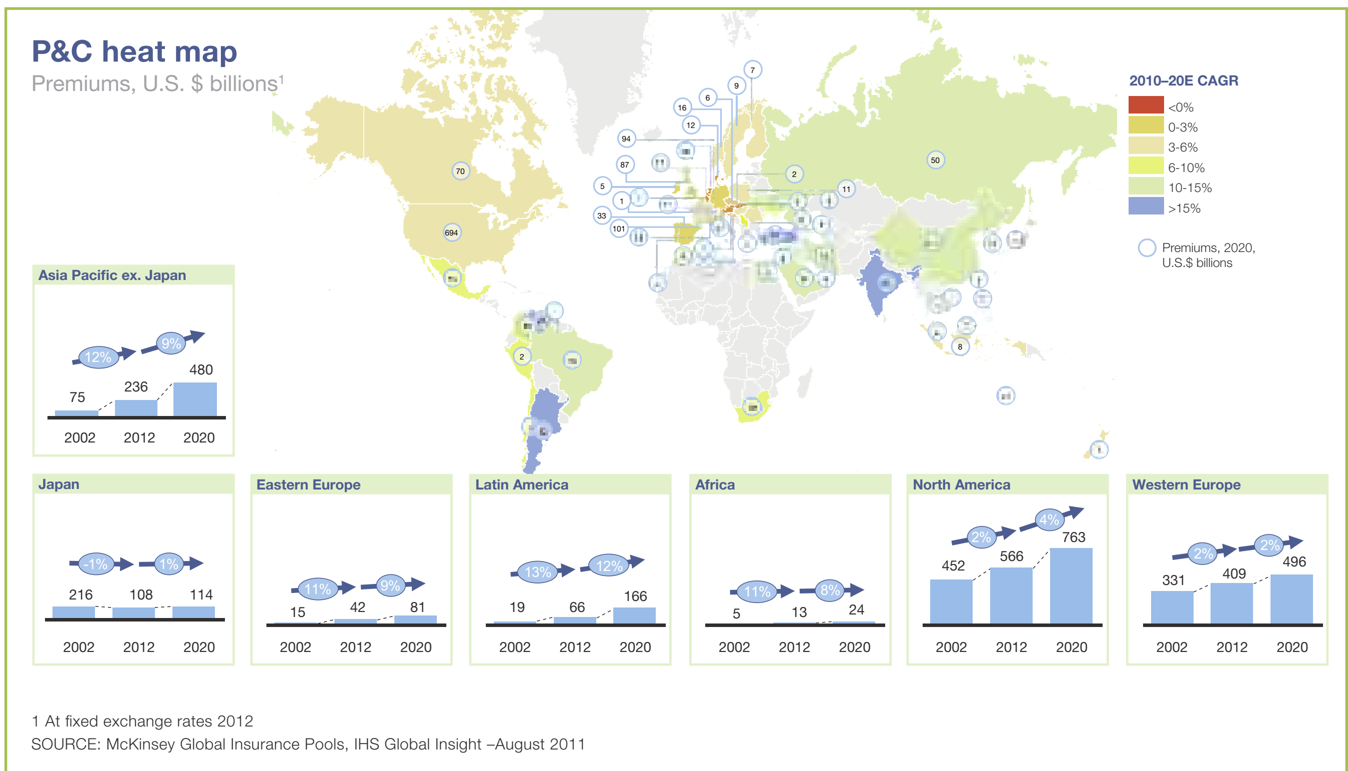
All of our models employ economic forecasts from Oxford Economics. Our global network of local experts reviews the forecasts produced by our regression models to adjust for any specificities in local markets (e.g., upcoming regulatory changes, demographic shifts, pension or healthcare system reforms).

Use of fixed exchange rates to reduce the impact of currency fluctuations

Our analysis generally uses nominal figures based on 2012 fixed exchange rates. This approach allows us to compare local growth rates without the interference of sometimes highly pronounced currency fluctuations. One drawback of our method, however, is that it does not account for differing inflation rates across countries. In consequence, estimates of growth in markets with high inflation (such as some countries in Latin America) may show an upward bias that can significantly distort comparisons among countries over the long term. In some cases, there are striking differences in the results, depending on the method used. For instance, an analysis using nominal figures based on fixed exchange rates showed that growth in emerging markets was three times higher than growth in mature markets from 2010 through 2012 (9 percent versus 3 percent). When we used yearly exchange rates, growth in emerging markets was only twice as high as that in mature markets (10 percent versus 5 percent).

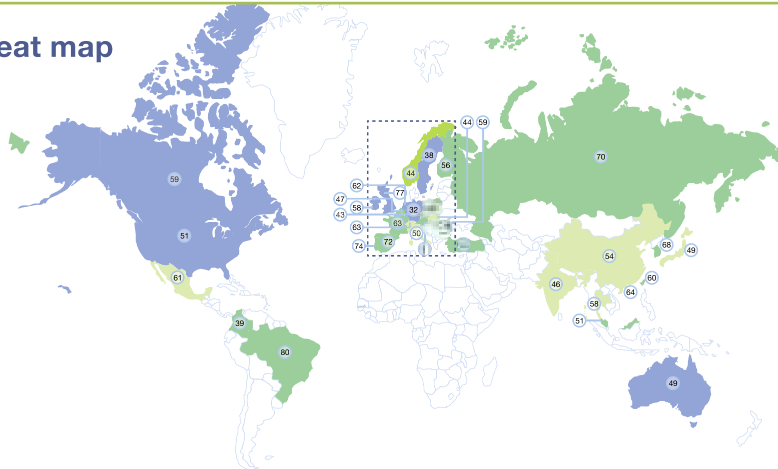
Appendix: Global insurance heat maps





Life distribution heat map

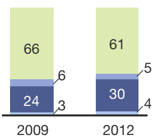
Premiums[1], percent



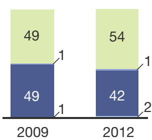
Dominant distribution channel

- Tied agents & branches
- Brokers
- Bancassurance
- Direct & other
- Share of largest channel (based on GPW), 2012, percent
- Europe scaled-up

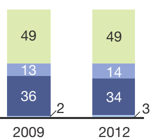
Mexico



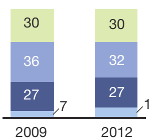
China



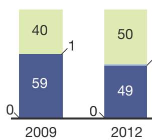
Japan



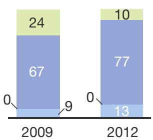
Germany



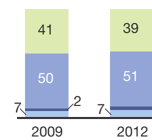
Italy



U.K.[2]



U.S.



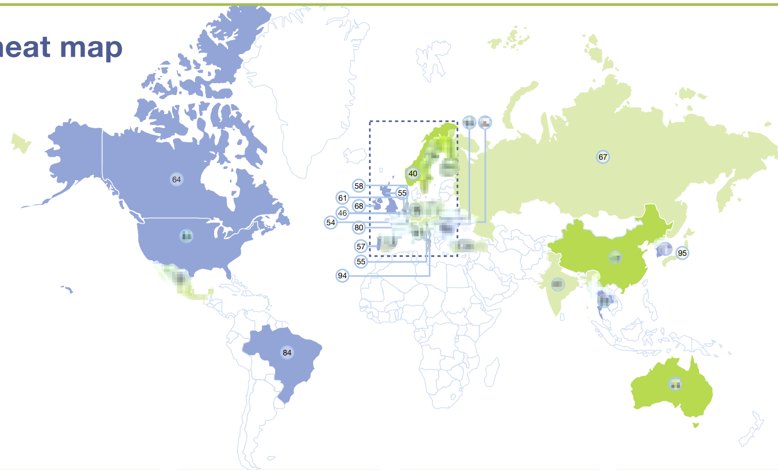
1 Distribution figures for Austria, India, Malaysia and South Korea are based on NBP; Germany, Ireland, UK and US are based on APE

2 Bancassurance share is not separately reported and is included across all channels

SOURCE: McKinsey Global Insurance Pools

P&C distribution heat map

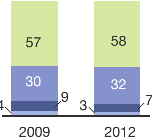
Premiums[1], percent



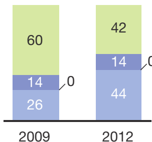
Dominant distribution channel

- Tied agents & branches
- Brokers
- Bancassurance
- Direct & other
- Share of largest channel (based on GPW), 2012, percent
- Europe scaled-up

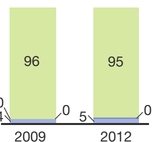
Mexico



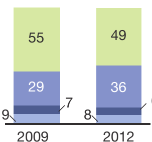
China



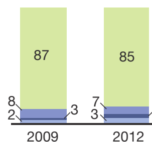
Japan



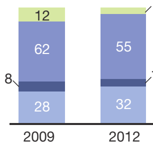
Germany



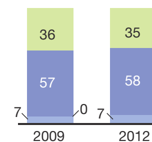
Italy



U.K.



U.S.



1 Figures for Austria, China, Denmark, Germany, Hungary, India, Ireland, Japan, Luxembourg, Poland, South Korea, Sweden, Switzerland and UK are for non-life.

SOURCE: McKinsey Global Insurance Pools

European author team

Lukas Junker
Principal, Frankfurt
Lukas_Junker@mckinsey.com
+49 (69) 7162 5536

Samuel Gerssen
Associate Principal, Amsterdam
Samuel_Gerssen@mckinsey.com
+31 (20) 551 3289

Marlous Jutte
Expert, Amsterdam
Marlous_Jutte@mckinsey.com
+31 (20) 551 3723

July 2014
Designed by Visual Media Europe
Copyright © McKinsey & Company
www.mckinsey.com