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Life journey: Winning in the life-insurance market

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The US life-insurance industry, in aggregate, has lost ground for 25 years. Yet a market worth tens of billions of dollars awaits companies able to seize the opportunity.

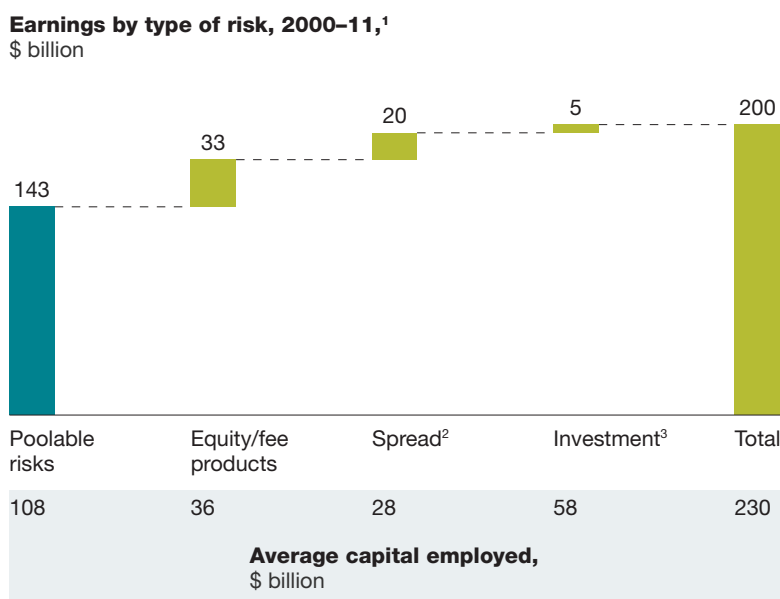
The US life-insurance industry, as a group, has returned less than its cost of equity since 1985. That year, life insurers represented about 40 percent of the financial-services industry in market capitalization; today, that's down to 25 percent. Life insurers have lost ground to banks, asset managers, and brokerage firms, and we believe the principal cause was the decision by many life insurers to move beyond products where they enjoyed a distinct competitive advantage—such as products where they manage poolable risk—to businesses where they do not. Ironically, this search for higher returns resulted in just the opposite: while riskier investment strategies boosted profits when markets cooperated, economic downturns more than erased those gains.

Yet not all life insurers have struggled. Despite the overall deterioration in the industry's performance during the past decade, our research revealed a stunning spread in value creation among the 30 largest life insurers in the US market. Those in the top quintile increased in value by about 10 percent annually, while those in the bottom quintile declined in value by about 3 percent—creating a 400 percent difference in adjusted book-value growth over the past decade. So what do the winners do differently? Do they have a more attractive product mix? Execute better within product lines? Achieve higher investment returns?

Several years ago, McKinsey launched “Life Journey,” a long-term effort to develop fact-based answers to these questions. We analyzed publicly available data for the life-insurance industry since 1985 and for the top 30 life insurers since 2000, and we interviewed dozens of industry analysts and executives. What we found is that the performance gap has been driven primarily by superior execution skills in managing liability risk, rather than from managing asset-based investment performance or product mix (Exhibit 1).

While many factors have contributed to the performance differential in managing liability risk among the top 30 insurers, none has been more important than skill in managing poolable risk—a risk type that has delivered close to three-quarters of the industry's profits using less than half its capital. This is striking given how little mindshare and resources life insurers are investing in

Exhibit 1 Carriers have made most of their profits by managing poolable risks.



¹ Based on statutory financial numbers; figures may not sum, because of rounding.

² Eg, fixed annuities.

³ Returns incremental to “risk free” and capital to support this incremental investment risk.

Source: A.M. Best; McKinsey analysis

risk-skill innovation. Another interesting insight from this inquiry is the limited role portfolio mix has played in explaining the spread in performance (only 25 percent difference between best and worst performance). Execution within a line of business was the leading driver of the spread in performance (45 percent), followed by investment performance (30 percent). Group lines and accident- and health-insurance products have significantly outperformed individual lines on value creation. Individual annuities have soaked up more than a third of industry capital and have created less than 20 percent of value. Career distribution has created significantly more value than third-party channels. Scale has not mattered.

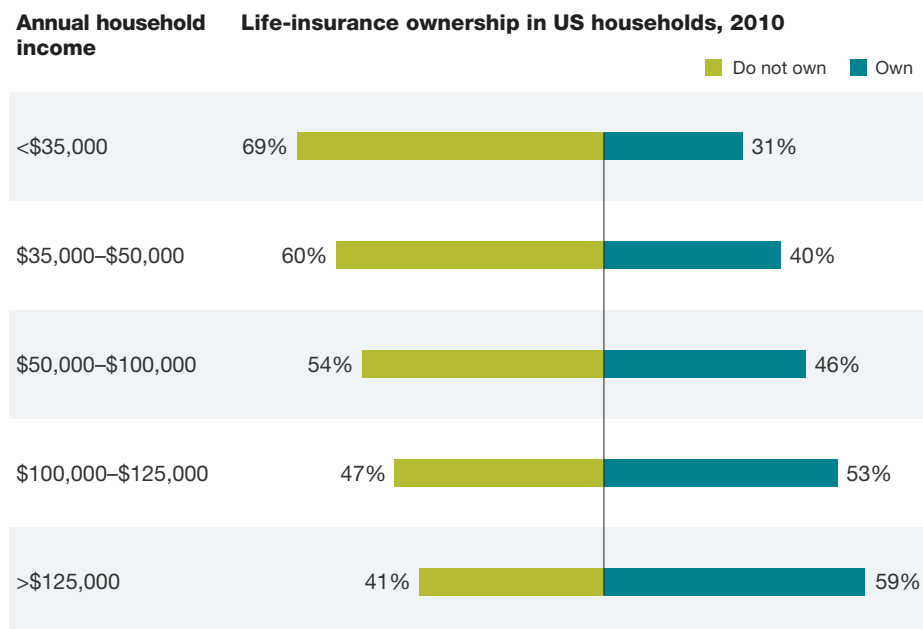
Our research suggests that during the next decade, outperformers will focus on four areas: building core risk and capital-management capabilities, including recognizing differences in cost of capital by line; using analytics to build competitive advantages in distribution; unlocking value in the in-force book; and leveraging customer insights to find growth in high-opportunity segments, such as managing retirement risk for baby boomers, serving the risk needs of the middle market, and capturing high-growth opportunities in emerging markets.

Finding new growth

The life-insurance industry, still recovering from the meltdown of 2008, will have to cope with a challenging macroeconomic and regulatory environment marked by high volatility, low interest rates, and slow economic growth. Yet there is a silver lining: new opportunities. The shift of financial responsibility from governments and employers to individuals, strong growth in developing markets, and an aging population not prepared for retirement will all offer profitable growth potential for life companies that can navigate the risks.

As economic pressures force employers and state and federal governments to cut back on benefits and eligibility, millions of Americans are unprepared for medical crises or retirement. Agent-based distribution has moved toward the affluent and mass affluent, leaving middle-market consumers underinsured (Exhibit 2). Simply returning penetration of this market—which comprises 63 million households with an annual household income of between \$25,000 and \$100,000—to 2004 levels

Exhibit 2 Less than half of US middle-market households have life insurance.



Source: Life Insurance Market Research Association's 2010 *Trends in Life Insurance Ownership Study*; MacroMonitor; US Census Bureau and US Bureau of Labor Statistics Current Population Survey; McKinsey analysis

could raise annual revenue by \$20 billion. Based on typical margins of 5 percent, this could lead to an increase in the industry profit pool of a billion dollars annually. Life insurers can play a major role in helping people meet their retirement needs, and the flow of funds will be unprecedented as the population ages. But capitalizing on this opportunity will challenge life insurers in several ways.

First, many consumers in the middle market simply do not have the resources to fund their retirement needs; life insurers will need to focus on those in a position to invest in retirement products. Meanwhile, many consumers are looking for comprehensive retirement plans that reflect their family, employment, and real-estate status and aspirations—issues that require much more than insurance products. The third challenge is that products that deal with critical-illness exposures, end-of-life care, and longevity risks are difficult to understand, suggesting that the sales process needs to begin with consumer education.

In their search for growth, many carriers are also looking overseas to developing markets, where economies are expanding and life-insurance penetration is low. Research suggests that developing countries will account for more than 80 percent of global growth in the life market in the next decade. Yet there are hurdles to penetrating this market, including regulation, a scarcity of management talent, and different consumer mind-sets and behaviors. Still, some companies are building strong positions that drive growth, profit, and valuations through acquisitions, joint ventures, and long-term development from the ground up.

Four opportunities

In short, while the new growth opportunities are substantial, companies must tailor products and distribution to meet the unique needs of consumers and deal with challenging macroeconomic and regulatory environments. We recommend that life-insurance companies focus on four areas:

- **Improving risk and capital-management skills.** Companies with the discipline to focus on value rather than volume growth will make better decisions. They will need to set clear parameters for risk appetite and establish robust metrics to manage capital and govern risk. Winners will also build more flexibility into product design and pricing to make fewer long-term guarantees and share risks with their customers.
- **Using data analytics to expand distribution capabilities and lower distribution costs.** Insurers looking for stronger margins will need to control costs, of course, which will lead to discussions about distribution, the single biggest source of cost today—and the biggest constraint on growth. There are many ways to improve distribution performance, from using deep analytics to identify leads and marketing opportunities to tailoring service offerings to agents based on their needs, as well as increasing the adoption of financial planning and building product-expert, wholesaler, and sales teams to drive agent performance.

- **Leveraging the in-force book and existing customer relationships.** The in-force book—policies life insurers have already sold to their customers and are now collecting revenue from and paying claims on—accounts for the lion’s share of profits, revenue, and operating costs, yet senior management focuses most of its attention on new business. To unlock the hidden value of the in-force book, carriers must capitalize on pricing, fee, and asset-allocation flexibility; pursue cross-selling and customer-behavior-management techniques; and improve operational efficiency.
- **Pursuing the middle market and developing markets.** To achieve profitable growth, carriers need to continue serving their core affluent markets while looking to less conventional sources of growth. While the life-insurance industry has been a major player in the retirement space, both as a manufacturer of individual retirement products and as an administrator and asset manager of defined-contribution and defined-benefit plans, asset managers and securities firms have been the big winners. To strengthen its position in this enormous and growing market, the life-insurance industry needs to help retirees understand the products that will cover the most important risks—ones that life insurers are uniquely positioned to address, such as death during peak earning years, end-of-life illness, and outliving assets. This will entail revamping advisory capabilities to a fee-based model that offers an all-encompassing approach to financial planning.

Differences in the performance of life insurers are driven primarily by risk skills and the ability to manage liabilities, none among them more important than poolable risk. Charting a course and setting the sails will be comparatively easy. As with all strategies, the challenge is in the execution: winners will be those companies able to best weather the inevitable storms while continuing toward their ultimate goals.

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