The Boston Consulting Group

From Cash to Capabilities

Profitable Growth for Life Insurers

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AT A GLANCE

The traditional life insurance industry in mature markets is in structural decline and faces long-term disruption. At the same time, global demand for savings and risk management is set to expand. In the developed world, aging populations and shrinking pension budgets will fuel the need for retirement solutions, while in emerging markets, an expanding middle class will drive savings growth.

A Mandate to Maximize Cash Generation

To adapt and prosper, it is vital for life insurers to maximize cash generation from declining parts of their business and redeploy that capital to new areas of long-term growth.

Four Business Models for Profitable Growth

Insurers should follow one or more of four winning business models to create profitable growth from emerging economic and demographic trends: low-cost savings provider, next-generation risk manager, customer and segment specialist, and captive distributor.

The life insurance industry faces a wave of structural change generated by long-term disruptions. These include less favorable macroeconomic and demographic conditions, weakening demand for traditional products and services, and increasing regulatory pressure. At the same time, insurers face growing competition from alternative providers.

Given the challenging outlook, life insurers are asking themselves fundamental questions about the future of their industry: Is there a structural decline in its attractiveness and profitability? Where should they place their bets, given the disruptive changes to existing markets and business models? Will demand in new growth markets offset weakening demand for traditional products and services?

Despite these concerns, many life insurers remain wedded to old business models. They continue to fund new business that has weak potential for long-term growth or value creation, while paying limited attention to the returns from their existing managed assets. We believe that these insurers, unless they make fundamental changes, will see ever-diminishing returns on new business and will eventually be forced to seek radical cost reduction and consolidation.

In contrast, a small number of leading insurers have embarked on successful efforts to build competitive advantage. They have done so by reallocating capital to new areas of long-term growth. These leaders have achieved such success through an underlying, shared capability: maximizing cash generation from their existing business. By improving returns in low-growth markets and redeploying capital, they are funding business model transformation and future growth.

By improving returns in low-growth markets and redeploying capital, leading insurers are funding business model transformation and future growth.

Insurers that have not yet done this still have the opportunity if they can succeed in maximizing the value of the cash generated by their in-force books.

In addition to their cash-generation capability, leading insurers have adopted one or more of the following four winning business models. Each model is based on a core capability sufficient to enable large, established life insurers to grow and create long-term value.

- *Low-Cost Savings Provider.* This model addresses the global savings gap that we believe will continue to widen as populations age and as governments and private employers reduce the scale of social security and retirement benefits.

- *Next-Generation Risk Manager.* These insurers address consumer demands for long-term security and peace of mind.

- *Customer and Segment Specialist.* This offering taps into the more complex needs of today's retirees and other growth segments, using both traditional and emerging channels.

- *Captive Distributor.* These players focus on reaching new customers and building stronger customer franchises, particularly in developing markets, by developing new captive-distribution channels, including direct and digital.

The key to the potency of these four business models is that they tap into specific, significant opportunities for growth and value creation that arise from macroeconomic and demographic trends. Our assessment indicates that these opportunities include the widening retirement-savings gap in the developed world; the growing demand for advanced retirement-age financial solutions, also in the developed world; and the huge new market for life insurance in the developing world—the next-billion customers—which is being driven by rapidly growing personal savings.

Regardless of business model, all life insurers should focus acutely on cash generation.

In the discussion that follows, we will detail how life insurers can evaluate their portfolios in the framework of these four winning models and the macro opportunities that support them.

But regardless of business model, all life insurers should focus acutely on cash generation. Where winning growth models exist and are succeeding, they should increase investment in them at the expense of other, more established areas. And where winning models are not apparent, they must decide whether to try to transform the business or, alternatively, to excel at generating cash for shareholders at a slower rate of growth.

To be sure, mature markets will continue to offer attractive growth opportunities. However, we expect smaller, specialist players to be strong competitors for these profits. Traditional life insurers have little certainty of dominating this terrain, even as it continues to diminish.

A Structural Decline in Profitability

For many years, life insurance companies enjoyed a unique position in financial services, thanks to generous tax incentives, strong financial-market returns, and healthy consumer demand for guarantees and risk protection. Insurers built their business models on the basis of high-margin products distributed through expensive broker and agent networks, while product complexity drove up back-office costs.

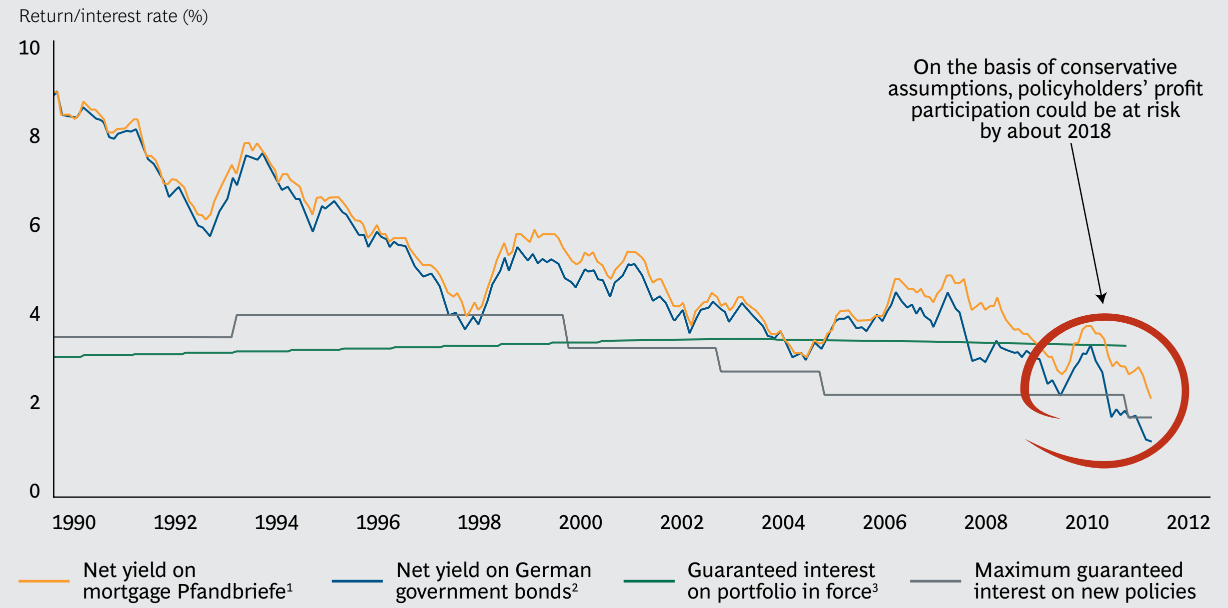
Then, during the last decade, the dynamics of the industry began to shift significantly—partly as a result of the financial crisis, but also owing to the generally more difficult macroeconomic environment. Consumer confidence has eroded, demand has fallen, investment returns have become more volatile, and margins have steadily declined. Since 2007, insurers' return on equity has fallen in almost all markets globally. Today, insurers are confronted by long-term disruptions and a structural decline in the attractiveness and profitability of their business, although this is not yet fully reflected in earnings.

In the developed markets, the industry's economic and financial-market drivers are largely negative. Weak economic growth, a low-yield environment, capital market volatility, and sovereign-debt risk in the countries of the European periphery imply low margins, weak revenue and earnings growth, balance sheet volatility, and pressure on capital and solvency margins. These pressures are not short term. In fact, they may well increase over the coming decade.

When stock markets fail to perform, demand falls for long-term savings products. In addition, low returns and low interest rates make it challenging for insurers to construct attractive long-term savings products to compete with short-term interest rates. In particular, it has become increasingly difficult for insurers to construct traditional guaranteed products that are profitable. The vulnerability of profits from products offering long-term guarantees is illustrated by Germany's mortgage-linked Pfandbrief bonds. (See Exhibit 1.)

To be sure, higher yields from investments made before the financial crisis still provide attractive dividends for participating products today—for example, sales of

EXHIBIT 1 | Pfandbrief Bonds Illustrate the Vulnerability of Profits from Products Offering Long-Term Guarantees



Sources: Bundesbank; annual reports; interviews; BCG analysis.
[1]Yields including bearer bonds and mortgage bonds with an average maturity of nine to ten years.
[2]On listed federal securities with a maturity of nine to ten years.
[3]Unweighted average of the top insurance companies in the German life insurance market.

whole life insurance in the U.S. are at record levels. Still, significantly lower reinvestment rates will inevitably reduce the attractiveness of such investments in the years to come.

The volume of bancassurance—insurance products offered through bank sales channels—has also declined, owing to the higher capital requirements imposed by Basel III. Increasing the amount of capital that they must keep on their own balance sheets has impelled banks to retain customer deposits rather than promote insurance sales.

Spread-based earnings still account for the largest portion of life insurance earnings across Europe, as most of the demand in the major European markets is still for traditional products. To some extent, insurers have been able to protect their earnings from traditional business by reducing crediting rates and cutting costs. But we see this as an increasingly difficult business line, with growth and profitability challenged for the foreseeable future.

Many insurers are seeking to reduce their exposure to macroeconomic trends by switching their sales efforts from traditional spread-based products to fee-based, unit-linked products or protection business, where the risk is fully diversified away from the purely financial. These lines of business are more capital efficient, but they offer limited medium-term growth potential.

Long-Term Regulatory Disruption

A rising tide of postcrisis regulatory rules and restrictions is also creating challenges for insurers around the world, and those measures will increase in the months and years to come—both locally and globally. This is particularly the case in Europe. The ongoing debate and persistent delays in implementing Solvency II have held back product development and capital allocation plans while driving up costs. The retail-distribution reviews in the U.K., the Netherlands, and Australia should herald more efficient and transparent distribution models but will inevitably cause disruption, further drive up costs as insurers redesign their products and systems, and increase pressure on charges.

A rising tide of postcrisis regulatory rules and restrictions is creating challenges for insurers around the world.

In Asia, the ongoing review of financial advisors by Singapore's Financial Advisory Industry Review and the recent introduction of commission transparency in Hong Kong on investment-linked products will significantly disrupt traditional agency distribution models. Regulators in China and India are rapidly issuing new directives on asset management, sales compliance, and pricing that are challenging insurers' economics.

For U.S.-based insurers, the prospect of designation as a "systemically important financial institution" has caused significant uncertainty about future regulatory burdens and capital requirements.

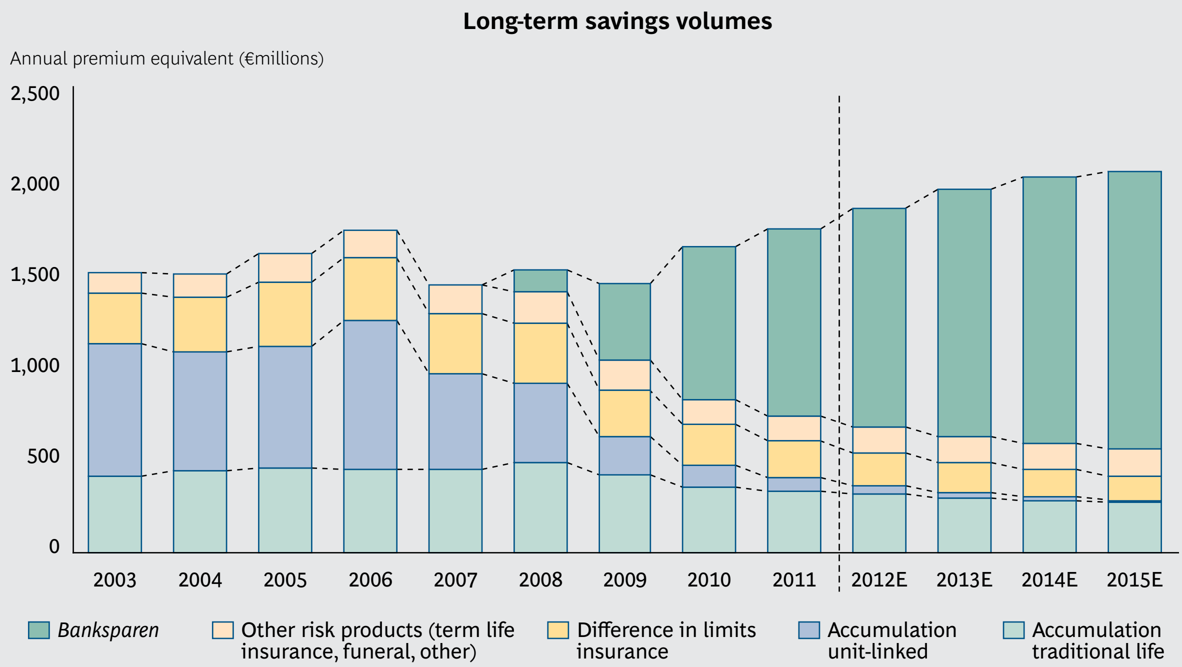
In some markets, regulation has taken away the tax advantages of insurance products. In the Netherlands, for example, *banksparen* savings products offered by banks, which enjoy the same tax advantages as insurance products, have gained market share dramatically since 2008 at the expense of the life industry and now dominate the market. (See Exhibit 2.) We expect further disruptions to the industry from regulatory intervention as governments around the world continue to shift the responsibility for retirement income from the state to individuals.

The Rise of New Competitors

Economic, competitive, and regulatory pressures have cast life insurers into a declining market with commoditized new-business products. The ability to manufacture and sell high-cost life wrappers is rapidly losing its traditional value as demand for those products wanes among consumers and advisors. Simplicity, scale, and low cost are becoming essential.

As a result, life companies face increasing difficulty competing with bank deposits, asset managers, and wealth managers. Profitable segments, where they exist, are now being pursued by smaller specialist insurers, unencumbered by legacy issues and with a sharper strategic focus and lower cost structures. We expect competition from alternative suppliers to remain intense for the foreseeable future.

Exhibit 2 | The Dutch Market Has Seen a Dramatic Shift from Individual Life Insurance to *Banksparen* Products



Growth in *banksparen* driven by:

- Change in tax law
- Scandal around charges on unit-linked life products
- Lower cost/higher transparency of *banksparen* products

Sources: Statistics Netherlands; Centrum voor Verzekeringsstatistieken; Consulting & Interim; BCG *banksparen* model/estimate.
Note: Annual premium equivalent defined as 1x annual premiums on new policies plus 1/10x single premiums on new policies.

It is clear that difficult times have arrived and are here to stay for life insurers, just as reduced demand, overcapacity, and weaker economics have permanently altered the competitive landscape of other industries. We anticipate consolidation in the industry as insurers in general look to gain economies of scale and reduce costs, and as insurers with marginally profitable in-force books turn to outsourcing and replatforming to boost returns.

Until now, the impact of this harsher environment in mature markets has been manageable for life insurers. This is largely because—under International Financial Reporting Standards (IFRS) in Europe and Generally Accepted Accounting Principles in the U.S.—insurers' in-force books provide profit and cash on an accounting basis, despite low margins, weak revenue, and earnings growth.

Life companies have been adept at using these funds to drive growth through investment in change and new business. But not enough has been invested in profitable and sustainable segments, and too much has been invested in propping up businesses that are in terminal decline.

Now, however, industry analysts are changing the way they measure life insurers. The focus in mature markets has turned from indicators of future worth—embedded value and net book value—to measurements such as cash generation and IFRS profits. (See the sidebar "Why Embedded-Value Metrics Have Fallen from Favor.")

WHY EMBEDDED-VALUE METRICS HAVE FALLEN FROM FAVOR

Investor trust has waned in embedded-value (EV) metrics, which are based on a range of assumptions and forecasts about future financial trends, including investment returns. The last five years have demonstrated how difficult it is to predict such trends and returns. Instead, investors increasingly focus on the ability of life companies in developed markets to generate cash to support dividend growth and investment in new business. Return-on-equity data have therefore become more relevant than EV earnings.

Global insurers have failed to agree on a common EV standard. Most continental European players have switched to market consistent embedded value (MCEV), whereas some U.K. players are still using European embedded value (EEV). The absence of a universal standard makes it difficult for investors to evaluate comparative performance across the sector.

Insurers' EV metrics are also losing relevance because they cannot be compared with the IFRS metrics published by other competing financial service companies, such as banks and asset managers.

Shareholders have become more critical about how cash is reinvested and what returns are delivered by new business. Life companies have to demonstrate that they are investing in segments and locations that offer a competitive advantage and sustainable growth. For many, this will require a change in strategy.

Major Growth Opportunities

Global economic and demographic changes, while posing myriad challenges, will also provide enormous potential opportunities for life insurers. The world's aging populations need help shepherding their financial resources before and during retirement, since governments and employers are less able to play a role. In the developing world, a new wave of savers is emerging—the next-billion consumers.

Global economic and demographic changes, while posing myriad challenges, will also provide enormous potential opportunities for life insurers.

Answering these needs will require many of the industry's existing core capabilities: long-term asset management, administration and record keeping, guarantees and risk management, and customer distribution. But the industry will need to invest in adapting its capabilities and transforming itself in order to play a role and reap the benefits.

As noted earlier, we believe that these global macro trends support a number of significant opportunities for life insurers to pursue long-term growth and value creation.

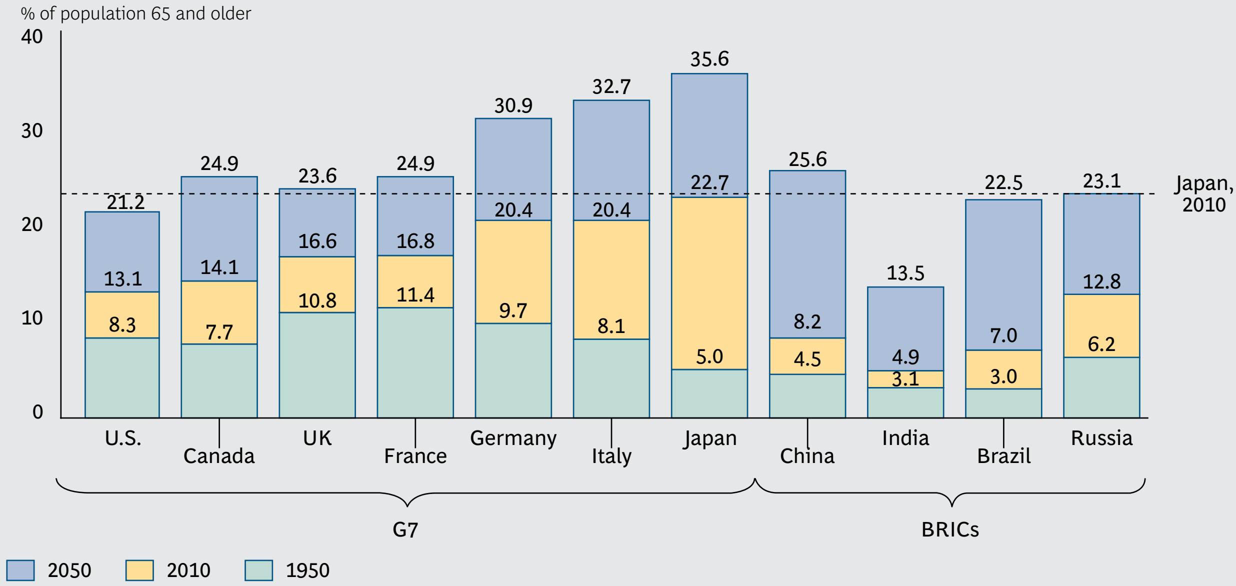
The Widening Retirement-Savings Gap in the Developed World. The aging of populations worldwide, combined with budget deficits, is forcing governments to shift responsibility for old-age provision from the state to individuals. Employers are also finding it difficult to cover the retirement needs of employees and are closing defined-benefit pension schemes to derisk their balance sheets.

By 2050, the populations of the world's largest economies—with the exception of the United States and India—will be as old as Japan's population in 2010, when nearly 23 percent of Japanese were 65 or older. (See Exhibit 3.)

The consequent retirement-savings gap is estimated to be more than €2 trillion per year in Europe and more than $6 trillion in the U.S. and getting bigger. Asia is not immune, either. Singapore and Taiwan have among the fastest-aging populations in the world; China's working-age population will start to decline beginning in 2015, and social safety nets are almost nonexistent. Governments are implementing a series of measures to try to close this gap and have driven huge growth in defined contributions and retirement savings. For example, compulsory enrollment in the Australian superannuation market has caused assets under administration to grow by more than 10 percent yearly since 1996.

As fiscal incentives and new pension legislation stimulate consumer saving, life insurers have the opportunity to position themselves as the solution to a huge global problem. However, with cost structures typically in the range of 100 to 120 basis points, insurers are not necessarily best placed to win in this market. We expect governments to select carefully preferred suppliers for long-term savings,

Exhibit 3 | By 2050, the Populations of Most of the World's Large Economies Will Be as Old as Japan's in 2010



Sources: United Nations, *World Population Prospects: The 2010 Revision*, 2011; BCG analysis.

based primarily on cost to the consumer. They are likely to opt for providers that can match the cost basis of the most efficient retirement providers, whose fees are less than 30 basis points of assets. The insurance industry's fees—on average, 100 basis points higher than those of passive funds—reduce a pension pot by 25 percent over 25 years. That is something governments will be keen to avoid.

If the industry's costs remain high, insurers could miss out on a huge prize as governments look to other industries (such as banking or asset management) or quasigovernmental bodies (such as ATP of Denmark) to provide low-cost retirement savings.

To reach these substantially lower cost levels, insurers will need to build highly scalable back offices and leverage distribution channels—including direct, digital, and work site—with a lower cost to serve than that of the traditional commission-based agent networks.

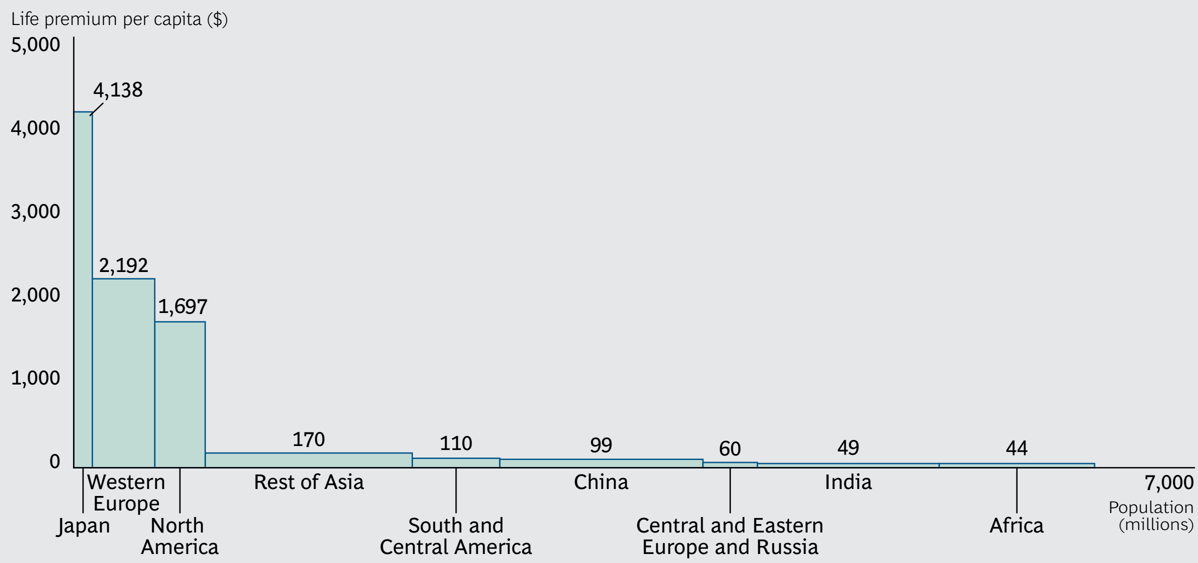
The Growing Demand for Advanced Retirement-Age Financial Solutions in the Developed World. While the world's working population is worrying about how to save for retirement, older generations such as the baby boomers in the United States are fortunate enough to be retiring in relative wealth. Over the next 20 years, people older than 55 are expected to account for more than 50 percent of all consumer spending, and almost half the retirees in wealthier countries such as the U.S. will enter retirement feeling financially secure or comfortable. We estimate that this group already accounts for more than 50 percent of the life insurance profits in developed markets, and we expect this portion to grow.

For this generation, financial security and health care are primary concerns, accounting for over a third of expenditures. These people have a strong need for help with pooling the risks associated with longevity, health costs, long-term care, and investment returns, as well as with tax management and intergenerational wealth transfer. These are areas where the life industry has a clear competitive advantage over banks and asset managers, given its traditional skills in pooling and managing risk, and where there will always be robust consumer demand.

Retirees also have increasingly complex and evolving needs. Retirement is no longer just an end-of-career event but rather the latest in an ongoing series of life stages with new financial priorities and needs. Retirement products are complicated and hard to sell. Life insurers have a lot of work to do if they are to win in this area. They lack consumer insight and could quickly find themselves marginalized by organizations that are better able to provide simpler solutions and to understand these customers' needs for products and advice.

The Huge New Market for Life Insurance in the Developing World. In many emerging markets, a rapidly growing middle class with a strong savings culture is an attractive and potentially huge new market for life insurers. The newly wealthy and mass-affluent markets have been the primary target for those Western insurers that have already made inroads in emerging markets. Currently, most of the world's population has little or no life insurance. (See Exhibit 4.) Rapid growth will be generated as the mass of the population—people who are now largely unserved by traditional business models—achieves the levels of discretionary income required to support expenditure on insurance.

Exhibit 4 | The Absence of Life Insurance in the Developing World Offers a Huge Opportunity for Revenue Growth



Source: Sigma Swiss Re.
Note: All data are 2011.

The current regulatory environment in many developing markets is favorable, with governments recognizing the social and economic benefits of life insurance and seeking to increase penetration. In Indonesia, which has a population of 235 million, penetration of life insurance products was just 1.1 percent in 2011, compared with the European average of 4.1 percent. In Brazil, life penetration was just 1.7 percent in a population of 197 million. The long-term growth potential of these and other emerging markets, which typically offer better pricing and margins and higher investment yields, is clear.

Distribution will be critical to exploiting the opportunity presented by the next-billion consumers. Bancassurance partnerships are a good entry point given banks' extensive branch networks, but margins for life companies in bancassurance relationships are often slim. Large sales forces are often inefficient and difficult to manage. Insurers therefore need to develop new captive-distribution channels, including direct and digital, in order to capture customers' full value and retain control of the relationship.

While this will require significant investment, it also provides an opportunity to migrate distribution to new, more efficient and effective channels, without the high cost and complexity that often characterize traditional channels in developed markets.

Some leading insurers have successfully reallocated capital and built competitive advantage in long-term growth areas.

Evaluating Your Portfolio Against the Four Winning Models

So how, exactly, can life insurers transform their own business models to exploit these long-term opportunities for value creation? As a starting point, we believe they should evaluate their portfolios in the context of the key attributes of the four winning business models and the best practices associated with each of them. (See the sidebar "Four Winning Business Models: Best Practices.")

As noted earlier, we believe that one capability is fundamental for all life insurers operating in mature markets: maximizing cash generation from existing business. This allows insurers to improve returns in low-growth markets in order to fund transformation of the business model. (See the sidebar "How Winning Insurers Maximize Cash Generation.")

Some leading insurers have successfully reallocated capital and built competitive advantage in long-term growth areas. Many others still have the chance to invest in order to build positions in such areas. This transformation will be expensive, but insurers should be able to fund the development of winning business models from the cash generated by the in-force books in their core, mature markets—in much the same way that Prudential and Manulife have funded growth in Asia. This implies a need to target profit growth and cash generation in mature markets and product areas at the expense of revenue growth.

Some U.S. and European life insurers have already adopted this strategy, trying to minimize new-business strain, shift portfolios away from low-return, capital-intensive business lines, and focus on the profitability of in-force books. (See Exhibit 5.)

FOUR WINNING BUSINESS MODELS
Best Practices

Each of the four winning business models we have identified is based on a core industry capability enabling life insurers to grow and create long-term value. The most appropriate model or combination of models for an insurer will depend on the characteristics of the markets in which it operates.

Low-Cost Savings Provider
This model addresses the global savings gap that we believe will continue to widen as governments and private employers scale down social security and retirement benefits. Winning insurers will do the following:

- Develop new, low-cost administration platforms.
- Build scale in assets under administration.
- Keep their core asset-management propositions simple and cheap.
- Focus on workplace savings where acquisition costs are lower.
- Use digital distribution and servicing to drive down processing costs.
- Provide product flexibility: aim to sell a lifelong pension account, not a product.
- Seek incremental sources of revenue, including asset management, fees, mass-affluent solutions, and new products.

Next-Generation Risk Manager
These players address consumers' demand for long-term security and peace of mind. Winning insurers will do the following:

- Specialize in selected risk and customer segments, chasing profit, not volume.
- Develop real insight into the needs and preferences of customers, both existing and potential, recognizing significant differences across markets and customer segments.
- Select and prioritize those segments that exhibit strong customer demand and the highest potential margins.
- Develop and market simple, low-cost, and capital-light guaranteed products to the mass market.
- Build high-touch and high-engagement propositions that meet the evolving needs of confident and affluent investors.
- Develop and deploy global capabilities in risk management and pricing.
- Make better use of the know-how and capital of third parties, such as investment banks and reinsurers.
- Invest in developing and perfecting simplified, low-cost sales processes.

FOUR WINNING BUSINESS MODELS (continued)

Customer and Segment Specialist

This offering taps into the more complex needs of today's retirees and other growth segments, using both traditional and emerging channels. Winning insurers will do the following:

- Identify target segments based on growth, value, and channel preference.
- Understand customer needs and decision processes for target segments.
- Use digital channels to collect data to help drive customer insight.
- Build a brand and proposition that resonate with the needs of target segments, such as retirees.
- Develop solutions and not just products: service, customer contact model, sales messages.
- Refocus the operating model to ensure that segment needs are best met by all the model's elements, such as communications, distribution, service levels, and pricing.
- Focus on customer needs, and be prepared to offer a broader range of in-house and third-party solutions to meet those needs—for example, health as well as life for retirees.

Captive Distributor

These players focus on reaching new customers and building stronger customer franchises, particularly in developing markets. Winning insurers will do the following:

- Seek to own the customer by building direct distribution wherever possible.
- Build sales management capabilities specific to emerging markets.
- Fully integrate digital channels into the proposition.
- Differentiate the level of service and engagement between lower-touch risk products and higher-touch long-term savings.
- Add scale through other channels, such as bancassurance and affinity partners.

Insurers that have tackled this issue have demonstrated improvement in metrics such as new-business strain, payback periods, internal rates of return, and free cash generation, although it will be some years before the shift on the new-business side is fully reflected in balance sheets and overall IFRS earnings.

A Structured Process for Transformation

For most life insurers, refocusing on cash generation and the development of new business models implies radical changes in managing the enterprise, with organiza-

HOW WINNING INSURERS MAXIMIZE CASH GENERATION

Today's leading insurers are building competitive advantage by reallocating capital from mature markets to new areas of long-term value. They are funding this business-model transformation and future growth through one fundamental common capability: maximizing cash generation from their existing business.

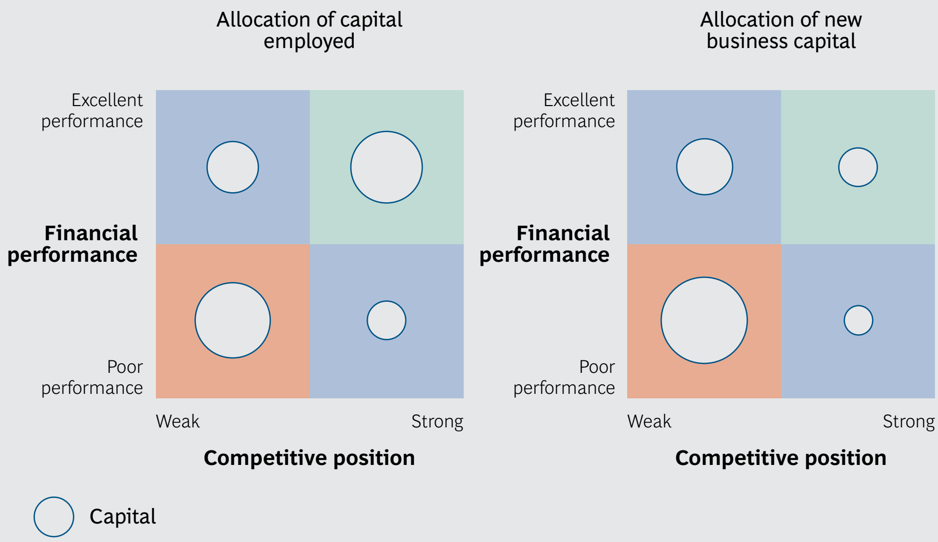
The following are the key steps they are taking to build that capability and reap its benefits:

- Conduct a portfolio review to identify which businesses to grow and which to scale back.
- Centrally manage strategic allocation of capital for new business and investment—based on return on capital and payback periods—and use this to shift the center of gravity of the business.
- Create separate business units to manage in-force and low-growth books with clear value objectives based on return on capital, cash generation, and cost and retention metrics.
- Reduce lifetime operating costs through productivity, systems consolidation, offshoring, and outsourcing.
- Build world-class retention programs with clear value targets.
- Review and improve other drivers of profit, such as solvency margins, asset liability management, pricing, crediting rates, and distributor commissions.
- Systematically review reserving policies, risk profile and diversification, and tax and regulatory management to identify opportunities for capital release.
- Improve investment returns through lower costs, a broader investment mix, a stronger operating model, and improved cooperation with the liability side.
- Consolidate or sell off books to capture value from scale and reduced capital requirements.

tional and financial implications. Defining and delivering this transformation requires a structured process:

- A review of the portfolio and capital allocation framework in order to understand where value is currently being created, where investment should be increased, and where capital should be withdrawn
- An assessment of in-force cash-generation capabilities and potential in order to devise a credible plan that allows investors to receive strong and increasing

Exhibit 5 | A European Insurer With Capital Committed to Uncompetitive Businesses and Poor Returns



Source: BCG case experience.

dividends with a high degree of certainty

- An audit of growth business plans against winning business models in order to focus long-term value creation and the investments that are required to deliver it

Across all four winning business models, excellence in asset management will be a key competitive advantage and driver of valuations. We believe insurers need to consider a range of measures:

- Strengthen investment capabilities, with a focus on strategic asset allocation and asset liability management.
- Reduce asset management charges and streamline investment operations.
- Focus on providing compelling investment propositions for target segments.
- Externalize asset classes that are competitively advantaged.
- Reconsider whether to participate in asset classes that are subscale.

Winning life insurers will be those that reconsider their traditional models and strike the right balance between building attractive growth positions and returning capital to shareholders. Those that do not face up to the challenge will struggle to break out of the current cycle of poor new-business performance and disappointing shareholder returns.

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