McKinsey&Company

Life insurance and annuities state of the industry 2018: The growth imperative

Our annual life insurance and annuities review finds that the industry is poised for growth but will need to improve its capacity for bold resource allocation and productivity improvement.

Insurance Practice October 2018

Introduction

The life and annuities industry is at a critical juncture—no longer in recovery mode and firmly focused on growth. The ground has shifted since the global financial crisis of 2007–08, and life insurers will need to look for growth in new areas.

For many industries, the global financial crisis had a far-reaching impact that took years to overcome, and life insurance was no different. Consider that the market capitalization of the 100 largest publicly listed global insurers lost more than half of its value in the immediate aftermath of the crisis, dropping from $2.1 trillion in 2007 to $1 trillion in 2008. The industry needed seven years after the crisis to reach its 2007 level and now represents 25 percent of the total financial services market as measured by market cap, on par with precrisis levels and well above its nadir of 21 percent in 2008. Thanks to the past several years—with growth trends up across all regions, increasing levels of M&A, and solid returns—cautious optimism has returned to the industry.

We studied the data collected by McKinsey's proprietary Global Insurance Pools (GIP) database and McKinsey's Power Curve to assess how the insurance industry might accelerate growth (see sidebar "About the research"). Our findings suggest that winners in the life and annuities industry will benefit from bold resource allocation to the right markets, customer segments, and adjacent sectors, such as asset management, while also driving substantial productivity improvement.

- *Industry growth is up.* The past year was particularly productive for life insurers. Global life insurance premiums grew 5 percent in 2017, up from 3.7 percent in 2016. In addition, total market capitalization for the top 50 insurance players rose 17 percent, with nearly all regions seeing the top insurance companies gain market value during this period.

- *The global view masks a divergence.* Top-line numbers obscure differences in industry performance among regions and verticals. Developed markets (such as Europe, Japan, and North America) recorded low growth of around 1 to 2 percent, while developing markets (for example, Asia and Latin America) grew much faster—at 12 to 15 percent. Asset managers have gained ground from life insurers, whose share of protection and accumulation profit pools has declined by nearly 15 percent over the past five years.

- *Industry cost structure has changed incrementally, but much more is needed.* Since the financial crisis, little has changed in the expense structure, investment management, and capital structure of life insurers. Expense ratios have remained flat or increased by one percentage point in most regions, which falls short of the structural cost reductions that have occurred in other industries, such as banking. Costs have become a greater priority because investment returns have remained fairly muted. Meanwhile, insurers have not substantially altered their customer engagement or distribution strategies even as customer expectations have changed dramatically.

- *Long-term value creation will be powered by bold moves.* Fifty percent of a company's long-term growth is determined by bold moves (or lack thereof) on resource allocation, M&A, productivity improvements, and investments in the future. Among the largest, most globally diverse companies in the life and annuities industry, a group we have dubbed the "Global Shapers," the top performers are more than three times as likely compared with all life insurers to have done programmatic M&A and achieved productivity or differentiation improvements over the past ten years.

- *Companies must pick the right markets.* To determine where to compete in the coming years, insurers should consider the dynamics of global markets. Over the past five years, for example, the still-developing Asia–Pacific region has accounted for almost 70 percent of global premium growth. Our analysis identified three archetypes of markets where insurance companies can compete: commodity, harvest, and cultivation. Understanding and balancing resource allocation across these markets by characteristics such as maturity, competitive environment, and level of government-supported pensions can support growth.

- *Executives should consider four shifts to their operating model to enable bold moves.* Insurers will need to deploy some or all of these actions to generate value creation and growth: strengthening the M&A and business development functions to partner with or acquire new companies in adjacent industries and benefit from the economies of new ecosystems; structuring the corporate center to better reflect more frequent resource allocation across the portfolio; dramatically improving productivity through automation and outsourcing; and accelerating the path to an agile operating model and more rapid decision-making. ■

About the research

The life insurance industry varies considerably from country to country. For this paper, life insurance includes individual life insurance, group insurance, and individual annuities.

The data in this report is taken from McKinsey's proprietary Global Insurance Pools (GIP) database. The forecasting tools developed by GIP were used to assess how the insurance industry might respond to global macroeconomic shifts over the next decade.

GIP distinguishes five product groups in life insurance, based on European terminology: term life, endowments (universal and whole life), annuities, unit-linked (variable products), and group life.

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

Endowments: All individual life-savings products (both single and regular premium) that provide a guaranteed credited-rate component and a lump-sum payout. In US terminology, this category includes universal life and whole life.

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—in other words, regular monthly payment streams either for a fixed duration or for life. In US terminology, this category includes fixed annuities.

Unit-linked: Individual life-savings products (both single and regular premium) for which the policyholder bears the investment risk and that provide a lump-sum payout. In US terminology, these products include variable life, variable universal life, and variable annuities.

Group life: This category includes group protection, group unit-linked, and group annuities. The largest segment is corporate pensions.

When calculating growth, we generally used nominal figures based on 2017 fixed exchange rates, as this approach enabled the comparison of local growth rates without the interference of currency fluctuations. The exceptions, which use floating exchange rates, are Argentina, Ukraine, and Venezuela, due to their high inflation rates.

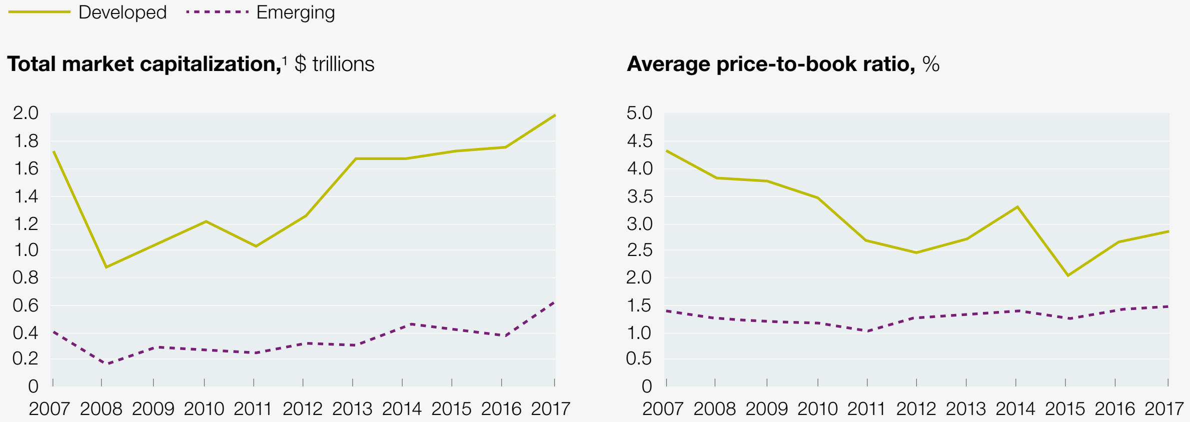
1 A snapshot of the life and annuities industry

Divergent growth between emerging and developed markets

For life insurers, 2017 was a particularly good year. Global life insurance premiums grew at 5 percent, up from 3.7 percent in 2016. In addition, total market capitalization for the top 50 insurance players rose 17 percent in 2017 (10 percent in developed markets and 35 percent in emerging markets). Median price-to-book ratios globally have also continued along their growth trajectory, rising from 88 basis points (bps) in 2015 to 113 bps in 2017 in developed markets, and to 147 bps, from 138, in emerging markets (Exhibit 1).

Exhibit 1

Life insurance companies have recovered from the financial crisis and grown beyond precrisis levels.



[1]Based on top 100 insurers globally. P/B ratio is a weighted average based on market cap.
Source: CapitalIQ database

Growth is back—it's just not evenly distributed. Geographic growth is uneven, with developing markets growing at 12 to 15 percent, while developed markets are growing at 1 to 2 percent. Demographic growth is uneven, with an aging crisis in Japan while half the population of India is younger than 25. Likewise, growth in the cost of risk is uneven, with healthcare costs growing rapidly in the United States relative to other risks. These trends create opportunities for insurers to take advantage of industry tailwinds (Exhibit 2).

In 2017, developed markets such as Japan, the United Kingdom, and the United States saw lower growth rates of 0.5, 1.1, and 1.8 percent, respectively. Similarly, absolute premium levels in these markets are still significantly below precrisis levels. Return on equity (ROE) trends, however, have varied by region. From 2016 to 2017, for example, the United States saw stable ROE, while Europe, the Middle East, and Africa (EMEA) experienced a 40 bps decline and Japan saw a 90 bps increase.

Developing markets have surpassed more mature markets to become the major source of premium growth, a trend that is expected to continue in the future (Exhibit 3). China is leading the pack, with premium growth of 15 percent in 2017, only slightly lower than its 18 percent growth rate over the past five years. In addition, China yielded 12.4 percent ROE in 2017. Latin America has experienced the highest ROE across regions—17 percent in 2017—due to higher interest rates and

Exhibit 2 **Developed and emerging markets are diverging.**

Developed markets are facing a slower growth outlook

The Wall Street Journal	"Americans shun life insurance, forcing new tactics at Prudential"
Business Wire	"US life/annuity sector looks to strong financials, slow growth"
Barron's	"Japan's life insurers jump as they promise to look abroad for better yields"
insurancenewsnet	"2018 life/annuity outlook marked by slow growth"

Emerging markets will continue to present high growth opportunities

Bloomberg	"Prudential plc splits to focus on faster-growth markets in Asia, Africa, and the US"
The Wall Street Journal	"Chinese tech giants target the next frontier in online insurance: Life"
Financial Times	"Zurich acquires ANZ's life insurance business for $2.1bn, strengthening Asia Pacific position"
Barron's	"AIA flourishes as Asia life insurance booms"

Source: Press releases

Exhibit 3 **Emerging markets have overtaken developed markets in volume of new life premiums added over time.**

Premium growth by market type, % of total premium growth, 2002–22

Source: McKinsey Global Insurance Pools database

growing scale (Exhibit 4). Significantly, many companies in mature markets are not seeing returns equal to their cost of capital. From 2012 to 2016, 44 percent of life insurers and 56 percent of multiline insurers around the world generated negative economic profit.[1]

Key trends across global markets

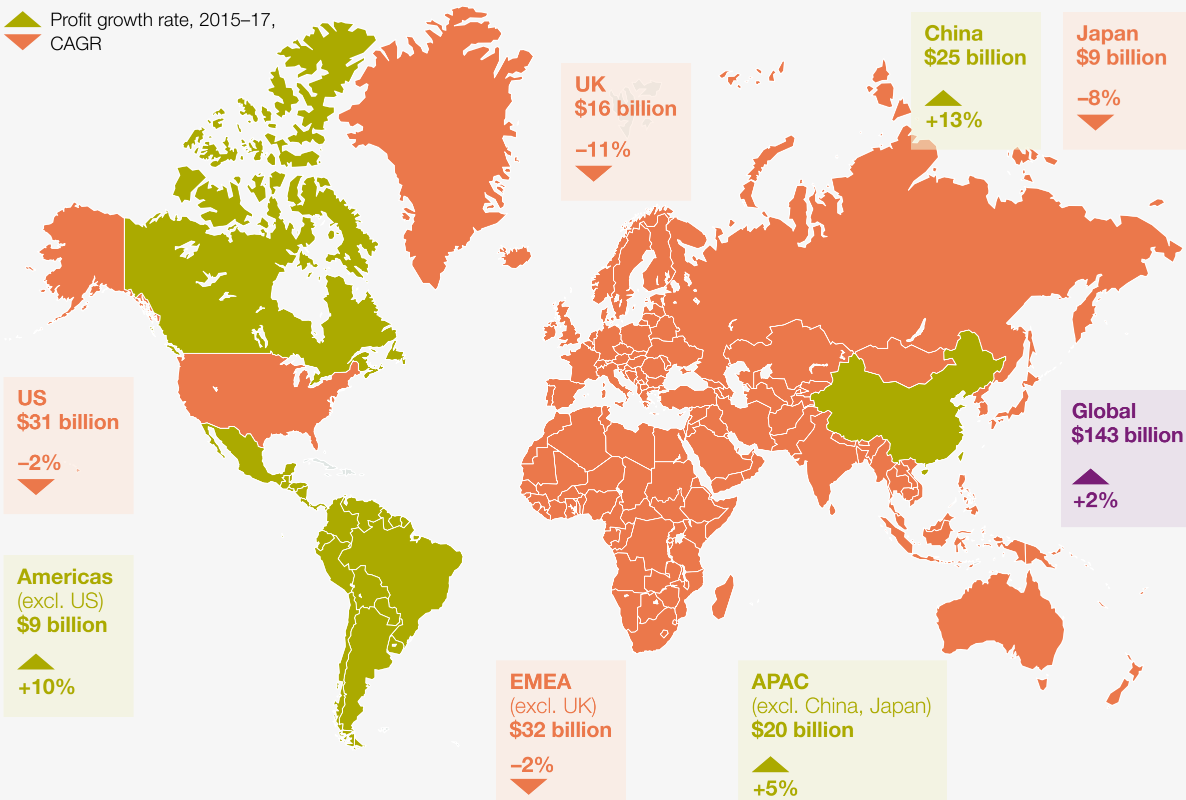
Across the globe, life insurance remains a cornerstone of protecting people's savings in old age and transferring wealth to the next generation, but real differences exist between trends in developed and emerging markets.

Developed markets

In mature markets such as Europe, Japan, and North America, the industry will benefit from several recent tailwinds. Longer life expectancy is the primary demand driver in both Europe and North America for retirement and annuities products. Therefore, individuals need to invest a larger share of their income if they are to retain a high quality of life in their old age and cover healthcare and long-term care costs. Longer lifetimes will require products that provide guaranteed income in retirement to supplement pensions.

Exhibit 4 **China is now nearly as large as the United States in terms of absolute profit in the life insurance industry, powered by explosive growth over the past several years.**

2017 after-tax profit, $



Source: McKinsey Global Insurance Pools database

Several tailwinds continue to offer fresh evidence that we may may be entering a period of renewed growth:

Retirement gap. In addition to the longer life expectancy, developed markets also have aging populations with increasing lifestyle and health concerns as well as growing reservations about their ability to retire. In the United States, 53 percent of workers age 60 or older are not financially prepared for retirement. This trend results in a growth opportunity as well as rising need for financial wellness education at all life stages.

Greater wealth. Personal financial assets are growing for both the wealthy and mass-affluent markets. The number of households with more than $25 million in assets jumped by 10 percent from 2015 to 2017, and the number of millionaire households in the United States grew by 700,000 in 2018 alone. In addition, Fidelity announced that the number of millionaires in its retirement accounts had tripled in the past year, creating opportunities for insurers to develop specific value propositions for those segments.

Public to private shift. In almost all Western markets, the proportion of final salary that people can expect to receive from both state and mandatory private (defined-benefit) pensions is falling. The state is not just retreating from pension provision; government debt-to-GDP levels also dictate that governments will need to look carefully at public healthcare expenditures. The ensuing gap translates into an enormous latent demand for safe retirement investments.

Rising interest rates. The low-interest-rate environment that has persisted for most of the past decade and placed significant strain on balance sheets is starting to wane. Across developed markets (apart from Japan), rising interest rates are expected in the second half of 2018 and the beginning of 2019.

Existing and new headwinds will need to be managed in developed markets:

Persistent challenging regulatory environment. Most global life insurers outside the United States are getting ready to implement the International Financial Reporting Standard (IFRS), which will take effect on January 1, 2021. The result of somewhat complicated accounting rules and different solvency regimes, these regulatory changes are expected to add volatility to balance sheets and profit-and-loss statements (P&Ls), as well as hurt valuations. In Europe, the Solvency II Directive has resulted in a significant drop in the solvency ratio as well as ROE. This directive has placed a heavy burden on guaranteed products from a risk perspective, making them increasingly capital intensive and limiting their distribution. In the United States, the Department of Labor's fiduciary rule was struck down by the Fifth Circuit Court of Appeals (it remains in limbo), but insurers are still considering a move toward fee-based products.

Ongoing impact of products written before 2008. Numerous insurers are still accounting for the full impact on profitability of products written a decade ago under different interest rate assumptions.

Intensifying competition from asset managers and digital attackers. Life insurers are not the only option when it comes to retirement products. Asset managers are tapping into life insurance value pools as insurers move away from guaranteed products, while digital companies with more customer touch points build stronger relationships and find new inroads to engagement, sales, and profits. In the opposite direction, many players in the life and annuities industry in the United States (but not in Europe) have started adopting a comprehensive financial approach (holistic financial planning), attempting to benefit from the value pools of asset managers.

Developing markets

Recent tailwinds characterized by a period of tremendous growth (more than 10 percent a year) are expected to continue due to several factors:

Rising middle-class incomes. By 2030, two-thirds of the global middle class will be living in Asia. In contrast, Europe and North America will together account for 20 percent of the world's middle-class population, down from more than half in 2010. This massive population shift is a major driver of the differences in growth rates between the regions.

Growing affluent and mass-affluent markets in China. Mass-affluent households now make up an estimated 45 percent of Chinese households, up from 38 percent just two years ago, creating a big opportunity for life insurance carriers to tailor offerings to those consumers.

Digital innovation. Developing Asian markets are fertile ground for digital innovation in insurance, as consumers embrace online and mobile channels at high rates. In China, for example, nearly 20 percent of retail sales in 2017 were made through digital channels, with mobile contributing the largest share. Digital uptake in life insurance is increasing, with the share of online life premium sales doubling from 2 percent in 2014 to 4 percent in 2017. This trend presents an opportunity to lower distribution costs.

Savvier consumers. While savings are still held primarily in deposits in developing markets, consumers are getting more refined on sophisticated financial options and are more financially savvy. As a result, customers in these markets are becoming aware of and open to new life insurance products.

Headwinds in developing markets are largely caused by regulation, market access, and cybersecurity threats:

Regulation. The growth of China's life insurance industry has slowed over the past two years as regulators stepped in, though the regulation is expected to have a positive long-term impact on professionalization, solvency, and liquidity. Since early 2017, the China Insurance Regulatory Commission (CIRC) has introduced a series of regulations on corporate governance, use of funds, product design, and asset and liability matching. Most recently, CIRC reduced restrictions on foreign stakes. And tighter capital controls have had a noticeable impact on unit-linked products such as variable annuities.

Cybersecurity. Insurers operating in emerging markets need to follow protocols to ensure cybersecurity. The number of incidents in emerging markets has rapidly increased, with insurers as potential targets.

Increased competition. The rapid growth in recent years is starting to show signs of slowing down in both Asia and Latin America. In the latter region, recessions in Argentina and Brazil are impediments. With these "softening" market conditions, competition for market share is putting pressure on profitability.

Volatile geopolitical situations. Escalating geopolitical tensions within developing countries and trade tensions with the developed world could negatively affect growth due to lower investor confidence and decreasing capital flows into emerging markets.

Over the past decade, the pace of change to the industry's expense structure, investment management, and capital structure has been muted

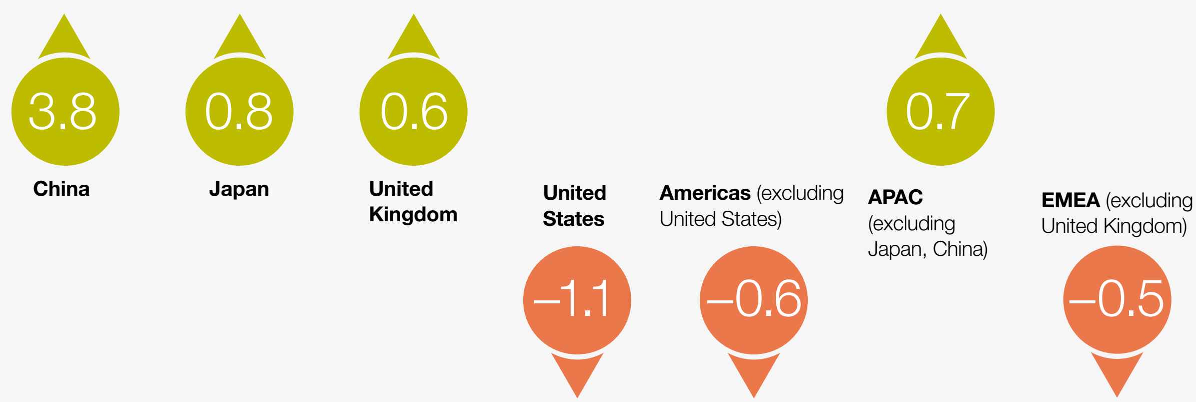
Little has changed in the life insurance industry's expense structure, investment management, capital structure, and operating model in recent years.

Unsustainable expense levels

Compared with other industries, insurance has not yet addressed its operating costs at a structural level, especially in distribution. As a result, expense ratios have been mostly flat (Exhibit 5). In a recent poll, senior executives in insurance firms estimated that the industry needs to reduce its costs by 35 percent in the medium term, which is far from the current aspirations (10 to 15 percent) of most cost-cutting programs. To date, the industry has shown a disappointing track record of managing costs. Some companies and regions have historically had better cost structures: insurers in Western Europe have had better expense ratios than those in the Americas and Asia–Pacific.

Exhibit 5 **Across geographies, life insurers have not yet begun to address operating costs, with expense ratios mostly flat in recent years.**

Average expense ratio percentage point change, 2011–16, by geography, %



Source: McKinsey Global Insurance Pools database

Investment management

The life insurance industry continues to face muted investment returns, which have decreased because of the persistent low-yield environment. Asset allocations for life insurers have stayed relatively stable, with fixed-income investments—especially bonds—retaining the lion's share of investment assets. Life insurers are starting to move, albeit slowly, into globally riskier, nontraditional investments, including private equity, infrastructure debt, and real estate. For example, insurers have demonstrated increasing demand for hedge funds in Asia–Pacific, equities and real estate in Europe, and mortgages in the United States. Due to this allocation strategy, the difference in the United States between life insurance book yield and key reference yield rates (for example, the moving average of ten-year treasuries) has been widening since 2009, reflecting a growing risk appetite within life insurers' investment portfolios.

Sources of capital

The largest insurers have not significantly increased their capital base over the past decade. However, new entrants such as Apollo, Blackstone, and others have recognized the opportunity in the market, captured significant returns, and increased their capital base. US private equity firms have expanded their share of the life insurance industry's capital reserves from around 2.8 percent before the financial crisis to 3.3 percent in 2017. This trend is particularly prominent in annuities, where private equity firms now make up 6.3 percent of total capital. ■

2 The path to navigate global markets

To determine where to make bold moves in the coming years, insurers should consider the market dynamics of global markets. This report finds that the opportunity for the life insurance industry in a region is largely determined by the strength of state-sponsored pensions and healthcare and the maturity of the retail asset management industry. The prevalence of these factors in each region defines the addressable market for life insurance and annuities.

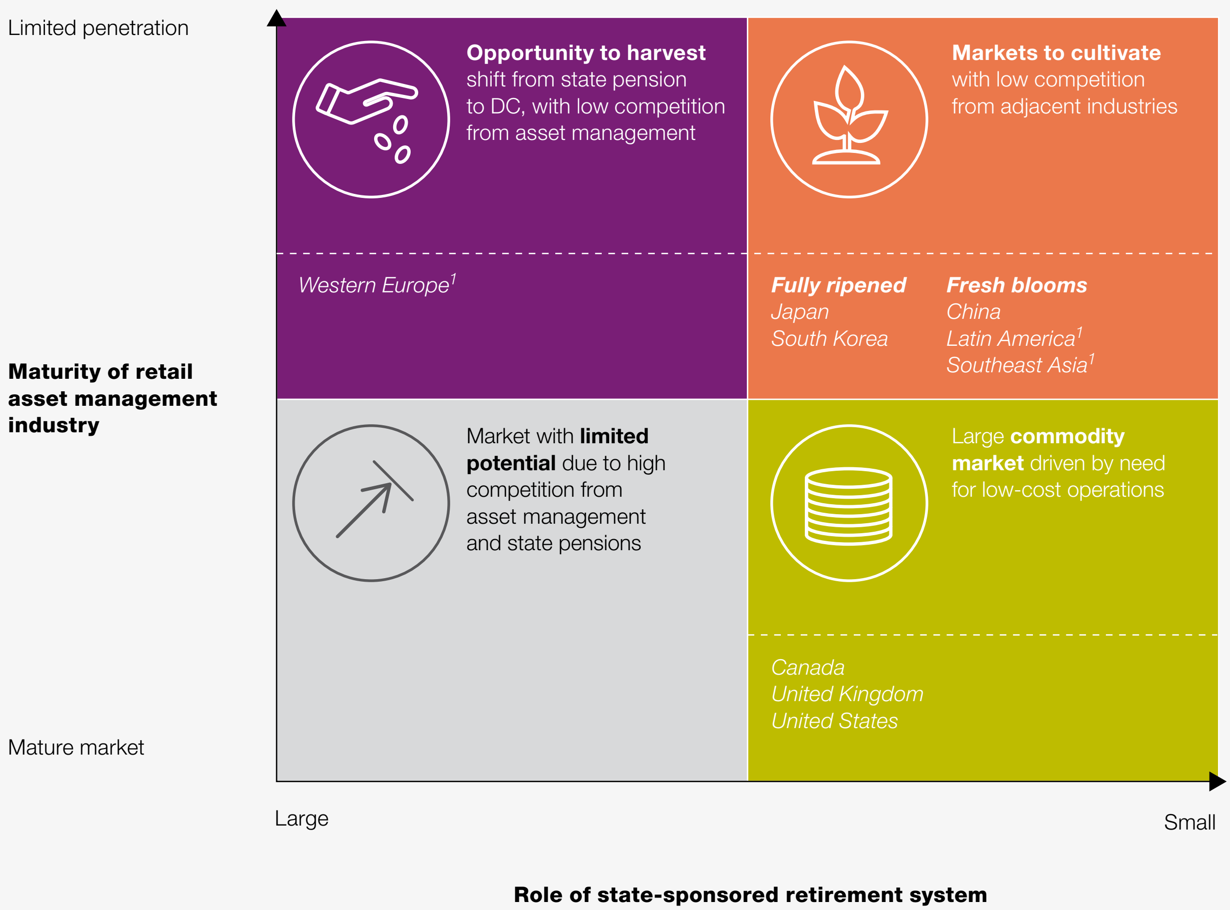
For instance, highly attractive markets such as China, Latin America, and Southeast Asia lack fully developed pension systems and have limited market penetration of asset managers (Exhibit 6). Alternatively, in markets where public pensions are relatively small but industries such as asset management are large and mature (the dynamic in the United States), life insurers face threats from those industries. For example, asset management has developed customer-friendly, universally available solutions to prepare their clients for retirement, including low-cost exchange-traded funds (ETFs) and target-date funds (TDFs). On the other hand, in markets where public pensions are relatively prevalent and asset management is a smaller industry, such as Europe, insurance is a large, relatively stable market.

The life insurance market has the highest potential in regions where both asset management and public pensions are relatively small. These markets can be grouped into two distinct sets: mature and emerging markets. For mature markets, such as Japan and South Korea, the life insurance industry is already relatively advanced, with high penetration (life insurance assets are 6.8 percent of GDP in these countries) and stability. For emerging markets, such as Brazil and China, the insurance market is growing rapidly and has proven to be a very attractive alternative to options such as asset management, which is viewed as a speculative and less-safe strategy to prepare for retirement (Exhibit 7).

State-funded healthcare will be a significant source of dynamism in this framework over the next five to ten years. Revenues in the global market for private health insurance—already $1.5 trillion—are expected to double by 2025. The demand for healthcare services, and hence health insurance, is

Exhibit 6 **High-level market attractiveness can be assessed through the role of state pension and healthcare systems and asset management penetration.**

Protection and accumulation demand framework



[1]Variations exist among countries in region.

increasing because of aging populations and the growing prevalence of chronic disease, as well as rising incomes in the developing world. At the same time, pressure on public finances is prompting many governments to impose healthcare-spending cuts or seek out private payers as intermediaries to better manage spending and outcomes.

Examining these findings in more depth, our analysis identified three types of markets where insurance companies can compete: commodity, harvest, and cultivation.

Commodity markets

Mandatory pensions in Australia, Canada, and the United States provide limited benefits, but a high percentage of the population in those countries has voluntary direct-contribution accounts (for example, the 401k in the United States) that are managed by well-established asset management

Exhibit 7

Life insurance penetration and growth vary among quadrants of the protection accumulation demand framework.

Market archetype	Life insurance market dynamics	Example markets	Life insurance as % of GDP, 2017, %	Life insurance premium growth, 2011–17, CAGR, %
	Emerging markets: Low contribution from state pensions and retail asset market leading to **fast-growing** life insurance market with limited competition from adjacent industries	China	2.7	16
		Brazil	2.2	17
	Mature markets: Steady and saturated life insurance market, facing low competition from retail asset market	Japan	6.8	0
		South Korea	6.8	6
	Mature asset management industry dominates retirement while insurers compete in narrow slice of retirement, leading to **commoditized market**	United States	2.8	0
		Canada	1.2	3
	Low penetration of **asset management** makes life insurance a **large** and relatively **stable** market complementing strong public pensions	France	5.9	0
		Germany	2.7	1

Source: McKinsey Global Insurance Pools database

companies such as Fidelity and Vanguard. Furthermore, the life insurance industry faces stiff competition from the asset management industry for funds typically earmarked for retirement. As a result, the life insurance market has lower penetration as a percentage of GDP and more challenging growth prospects.

Today, the life insurance industry in the United States faces the risk of playing a more confined role, solving tax and savings needs for a narrow, more affluent demographic. This position may result from the rise of the asset management industry, which has become the dominant retirement savings vehicle. The life insurance industry faces significant spread compression: it competes against industries whose products provide certain customer segments with clearer value propositions (such as asset management), while offering a more expensive product in certain situations due to higher distribution costs.

Property and casualty insurers, health insurers, and asset managers have an increasing mix of life insurance products as part of their integrated offerings. For example, healthcare payer Cigna plays in the group life insurance market, and Ameriprise and Fidelity offer life and annuities products (through a mix of their own products and white-labeled products from other manufacturers). As such, players from adjacent markets had around 15 percent of the total life insurance market in 2017 (Exhibit 8). On the other hand, life insurers have just a 4 percent share of adjacent markets.

Exhibit 8

Asset managers and health and property and casualty (P&C) insurers make up 16 percent of life insurance profit pools, while life insurers have only 4 percent of its adjacent markets.

CAGR %, 2015–17

–35% 65%

Bubble size represents size of profit pool

Life insurers on the attack

Life insurers getting attacked

Volume of profit flows from products to companies, US only, 2017, $ billions

	Products				Capital intensity
Companies[1]	**Life insurance**	**P&C insurance**	**Health insurance[3]**	**Retail asset management[2]**	**Equity/ revenue[4]**
Retail asset management[2]	1.1	n/a	n/a	27.6	70%
Life insurance	39.7	1.2	0.8	1.2	95%
Health insurance[3]	3.5	n/a	18.1	n/a	10%
P&C insurance	2.8	38.4	0.5	n/a	50%

Nonlife players have captured 16% ($7.4B) of total life insurance profits in the US, and health insurers' share is growing at 16% p.a.

Life insurers have a small foothold in retail asset management (4% of market) and are growing at 35% p.a.—in contrast, their share of P&C and health insurance is small and shrinking.

The size of the life insurance profit pool is offset by its capital intensity, which is ~35% greater than asset management and nearly 10x greater than health insurance.

[1]Companies are defined as a different type of insurer if their largest size of premium is for that type.
[2]Data for 2016 is used for AM.
[3]Health insurance includes comprehensive medical coverage (individual and group), federal employee health benefits, medicare supplements, and ASO/ASC but excludes Medicare/Medicaid.
[4]Simple average of publicly listed players in SNL Financial, calculated as equity minus goodwill over revenue.

Source: SNL, McKinsey Asset Management Growth Cube

Harvest markets

Western European countries have well-paying state pension schemes, along with a less-developed retail asset management industry. Most consumers supplement their pensions with life insurance due to favorable tax treatment, resulting in a high-penetration market with slow growth. This trajectory is due to low interest rates, an aging population, and the stagnant economies of several countries, including Italy, Spain, and—to a lesser extent—France.

Low interest rates are an important factor in the incremental growth of European markets, as insurers have traditionally pursued a spread play through products with guaranteed returns. However, after the financial crisis, low interest rates led to a decline in spread opportunities. As a result, insurers had to stop offering guaranteed products, which were previously driving the growth in premiums.

The life insurance market differs significantly between countries. For instance, the Netherlands has a much stronger mandatory pension system in place (97 percent gross replacement rate), while France and Germany have relatively weaker mandatory pension systems (61 and 38 percent, respectively, which are among the lowest in the region). Germany and Italy have stronger retail asset management markets, whereas France's asset management market is relatively weaker.

Western Europe is seeing a gradual but accelerating shift from defined benefit to defined contribution, as pension replacement rates have dropped in recent years. In an effort to address the lack of standards in pension plans, the EU Commission's proposed Pan-European Personal Pension (PEPP) product will provide standardized features wherever they are sold in the European Union. Given the switch from defined-benefit to defined-contribution plans, insurers will have ample opportunity to capture new markets, with limited competition from relatively less developed asset managers.As such, insurers will have the competitive advantage from scale, cost, and performance perspectives.

Cultivation markets

Asian markets are fertile ground for digital innovation in insurance. Asian consumers are more digitally savvy than consumers in Western markets, and they are therefore open to making financial decisions online, on mobile devices, or through social media. Capitalizing on this environment, insurers in Asia are at the leading edge of tech-enabled innovation such as digital platforms, data analytics, and automation. As a result, both direct and digital insurance have grown significantly. For example, digital insurance gross premiums have grown at a CAGR of more than 300 percent since 2011, and digital distribution now accounts for nearly 4 percent of all life premium sales.

Blooming: China

One key aspect of Chinese consumers is that a high portion of their personal financial assets sits idle in cash form. The percentage of cash in personal financial assets is 36 percent in China compared with the United States (4 percent), Canada (5 percent), Germany (16 percent), and France (17 percent). However, with savvier customers and a steady supply of attractive products with guaranteed returns—especially participating policy products—a further shift from cash to life insurance is possible.

The life insurance market has the highest potential in regions where both asset management and public pensions are relatively small.

The past few years have seen the rise of ecosystems in banking, often enabled by partnerships, application programming interfaces (APIs), and customer-centric strategies. Chinese firms are at the forefront of the "blurring lines" between insurance, retail asset management, and health insurance—and the big Chinese ecosystems are already playing in all three areas. We expect to see these ecosystems, and even new ones, shape insurance in the coming years, offering consumers a single hub for their protection and accumulation needs.

Ripened: Japan

In contrast to the life insurance market in China, which is developing rapidly and has become a leader in digital innovation, the Japanese market is already developed and even quite saturated. Furthermore, the limited growth potential in this market is compounded by low birth rates and an aging population.

Life insurance is the dominant retirement savings vehicle in Japan, where the state pension system's gross replacement rate is only 35 percent—little compared with other countries—and the asset management industry is still relatively small. The life insurance industry has the highest level of spending per capita as well as the largest share of GDP in the world, making it one of the most robust markets globally, though with limited growth potential due to saturation.

As with the Western European markets, low interest rates limit further growth in Japan's life insurance market. The ultra-low-rate environment has particularly affected the viability of single-premium insurance products, which are typically the flagship savings products of life insurance companies. Before this move, Japanese insurers primarily profited on the spread between guaranteed yields and long-term government bonds. Yet lower interest rates on government bonds made it too difficult for insurers to guarantee the yield, leading them to discontinue the sales of such products.

With limited growth prospects, Japanese insurers are increasingly looking to international markets as a potential source of growth, and some players have already started building positions through acquisitions, joint ventures, and organic growth. ■

3 Bold moves to generate value creation and growth

The Power Curve can be a helpful tool in pinpointing how leading companies are responding to industry trends and pursuing growth.[2] From 2010 to 2015, McKinsey examined 2,393 companies across multiple industries and compared them using economic profit as a proxy for success.[3] We found that companies in the top 20 percent (or to the right of the curve) generated more than 30 times the profit of those in the middle 60 percent, which made only marginal economic profit. The curve is broadly stable over time, and a company's position on the Power Curve is sticky (see sidebar "The Global Shapers"). Over the past ten years, only 1 in 12 companies moved from the middle to the top of the Power Curve, and approximately 40 percent of companies in the bottom third stayed there during that period.

We then looked at the factors that determined a company's position on the Power Curve. Our results show that 50 percent of a company's position was determined by its starting point and industry trends, with the remaining 50 percent influenced by the moves they made. The "big moves" that matter include (Exhibit 9):

- *M&A and divestments*
- *Resource allocation*
- *Productivity improvements*
- *Differentiation improvement (investment for future growth)*

Success is not the result of making just one move but rather making multiple moves. In fact, three or more moves heighten a company's chances of moving upward substantially—by nearly 50 percent. In contrast, one to two moves increase the chances of moving up but only by around 17 percent.

The extent of the bold moves is equally important. Many companies are pursuing these four strategies, but few are pursuing them at the scale that we found to have material impact. Company leaders must ensure that the organization is aiming high enough as they pursue these bold moves.

The Global Shapers

We have identified a group dubbed the “Global Shapers,”[1] comprising companies that operate in a dozen or more countries across more than one region. In addition, these companies have at least $10 billion in life insurance premiums or $15 billion in total premiums, with more than 20 percent of premiums in life. Our analysis shows that Global Shapers with the highest profitability and growth make more of the bold moves identified by the Power Curve.

The top five performers in terms of ROE from 2012 to 2017 are more than three times more likely to have done programmatic M&A and achieved productivity or differentiation improvements over the past ten years as compared with the rest of the Global Shapers. In fact, two out of five have engaged in programmatic M&A, four out of five have made significant productivity improvements, and three out of five have made significant differentiation improvements.

Global Shapers that engaged in programmatic M&A have avoided big-ticket deals in favor of targeted, strategic transactions, including deals to expand into new product lines, go up- or down-market in a given segment, acquire new technological capabilities, or diversify into less capital-intensive lines of business, such as asset management.

In addition, what separates the top performers in the Global Shapers from the rest of insurers is their volume of annual resource allocation—both across geographies and adjacent markets. Our data demonstrates that the top quartile of resource reallocators generate three to four percentage points in additional ROE and 4 to 5 percent additional growth compared with the bottom quartile.

The greater the magnitude of capital reallocation between domestic and international markets, the higher the ROE impact. On average, allocating an additional 10 percent of capital to international markets nets a company two percentage points in additional ROE two to three years after the capital shift.

[1] The 20 Global Shapers comprise the following companies: Aegon, AIA, AIG, Allianz, Aviva, AXA, China Life, Credit Agricole, Generali, LIC of India, Legal & General, Manulife, MAPFRE, MetLife, Ping An, Prudential Fin, Prudential UK, Sumitomo, SunLife, and Zurich.

Exhibit 9 **Our research found that four moves increase a company’s likelihood to move up the Power Curve.**

What a “big move” means over 10 years

Mergers, acquisitions, and divestments	At least one deal per year, with no single deal greater than 30% of market capitalization but adding up to 30% of market capitalization over 10 years
Resource allocation	Shift in capital expenditure across the portfolio such that more than 60% of annual capital expenditure allocated to different business units
Productivity improvement	SG&A productivity improvement relative to industry in top 40% of companies; and labor productivity improvement relative to industry in top 30% of companies
Differentiation improvement	Gross margin improvement relative to industry in top 30% of companies

Source: McKinsey Power Curve

To successfully execute on one or multiple bold moves, many companies must start by strengthening internal functions. We identified four actions that insurers should take to support a strategy of bold moves: build more robust M&A and business development functions; restructure the corporate center to support growth; build a plan to automate and outsource; and embrace a more agile, entrepreneurial operating model.

M&A and divestments

Conditions continue to be attractive for M&A, including improved investor confidence, rising rates, and areas for potential technology acceleration. As a result, M&A activity increased in the second half of 2017. At the same time, our research found that only a third of the Global Shapers have conducted what we would call "programmatic" M&A (at least one deal a year, with no single deal greater than 30 percent of market cap but adding up to 30 percent of market cap over ten years).

Insurtech investment is one area for continued focus. Over the past five years, investments in this category have grown rapidly—insurtechs drew $140 million of investment in 2011, and this number climbed to $3.5 billion in 2017. The average investment per insurtech rose from $5 million in 2011 to $35 million in 2017. After the United States, Germany and the United Kingdom are home to the most insurtech companies. The Asia–Pacific region accounts for only 14 percent of insurtechs but is expected to be the fastest-growing region in the coming years. In addition, insurtechs are active in all major insurance products and business lines, with concentrations in the property and casualty business and in the marketing and distribution areas of the value chain.

Action: Strengthen the M&A and business development functions

In light of the need to move more quickly on M&A and divestiture activity, insurers will need to look at ways to strengthen the business development and M&A functions.

Enhancing these functions typically requires a thematic M&A and partnership strategy aligned with overall corporate strategy; a pipeline of both long- and short-list targets that is continually reviewed; in-house talent with specialized M&A expertise and clearly defined roles and responsibilities; a standardized end-to-end deal process and systematic decision-making to avoid biases; and focused efforts (for example, transaction strategy, integration, learning, and tracking) during pre- and post-transaction stages, which are often neglected.

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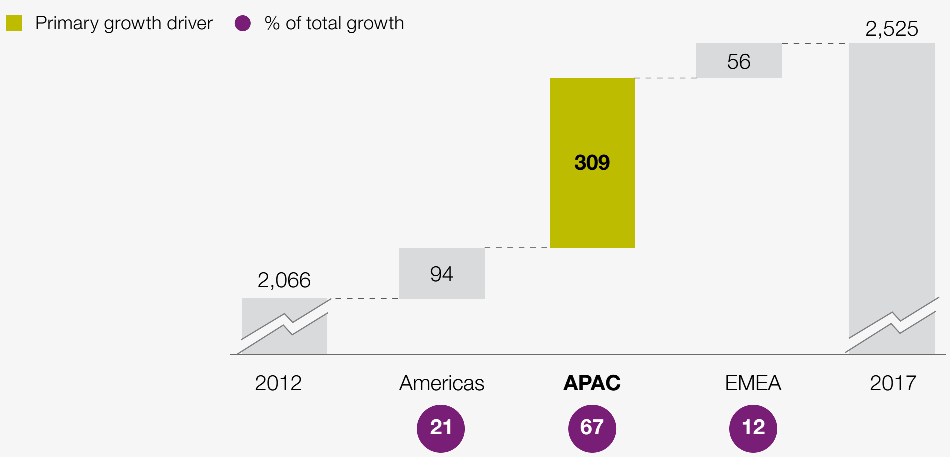
Resource allocation

As part of our analysis of Global Shapers, we examined how insurers allocate resources differently across three primary vectors: geography, adjacent markets, and risk profile. Each comes with a unique set of challenges and risks.

Geography. Many insurers that have expanded to faster-growing developing markets have reaped the rewards through greater profitability. Of the three vectors, geography has far greater implications on performance and returns compared with the remaining two, making it the most important lever for life insurance executives to focus on when developing strategy. Over the past five years, the still-developing Asia–Pacific region has accounted for almost 70 percent of premium growth (Exhibit 10).

Exhibit 10 **Nearly 70 percent of total premium growth has been driven by APAC over the past five years.**

Sources of direct premium growth by region, 2012–17, $ billions

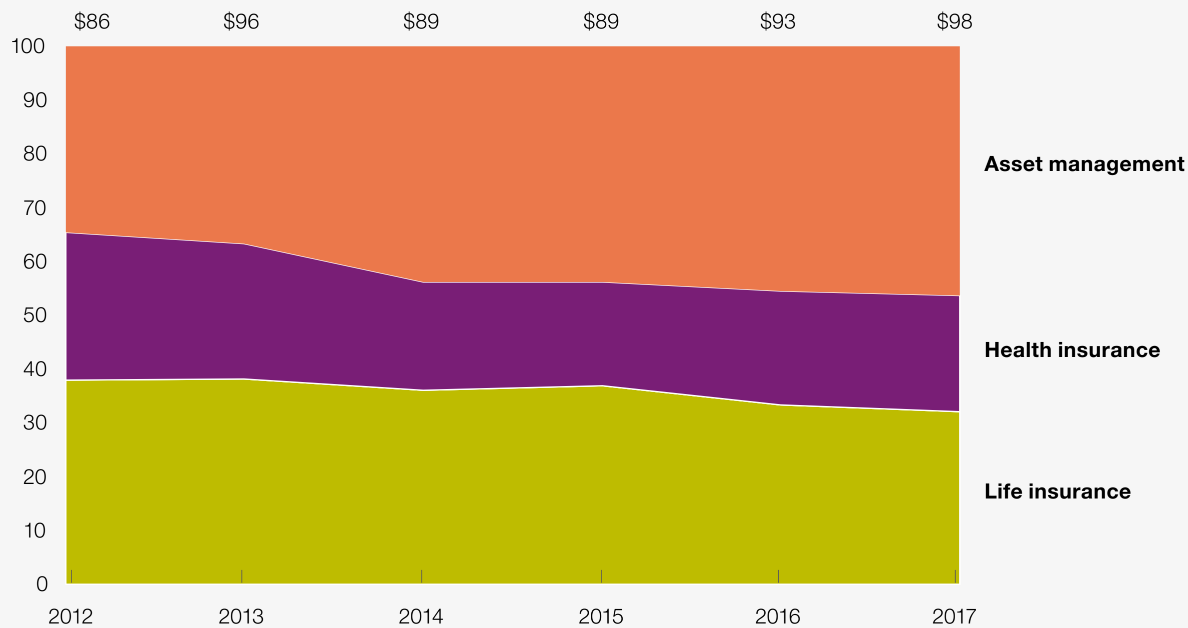


Source: McKinsey Global Insurance Pools database

Adjacent markets. For the past five years, life insurance has maintained its nearly 25 percent share of the protection and accumulation profit pool. This does not include property and casualty, which has seen a decrease of 15 percent in its portion of the profit pool—even as asset management increased its share by about 30 percent during this time (Exhibit 11). Cross-category incursions are expected to continue, with health insurers increasingly competing in property and casualty, and more life insurers expanding to asset management and verticals beyond life insurance.

Exhibit 11 **Life insurance's profits decreased by nearly 15 percent in the past five years as a share of total profit pool, while asset management increased its share by 30 percent.**

Total profit pools for insurance verticals and asset management, 2012–17, $ billions



Life insurance's share of the profit pools has declined by ~15% over the past 5 years

Within the past 5 years, asset management has increased its share from 37% to 47%, due to rising market performance

P&C profit pools were excluded from the analysis as a result of swinging performance due to rising natural catastrophes in recent years

Source: McKinsey Global Insurance Pools database

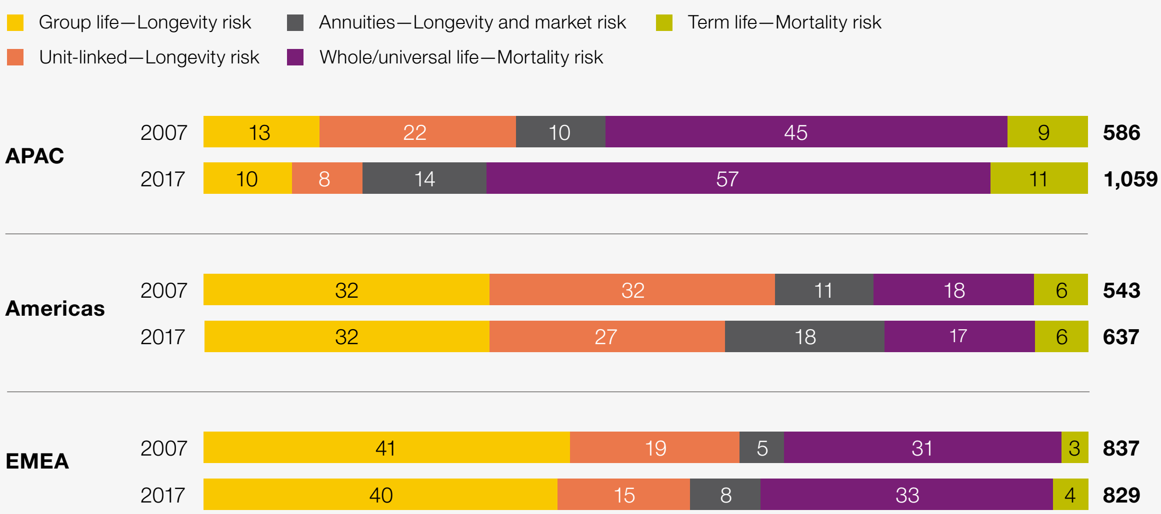
Risk profile. Over the past decade, the Asia–Pacific region has seen a significant shift from longevity risk to mortality risk as endowment products such as whole life and universal life gained in popularity relative to annuity products (Exhibit 12). In regions such as the Americas and EMEA, where insurers must deal with solvency issues for defined-benefit pension plans and changes in life expectancy, companies are significantly more exposed to longevity risk.

Action: Restructure the corporate center to accomplish goals

Resource allocation is fundamental to pursuing opportunities across geographies, adjacent markets, and risk profiles. Since corporate centers play an important role in developing and executing resource allocation strategy, their organizational structure and mandate are important. Corporate centers can follow four different models—holding company, strategic architect, strategic controller, and operator—to help strategize and achieve the goals of insurance companies.

Exhibit 12 **Life insurers have moved toward products with market risk globally and toward products with mortality risk in Asia.**

Sources of direct premium written over the past 5 years, by product, $ billions



In Americas and EMEA, there has been a switch from unit-linked annuity products, bearing market risk, to fixed annuities, as investor confidence fell post–financial crisis

In APAC, there has been a shift from unit-linked products to endowments as there is rising demand in China and India for savings- or pension-type products

Source: McKinsey Global Insurance Pools database

The nature of corporate guidance and degree of business unit and market integration for large insurers will help determine the right model. Different models of corporate centers have strategic implications ranging from talent to performance management to IT infrastructure, but their impact on how resources are allocated remains the most important.

Productivity improvements

The life insurance industry has pursued multiple approaches to achieving productivity improvements over the past year. A few life and annuities companies, for example, are focused on being low-cost, streamlined, and agent-friendly product manufacturers, with a limited consumer-facing brand. Another US-based holding company is outsourcing 40 percent of its operations associates to a third party. Other companies are using new technologies and advanced analytics techniques—particularly robotic process automation, optical character recognition, natural language processing, and digital distribution channels—to gain a competitive edge in a specific part of the insurance value chain.

Action: Outsource, automate, and optimize

Life insurers can pursue a number of actions to significantly affect productivity, including:

- *Outsourcing and offshoring.* Life insurance companies have many opportunities to outsource and offshore noncore operations (Exhibit 13). Overall, insurance companies are lagging five years behind other financial services companies, especially banks, in their degree of outsourcing and offshoring.

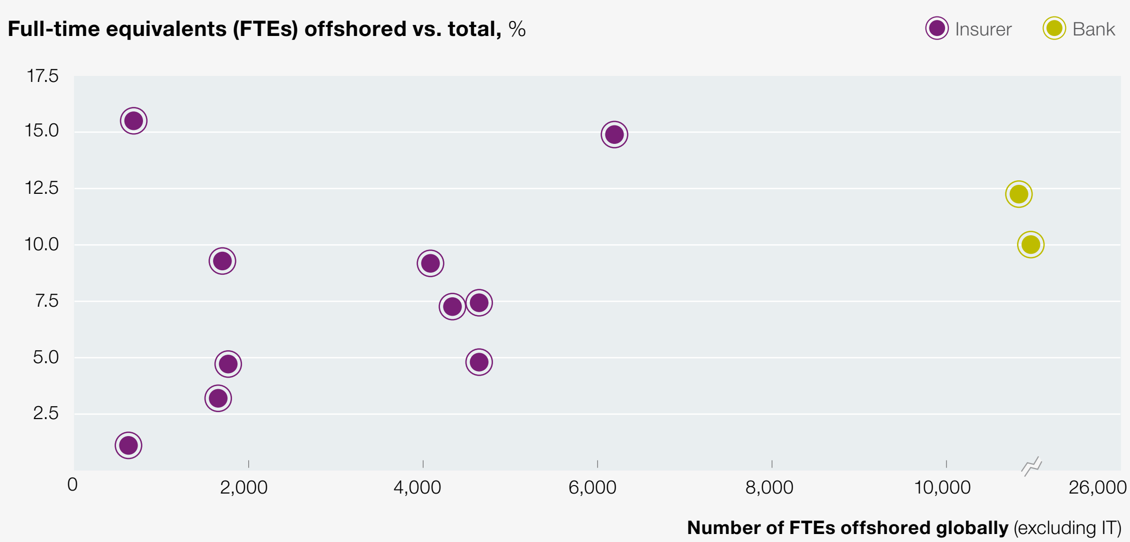
- *Automation.* A significant number of activities across each step of the insurance value chain—up to 70 or 80 percent in some areas—could be automated.

- *Optimizing the back book.* Insurers can still do much more to improve the efficiency of the business they already have. Introducing lean operations and overhauling legacy IT systems would be a good start, but they can achieve enormous cost savings from digitizing existing high-touch processes as well as simplifying the product shelf both for new business and the existing portfolio. Enhancing back-book management can free up valuable resources that can then be channeled toward growth.

Differentiation improvements (investments for future growth)

Another battleground lies in making investments for future growth and differentiation. Distribution is becoming increasingly fragmented, and insurers face an expanding group of partners and intermediaries. In the United States, for instance, life insurers that distribute through third parties recognize that the experience they offer to distribution partners, including brokerage general agents, wire houses, and independent marketing organizations (IMOs), is as important as the experience

Exhibit 13 **There is still relevant offshoring/outsourcing potential in insurance when compared with other financial institutions.**



Source: Press search; company websites, annual reports of the end customer. At the same time, customer and partner expectations are changing, prompting carriers to emphasize the experience of these two groups and create new product value propositions.

- *Changing partner expectations.* Just as expectations for customer experience are changing, so too are the expectations of partners. Financial advisers and captive general agents will expect a digital interface and automated tools in their interactions with insurance home offices and wholesalers—same as their customers. Successful insurers will focus on improving the partner experience to help elevate the customer experience.

- *Innovate around the customer value proposition.* Insurers must respond to the customer needs for flexibility, personalization, and relevance. On flexibility, insurers could bundle products across the verticals of retirement, insurance, and health and wealth management—for example, allowing customers to pledge savings-oriented insurance policies against a mortgage that is underwritten by the insurer. On personalization, insurers could deepen inroads into health and long-term care. A product could allow customers to adjust how their premiums flow into different types of protection as they get older—for example, to build up the share that goes toward chronic care coverage. On relevance, insurers must retain their core competence of offering some downside protection for retirement solutions—for example, through hybrid products, which combine unit-linked products with a guarantee of 80 to 85 percent of the invested capital. This product category remains an important differentiator for life insurers compared with asset managers.

Action: Embrace the power of an agile operating model

The need to innovate the value proposition and create a differentiated customer and partner experience presents an unprecedented challenge for life insurers. To succeed, they need to increase agility and speed in their organization. A full transition to an agile setup with tribes, squads, and capacity-based planning might seem far-fetched. Still, insurers need an influx of fresh talent to shift the culture, with a focus on speeding up the "metabolism" (for example, faster, bolder innovation in product and servicing; use of agile methodology; and a shift to a test-and-learn mind-set), as well as putting the customer (in addition to the agent or the broker) in the center.

Research by McKinsey's Organization Practice suggests companies that have adopted agile operating models see significant productivity improvements—for example, 90 percent faster time to market for new product innovation and a 30 percent increase in frontline productivity. In addition, they have better organizational health. Put another way, agile companies have a 70 percent chance of being in the top quartile of organizational health, employee engagement, and customer satisfaction, all factors that enable faster growth.

Agility is not a new concept. According to a 2017 McKinsey survey, more than 46 percent of financial services companies have started large-scale efforts to increase their organizational agility.

In addition to standing up agile teams, insurers that have been successful in their efforts had to rewire core processes, change mind-sets and culture, implement new performance management systems, develop new capabilities, and recruit digital talent to build a stable backbone that supports dynamic practices.[4]

■ ■ ■

The best way to adapt to a changing environment is by being proactive. Life insurers should strive to seek out areas of growth and stay abreast of the changing industry landscape. This path will require investments in organizational capabilities to pursue new market opportunities. Executives who take the time to understand fast-growing regions and emphasize operational excellence will best position their company for growth. ■

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[1] McKinsey Insurance Power Curve analysis.

[2] *The Strategy & Corporate Finance blog,* "Is your strategy good enough to move you up on the Power Curve?," blog entry by Martin Hirt, January 30, 2018, McKinsey.com.

[3] Economic profit is defined as profits minus the cost of capital. In addition, while our analysis did not focus on the insurance industry, the results should be considered comprehensive and can therefore be applied to all industries.

[4] "How to create an agile organization," October 2017, McKinsey.com.

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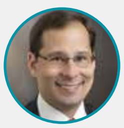
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