

FINANCIAL SERVICES

Going on the Offensive – the \$1,600BN Prize

The Future of Life Insurance



Contents

Executive summary	1
1. Introduction	5
2. Life insurers on the defensive	7
3. The offensive agenda	13
4. Business models and market impact	35
5. Start now	49

Originally published in June 2004 by Mercer Oliver Wyman

OLIVER WYMAN

Oliver Wyman
99 Park Avenue
New York, New York 10016
www.merceroliverwyman.com
(212) 541-8100



Executive summary

The past four years have been tough for the global life insurance industry. At one point the industry had lost half of its aggregate peak market capitalization, leading some to question the sector's long-term health, or even survival.

A return to reality –
not a terminal illness

We beg to differ. While some of the fall in market capitalization represents real losses in shareholder value – the capital destruction, for example was real – our view is that over the longer-term, the experience of the past four years will be seen primarily as representing a *return to reality*, not a terminal illness. Indeed, we go further and contend that the major risk for life insurers today is that they fail to move beyond the short-term defensive measures adopted (out of necessity) over the past few years and surrender the high ground of long-term savings and protection to other financial services players.

\$1,600 billion
shareholder value at
stake for insurers on
the offensive

As detailed in this report, we estimate that the potential for shareholder value creation by the life sector is some \$1,600 billion over the next decade. But at this point it is only *potential* value. Life insurers who seize the opportunity to move back on to the offensive can, and will, capture this value. But for those who let the opportunity pass them by, predictions of a terminal illness will be self-fulfilling.

The corner-stones of
an offensive agenda

What does 'moving back on to the offensive' mean? We've identified four key imperatives for life insurers:

1. **Compete for personal financial assets.** Life insurers compete so fiercely amongst themselves, product by product, that they risk missing the forest for the trees. Today's financial services industry is characterized by many different types of competitor chasing a single (growing but finite) pool of assets. Life insurers' failure to grasp, and act on, this fact in the past has been reflected in a "Who Moved My Cheese?"¹ reaction as they have seen natural expansions of their territory taken over by others – for example, as mutual funds took the 401(k) market in the US. Life insurers on the offensive, on the other hand, recognize that personal financial assets (PFA) are the prize, and that they and other insurers are only one faction among the competitors. Non-asset-based products (such as life protection) constitute a sufficiently large market only for smaller insurers in large markets

¹ Copyright © 2000 Spencer Johnson, "Who Moved My Cheese"

2. **Promote a 'long-term financial security' value proposition.** There is a significant customer need for asset protection and long-term security. Life insurers have most of what it takes to capture that demand and deliver against those promises – brand, financial structure, product design, distribution reach. To compete for personal financial assets, as they must, life insurers need to take advantage of the differentiation these capabilities offer them: they need to compete on a 'long-term financial security' platform. To do that requires capital, but capital can be raised if a strong business case is presented to potential providers. The capital-lite alternative is to compete for short-term investment assets. This requires a life insurer to buy (or build) an asset manager and integrate it, and to compete head-on against highly-focused incumbents. However, life insurers cannot usually claim to feature many of the sources of sustainable competitive advantage for pure asset managers: for alpha specialists² achieving sustained outperformance, for beta specialists having a strong brand perception and a cost advantage. In fact they may even be disadvantaged in these areas

3. **Wrest back, and defend, customer capture.** The need for face-to-face selling inevitably means that the bulk of the value generated by distribution will continue to be captured by distributors themselves. But *influence over distribution* is vital to the economics of product manufacture. We call this “customer capture” – a situation where, for whatever reason, the balance of power rests at least partially with the manufacturer. Without customer capture a dominant distributor will eventually squeeze all the value out of the manufacturer; achieving it is about creating a pull-effect from end customers and tying in distributors. But customer capture is not synonymous with *owning* distribution. In fact, those product providers with tied salesforces in practice often cede control of the customer to individual agents, severely limiting their ability to deliver a consistent customer value proposition. In some insurers, we have observed that the 'independent' channel exhibited greater customer capture than the tied channel, due to the control the insurer is able to exert on the actions and behaviors of independent distributors who are locked into a long-term symbiotic relationship with the insurer. To go on the offensive life insurers have to defend what customer capture they have, and develop strategies to regain that which they have lost (or never had). Value goes where customer capture goes

4. **Forget grand designs – focus on the detail.** Future market opportunities are not pan-regional, but differ between countries within a region, and between segments within a country. For example, while much has been made of so-called 'Asian Strategies', the Japanese, Korean, Chinese and Taiwanese life insurance markets are each vastly different in size, maturity and existing competitive structure, and so their corresponding drivers of value are completely distinct. Similarly, in Europe each country has its specific characteristics with no trend towards convergence. Broad brush regional strategies might offer initial growth, especially in regions where life insurance penetration is extremely low but growing quickly, but they do not create any sustainable shareholder value as markets grow and mature. Grand designs dilute, rather than increase, value

² Alpha specialists: active managers aiming to outperform the market or benchmark; beta specialists: passive managers aiming to produce a return in line with the benchmark

The future global competitive landscape: big global winners and specialist players

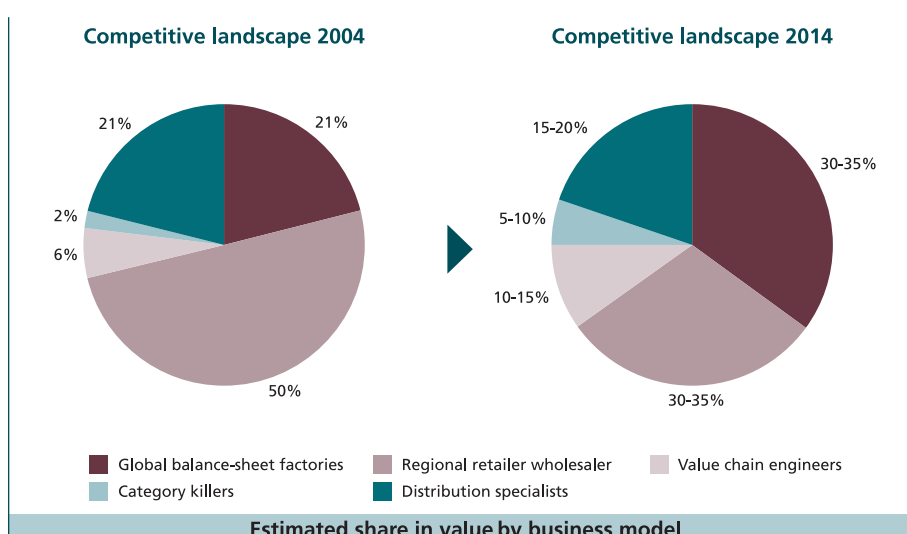
Regional retailer-wholesalers must change or die

Life insurers that move on to the offensive have the potential to alter the global competitive landscape significantly. In particular we see (Figure 1) a major shift towards **global balance-sheet factories** that have the reach, capital strength, and expertise to perform in terms of all four of the imperatives above.

The big losers will be among those firms who operate undifferentiated **regional retailer-wholesaler** business models. Some will have used their local market power to become a global balance-sheet factory but many will be sub-scale, left clinging to local customer capture. These insurers may eventually be forced to consider one of three other broad business models:

- **Category killers** dominate niche areas of big markets, typically in capital-lite but underwriting-heavy products. Category-killing will become more popular, but there are not enough sufficiently large niches for this to become anything more than a minor part of the overall market
- **Value-chain engineers** attempt to disaggregate the value chain, focusing on specialist areas such as asset management and administration. While this segment is likely to grow, it is necessarily focused on the most easily-commoditized and lowest-value parts of the chain. The steps that add most value – distribution and the taking of complex balance-sheet risks – are much less easy to ‘engineer’
- **Distribution specialists** will increasingly steal value from insurers that fail to retain customer capture. In particular, this model is a natural haven for those regional retailer-wholesalers who find that they have no competitive advantage in product manufacture, operating efficiency, asset management, or in fact *anything* aside from distribution reach and control in their local markets. However, while the value captured by distribution specialists is likely to grow, for each individual player this will be bounded by local market limits. Even among retail banks, which are well placed to play the role of distribution specialists, there are few examples of successful multi-market players (Citigroup and HSBC being the main examples), due principally to the lack of natural cross-border economies of scale in a business that revolves around servicing individual consumers

Figure 1: Changing life insurance landscape



Note: Shareholder value creation measured as net present value of economic profits
Source: Oliver Wyman

The only exception to the 'adapt or die' rule for regional retailer-wholesalers will be those in markets that are either too small, growing too slowly or too heavily regulated to attract major investment from global players. These players will be able to survive if they are strongly capitalized, control distribution (whether through a tightly controlled tied salesforce, locked-in bank distribution, or 'captive' brokers), and use their local scale to occupy all local niches.

So the strategic future of global life insurance, taken as a whole, is a combination of consolidation and specialization. There will be fewer players in aggregate, and greater concentration of value in fewer players still – but there will also be far greater differentiation of the strategies adopted by life insurers, even within each of the general business models (global balance-sheet factory, regional retailer-wholesaler, category killer, value-chain engineer, distribution specialist) that we present in this report.

Carpe diem

The common message for all life insurers is clear: move back on to the offensive and seize the \$1600 billion of shareholder value-added being created. Of course, easier said than done. Each of the four imperatives involves tough decisions. Many of these decisions involve substantial investments in new channels, markets or capabilities, which will only bear (uncertain) fruit over the medium term. For some companies, life on the offensive means playing a high-stakes game aimed at building a focused, high-value and high-growth business, rather than the lower-risk approach of a broad regionally-organized and low-growth portfolio of businesses.

Moving on to the offensive will not be easy. It will involve emotionally and intellectually difficult choices. But there is no alternative: life insurers need to start their strategic offensive today. There is \$1,600 billion at stake, and no shortage of competitors – both within the life sector and beyond – trying to steal it away.



1.

Introduction

For years, life insurance was a regulated, stable and secure business. No more. Over recent years, the sector has experienced turbulent times. Pundits have responded with a plethora of articles, reports and studies covering almost every aspect of the industry's fate – including markets, products, customers, capitalization, distribution channels and operating efficiency – in excruciating detail.

What is the future of life insurance?

We have taken a different approach. Our research began with the broad, general and global question:

'What is the future of life insurance?'

Our approach to answering this question begins by breaking it into four sub-questions:

1. **Where is the industry today?** What are the current sources of value-creation in the life insurance market, and how do these compare with today's (yesterday's) management agenda?
2. **Where is the industry heading?** How will the sources of value creation evolve over the next ten years and what are the key items on the strategic agenda through which life insurers can create value?
3. **What are the implications for competitive strategy?** What kinds of different generic business models are there, what are the outlooks for each such model and what strategies do different types of life insurer need to adopt?
4. **What do life insurers have to do today?** What questions do life insurers need to ask themselves today to better understand their current situation and take best advantage of the available opportunities? What do they need to focus on in the strategy development process?

These four sub-questions form the basis of the major sections in the report, which summarizes our findings. It has two main objectives:

- To identify and develop an agenda through which life insurers can move away from their defensive retrenchment of recent years and return to offensive, growth-oriented strategies, based on a comprehensive and granular assessment of the value-creation opportunities over the next decade
- To assess the outlook for different business models in life insurance, and thence derive the consequences for the future global landscape of the industry

Throughout the study we applied a mixed quantitative and qualitative approach utilizing our full global breadth and depth of expertise. We also took advantage of market knowledge and data from our sister companies in the Marsh & McLennan Companies.

Central to this study were the findings of around forty discussions with senior life insurance executives around the globe. These discussions provided significant insights that form a cornerstone of our findings. Since we regard these discussions as fully confidential, we have not named any person or company; nevertheless, we would like to record our gratitude here towards those that gave of their time and insights.

2.

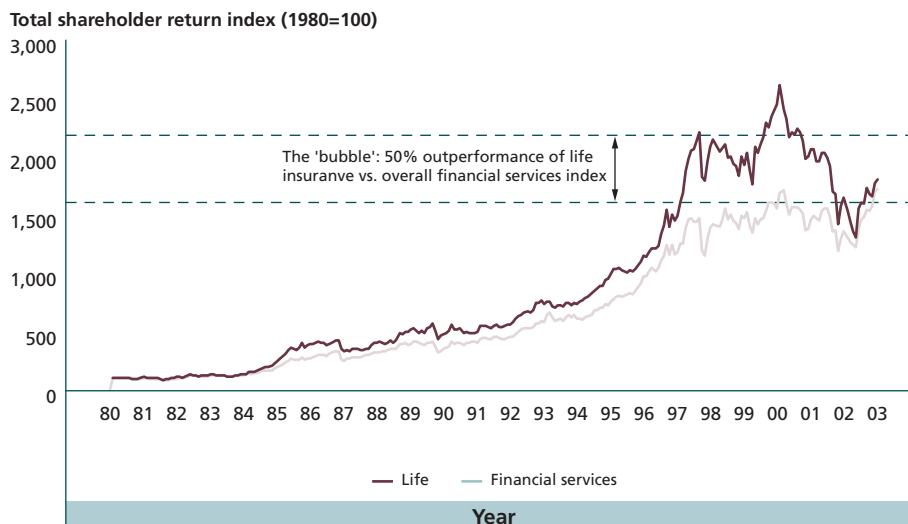
Life insurers on the defensive

A return to reality – not a terminal illness

The tough times endured by life insurance businesses over the last four years – in which we include providers of annuities, pensions and other related products – have somewhat overshadowed the roaring 1990s that preceded them. Yet on closer inspection, we can see that the ebullience of the 1990s were nothing more than a bubble, and the subsequent four years have been nothing more than a correction (Figure 2). Those insurers that surfed the wave of asset growth in the 1990s are precisely those who have found the last four years most painful. The sector is coming back down to earth, not succumbing to terminal illness.

The late 1990s boom and the following correction were felt most by European life insurers, who benefited from – and then suffered from – their leveraged equity positions and the impact of declining interest rates on guarantee liabilities. The picture was slightly different for North American life insurers. Many of their risks materialized earlier in the cycle and were markedly less pronounced than their European equivalents. With a few isolated exceptions (such as American Skandia), North American insurers' equity headaches have been concentrated in a few product lines and have proven much less painful than in their European counterparts.

Figure 2: Total shareholder return index 1980-2003



Today's defensive management agenda

Unsurprisingly, the management agenda in Europe (as well as in developed Asian markets, who have suffered from declining interest rates that have exposed high guarantees) has for the last four years been overwhelmingly defensive: retrenching back into core markets, de-risking, re-capitalizing and cost-cutting. Even in the all-important arena of public policy, insurers have focused on attempts to ensure that regulation is amended to alleviate short-term pain – or at least not amended in a way that makes the short-term pain worse.

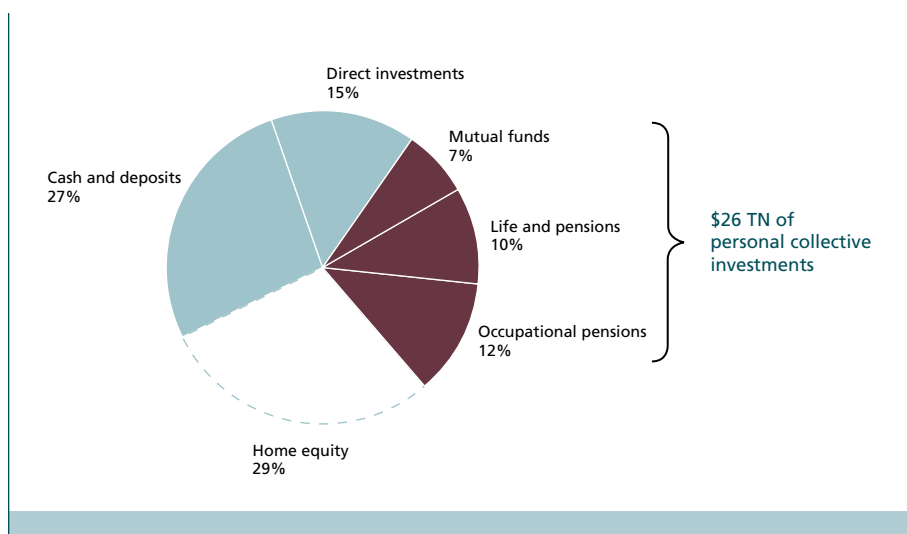
While US life insurers caught only a relatively mild case of the ‘insurance influenza’ that affected their European and Asian cousins so badly, there are nevertheless some striking similarities between their reactions. Many large US life insurers have been retrenching for some years now; many are now significantly disengaged from the broader savings and investments market, where mutual funds hold the stronger position. Even in products where there has been considerable top-line growth (e.g. annuities), many US insurers have re-focused on traditional products (fixed annuities instead of variable, for example), on hedging programs to mitigate market risk, and on efficiency-driven consolidation.

In this report we argue that while regional differences are important, there are some common global issues that need to be addressed by all life insurers, no matter which market they call ‘home’.

Where is value created today and in the future?

In this section, we first examine where value is being created today and where it will be created in the future across the global life insurance sector. We then move on to the critical question of whether today's primarily defensive strategic agenda is sufficiently strong for life companies to tell a compelling value-creation story for the future.

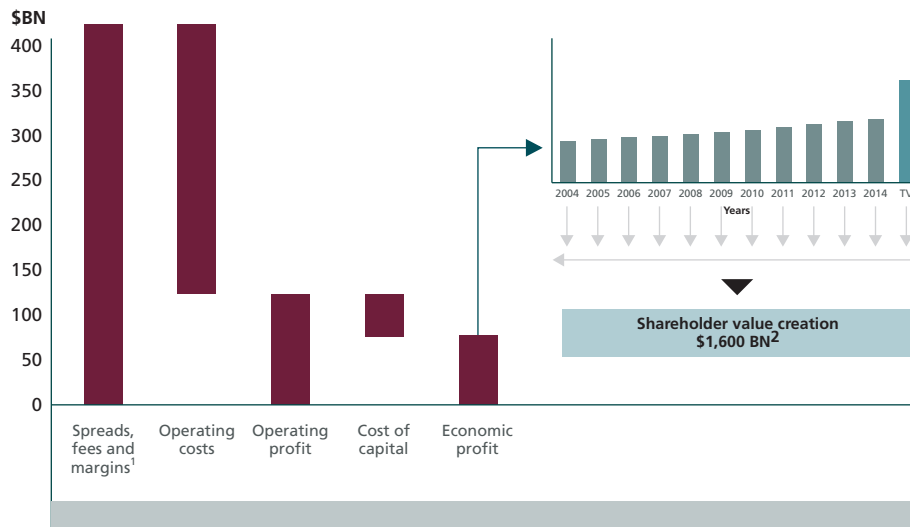
Figure 3: Split of global personal financial assets – total \$90TN



Source: Oliver Wyman

\$1,600 billion total shareholder value at stake

Figure 4: Value creation in global life insurance



¹ On average 1.2-1.5% of assets

² Shareholder value creation measured as net present value of economic profits

Source: Oliver Wyman Analysis

\$26 trillion of personal collective investment assets

If we define life insurance broadly, along the lines described above, the sector globally accounts for a total of approximately \$26 trillion of personal collective investment assets, equivalent to 70% of global GDP or \$4,500 per capita. To put this in context, the total personal financial assets (PFA) held globally amount to approximately \$90 trillion, or \$16,000 per capita. Figure 3 shows the split of global personal financial assets in more detail, within which life insurance is expected to be the fastest growing class with an annual growth rate of 6%, some 20% higher than the overall growth rate of total personal financial assets.

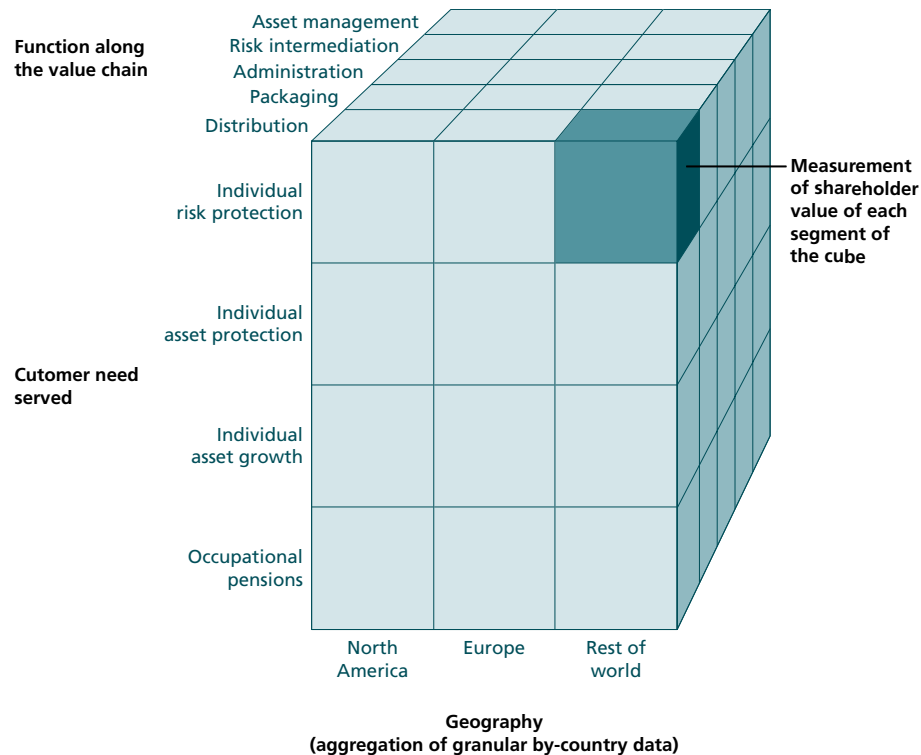
\$60 billion economic profit per annum

This \$26 trillion of assets in personal collective investments currently generates approximately \$100 billion in annual profits, or \$60 billion in annual economic profit once the cost of capital has been subtracted, as shown in Figure 4. Making some assumptions on asset growth and margin expectations, we estimate that future value creation in this business is worth \$1,600 billion to the industry³.

To understand where and how this value is created, we have decomposed operating profits and (economic) capital requirements – the two principal drivers of economic value – at a detailed level by country, by customer need (which roughly aligns with product), and across the value chain, as shown in Figure 5.

³ Figure 4 shows how annual economic profit changes over time. The result is of this forecast is our central estimate of shareholder value creation, measured as the net present value of economic profits over the next decade plus the residual terminal value at the end of that period.

Figure 5: Valuation cube



Most value is created in distribution and in using the balance-sheet to take risk

Decomposing this value by customer need and across the life insurance value chain, one sees that the bulk of value creation is concentrated in two areas. The first is the *distribution* of asset growth and asset protection products; the second, using *the balance-sheet* to take calculated risks in order to provide long-term guarantees to policyholders (Figure 6).

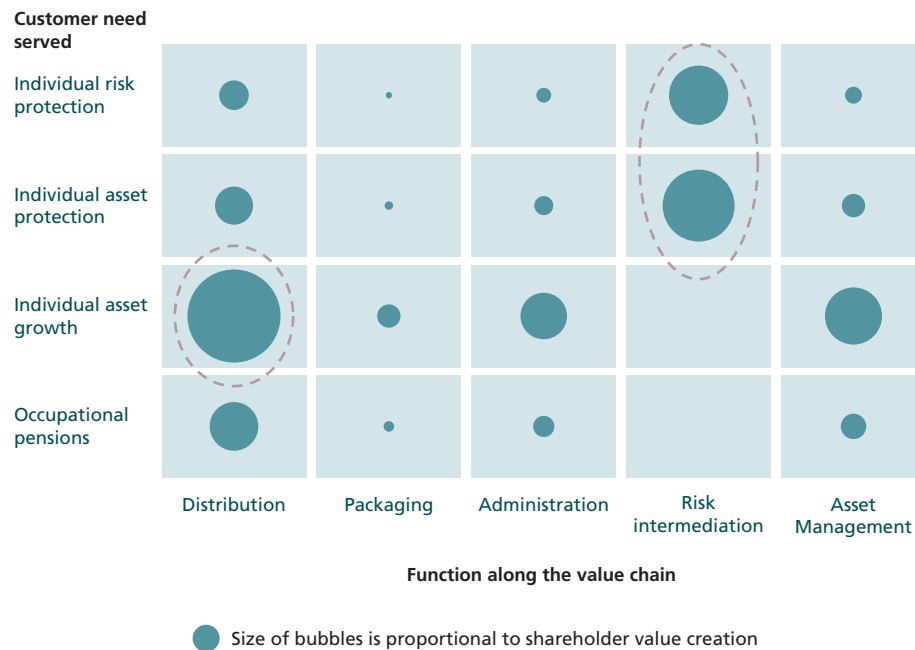
This analysis challenges the long term sustainability of defensive strategies for life insurers.

Defensive approaches not viable in future

Our analysis demonstrates that a defensive management agenda cannot capture the majority of this potential shareholder value. In particular:

- **Indiscriminate de-risking weakens life insurers' ability to differentiate themselves against other competitors for personal financial assets.** This is not to say that hedging risk destroys value *per se*. On the contrary, lack of hedging was the main reason behind the European life sector's massive exposure to the asset price bubble. Rather, the point is that market participants with no risk-carrying ability (in particular mutual fund manufacturers) can only compete directly against life insurers when de-risking reaches the point where the only products written are ones that either pose no risk to the insurer at all, or whose risks can be hedged away entirely, thus driving down margins and value-creation

Figure 6: Value creation segments



Source: Oliver Wyman Analysis

- **Cost focus is a useful discipline but misses the point.** Efficient administration is desirable but will not make a step-change to a life insurer's economics. As with hedging, this is not to say that cost-cutting is misguided – on the contrary, cost pressures over the last few years have seen insurers trim away much of the 'fat' accumulated during the boom years. But the benefits achieved by such cost-cutting are beginning to plateau for many players, while differences in administration expenses between different companies are miniscule compared to differences in distribution and risk-return economics. Achieving a step-change in economics therefore requires, first and foremost, a more rigorous approach to understanding and prioritizing those parts of the value-chain – by country, channel, product or customer segment – which offer sustainable value
- **Retrenching to home markets means giving up options for long-term growth.** Insurers who have come under severe financial pressure, and whose international ventures have not proven successful, have had little choice but to retrench to their home markets and de-emphasize growth in international markets. This, however, is not a recipe for long-term growth for those insurers that have the capital and capabilities to exploit international opportunities. As we shall see in the next section, many of the most valuable growth opportunities arise from finding scattered growth opportunities in international markets

Life insurers need to move on to the offensive

In summary, we are not arguing that it was a mistake to adopt a defensive stance; we are arguing that it was a necessary evil whose time has now passed and that there is now significant value at risk. Life insurers need to move on to the offensive if they wish to capture this value and avoid contracting the terminal illness of long-term decline and irrelevance.



3.

The offensive agenda

Life insurers must follow four key imperatives in order to move their strategic agenda back on to the offensive:

1. Compete for personal financial assets
2. Promote a 'long-term financial security' value proposition
3. Wrest back, and defend, customer capture
4. Forget grand designs – focus on the detail

1. Compete for personal financial assets

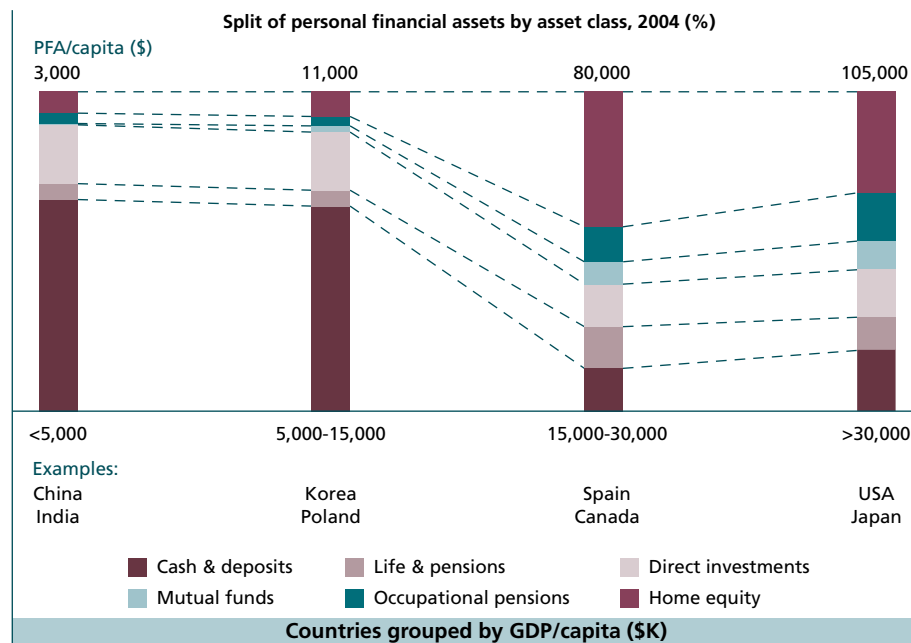
Life insurers are not the only group chasing the finite pot of consumers' personal financial assets – life insurers on the offensive need to take a broader perspective. The competition is not just against other life insurers, but against other companies that can house personal financial assets. Insurers need to understand that the market for these assets is much broader and bigger, and much more heterogeneous, than it might seem from a narrow insurance product perspective.

If we think of a broader definition of personal financial assets as covering all personal wealth, including, for example, home equity, direct investments in companies or in stocks, cash & liquidity instruments, occupational pension schemes, mutual funds and individual life and pensions, we see a much bigger market worth around \$90 trillion, a figure we expect to grow at about 4.5% per annum (in real terms) to reach around \$140 trillion by 2014.

The allocation of this broader definition of personal financial assets is driven significantly by market maturity, of which GDP per capita is a good, but not ideal, proxy. As markets mature there is a pronounced shift away from bank deposits and other liquid products, towards home equity (reflecting increased home ownership) and more sophisticated investment products, including life and pensions (see Figure 7). In particular, there appears to be a 'tipping point' as a country's GDP per capita approaches \$15,000, after which the proportion of more sophisticated savings vehicles increases rapidly. Life insurers benefit greatly when markets pass this tipping point.

A 'tipping point' when GDP per capita reaches \$15,000 opens up opportunities . . .

Figure 7: Split of personal financial assets grouped by country GDP/capita



Source: Oliver Wyman

... But life insurers lose out in super-mature markets

However, as markets further mature, the flows from liquid products dry up. Life insurers increasingly compete with other providers of medium and long term investment products for flows that are growing only in line with GDP. At this point, life insurers become threatened by other players offering mutual funds and other collective forms of investment. The US 401(k) pension scheme market is a good example, as described in Box 1.

Life insurers have a shortage of imagination, not of opportunities

So life insurers on the offensive need to:

- Find ways to encourage the flow out of liquid asset classes
- Increase their share of investment assets in mature markets at the expense of other financial services sectors

There is no lack of opportunities here: Figure 9 identifies two examples. To compete for personal financial assets, life insurers need to make their propositions more customer-centric and less capable of replication by other types of provider.

2. Promote a 'long-term financial security' value proposition

We see many customer needs in the pre- and post-retirement segments which life insurers who have a coherent, integrated proposition are ideally placed to address. These needs represent a huge value creation opportunity as illustrated in Figure 10:

Box 1: "Who Moved My Cheese"⁴ in the US 401(k) market

As the chart below illustrates, the US market for 401(k) pension plans provides a good example of life insurers failing to compete aggressively for personal financial assets.

In 1988, insurers dominated the nascent 401(k) market, holding some 44% of market share by number of schemes. But life insurers did not develop their offerings as the market developed and ultimately exploded, and thus failed to differentiate themselves from mutual fund providers. In the meantime, mutual fund providers had developed strong performance-related brands and capitalized on rising markets and bullish consumer sentiment. By 2002 life insurers had retained just 16% of a much larger market: they had successfully defended what they already had (and fought over it among themselves), but had not capitalized on the huge value unlocked by the market's growth.

Figure 8: US 401(k) market development

Source: DOL and Cerulli Associates, Oliver Wyman Analysis

Number of 401(k) schemes

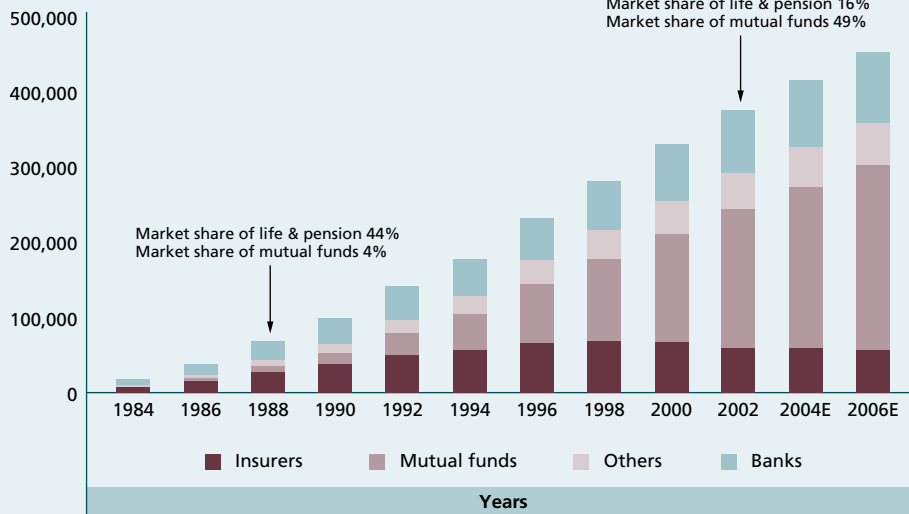
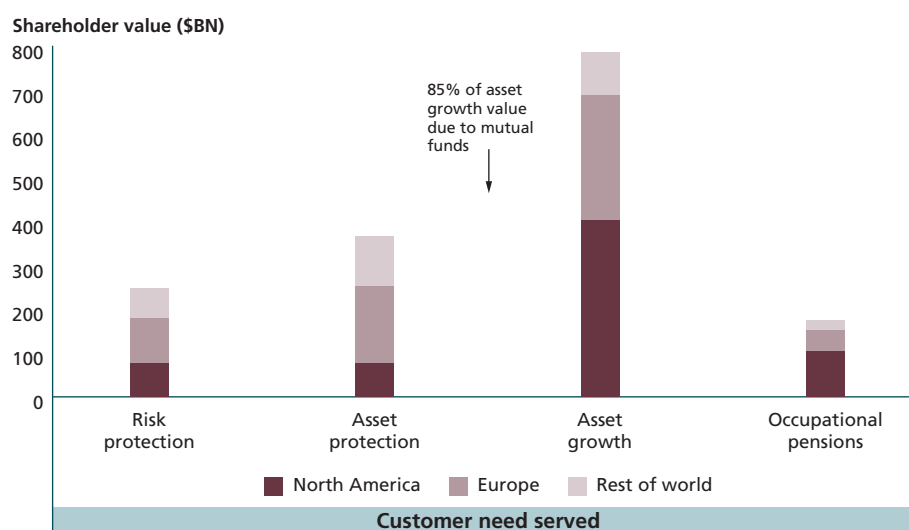


Figure 9: 2 Opportunities to Compete for Personal Financial Assets



- **Risk protection** – providing customers with protection against risks to their well-being without providing a true savings component. This includes, for example: term life, disability cover and long-term care insurance
- **Asset protection** – providing long-term guarantee-protected asset accumulation such as traditional whole life or endowments, fixed annuities or guaranteed equity-linked annuities. Asset protection products can cater to a broad spectrum of risk tolerance, from pseudo-deposit accounts through to almost-unprotected pseudo-asset growth
- **Asset growth** – providing simple pass-through access to the market via, say, mutual funds, unit-linked products or variable annuities without guarantees

Figure 10: Value creation by customer need



Note: Shareholder value creation measured as net present value economic profits
Source: Oliver Wyman Analysis

Asset growth – a pot of gold? . . .

- **Occupational pensions** – our analysis includes the total potential involvement of insurers in the administration and asset management of occupational pension schemes

At first glance, asset growth is by far the largest source of potential value. Figure 11 illustrates how the capture of personal collective investments translates into value-creation.

- First, consider assets. Occupational pensions dominate the asset picture, accounting for 46% of assets that create value for financial services providers; asset growth accounts for 30% and asset protection 21%
- Second, consider how assets translate into profit. Occupational pensions may account for 46% of value-generating assets, but their administration and asset management are very low-margin businesses with profit margins below 10 basis points⁵ per annum. Occupational pensions account for just 7% of the overall global profit pool. Asset growth (50-60bp) and asset protection (80-90bp) are significantly more attractive, and thus these categories together dominate the total profit pool
- Finally, consider the connection of profit to value. Here there are a number of factors at work, but the most important (in terms of ‘dividing up the cake’) is capital requirements. This is where asset growth begins to look so valuable compared to asset protection. Because asset protection involves offering guarantees to customers, it consumes significant amounts of (economic) capital⁶. Asset growth products, in contrast, pass the investment risk on to the customer and thus require the insurer to hold very little capital. So despite similar profit margins, asset growth turns out to generate twice as much shareholder value as asset protection

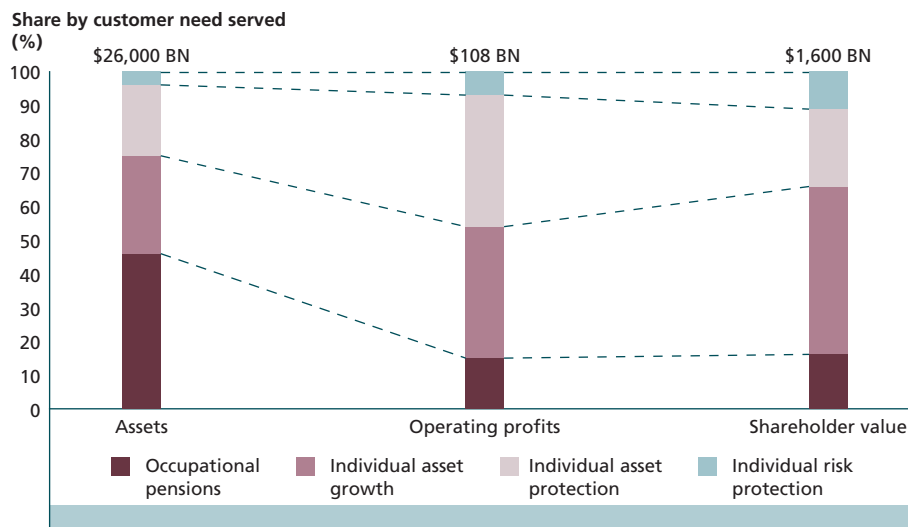
. . . driven by low capital requirement

But life insurers should not focus on asset growth

Does this combination of high value-generation and low capital-consumption imply that insurers should move into the asset growth business? The answer is ‘no’, for several reasons.

Figure 11: Assets, profits, and shareholder value

Note: Shareholder value creation measured as net present value economic profits



Source: Oliver Wyman Analysis

⁵ 1 basis point, or 1bp, is one-hundredth of 1% i.e. 0.01%
⁶ Or equivalently, requires an expensive hedging program

First, the mutual funds business differs more from life insurance than first appears, as insurers who diversified into retail asset management might testify. While non-professional customers have similar demands from both life insurance and mutual funds – relating to brand, distribution relationship and size – mixing life insurance and mutual funds in the same corporate entity often encounters significant practical difficulties. Conflicting objectives, weak performance, confusion between institutional and retail asset management, cost inefficiency and brand over-stretch are just a few examples.

The only practical way to resolve these difficulties is to run the asset manager as an entirely separate entity: separately rewarded, separately branded, and with a separate culture. This may even require that the asset manager not manage the insurer's own assets. To run an asset manager purely as shareholder, not manager, requires the scale and organizational structure of a large financial conglomerate. Even those that have these characteristics are not always effective; the temptation to integrate through apparent operational or distribution economies of scale, or the desire for a group brand, proving too strong to resist.

Second, most of the value in the mutual funds business is created in distribution, whose structure is atomized and heterogeneous. The balance of power is tilting toward independent third-party distributors as markets mature, particularly for asset growth products. This trend is already well underway in the US and UK, where more than 50% of assets under management are distributed via third-parties or an open architecture; it is becoming more widespread in Continental Europe. Moreover, mastering the distribution of asset growth products in mature markets requires a broad product range and some degree of open architecture. The rationale for a life insurer manufacturing (as opposed to distributing) mutual funds in such markets is therefore questionable.

Third, asset management seems a bad fit culturally. Asset manager outperformance in consecutive periods – important to sales – is essentially random, which makes the competitive landscape for mutual funds transitory and cyclical. This cycle accelerates as markets mature and customers become more sophisticated; in the US 97% of net inflows go to funds currently rated in the top third of the fund universe. Asset managers adapt to this volatility both organically and inorganically. *Organically*, by offering many funds with different investment positions, with the inevitable result of making some customers happy and others unhappy. *Inorganically* by a repeated process of consolidation and fragmentation. Neither of these adaptive approaches fits neatly into the corporate culture of most life insurers.

Asset protection is a more attractive opportunity

We would therefore argue that most life insurers should avoid chasing – and most likely losing – the asset growth segment. Instead, they should target the asset protection needs of the customer which most firms will find more attractive and valuable from both supply and demand perspectives.

On the supply side, asset protection is a good fit with the core brand values of life insurers. Customers perceive life insurers as embodying the three differentiating features required for a successful 'long-term financial security' value proposition:

- They provide *insurance*, that is they offer protection, whether against biometric or financial risks
- They offer *financial safety* and security, though not excitement
- They are truly *long-term* in outlook, in contrast to (say) a mutual fund

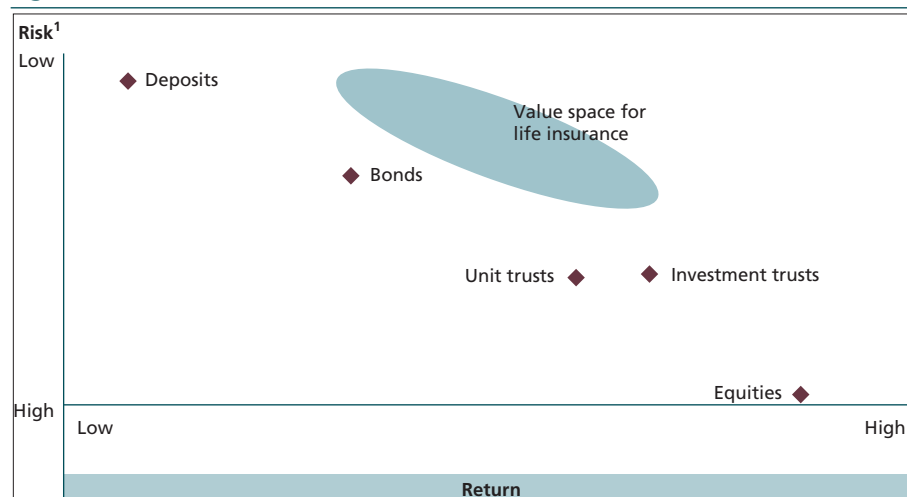
On the demand side, many life insurers have done their best to realign their brand values to make them more ‘exciting’ (usually meaning investment-oriented). But this fails to recognize the strong empirical evidence⁷ that a majority of customers exhibits risk aversion, under almost any market conditions. Thus customers are prepared to sacrifice significant upside to obtain protection against financial downside.

As Figure 12 shows for the UK, life insurers can and do neatly fill the gap between no-risk deposits and high-risk mutual funds or equities. It is interesting to note on Figure 12 that UK life insurance returns have sat some way above the efficient frontier. This is partly a result of the uneven fiscal environment – certainly not a reliable factor in the long-term – but it also indicates failure to charge customers adequately for the risks borne for them. Similar failures occur in many other markets, although there are exceptions that indicate customers’ willingness to pay for asset-protection features ‘if asked’ (for example, some US products and recent structured investment products).

Furthermore, the bear market’s sustained psychological impact on customers has led to increased awareness of asset protection; demand has risen accordingly. This effect has been heightened by the adjustment from the bull-market of the 1990s, which created an unprecedented increase in asset growth inflows (a quarter higher than those into asset protection). In the longer-term, this trend might be reinforced by the ageing population as the so-called ‘sandwich generation’ retires.

The asset protection market may grow much more quickly than expected

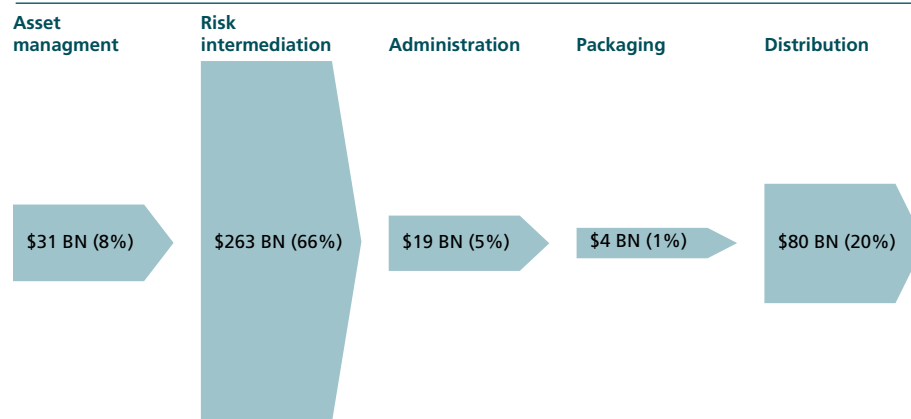
Figure 12: The UK market’s efficient frontier, 1989-99



¹ Risk is represented by the volatility in annual returns
 Source: Datamonitor, UK Savings and Investments 2000, Oliver Wyman Analysis

⁷ See for example Stewart, Chater, and Stott, Risk Aversion and Financial Decisions, 2001

Figure 13: The asset protection value chain



Source: Oliver Wyman

Our base assumption is that asset protection and asset growth will experience similar growth rates in mature markets. However shareholder value is sensitive to even small changes in attitude towards asset protection vs. asset growth. For example, if asset protection captures 20% of the expected increases in asset growth, it will become significantly more valuable (25% in North America and 10% in Europe) while asset growth will lose some of its value (10% in both regions), compared to the base case. When one considers, for example, the significant fall in both European unit-linked premiums and US variable annuities between 2000 and 2003, it is clear that such a scenario is not unrealistic.

Asset protection value-creation is focused on distribution and risk intermediation

Sources of Value in Asset Protection

To understand how life insurers might capture the value offered by asset protection, we considered how value is currently apportioned along the value chain, as shown in Figure 13.

Consider each of the links in the chain in turn:

Distribution value is heterogeneous and hard to capture

- Distribution** offers significant total value, but is so heterogeneous and atomized that it is difficult for insurers to capture this value. Banks, independent agents and brokers are all competing for customers. Can life insurers stop or reverse the loss of the significant value pool represented by distribution and 'ownership' of the customer? We argue that this is possible under some limited circumstances but that it is not a question of buying a distribution network or doggedly continuing to own one. Instead, life insurers must recognize that distribution value is a proxy for what we refer to as *customer capture*, and that there are many ways of 'capturing customers' that do not require insurers to own distribution. We will discuss this further in the next section

- **Packaging**, meaning the assembly of individual asset protection and administration components and wholesale delivery of the resulting 'product' to distributors, is a niche with very limited potential. While packaging can be valuable to some individual regional players (such as Skandia), low barriers to entry mean it risks being commoditized by technology-based 'supermarket' solutions. In Australia, for example, 'wrap' products are possibly the most evolved example of the 'packaging' model, but in practice, they primarily contribute distribution value. Indeed, many wrap providers are in fact simply full-service financial advisers who do not even boast a technology platform
- **Administration** offers significant value for some outsourcing specialists – who might themselves be life insurers. Margins are positive for both onshore and offshore outsourcing markets. The rationale for onshore outsourcing deals is either to remove closed blocks of business or to allow a strategic focus on distribution and product design. In both cases there is less price pressure than might be imagined. Offshore administration is a reasonably high-margin business because staff cost-savings are so great and information technology costs are so low. However, the global growth of outsourcing will be limited by a number of factors, including political and tax-based pressures to 'keep jobs at home', frictional costs and concerns about quality assurance and risk management. Moreover, large players who've already achieved scale stand to gain only minor additional economies by outsourcing anything beyond commodity activities. The overall conclusion is that while outsourcing and third-party administration will grow it will still be a niche, albeit a profitable one
- **Risk intermediation** offers the best opportunity for insurers to capture value – depending on the availability of capital and appropriate skills. The opportunity is mostly at the long-dated end of the product spectrum. For short-term products, risk intermediation ability is less of an advantage since it can be (and is) outsourced to the capital markets by providers without a 'balance-sheet' (e.g. mutual funds)

Risk intermediation
the best opportunity

But for long-term asset protection products, risk intermediation is a critical part of product manufacturing and one in which life insurers have a natural competitive advantage. The capital markets are insufficiently liquid to allow the risks of such products to be hedged comprehensively. Add that to the complexity of offering policyholders various options (such as to surrender before the maturity date), and it becomes clear that risk intermediation, in the context of a value proposition based on long-term financial security, is almost exclusively the preserve of life insurers

The value of risk
intermediation
is dependent on
rational pricing

However, realizing value from risk intermediation depends on the rational pricing of risk to the customer and, as noted above, life insurers have historically done a woeful job of fully pricing the benefits they have provided to customers. It is critical, therefore, that life insurers understand the economics of the products they are offering, and price them accordingly. Of course, new types of providers could also seek to exploit this part of the value chain. For example, hybrid capital markets/reinsurance businesses formed for the sole objective of capturing this value opportunity. However we see the life insurance companies, as incumbents, in prime position – the value is theirs to lose

- Asset management** – In contrast to asset growth products, asset management in the context of asset protection products, is essentially an institutional activity, akin to the business of winning and managing large mandates in the occupational pensions business. It therefore offers extremely low margins. Consequently, life insurers can hope to extract only limited economic value from asset management, even for asset protection products. In asset protection, the decision to outsource asset management depends almost entirely on scale. Sufficiently large insurance groups can already achieve so much scale in the management of their internal assets that they stand to derive few, if any, benefits by outsourcing asset management to third parties (except for certain specialist asset classes)

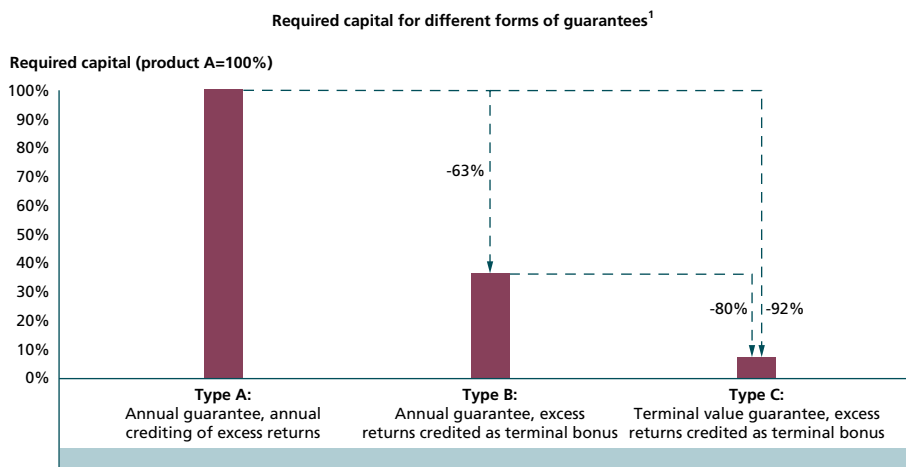
In summary, we argue that life insurers should focus on ‘long-term financial security’; in particular they should concentrate on risk intermediation as the largest and most sustainable source of value. However, as we imply above, one important aspect needs to change – the failure of insurers to properly value, or price for, the protection they are providing to customers.

Pricing for asset protection needs to become more rational

We are optimistic that rational pricing will emerge as standard practice for life insurers over the next few years. One key driver of this transition is the global shortage of capital. Rationality is already blooming in some markets; for example, Italy's Generali has pioneered new guarantee structures that feature significantly lower costs, but which do not appear to weaken the customer proposition. Other Italian insurers have followed Generali's example. Figure 14 shows the impact of changing guarantee structures for a typical European life insurer.

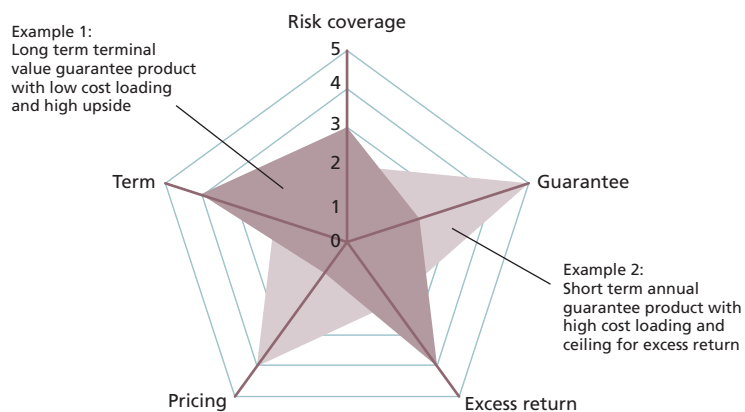
However, restructured guarantees may not be enough. If one compares the economics of a product with almost any guarantee to its economics *without* that guarantee, it is virtually impossible to justify adding the guarantee on sales grounds alone. Unless volumes are extraordinarily sensitive to the level of guarantee, *not* offering the guarantee will always generate more absolute total shareholder value than offering it.

Figure 14: The benefit of changing guarantee structure



¹ Based on a case example for a European life insurer
Source: Oliver Wyman Analysis

Figure 15: Integrated product design



Source: Oliver Wyman Analysis

Transparent and integrated product design is key

Consequently, life insurers need to demonstrate the value of asset-protection to customers through transparent and integrated product design. The winning products of the future will allow customers to see and understand the trade-offs they are being offered between protection and potential returns. Beyond that, the customer should be able to choose the position that best suits them. There are already limited examples of such products, both in the US (where transparently-priced guarantees on variable annuities are fairly common), and (to a lesser extent) in other markets. For example, Prudential UK offers twin with-profit bonds⁸: one promotes higher potential returns at the ‘cost’ of higher volatility; the other promotes higher and less volatile annual crediting rates in the clear expectation of lower overall returns.

There are five aspects of integrated product design that merit particular consideration (as illustrated in Figure 15):

- **Risk coverage:** what biometric risks are protected; what death or living benefits are included?
- **Guarantee:** what type of guarantee is given and how is it structured?
- **Term:** what is the duration of the contract and what degree of flexibility is on offer?
- **Excess return:** how are the funds invested and how are investment returns apportioned between insurer and policyholder?
- **Pricing:** what does the product cost; what charges does the insurer levy?

Understanding how customers value these different components, how such components can be cost-effectively engineered and priced, and how the benefits can best be communicated to customers through the various elements in the marketing mix – channel, advertising, price structure and sales process – is crucial to the successful design of integrated products.

Our view is that this integrated approach to product design – one that clearly demonstrates the value of asset protection – is a critical part of a life insurer’s offensive strategy. It is by developing these tailored and differentiated offerings that life insurers can build on their natural ‘long-term financial security’ brand promise and capture significant shareholder value.

⁸ Single premium investments with smoothed returns

3. Wrest back, and defend, customer capture

We described above how distribution value is aligned with customer capture. Here we further argue that customer capture is essential to all steps in the value chain.

Distribution is a significant component of the value chain. It represents around 27% of the total value-creation opportunity for life insurance, and some 64% of that for mutual funds. The biggest share of this value is, however, captured by the vast number of tied and independent agents, brokers and bank branch employees. It is difficult for life insurers to capture distribution value in such an atomized and heterogeneous environment.

Manufacturing value, not just distribution value, depends on customer capture

Distribution's share of shareholder value-created tends to increase as markets develop. Mature markets are typically served by too many product manufacturers, since the pace of consolidation among product manufacturers often lags the shift towards more independent channels (which do not necessarily need twenty different providers offering similar products to cover the range of customer needs). Thus, the critical point of value-creation depends not on product but customer ownership. Customer capture is a *sine qua non* for life insurers on the offensive – there is simply no way to capture *manufacturing*, as well as distribution value, without it.

Customer capture has two dimensions, both of which are important: direct – 'B2C customer capture' – and via intermediaries who deal with customers – 'B2B customer capture'.

B2C customer capture

In B2C, the customer's buying decision is (more often than might be imagined) materially altered by activities over which the life insurer/product manufacturer can exert control. This can happen in a variety of ways: often, the choice of *product* is driven by the intermediary's advice, but the choice of *provider* is driven by the customer's preference for a particular brand. This brand preference may be developed through a whole range of provider activities – including, but not limited to, marketing, advertising and sponsorship – that serve to strengthen and uniquely position its brand. Other times, the consumer may be responding to direct mail or an advertising campaign from the life insurer and will take the initiative to contact an agent or adviser, who is effectively providing only a product fulfillment role. This is usually only the case for relatively simple products.

We consider that both of these mechanisms constitute B2C customer capture. Together, they suggest that life insurers must take four key actions:

- **Pro-actively deepen customer relationships, maximizing useful interaction:** Market studies show a significant correlation between the intensity and quality of customer relationships and the likelihood of further product sales to those customers. Life insurers therefore need to build strong and direct customer relationships complementary to the customer's relationship with an intermediary. This could be done, for example, through the frequent provision of product information and performance in a convenient format, value-focused rather than cost-driven 'over-delivery' on customer service, or pro-active solicitation of customer feedback

- **Strengthen branding:** Brand awareness and trust correlate with growth in both intermediated and owned sales-force channels. In particular, life insurers who build up a coherent and differentiated consumer brand can generate significant B2C customer capture even for complex products sold through independent agents
- **Embed customer capture in all parts of the business:** All functions have a part to play in achieving B2C customer capture, not just marketing and distribution. For example failures of administration, even if brief and minor, can destroy years of effort expended in building a consumer brand
- **Do not over-stretch the customer proposition:** If B2C customer capture is to be fully effective, the choice of customer segmentation, product and service offerings and channel management all need to be closely aligned. The temptation is to stretch a particular proposition to additional customer segments, additional channels and additional products, in the hope of generating incremental sales growth. But while such activities may appear to add value when considered in isolation, they may in fact damage the overall coherence of the value proposition, and thereby inadvertently damage B2C customer capture by diluting the brand. Activities exposed to this risk need to be clearly demarcated and discipline needs to be maintained when managing each customer proposition

B2C initiatives are essential to building customer capture, but are by their very nature difficult to implement successfully. This is especially true in independent channels, where their success may only become apparent over the very long term.

B2B customer capture

In B2B, in addition to directly targeting the end customer, 'capturing' the agent or financial adviser who intermediates between the supplier and customer is critical. Insurers need to develop strong links with their distributors to ensure sustainability: buying into an intermediary via high commissions does not in itself generate customer capture. In fact, high intermediary commissions are symptomatic of a life insurer that lacks customer capture. Buying an intermediary does not necessarily create value either, as the incremental share of business captured may not be sufficient to offset the price paid and the additional risks incurred through ownership of an intermediary (or a bank, for that matter). There are three actions that life insurers need to take to develop B2B customer capture:

- **Build linkage:** Weaving together activities and processes can lock in distributors to the extent that the cost of changing suppliers becomes larger than the potential value that might be generated. Joint ventures are the most obvious form of linkage, but any irreversible weaving together will work in much the same way. One approach, for example, might be to integrate the intermediary's sales administration systems with the life insurer's back office. Note that this is not simply a question of the insurer taking control of an entire process. Life insurers who provide financial advisers to a distributor such as a small bank, for example, do not necessarily generate linkage, since it remains easy for the distributor to switch to an equally competent supplier

Partner with a distributor that knows about retailing, not just cost-efficiency

- **Drive towards critical mass:** A distributor's top tier partners are in much more stable positions than its tier two or three providers. Hence life insurers should focus on selected relationships with preferred distributors, thus creating long-term partnerships, rather than trying to manage a large number of minor relationships. Note, however, that critical mass alone is not enough: a large and professional distributor who chooses a partner based on the deal economics rather than personal chemistry (which is the dominant factor in relationships between life insurers and small intermediaries), will inevitably cause value to concentrate at the distributor rather than the life insurer, unless other linkages are also in effect
- **Pick a partner who knows about retailing:** The interests of individual financial advisers typically revolve around maximizing the sale of insurance and other financial products to customers and servicing customers' long-term asset growth and protection needs. That may not be the case with other intermediaries, particularly banks. Many retail banks are far more concerned with cost-reduction and branch consolidation, and may also find it difficult to reconcile themselves to the potential cannibalization of deposits. For that reason retail banks often make poor partners for insurance companies: the road to bancassurance is littered with tattered distribution agreements between misty-eyed insurance providers and banks that turned out to be rather less enthusiastic sellers than expected. Pick a partner who knows and cares about *retailing*, not cost-cutting
- **Build a balanced partnership:** While distributors may drive hard to maximize the value of their gatekeeper role, strong life insurers need to keep the idea of a win-win partnership in mind. A weak distribution partner will eventually mean weak distribution. Life insurers must balance short- and long-term economics

Customer capture is possible in every channel but not certain in any

Channel structure is clearly important to understanding distribution value and customer capture. In Box 2, we discuss the distribution lifecycle and its potential implications for life insurers whose markets are in transition from one model to another. However, there is a broader point to consider that does not depend on channel structure: customer capture is *possible* in every channel, but not *certain* in any channel.

In **wholly-owned tied-agent channels** two conditions must be fulfilled. First the agent must be able to capture the customer, for example, through a strong personal relationship. This is often helped if the insurer has established a dominant presence in a relevant 'affinity' group (e.g. the farming community).

Second, the insurer must ensure that the agent is sufficiently bound-in – whether contractually or by the strength of the proposition – or else ensure that the customer perceives the relationship as solely with the insurer, not with both the insurer and the agent.

If neither of these two conditions is met, the agent will have customer capture but not the insurer. That allows the agent to bid up his share of the value created, squeezing out the value captured by the insurer.

In **independent intermediary channels** (IFAs and brokers) customer capture at first glance seems difficult, but several factors may enable some degree of customer capture to take place:

- Some IFA markets, such as the UK and Belgium, are extremely fragmented. In these cases there are few IFAs that are so large that they are indispensable to insurers; thus leading insurers do enjoy a form of customer capture by virtue of their oligopoly position. In these markets, the consolidation of IFAs is clearly a threat to insurer customer capture
- Some insurers, particularly dominant local players, generate significant B2C customer capture even in the IFA market by creating brand-pull from consumer advertising
- Insurers can generate B2B customer capture by virtue of leading-edge product design, IFA service, or relationship management – Aegon in the Netherlands being a good example. This approach is riddled with pitfalls however: many IFA-focused insurers effectively buy share by offering higher commission or more attractive terms, thus transferring value to the intermediaries without strengthening customer relationships

In the **bancassurance channel** customer capture can be achieved by building strong linkages between an insurer and the bank, as described above. Such linkages are essential for customer capture: it is difficult to envisage a sustainable and successful model without them. The obvious vehicle for building these links is a joint venture arrangement whereby the insurer and bank establish a jointly-owned shell company to service the bank's customers (for example Aviva's ventures with the Cajas in Spain).

However, customer capture is not certain even given such an arrangement. The insurer's products compete against all the other products offered by the bank; and this competition is often biased against the insurer because its products are seen as more complex or difficult to sell, or simply because retail managers do not consider selling life insurance to be among their highest strategic priorities in serving the customer.

Customer capture in bancassurance therefore depends on securing the understanding (of both the product and the economic opportunity) and interest of retail bank staff, from senior management who set the overall priorities for the retail network to the tellers who can generate the leads.

Bancassurance is the dominant model in some countries, for example France, Spain, and to a lesser extent Italy. However the success of bancassurance in these countries is driven more by banks responding to the fiscal or regulatory environment (and effectively choosing to allocate the assets of their customers into one sort of vehicle rather than another) than by insurers achieving customer capture.

The value impact of successful customer capture

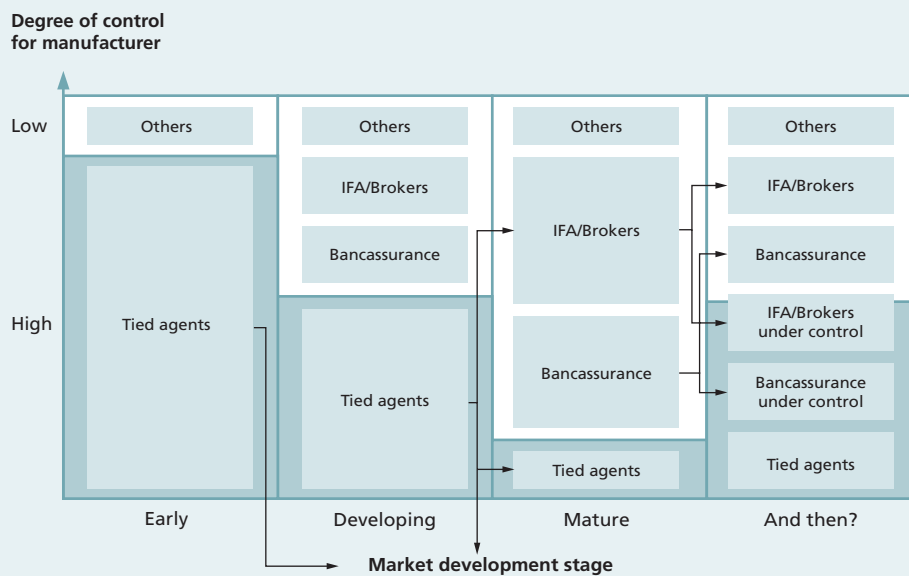
Successful customer capture has a significant impact. For example, our analysis of the tied-agent channel suggests that a life insurer with customer capture is more than three times as profitable than one without such capture, all other things being equal. One of the best examples of customer capture in the tied agent channel is the 'Freedom 55' strategy of London Life, Great West Life Insurance's Canadian subsidiary. 'Freedom 55' has become a strong brand representing a tailored product offering with a distinct financial planning-driven distribution approach that creates 'pull' from customers.

Box 2: The distribution life-cycle

Figure 16: The distribution life-cycle

The distribution life-cycle can be divided into four stages:

Share of various distribution channels by market development stage



- **Early** – early stage markets are dominated by large-scale organizations of tied agents: China Life, for example, has 650,000 agents. While these distribution organizations are relatively unprofessional and unproductive, they are firmly under the life insurer's control and defections to rival insurers are rare
- **Developing** – as markets develop, the tied agent model professionalizes, typically involving a shake-out amongst the existing agent force. New channels emerge, such as independent agents focusing on up-market segments and banks looking to retain customer assets. Both of these developments weaken life insurers' control of distribution. Tied agents become more mobile and self-aware, while new channels force life insurers to rethink their business models.

- **Mature** – as markets mature, the trend towards independent or bank distributors accelerates. This trend is enforced by customers, agents and insurers alike. The growing affluent customer segments demand independent professional advice and tend towards the kind of services provided by IFAs. Tied agents are left with the less attractive mass market, and so come under further pressure. The gradual retreat of tied agents, and thus their loss of local visibility, provides an opening for bancassurance models offering easily accessible low-cost financial advice under major brands. The result is further decline of the tied agent channel, sometimes precipitous in nature. The exact split between independent and bank distribution is hard to predict: it depends on numerous factors including regulation, wealth inequality, cultural conditions, fiscal policy and timing.
- **And then?** – In super-mature markets, the major threat to life insurers is the loss of control over distribution. They become more dependent on independent distribution networks and are excluded from much of the value created by distribution. However, in some markets such as the Netherlands, life insurers on the offensive have focused on regaining control of distribution by entering into bancassurance joint ventures, purchasing IFAs or establishing their own networks of financial advisers which allocate some shelf-space to competitors' products (typically in return for their own products getting shelf-space in their competitors' networks).

Life insurers can learn valuable lessons from better understanding three golden principles:

- First, distribution value is driven by customer capture, hence the ability to control the customer's buying decision
- Second, except for early stage markets, distribution value is highly fragmented with the major share taken by the single gatekeeper, being tied agents, IFAs, brokers or banks
- Third, customer capture in distribution offers strategic control that has significant impact on the ability to create value along the other functions of the value chain

The value impact in other channels is more difficult to quantify, but there are obvious examples of success built on customer capture, including the following:

- **Norwich Union (Aviva) in the UK IFA market:** Norwich Union invested heavily and consistently in building an extremely strong consumer brand. This brand now gives them significant B2C customer capture. Norwich Union also works hard at building B2B customer capture in the IFA market through a strong partnership ethos. These efforts have helped Norwich Union to become the UK's best performing life insurer by a considerable margin
- **CNP in the French bancassurance market:** CNP has become the largest life insurer in the French market by focusing on major long-term distribution relationships, primarily with the national network of post offices (La Poste) and the retail banking network of Caisse d'Épargne. Between them, these two partnerships account for almost 80% of CNP's total new business production

4. Forget grand designs – focus on the detail

Life insurers with operations in more than one country are typically organized on a regional basis (e.g. Americas, Asia etc.). While this makes logistical sense, it may cause life insurers to miss out on some opportunities. For regional characteristics mask some important heterogeneity within regions as we see in Box 3 below.

A tailored strategy is 3 times as valuable as a broad regional one

Our analysis shows that the kind of broad regional strategy adopted by most multinational insurers dilutes value significantly; a granular and tailored strategy is likely to generate at least three times as much value. Put another way, the opportunities are specific to local markets and are not characteristic of a region.

An alternative global market characterization: big, fast, rich

We propose a different characterization of global markets, which identifies three more useful categories for further exploration: 'big', 'fast' and 'small but rich'.

- **The big** are the largest markets for personal financial assets (PFA) in general and life insurance in particular. The three largest markets, those of the US, Japan and the UK, account for 53% of PFA and 60% of life insurance assets. These three markets also account for 44% of expected absolute growth in PFA. The next three largest countries (in terms of absolute size) are Germany, China and France.

Big markets offer the possibility of niches large enough to sustain companies by themselves. These niches create room for new entrants with suitably focused strategies, and for incumbents to develop new, focused approaches to the market. Even China, though still a developing market, is in reality two markets: coastal regions/large cities, where GDP per capita and insurance penetration is on par with countries such as Malaysia and Thailand, and the inland and rural regions, where GDP per capita is closer to that of many African countries.

Box 3: Regional characteristics and heterogeneity

Regional Characteristics

North America accounts for about 42% of our \$1,600 billion shareholder value target.

Life insurers suffer, however, from their declining share of US personal financial assets – which has dropped from 11% in 1991 to 8% in 2003 – and from a rather weak position in the long-term savings market.

Some market niches are expected to grow significantly, such as post-retirement products and living benefits.

Europe accounts for about 38% of our \$1,600 billion shareholder value target. Life insurers enjoy strong positions in the long-term savings market, in many countries driven by a guarantee-based value proposition and supported by favorable tax incentives.

However, pressure is now coming to bear on this value proposition, due both to a stricter focus on solvency and capital constraints, and 'leveling of the playing field' through more harmonized regulation and taxation of financial services.

Japan typically is regarded as a region in itself. Its life insurance market accounts for 12% of global shareholder value potential due to its current size, but growth prospects are limited.

Asia accounts for just 5% of total global shareholder value potential despite some significant relative growth numbers and population. Most markets are extremely small, but offer major potential for future development.

Heterogeneity Within The Region

Only the US market is large enough to contain niches that individually can support dedicated insurers. AFLAC is one classic example of such a 'category killer'. The existence of these niches makes the US an attractive investment destination, though caution is advisable.

Although the same niches are attractive in Canada, they are too small to support dedicated insurers. Consequently, Canadian regional insurers have to be broad players, and Canada is not an attractive opportunity for global insurers.

Individual European markets vary considerably in their development. Countries such as Turkey host almost no life insurance market whatsoever; many other national markets are transforming and maturing; and some, such as the British market, are already super-mature.

There are also different opportunities even when markets are developmentally similar. Each country has its own tax and regulatory regimes, channel structures, products, asset allocation, wealth, and wealth inequalities. All of these play important parts in affecting investment decisions.

Japan has some large and profitable niches, for example the cancer insurance market which is dominated by AFLAC by virtue of innovative product design and workplace distribution. Financial reform, such as bancassurance deregulation and the creation of a DC market, is opening up some further opportunities for foreign entrants, such as US 401(k) specialists in the case of DC.

There is huge heterogeneity between markets. For example:

- Mega-developers (such as China)
- Large and almost developed (South Korea)
- Rich developing (Singapore)
- 'Super-growth' (Indonesia)
- 'Not in my lifetime' (Nepal)

- **The fast** are some countries, scattered around the globe, that are experiencing explosive growth in personal financial assets and life insurance. These include Turkey, India, Poland, Indonesia, China and Russia, all of which are expected to achieve annual growth of more than 12% over the next decade. Value in these countries is not just driven by growth in per-capita GDP and population; it also arises from the movement of personal financial assets out of cash and other liquid instruments into more sophisticated savings products, including life and pensions.

Some fast markets (India and China) are on everyone’s list. Others tend to be ‘regionalized’ (Indonesia, often considered erroneously as little more than a clone of Malaysia), or ignored altogether (Turkey, some former Soviet republics). Early entrants to these neglected fast markets may obtain huge first-mover advantage (as they did in Poland slightly more than a decade ago, for example).

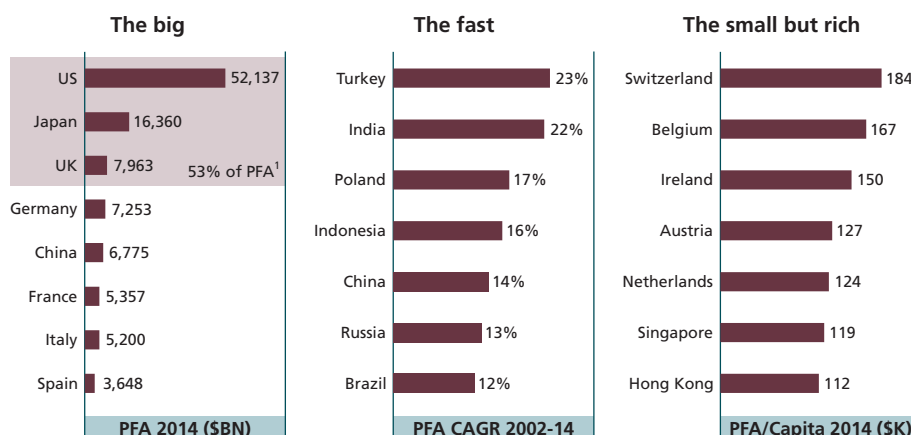
- **The small but rich** are a handful of countries in Western Europe (Switzerland, Belgium, Ireland, Austria and the Netherlands), as well as Hong Kong and Singapore, that are small in market size but potentially attractive because per-capita personal financial assets are likely to exceed \$100K over the next decade. These markets are valuable but also challenging. Their entrenched distribution makes it hard for newcomers to enter with a broad proposition; but their small size limits the value of highly focused offerings.

The membership of these categories is given in Figure 17.

Pensions reform:
a fourth attractive
category?

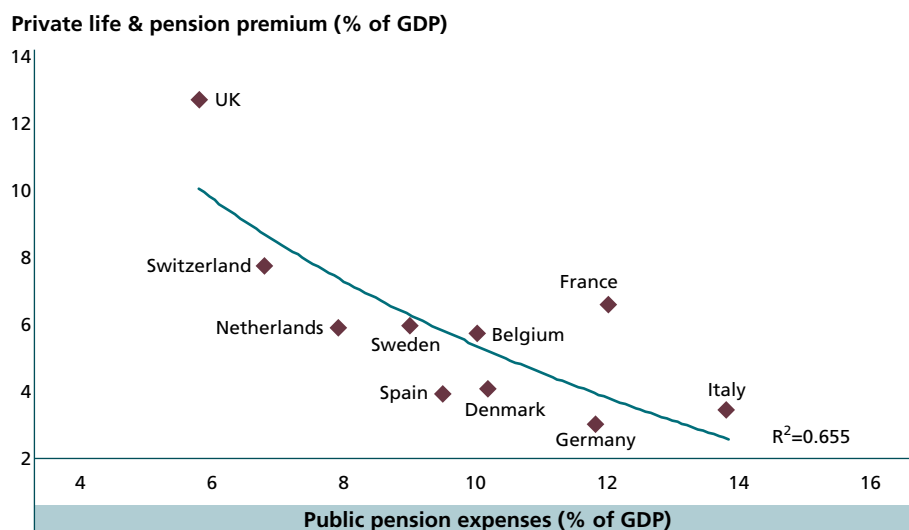
There is arguably a fourth category of attractive countries: those whose pension systems are expected to make public-to-private transformations that would accelerate growth in life insurance. The most obvious candidates are in Continental Europe (Germany, France and Italy); but there are many other examples worldwide, including Korea, Japan, and Brazil. Since there is a strong correlation between high public pension expenses and low private retirement savings (Figure 18), a shift from public pay-as-you-go schemes to private retirement savings would boost the expected annual growth of life insurance assets from approximately 2.8% to as much as 5% over the next decade.

Figure 17: Attractive geographic market categories



Source: Oliver Wyman analysis

Figure 18: Public pension expenses and private life and pension premiums in Europe



Source: Oliver Wyman Analysis

While this transformation is likely to generate significant growth, it is not yet clear if it will generate value for life insurers, or just volume. The lessons learned from previous pension reforms in various countries suggest caution is advisable:

- ‘Privatized’ pension products are often so over-regulated and restricted that they do not actually generate value for insurers. UK ‘stakeholder pensions’, for example, suffer from a Government-imposed maximum management fee of 1% per annum, which only permits reasonable profitability in a few niche direct-offer channels. German ‘Riester’ products are complex and feature severely-restricted agent commissions; they have sold in quantities well below expectations
- Even when privatized products do create value, life insurers have historically failed to take advantage and secure their share of the market – as in the cases of Australian Superannuation and US 401(k) pension schemes. We do not dismiss the idea that insurers can benefit from pension reform altogether; we merely suggest that a careful, granular, and sober assessment of the true value opportunity is in order

The need for a more granular and tailored approach

The common theme in all these opportunities is the need for a more granular and tailored approach:

- The big markets’ size, maturity and heterogeneity demand a highly granular approach which focuses on specific segments and niches within each market. To get an idea of the granularity required, one such niche might be the living benefits market for mass-affluent baby boomers in the US; another might be the emerging market for financial advice in Chinese coastal cities – indeed foreign insurers in China have already gained close to a 10% market share in those regions where they have licenses

- Fast markets require a two-step granular approach: insurers must first identify a successful entrance opportunity and then identify ways to generate sustainable value. The first step is to select the correct country, based on market entry opportunities and internal strengths. The second step is to narrow the focus to specific segments within these markets, such as the growing middle class in countries like India, or to specific fast-growing channels. A 'me-too' strategy – simply copying incumbents – is unlikely to offer sustainable value-creation
- The small but rich markets offer limited growth prospects. A tailored approach is therefore necessary to identify underserved customer needs and the best points of market entry to gain a sustainable and profitable share of personal financial assets. For example, one target might be the underserved yet still attractive 'second-tier' customers – who do not receive the best quality service and advice from incumbents, whether banks, asset managers or other insurers

While the 'big', 'fast', 'small but rich' characterization is significantly better than a purely geographical perspective, it does not in itself offer enough detail. As the examples above illustrate, neither the individual markets in each group, nor the customer/product/channel segments within these markets, are homogeneous.

Life insurers on the offensive need to understand where and how they can create value – both within their own markets, and within any market they might consider entering. Life insurers on the offensive should forget about making grand designs on geographical regions; they should instead look for the country-specific opportunities, and then develop (even more specific) strategies within each country.



4.

Business models and market impact

The global life insurance industry will be very different a decade from now. Life insurers going on the offensive will significantly alter the competitive dynamics of the market – and not just those of the life insurance market, but of asset-gathering in general.

What kind of impact are they likely to make? To answer this question, we need to distinguish between the five general business models that participants in the global life insurance market have begun to adopt⁹:

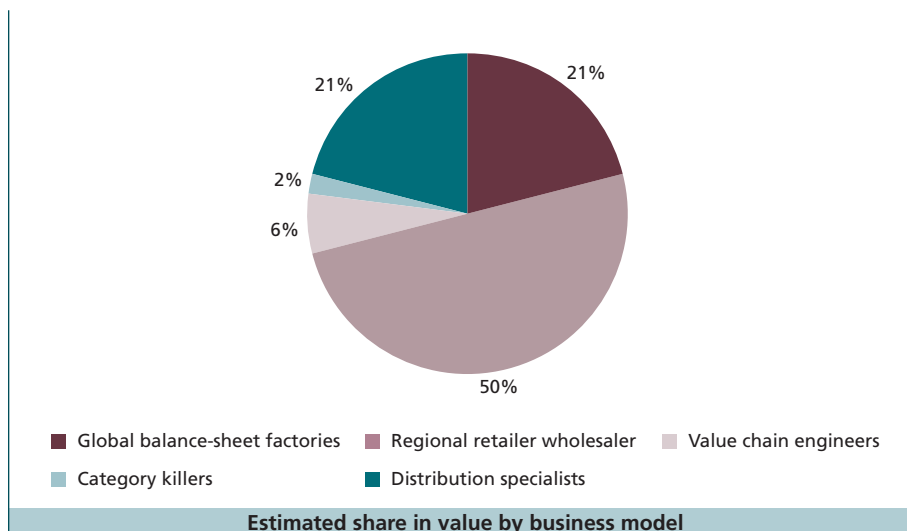
The 5 broad business models of life insurance

- **Global balance-sheet factories:** global market leaders with the capital and skills to manufacture capital-intensive products, and the brand, scale and distribution reach to take those products to market
- **Regional retailer-wholesalers:** life insurers who operate strong franchises in no more than a few local markets
- **Category killers:** specialist product manufacturers; the product set involved is typically capital-lite but underwriting-heavy (or other specialist skill-heavy)
- **Value-chain engineers:** companies that focus on specific parts of the value chain, e.g. third-party administrators, asset managers, packagers and technology providers
- **Distribution specialists:** Pure independent distributors, as well as insurers whose core business is a strong but small distribution franchise

Figure 19 shows how the global life industry today divides up into protagonists of these five models. Note that we are not suggesting that every life insurer maps to exactly one of these models; many operate a combination of several business models more or less intertwined.

⁹ These are described in more detail in the Oliver Wyman report “Life at the end of the tunnel? The capital crisis in the European life sector” (February 2004)

Figure 19: Today's life insurance industry landscape



Note: Shareholder value creation measured as net present value of economic profits
 Source: Oliver Wyman Analysis

There will be winners and losers in every model

There will inevitably be winners and losers in all business models, but life insurers who persist in stubbornly playing defense will surely be amongst the losers *regardless* of their business model.

To understand the future of life insurance, the more important question for life insurers to answer is not: *Will they go on the offensive*, but *To what extent can they*, given the business model they find themselves in? Our analysis shows that the future prospects of the business models will differ greatly.

Global balance-sheet factories

Global balance sheet factories are the powerhouses of the global life insurance market

Global balance-sheet factories are the powerhouses of the global life insurance market. Over little more than a decade these major players have emerged from their regional bases to become names that everybody knows and forces that seem to dominate the global industry.

And yet the reality does not quite live up to the perception. There are only somewhere between 6 and 12 global balance-sheet factories in the world today; the exact number depends on the precise definition used (and of course any definition is essentially arbitrary). Figure 20 shows one such definition.

Perhaps more interesting than those who are 'in', is to consider those who might aspire to be in this category (the "aspirants"). These include some North American players that have the scale and strength to challenge the top-tier incumbents, particularly when playing on newly-emergent turf. Similarly, the future growth opportunities of a handful of Japanese giants will lie outside their big, but stagnating, home market, as long as they can harness the necessary capital strength and management depth.

Figure 20: Today's life insurance industry landscape

Criteria for global balance sheet factories	Companies	Size	Financial strength	Global reach	
Size: ■ Life Gross Premiums written above \$10BN	Aegon N.V.	✓	✓	✓	
	Prudential Financial	✓	✓	✓	
	Allianz Group	✓	✓	✓	
	AI Group	✓	✓	✓	
	Prudential PLC	✓	✓	✓	
	ING Group	✓	✓	✓	
	AXA	✓	✓	✓	
	Generali Group	✓	✓	✗	
	Aviva	✓	✓	✗	
	Mass Mutual Life	✓	✓	✗	
Capital strength: ■ Minimum A Rating	Met Life	✓	✓	✗	
	Manulife	✓	✓	✗	
	Nippon Life Insurance	✓	✓	✗	
	Sun Life Financial	✗	✓	✓	
	Zürich Financial Services	✗	✓	✗	
	New York Life Insurance	✗	✓	✗	
	Global reach: ■ Presence in >10 countries ■ Presence in North America, Europe and Asia ■ >25% of premiums written outside home region				

Source: Company data, Oliver Wyman

On to the offensive, today

Global balance-sheet factories can and should go on the offensive today. They have the presence, the capital, and the opportunity to meet all of our strategic imperatives:

- They have the brand strength, scale and reach needed to achieve deep penetration of personal financial assets with a broad product offering covering different savings needs
- They have the capital strength and the risk and capital management expertise to create a strong 'long-term financial security' value proposition, for which they already have the right brand values
- They have the power to capture customers in core markets. They can use their already-known brand to promote a differentiated value proposition to consumers, leading to 'B2C' customer capture, and have the strength and resources needed to create 'B2B' customer capture through large-scale, unbreakable, links with key distribution partners
- They have the resources (and can build the experience) to exploit the many granular growth opportunities in different countries. In particular, we believe that global leverage is not only a question of capital management, though this is important, but also of multiplying and leveraging experience across similar, but singular, markets

Managing a strategic portfolio of businesses

Since global balance-sheet factories play across many markets they are also well placed to benefit from an additional opportunity: the ability to manage their global operations as a strategic portfolio. This implies finding the appropriate mix of growing businesses (which require investment, but enhance share price), mature businesses (which generate the cash flows needed for investment) and declining businesses (which free up allocated capital).

Getting that mix right can provide a major additional source of value creation for global balance-sheet factories. But managing such a varied global business portfolio is also their major challenge. Even assuming global reach, each local business must ultimately be independently successful; a collection of second-tier businesses is unlikely to remain a global balance-sheet factory for long unless it improves its position in core markets. Global balance-sheet factories can choose from several possible strategic options when responding to this challenge, as detailed in Box 4.

Given global balance-sheet factories' natural advantages in adopting the offensive agenda, they are likely to achieve superior growth and value-creation compared with other groups of life insurers. While limited in number, they will dominate the market for capital-intensive products, leverage their global reach to identify and exploit dispersed (and well-hidden) growth opportunities and gain market and value share, particularly at the expense of weaker regional retailer-wholesalers. Accordingly, we expect these global titans as a group to increase their share of total value-creation from its current 20% to around 30-35%.

Success is achievable, but not automatic – the competitive temperature is set to rise

However, not all global balance-sheet factories will be successful. Competitive advantage from an offensive agenda is achievable but not automatic. Moreover, competition among these global balance-sheet factories will accelerate; we anticipate a first round of shakeouts within the decade covered in this report as unsuccessful 'pretenders' retrench to their regional roots.

In contrast, those aspirants which seize the offensive face a much rosier future once in the club than they would while waiting outside it. They will raise the competitive temperature as they fill in the gaps in their offerings and skills and go on the offensive, especially if they make a virtue of their late entry to the global market by cherry-picking the most attractive niches in large emerging markets. Incumbents who stay on the defensive will find this heat uncomfortable indeed.

Regional retailer-wholesalers

Regional retailer-wholesalers dominate the market through sheer force of numbers

The multi-local character of the global life insurance business means that regional retailer-wholesalers still dominate most markets today. We estimate that they account for 50% of total current value-creation, although this share is thinly spread amongst many insurers.

Consolidation is spreading

However, the regional retailer-wholesaler model has come under significant pressure in several markets, with weaker insurers in particular losing ground as part of a 'flight-to-quality'. For example, in Switzerland and the Netherlands the top-ten life insurers hold more than 80% market share; the market share of the top-ten life insurers in the UK and Spain has risen from 30 to 60% over the past six years. This polarization has not yet happened in other markets, such as the US and Germany (highlighted in Box 5), where the market shares of the top 10 remain in the low 40%-range. In both markets there are good reasons why consolidation has been slow – simple market size in the US, public policy and channel-structure in Germany – but it is now firmly on the horizon in both markets.

Box 4: Strategic options for global balance-sheet factories

If a global balance-sheet factory has (or can build) . . .	Then it could act as a . . .
<ul style="list-style-type: none"> ■ Broad expertise and a product offering beyond life insurance ■ Capital strength ■ Financial planning capabilities or access 	<p>'Global Asset Gatherer'</p> <ul style="list-style-type: none"> ■ Step-wise expansion of product offering ■ Focused on penetrating personal financial assets in each market rather than adding regional markets
<ul style="list-style-type: none"> ■ A narrow competitive positioning in respect of customer needs, products or channel ■ Flexible, global organization ■ Capital strength 	<p>'Multi Market Manager'</p> <ul style="list-style-type: none"> ■ Creating a 'standardized' competitive strategy to be replicated across similar regional markets ■ Focusing on one segment or model across several regional markets instead of broadening activities within one region
<ul style="list-style-type: none"> ■ Fungible resources and capital for forceful market entry ■ A strong, global brand ■ Flexible, global organization 	<p>'Emerging Markets Explorer'</p> <ul style="list-style-type: none"> ■ Identifying, entering and penetrating attractive emerging markets ■ Achieving a leadership position in each market
<ul style="list-style-type: none"> ■ In-depth expertise of pension systems, reforms and products ■ Low-cost structure and scale 	<p>'Pension Reform Specialist'</p> <ul style="list-style-type: none"> ■ Assessing, entering and exploiting privatized pension markets ■ Actively encouraging pension reform with global governments ■ Maintaining profitability in a high volume, low margin environment
<ul style="list-style-type: none"> ■ A broad portfolio of de-centralized and heterogeneous businesses ■ Capital strength and scale 	<p>'Strategic Portfolio Manager'</p> <ul style="list-style-type: none"> ■ Managing a portfolio of stand-alone strategic investments with little integration ■ Balancing cash flows and investments ■ Centralizing core portfolio-control areas such as capital management

Despite its current prevalence, the future is bleak for the regional retailer-wholesaler model. These firms will come under increasing pressure from global balance-sheet factories, and will suffer as their markets mature and their hold over distribution weakens. This is not necessarily bad news for all firms, though. In most large markets there will remain a small number of regional retailer-wholesalers who will not only defend what they already have, but will also take the offensive against peers in both local and new markets.

If you can, go global. . .

In short, the stronger regional retailer-wholesalers need to develop a long-term roadmap to becoming a global balance-sheet factory. This is not impossible – indeed, most existing global balance-sheet factories used to be regional retailer-wholesalers – but it is difficult, and becoming increasingly more so, to make this transition. However, regional retailer-wholesalers who don't make the global leap forward will find it increasingly difficult to maintain growth in their regional and local markets:

- Only true regional market leaders have the credibility and ability to compete for personal financial assets broadly. As customers become more sophisticated, weaker regional retailer-wholesalers will increasingly be seen as providers of niche products (such as tax-advantaged life insurance savings – a high-risk strategy on which to base your new business franchise), or, worse, as a down-market option
- Regional retailer-wholesalers have limited capital and resources with which to create a compelling 'long-term financial security' value proposition. Some more developed markets have seen a marked shift by second-tier regional players into pure asset-growth products; this has been unsuccessful almost without exception
- They do not have the resources or expertise to exploit diverse growth opportunities. Some build-out may be possible for the stronger players, and could be one route to going global. Even this is out of reach for other firms; they face a domestic straitjacket on their home turf

. . .if you can't, aggressively defend the domestic franchise

As well as planning an offensive strategy, regional retailer-wholesalers must also be prepared to defend their local market position aggressively. Weaker regional retailer-wholesalers will have no choice, since they will not have the resources or capabilities to go global. The feasibility of an aggressive defense will depend on the degree to which such insurers are able to maintain and reinforce customer capture in the face of increasingly-sophisticated market demand.

The impending death of the tied agent is exaggerated . . .

Since the core strength and value driver of regional retailer-wholesalers is, and always has been, customer capture, this strategy is certainly sustainable in the near-term, particularly in markets which are still reliant on tied agents (barring external factors such as regulatory change). One market-structure implication is that the optimal channel-mix in these markets is likely to remain stable for longer than some predictions suggest. Reports of the impending death of the tied agent channel are exaggerated, especially if such regional retailer-wholesalers invest (heavily, but selectively) in upgrading the quality and professionalism of tied-agent networks towards a more advice-oriented offering, lock in successful agents through differentiated support and long-term contracts, and are disciplined in aligning their sales-forces, products, and marketing with a specific customer segment and need.

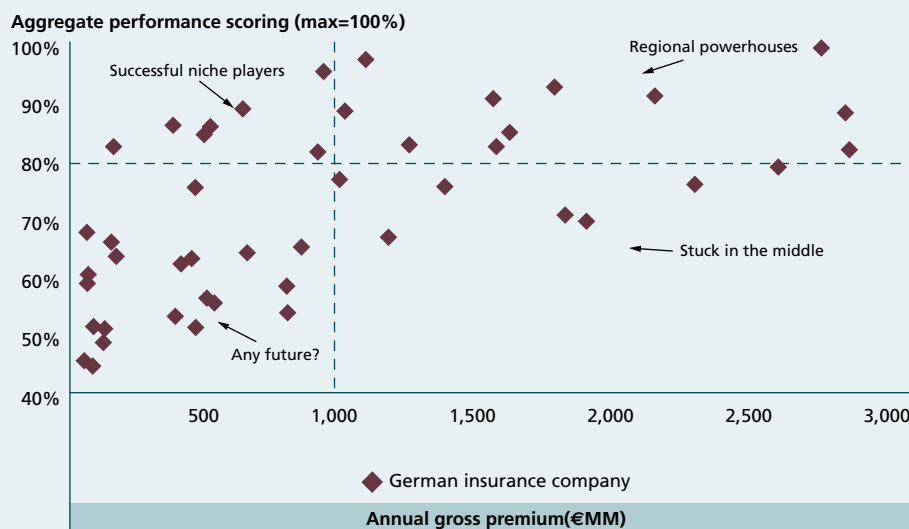
Box 5: Germany's many regional retailer-wholesalers

Most German life insurers are composites focusing on both life and non-life insurance, distributed through large tied-agent sales-forces. The 'flight to quality' has not yet led to consolidation; the top-ten life insurers only account for around 40% of total market share. As a consequence, the market is dominated by around 50 medium-sized regional retailer-wholesalers, each with typical annual gross premiums between \$0.5 and \$3 billion, often evenly distributed between life and non-life.

To understand how these companies could react to the pressure they feel from aggressive global balance-sheet factories, we have benchmarked the strengths and weaknesses for each along four dimensions: capital strength (including risk mitigation buffers), life insurance growth, operational effectiveness and current life insurance market share. Below we present this benchmarking, compared with total gross premium.

Figure 21: Size and performance of German regional retailer-wholesalers

Source: Oliver Wyman Analysis, Data from 2002



Of the analyzed companies, less than a quarter have the potential to become a regional powerhouse or eventually go global. Not all will succeed: to become a global balance-sheet factory they will have to take share both from each other and from their counterparts in other markets. A further seven have strong local positioning but not scale: these have the potential to be high-value specialized companies – whether category killer, value-chain engineer or distribution specialist.

Most worryingly, the remainder, about two thirds of the total, do not yet have what it will take to succeed in any future business model. These companies need to take drastic action right now to move into a more attractive position, or consolidate with a stronger partner.

Thus the German market presents an excellent example of the polarization of regional retailer-wholesalers. The regional retailer-wholesaler model is in decline, but some of those who currently operate it will go on to make successful transitions to other models.

However, defense for the sake of defense will eventually be doomed to failure. Instead, defense should be used only to buy time in which the firm can make the transition to another business model. For stronger regional retailer-wholesalers, defense buys time to build the global model. For weaker ones, it buys time to find another alternative. Indeed, the aggressive defense strategy described above for a tied agent network is one example of the early stages of a truly sustainable strategy – specialization.

... but weaker regional retailer-wholesalers need to plan their transition to another model

The final three business models – category killers, value-chain engineers, and distribution specialists – are all potential homes for former regional retailer-wholesalers. For example, they could decide to manufacture only capital-lite products, outsourcing capital-intensive products and asset management to global players. This approach acknowledges that their value-added is in their distribution franchise and thus is one step along the road to becoming a distribution specialist. Finding the appropriate future model and making the transition to that model is one of the key challenges facing regional retailer-wholesalers today.

In summary, then, regional retailer-wholesalers will see their total share of global value-creation decline from 50% to around 30%. Moreover, this value will be concentrated in a few regional giants rather than liberally spread amongst several hundred insurers globally, as it is now. Even these regional giants can not remain that way for ever: they need to use their local market strength as a platform from which to build out.

Category killers

Category killers are limited by the size and availability of suitable niches

Category killers are a very small part of today's global industry. Their number and size is restricted by the fact that most exploitable niches are relatively small, at least in comparison to the global marketplace. There are some large and successful exceptions, exemplified by companies like AFLAC and UNUM, who focus on niches with high barriers to entry, in several very large markets, as opposed to looking for cross-border synergies. We see some potential for this kind of model to expand as other insurers exit spaces that can only ever be a distraction for them.

Mostly, however, category killers will be ex-regional retailer-wholesalers who have been forced downwards in size. For these insurers, the question is whether there is a genuine niche they can exploit, and whether they will have the courage to make the significant changes needed to succeed as a category killer.

Of course, the nature of category killers is that they form a heterogeneous group of businesses and there will therefore be a broad range of specific strategies within this business model, depending on the size and nature of the niche exploited. However there are nonetheless key success factors that are common to all category killers, and apply irrespective of the specific niche or strategy targeted:

- What true level of differentiation can they produce?
- What barriers to entry can they can exploit or build?
- How can they capture both their distribution partners and their end customers?

Comparing these key success factors with the offensive agenda demonstrates just how difficult it is to be a successful category killer in life insurance:

- Category killers need to manage and optimize the trade-off between, on the one hand, getting caught in a niche which features high barriers to entry but which is too small, and on the other, losing differentiation by adopting a position in large segments where category-killing may simply be impossible. In particular, the paucity of category-killing opportunities in the broader personal financial assets space significantly restricts the value of the business model
- Unless category killers can fill niches within the general 'long-term financial security' value proposition they will have to reinvent themselves completely, to the extent that they no longer retain the structure and brand character of a life insurer
- Category killers need customer capture just as much as any other life insurer. In this case, it is driven first by product strength, and second by focus, leading to strong brand-product connection. Both of these require obsessive narrowing-down of the overall offering – it is not possible to be a category killer alongside a broader business model
- Because each niche is small, category killers must either focus on big markets (for example AFLAC in the US and Japan), or find niches that offer genuine scale benefits across markets. We are skeptical that this latter approach offers much genuine opportunity; and of course there are not many really big markets

Category killers need to narrow-down on, and obsessively focus on, their niche

In summary, we see category killing as a growing market sub-sector, and as an interesting strategic avenue to consider for those insurers whose current model is under threat. But given these constraints, we do not see it becoming a huge feature of the future industry landscape.

Value-chain engineers

Despite the publicity some large deals have recently garnered, outsourcing and partnering with functional specialists is still relatively uncommon in life insurance compared with other industries. To date, the various specialists in third-party administration, IT and asset management capture less than 10% of overall value creation in life insurance; the bulk of this is in asset management.

Value-chain engineering's time has come

This is partly due to the fact that some of the major areas of value creation, such as risk intermediation, cannot really be outsourced to specialists. Others, such as distribution, are large and specialized enough to warrant their own business model. However, it is also because value-chain engineering is an idea whose time has only just come. There are two reasons for this.

First, the key technological enablers (telecommunications in particular) are now in place – in particular offshore outsourcing (or ‘offshoring’, where no external party is involved) has become feasible. Second, the demand from life insurers for outsourcing partners, and the attempt by some to become outsourcing partners themselves, has increased, significantly so in the case of some markets and some activities.

Value-chain engineering will be an important area for life insurers to consider as they try to move on to the offensive. For example, consider a weak regional retailer-wholesaler that has no realistic prospect of becoming global, and therefore has no option but to change or die. Such an insurer may realize that it creates value only through distribution, and thus begin to outsource non-core activities. On the other hand it may decide (as the UK’s Britannic did) that it has no distribution franchise, and as a result close to new business in order to become a specialist owner and administrator of closed books, focused on exploiting synergies in capital, IT and administration.

The makings of a successful value-chain engineer

The key success factors for value-chain engineers are almost as diverse as the functions along the chain. However, the offensive agenda is just as relevant and important for them as it is for the other life insurance models.

Value-chain engineers also need to be on the offensive themselves

First and foremost, value-chain engineers not only need to go on the offensive themselves, but they also need to understand the reactions of their partners – life insurers – to the agenda. This has several implications.

- Value-chain engineers need to understand the potential size and growth of the element of the chain they are trying to engineer. A focus on the personal financial asset-gathering value chain offers much more potential than one focused more narrowly on life insurance or risk protection
- Similarly, within personal financial asset-gathering, their most successful customers will be focused on the core ‘long-term financial security’ space. For example, this has important implications for third-party asset managers who must decide how much to invest in creating ‘high-alpha’ capabilities
- Finally, where it is important for the value-chain engineer that the partner’s business grows (as is clearly the case in asset management, for example), the value-chain engineer needs to understand how much customer capture the partner has, and what its prospects are in the various markets and niches where it is active

Second, value-chain engineers, too, need to focus on B2B customer capture. Sometimes customer capture is easy once the deal is done: back-office outsourcing is so complex that once completed, a deal is likely to be virtually permanent. Other activities, such front-office administration, are much easier to replicate and will therefore suffer much more price pressure.

Finally, value-chain engineers suffer from market granularity just as life insurers do, with the possible exception of those working in asset management¹⁰. Thus they need to focus on large markets or on replicable activities that offer genuine economies of scale, just as category killers do. Here, however, we are more optimistic about their chances of success: while scale economies may be 'illusory', there are clearly benefits from moving activities to low-cost territories, and these benefits do not rely on integration synergies. Beyond IT and front- and back-office administration, we see significant potential for other support areas such as finance and actuarial to be moved to low-cost territories.

The future's bright

In summary then, value-chain engineering's star is set to rise significantly. However, we sound two notes of caution. First, value-chain engineers will be limited by the size of the value pools they seek to exploit. In particular 'keep jobs at home' pressures will restrict the size of administrator outsourcing. Second, some of the value will be taken by global balance-sheet factories who will offshore their own activities rather than outsource (there being little scale benefit and hence cost advantage in outsourcing). Global balance-sheet factories might even exploit their offshore capabilities to create a value-chain engineering business alongside their core life insurance business.

Thus, we see value-chain engineers doubling their current share of value (albeit from a low base) to around 15% of total global value-creation, but remaining of secondary importance relative to any of the other models except category killers.

Distribution specialists

Most distribution value accrues to individuals not companies

Life insurance distribution is a valuable yet highly fragmented activity. Most of the available value is captured by the huge number of individual tied or independent agents and advisors. With the exception of bancassurance, relatively few distribution specialists have evolved to become larger corporations who create value beyond that of a similar sized collection of individual advisers. MLP in Germany, Austria, and Switzerland is one exception: MLP has created a strong ethos and brand around high-quality long-term financial advice where the adviser grows with the customer. This differentiation allows MLP to create value as a group, not only as a collection of advisers.

Overall, distributors count for around 15-20% of total value-creation in life insurance. Put another way, distributors capture some three quarters of the overall value embedded in distribution¹¹; insurers who have distribution organizations capture just one quarter of the distribution value.

Distribution specialists on the offensive have to create value beyond that of a collection of individuals

For distribution specialists, then, the challenge is not so much in creating value, but in moving value to the centre of the organization as opposed to purely at the end-adviser. Distribution specialists who wish to grow have to be more than a collection of individuals. For this they need to respond to the offensive agenda:

¹⁰ Though even here, the incremental scale economies of asset management are extremely small given the typical size of the asset manager involved in this activity

¹¹ For life insurance, distribution represents some 27% of total value-creation. Of that 27%, distributors themselves capture 20%, insurers 7%.

- The more broadly distributors cover all personal financial assets, the better they can serve as financial advisor for end-customers. Introducing open architecture technology such as genuine wrap products is one way of centralizing value away from the end-adviser, as well as being an attractive customer proposition in its own right
- Distributors have the ability to offer products right across the spectrum of customer needs, from protection to pure asset growth. Their choice of model needs to be based on two considerations: first, the need to build customer relationships, which lies at the heart of the distributor's value-creation; and second, the need to avoid risking this relationship for the sake of a short-term sale. During the 1990s boom many distributors tried to create a differentiated brand focused on 'excitement' and asset growth. This short-termism failed on both counts: the transactional nature of asset growth sales (such as in mutual funds) did nothing to strengthen of customer relationships; and the downturn destroyed those that had been built
- Customer capture is fundamental to distribution specialists. First, distribution specialists need to build and sustain strong customer relationships. Second, they need to add value at the centre of the organization, thus holding in the end advisers. One way of achieving both of these objectives is for a distributor to move to a multi-channel structure, allowing customers to interact with the organization in several ways while ensuring that the end-adviser is closely involved at all points. Distributors who fail to do this will increasingly find themselves marginalized as just one channel through which the customer accesses products and services
- Distribution specialists are typically small and regional. In our view, it is difficult enough for a local distributor to create value at centre. It is almost impossible to do so across markets with different cultures, fiscal policies, maturities and regulations. Instead distributors need to either stay local, in larger markets, or at least to *think* local

Distribution specialists will remain fragmented

As customer segments, channels, product offerings and markets consolidate and fragment simultaneously, we see no great impetus for consolidation of distribution value. The market will remain atomized and heterogeneous, since the majority of the value must always lie in the one-to-one relationship between adviser and customer.

Distribution specialists as a group will face margin pressure as a result of consolidation amongst global balance-sheet factories and regional retailer-wholesalers. Set against that, there will be some degree of reclassification as weak regional retailer-wholesalers reliant on distribution move towards becoming a fully-outsourced model – that is, towards being a distribution specialist.

Overall, the share of distribution specialists is set to remain at around 15-20% of total global value-creation. It is worth reiterating the points made in Section 3 of this report about the life-cycle of distribution. However, the stability of distribution's share of value does not mean that any one distributor can be complacent about its position; on the contrary, a distributor's position is, arguably, more under threat at any point in time than that of any other participant in the value chain.

Summary: consolidation and divergence

At the peak of the boom, many industry commentators confidently predicted the 'grand convergence' of financial services, whereby insurers, asset managers and banks would relentlessly merge with each other in search of an inevitable nirvana of scale economics and cross-selling-driven 'revenue synergies'. This state of affairs has not materialized to date, although many still hold out hope that it will come into being at some point in the future.

Consolidation and divergence: we are neither Pangloss nor Cassandra . . .

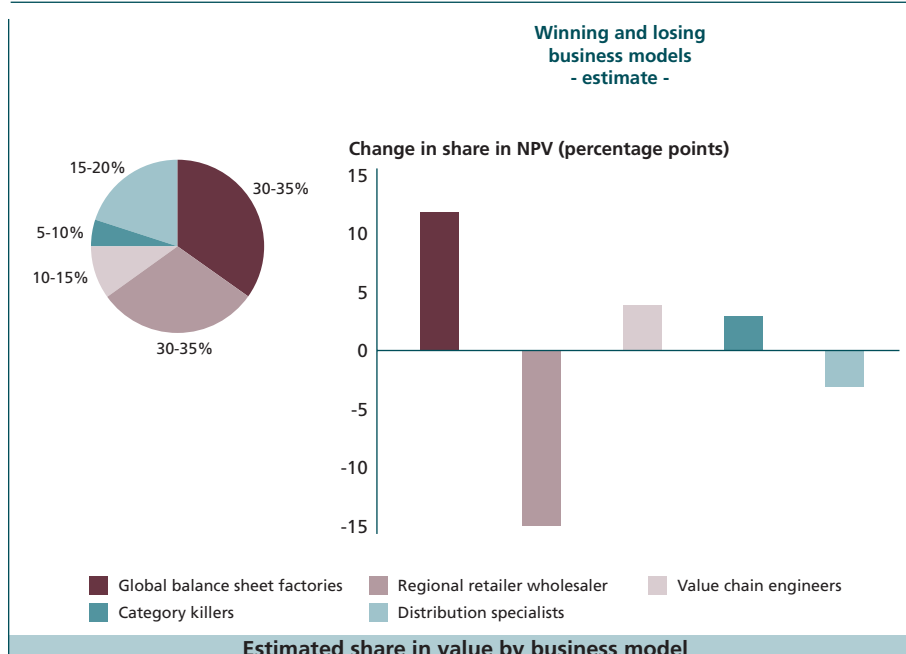
. . . but life insurers need to return to the strengths on which they were founded

Others have now turned from Pangloss into Cassandra, confidently predicting the end of the life insurance sector as a significant force in financial services.

We share neither of these views. We believe that the life insurance sector has an opportunity to seize the growth agenda back from asset managers and banks in the management of personal financial assets. This can be done by returning to, and building on, the sector's traditional strengths in financial protection, customer capture and risk management: the very strengths on which the life insurance industry was founded hundreds of years ago.

However, there will be continued turbulence over the next few years, as the universe of life insurers becomes increasingly polarized into those that are working to the offensive agenda, and those that can or will not. This polarization will be both at a macro-level and at a micro-level.

Figure 22: Future life insurance industry landscape



Note: Shareholder value creation measured as net present value of economic profits
Source: Oliver Wyman Analysis

The future industry landscape – more value in global life insurers, less in regional ones, more in specialists

At the macro-level, global balance-sheet factories will be the big winners; they will see their share of value increase by half, to around 30-35% of the total. Importantly, most of these companies will remain pure insurance groups, with any banking activities increasingly relegated to a small number of niches or local markets.

Regional retailer-wholesalers will come under pressure and will as a group lose up to a third of their share of value. The common characteristic of successful retailer-wholesalers will be excellence in customer capture, whether by virtue of maintaining and developing excellence in managing a tied agent network, or by virtue of being part of a broad-based local bancassurer (e.g. the big banks in Spain).

Specialists such as category killers and value-chain engineers will both grow, but these will be extremely diverse groups made up of a large number of 'niche-oligopolists'. Distribution specialists will remain fragmented; while this group's total share of value creation will remain more or less stable, there will be much movement of value *between* the individual distribution specialists.

These views are summarized in Figure 22 above, which shows the landscape of the global life insurance industry across our five business models in 2014.

Taken as a whole, the strategic future of global life insurance is an apparently paradoxical mixture of consolidation, on the one hand, and diverging business models on the other. There will be fewer players, and more concentration of value in even fewer players, but at the same time much more variety in strategies, even within each business model.



5.

Start now

The key message of this report is that life insurers need to go back on the offensive. Today's managers are still playing defense, focused on securing operational survival while leaving attractive growth opportunities untouched. But the time for defense is over. Now is the time for life insurers to develop strategies for executing against an offensive agenda; they cannot afford to miss out on their share of the \$1,600BN in shareholder value that will be created over the next decade.

Returning to the offensive involves tough management decisions . . .

But it is easier to talk about going on the offensive than actually to do it. To begin with, the four imperatives listed in our offensive agenda (detailed in Section 3 of this report) involve tough decisions:

- **Competing for personal financial assets** might require the development of fledgling alternative sales channels, as well as entirely new asset origination vehicles, such as ING has achieved through ING Direct. Both will require upfront investment
- **Promoting a 'long-term financial security' value proposition** requires tough decisions to be taken about corporate strategy. For example, should captive asset management operations be repositioned, away from an alpha-focused retail/institutional segmentation to a more passive stance, possibly outsourced? It will also involve major product and market strategy decisions: for example, redesigning products to have transparently-priced asset protection features
- **Wresting back customer capture**, and holding on to it, may require significant investment to tie in distributors, which will only bear (uncertain) fruit over the medium term; it also requires willingness to accept the short-term pain of exiting distributor relationships where customer capture is never going to be achievable or recoverable

- **Focusing on the detail** is a high-stakes game. For example, chasing a specific opportunity aggressively – occupational pensions across a small number of countries, say – ‘bets the house’ on the outcome being a focused, high-value and high-growth business. Running a broad portfolio of businesses, organized by geography, might not generate much (or any) growth, but it is also less risky for management

... As well as complex strategic choices

The decisions are not just tough, but numerous and complex. Each of the five broad business models described in Section 4 contains a myriad of strategic options. For example, we saw that ‘global balance-sheet factories’ face the major strategic challenge of managing a heterogeneous global portfolio. We identified no less than five distinct strategic responses to this challenge and within each of these five strategic responses are at least five *sub*-strategies. And of course the right course of action depends as much on where the company is today as on external factors.

Starting now means answering six big questions:

1. How well am I positioned to deliver against the offensive agenda?

Answering this question means understanding one’s own competitive positioning in the broad market for personal financial assets – not just the narrow market for life insurance – and analyzing one’s capabilities relative to those that are required to offer a credible ‘long-term financial security’ value proposition: brand, capital, products, technical skills.

It also means taking a long, hard look at one’s current success in capturing customers, whether in the B2C sense or in the B2B sense. Traditional information on customer and intermediary satisfaction levels will not tell you much here; you need to make a more detailed investigation of markets, segments, channels and intermediaries within channels.

Finally, you will need a clear view of the attractiveness and outlook of markets, particularly if you harbor global ambitions. That will need to include both markets that you currently cover and potential ‘green-fields’, at a level of detail that allows the value ‘hotspots’ to be readily identified. You will also need to assess the degree to which you have the global reach, expertise, resources and culture needed to succeed in them.

2. What are my strengths and weaknesses relative to competitors?

What gaps can we exploit and where will we be exploited?

Answering this question means understanding how one’s *competitors* are positioned against the offensive agenda. Which of their weak points can you exploit, and which of your weak points will your competitors seek to exploit?

Life insurers on the offensive need to understand their position against each of their key competitors in every local market where they are (or plan to be) active. Going on the offensive means aggressively exploiting one's strengths and competitors' weaknesses across a range of dimensions:

- Market positioning and customer focus
- Value proposition and product offering
- Capital strength and management
- Organization, culture and global reach
- Operational excellence
- Strategic control of distribution

3. How does my business model compare to tomorrow's winning ones?

Understanding one's own business model is not easy. Most life insurers actually operate some combination of the five basic models described in Section 4; and companies differ dramatically in their abilities and options even if they share a model. There is a world of difference between the capabilities and priorities of a regional retailer-wholesaler that enjoys absolute dominance over a large local market and is tending a couple of 'green shoots' in new markets, and one which occupies a second-tier position in its home market and nowhere else.

The second part of the challenge is to understand where one's own positioning within the generic business model has come from and to where it might go. That means answering questions such as: Is the customer base narrowing or widening? Is customer capture steadily improving or are we leaking value to distributors? Are our overseas interests strong, differentiated and growing, or are they withering away?

Finally, one will need to understand how the business model itself might evolve. What opportunities will open up to life insurers following that model, and what threats will confront them? What are the key challenges faced by adherents to that model? All else being equal, what is the realistic outlook for the model?

4. Where do I want to be in tomorrow's life insurance landscape?

Both vision and gritty realism

Answering this question requires equal proportions of vision and gritty realism. Having mapped out the future shape of one's own business model, the next step must be to determine a target model for the future.

Vision is clearly important. It takes vision, for example, to imagine a regional retailer-wholesaler overcoming the terminal sickness of a gradually-declining competitive position and becoming a new global powerhouse with a strong and consistent brand and proposition, increasing control of customers and a leading presence in key emerging markets.

But gritty realism is important too. Life insurers, like any other kind of company, have often made sacrifices to bring about a 'grand vision' that was never at all likely to become a reality. The acid test is to step down a level or two in granularity; down to what the vision implies for the strategic proposition: what it means for markets, customers, value proposition, profit model, resources, distribution, organization and culture.

5. How do I get there from here?

Once the destination is understood in detailed terms, including the key challenges and success factors, a plan of attack can be put together. The plan is critical, not just because it translates into short-term actions, but also because the completion of an implementable plan proves that the vision is realistic. So the plan needs to be long-term –starting with today's business model and ending up with the vision. It needs to be set to a timetable, with measurable milestones marked out along the way. Some of those milestones should be near-term, but represent a significant step forward.

The plan needs to include the whole range of activities necessary to reach the vision, including (for example) potential investments or divestments that must be made along the way. And it needs to recognize the level of change involved: if the life insurer is changing its business model then it is probably also changing its value proposition, its culture, its customer base, its organizational structure, and perhaps even its brand values. The scale and difficulty of these challenges should not be underestimated.

6. Should I?

Developing answers to the first five questions is only the beginning of the journey towards a future taken on the offensive. But the answer to this final question is unequivocally "yes, and now". There is \$1,600BN of value at stake, but no shortage of competitors – life insurers and others – trying to snatch the value away. You should make sure you get there first.

OLIVER WYMAN

For more information please visit our website at www.oliverwyman.com, or contact:

In North America

1 212 541 8100

marketingna@oliverwyman.com

In Europe

44 20 7333 8333

marketingeu@oliverwyman.com

In Asia Pacific

65 6510 9700

marketingasia@oliverwyman.com

Copyright © 2006-2007 Oliver Wyman Limited. All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman. This report is not a substitute for tailored professional advice on how a specific financial institution should execute its strategy. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisers. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages.

This report may not be sold without the written consent of Oliver Wyman.

OLIVER WYMAN

