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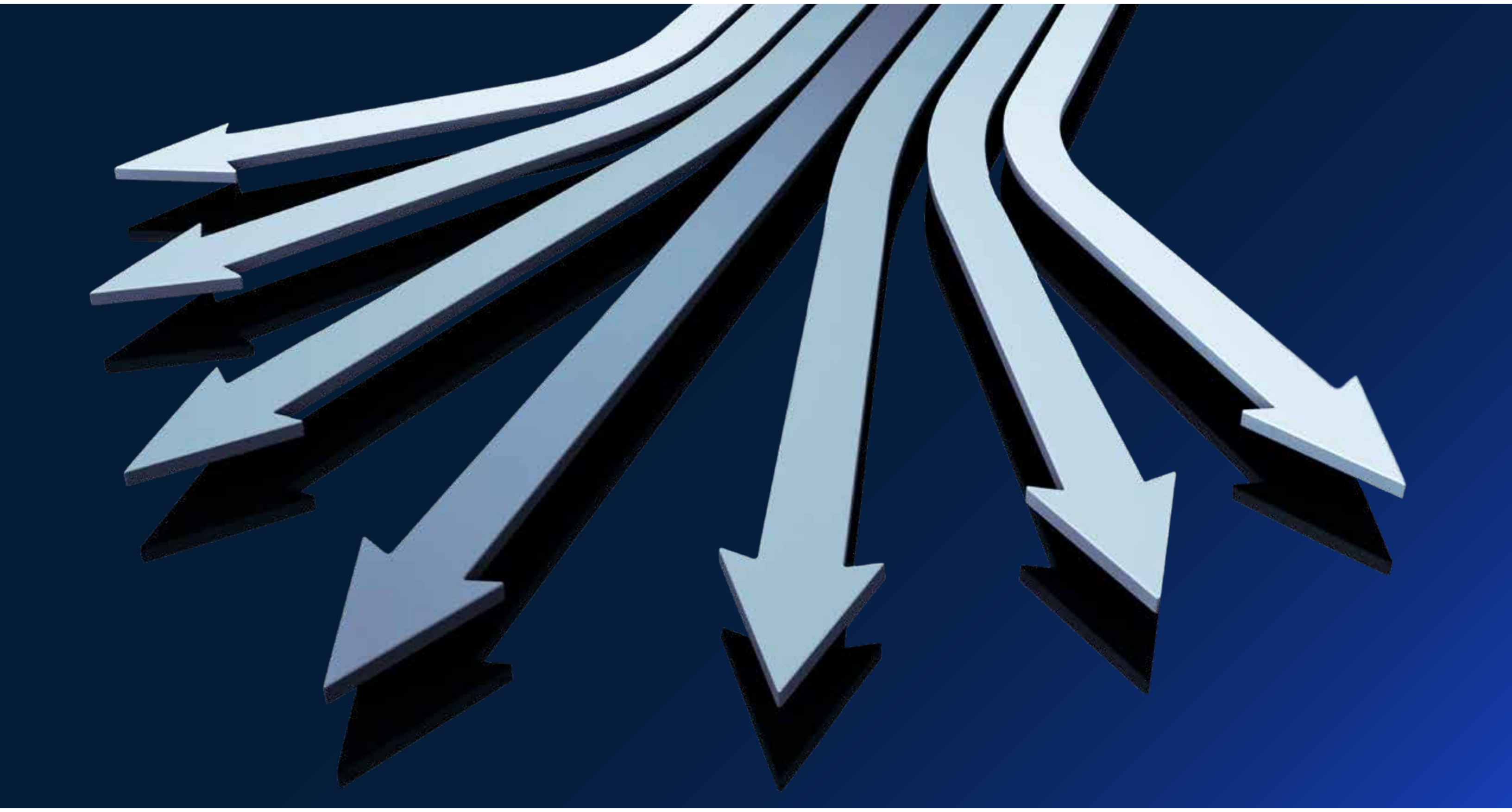
Unbundling value: How leading insurers identify competitive advantage

For US life insurers to address new and old challenges, they need a fresh approach to their business model and how they create value.

by Ramnath Balasubramanian, Rajiv Dattani, Asheet Mehta, and Andrew Reich



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Since the end of the global financial crisis in 2008, US equity markets have boomed, yet most public US life and annuity insurers have been left behind. Recent developments, including the expectation of federal interest rate hikes, will provide a near-term tailwind. This will not, however, be enough to counter the long-term challenges life insurers face.

Traditional problems that have plagued the industry for decades—such as earnings sensitivity to external factors and opaque risks that investors are challenged to underwrite—will remain. More recently, fundamental changes in industry structure have created significant competitive pressure. Specifically, the emergence of private capital–backed platforms—which have evolved their primary focus to include new sales as well as the acquisition of legacy blocks of business—has changed the game in new-product development, where such platforms have become leaders in several retail and institutional categories.

US life insurers also face drastic changes in other parts of the value chain. In general account asset management, a significant spread between top- and bottom-quartile performers has emerged as poorer performers struggle with dynamic asset allocation as well as investment performance within each allocation. Changing market dynamics in distribution—such as a shift toward independent channels, new technological capabilities, and evolving investor perceptions—also raise new important strategic questions for insurers to consider. Finally, life insurers continue their struggle to modernize operations and technology as further investments fail to reduce net expenses in the system.

These new market dynamics may be daunting, but leading life insurance leaders also see opportunities to pave new paths toward value creation. To compete, insurers should carefully consider each part of the industry value chain and determine where they can and cannot reasonably have competitive advantage. And similar to other industries—such as auto manufacturers—life insurers now need to consider unbundling their value chains and doubling down on the right links.

In this article, we share insights and implications across each major component of the life insurance value chain—new-product development, distribution, asset management, and operations and technology—and outline three main life insurer archetypes that will likely emerge: product origination specialists, balance sheet specialists, and integrated insurers.

Life insurance leaders who take a deliberate, unbundled approach to their business—and double down on their strengths—will outperform in the decade ahead. Making this transition will not be easy, but failing to act will only result in further challenges.

Unbundling the life insurance value chain

Before insurers can determine in which parts of the value chain they are best positioned to win, they must first gain an understanding of market dynamics and trends, then determine what it will take to be distinctive.

New-product development and risk assessment

New-product development has historically been perceived as an area of distinctiveness for life insurance companies. Shifts within the marketplace, however, have already ignited unbundling of new-product development, with a clear bifurcation in natural ownership among public life insurers, mutual insurers, and private capital–backed insurers.

Market dynamics and trends

Over the past ten years, we have seen the entrance and expansive focus of private capital–backed platforms, from legacy back books to new-business generation. These platforms now have significant market share in select retail annuity sales categories—specifically fixed and fixed-indexed annuities, where they have 20 and 40 percent shares of new business, respectively (Exhibit 1). Even in variable annuities, where public insurance carriers have maintained their leadership position, those insurers are pulling back by focusing on investment-only variable annuity products and reinsuring or selling back books to private capital–backed platforms.

Beyond the retail annuity segment, these platforms are rapidly expanding their position in institutional categories, such as funding agreements and structured settlements, as well as in pension risk transfer, which has now surpassed $200 billion in assets alone.[1]

In the past decade, market positions on the life insurance side have drastically shifted, as well. In 2010, US public life insurers were the leading providers of individual life insurance, with 42 percent of the market. However, US mutual companies have replaced that leadership, now accounting for 56 percent of the market. While private capital–backed platforms have not yet targeted the individual life insurance market to the same extent as the annuities market, it may become their next frontier.

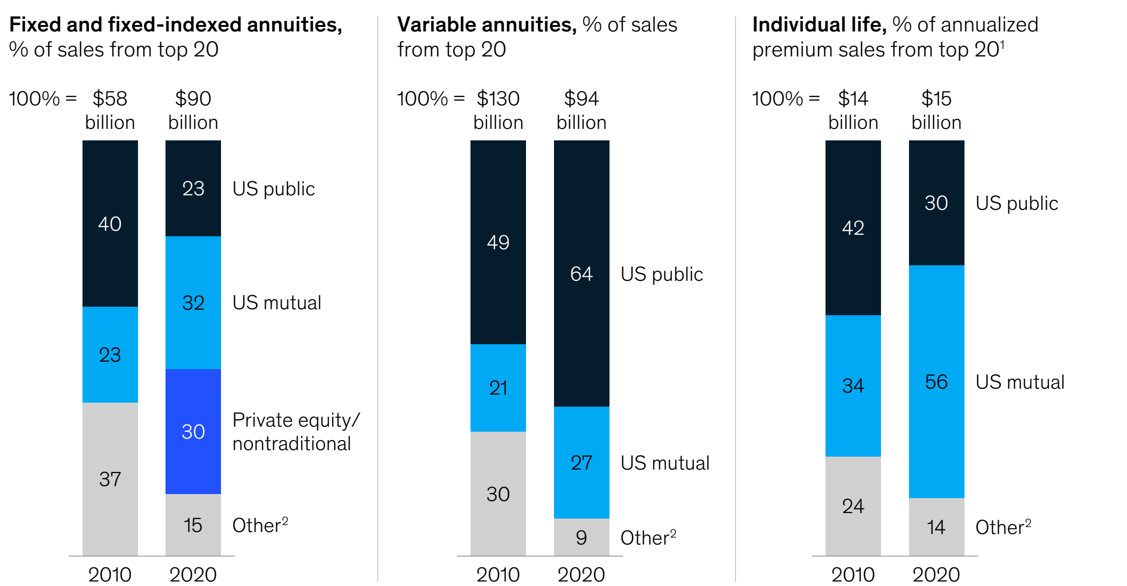
Building competitive advantage

Achieving distinction in new-product development will require leading capabilities across customer insight–led product design, risk assessment, pricing, and claims management. In most cases, insurers

[1] Mark Paracer, *Group annuity risk transfer summary report: Fourth quarter 2020*, Secure Retirement Institute, 2020.

Exhibit 1

Private capital–backed platforms now have a significant market share in fixed and fixed-indexed annuities; variable annuities and individual life may be the next frontier.



[1] Annualized premium = 10% of single premium and first year of nonrecurring sales.
[2] Includes US privately owned and foreign-owned traditional insurers.
Source: LIMRA

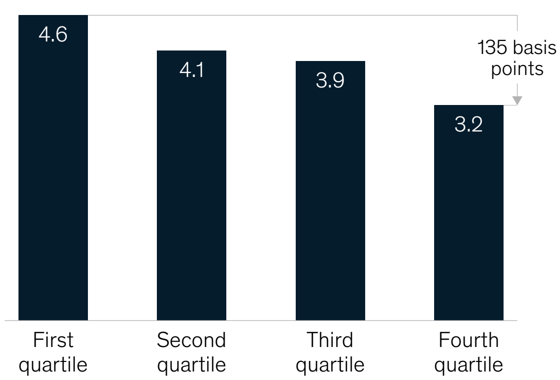
will likely focus on building these capabilities in a few core product categories consistent with their risk appetite, return expectations, capital efficiency, investor considerations, and ability to develop competitive differentiation.

In product categories where they don't have competitive advantage, insurers will increasingly seek to exit. This trend is well under way, as the US M&A market continues to build on the $620 billion of life and annuity assets that have already traded to private capital–backed platforms.[2] We anticipate there will, indeed, be a "middle ground" where insurance carriers can leverage their own capabilities in certain product lines and partner with others for complementary capabilities. As a result, models such as white labeling, coinsurance, and flow reinsurance are likely to grow in use, and insurers may increasingly distinguish between product design, distribution, and balance sheet risk retention. Indeed, by 2020 the volume of flow reinsurance across US life insurance increased to $598 billion, up from $407 billion in 2015.[3]

Exhibit 2

Among insurers with more than $50 billion in assets, there are 135 basis points of yield between top and bottom performers.

US life insurers with >$50 billion in general account assets,[1] %



[1] Includes US regulatory assets only.
Source: S&P Capital IQ Pro

General account asset management

General account asset management has become a critical source of value creation among life insurers—and one with wide disparity between top and bottom performers. This gap will provide further impetus for asset management unbundling.

Market dynamics and trends

Investment portfolios are designed for a wide variety of liability profiles, inherently driving differences in asset allocations and yield. Nevertheless, performance variability across general accounts is significant. Among insurers with more than $50 billion in assets, top- and bottom-quartile performers are separated by 135 basis points (bps) of yield (Exhibit 2).

The prolonged impact of historically low interest rates has forced investment portfolios to reconfigure their strategic asset allocations. Many insurers increased their allocations to high-yielding debt, structured products, private credit, and other alternative asset classes. Indeed, in 2020, North American insurance companies allocated $355 billion to alternatives, up from just $184 billion in 2010.[4] As insurers consider shifting toward higher-yielding alternative asset classes, they will have to marry their investment decisions with rigorous risk management, making deliberate choices about their risk tolerance and ensuring their risk management capabilities are commensurate with their risk appetite. When making such choices, insurers will have to consider capital availability, robust monitoring and stress testing of various types of risks (credit, liquidity, duration), and active reviews based on market conditions. Taken together, we believe more evolved and dynamic strategic asset allocation will continue in the years to come.

[2] For more, see Ramnath Balasubramanian, Alex D'Amico, Rajiv Dattani, and Diego Mattone, "Why private equity sees life and annuities as an enticing form of permanent capital," McKinsey, February 2, 2022.
[3] "2020 life reinsurance survey results," Munich RE, June 2021.
[4] McKinsey Performance Lens Global Growth Cube.

Competition for alpha-generating assets will remain fierce, as will access to leading alternative managers that can create material performance advantages.

In the past decade, insurers have learned the critical importance of not only dynamic asset allocation but also effective execution within each allocation. Competition for alpha-generating assets will remain fierce, as will access to leading alternative managers that can create material performance advantages. For example, 20 percentage points of internal rate of return (IRR) separate top- and bottom-quartile private equity funds, with similar disparity in performance across other alternative asset classes.[5]

Building competitive advantage
Insurers that continue to own asset management will have to meet a high bar. They must have strong asset origination capabilities, industry-leading talent and investment processes, and quantifiable proof points of investment alpha. Further, such insurers will have to optimize the role they play across their investments—acting as an allocator among certain asset classes and an operator in others, such as real estate. Finally, they will need to have leading risk management capabilities commensurate with their placement on the risk/return frontier.

Insurers unable to meet this bar have several options, ranging from complete outsourcing to outsourcing select capabilities to specialists while building certain capabilities in-house. Those that have distinctive asset management capabilities, however, may create the next frontier of third-party asset management.

Such insurers may launch new outsourced chief investment officer (OCIO) or subadvisory businesses targeted toward subscale insurers. According to a recent report, 33 percent of life insurers outsource more than 50 percent of their assets to unaffiliated managers.[6] Life insurers with less than $10 billion of assets—which represent $267 billion of general account assets[7]—may be prime early candidates on which to grow such businesses and to capture the capital-light, fee-based income they offer.

Distribution
For many insurance carriers, the distribution function holds a place of pride and significance beyond all other functions. And many insurers are now thinking about earnings streams from distribution in different ways. Indeed, insurers have witnessed how investors reward the capital-light earnings generation of pure-play distributors—such as brokerages, independent marketing organizations, and field marketing organizations—which have generated 2.6 times the TSR of life insurance companies and currently trade at nearly

[5] Burgiss, Global fund performance by asset type for vintages 2008–2018, as of September 30, 2021.
[6] *U.S. insurance general accounts 2021: Adopting new strategies for global challenges*, Cerulli Associates, 2021.
[7] "Best's Financial Suite – US," A.M. Best, accessed February 28, 2022.

2.9 times the P/E multiple of their life insurance counterparts (Exhibit 3).

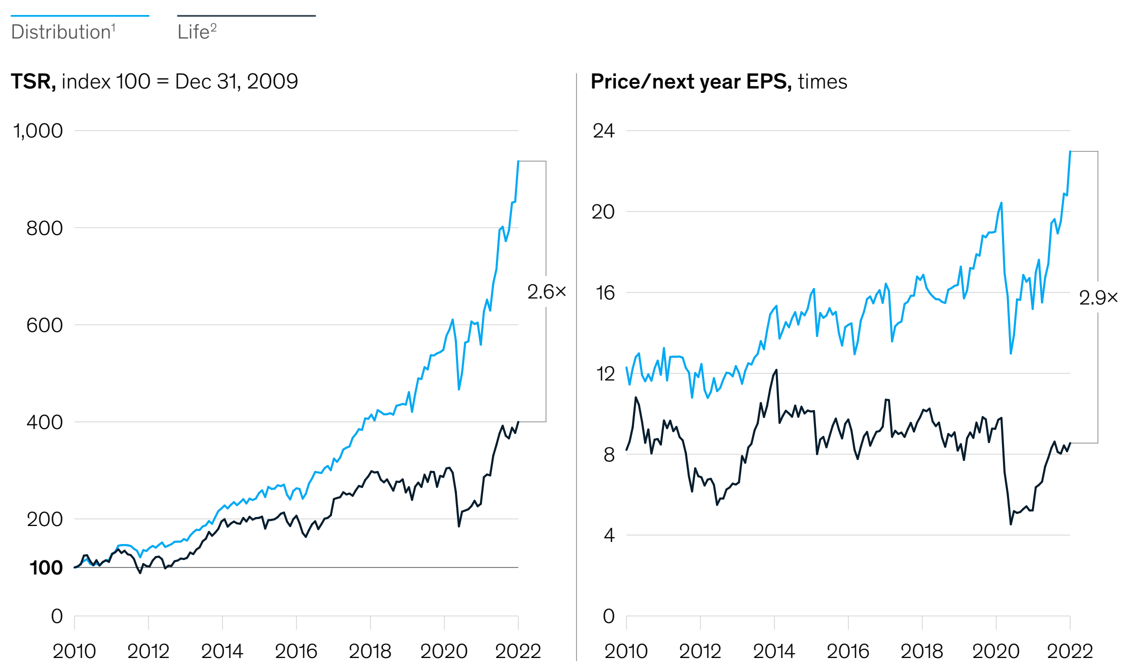
Market dynamics and trends
Historically, life insurers have invested heavily in their captive distribution, including recruiting and training their own sales forces to ensure that their new products were marketed and sold properly. Captive distribution, however, is no longer economically viable for most insurers. The increased commoditization of many insurance and annuity products, coupled with the increasing open architecture of insurance distributors, has resulted in the slow and steady shift away from affiliated agents. In 2000, affiliated agents sold nearly half of all individual life policies in the United States. In 2020, that share had fallen to one-third.[8] The difference in share has been captured almost entirely by independent agents, banks, and broker–dealers.

Building competitive advantage
For insurers that no longer have captive distribution or that can no longer afford to maintain it, the focus will shift to more effectively managing third-party intermediaries. They will also focus on building unique value propositions beyond product features and pricing. Such propositions will have to include more digital and analytics capabilities and technological connectivity—leading to a seamless end-to-end experience from manufacturer to distributor to customer.

[8] Ashley Durham, *U.S. individual life insurance sales, industry estimates (1975–2020)*, LIMRA, 2021.

Exhibit 3

Pure-play distributors have generated more than twice the TSR of life insurance companies.



[1] Includes AON, Arthur J. Gallagher, LPL, Marsh, Primerica, Raymond James, and Willis Towers Watson.
[2] Life market capitalization-weighted index includes Aflac, American Equity, Athene, Brighthouse, CNO, Equitable, Genworth, Globe Life, Lincoln, MetLife, Principal, Prudential, Unum, and Voya.

Developing such capabilities and creating this seamless experience will be table stakes for insurance carriers that maintain captive distribution as a primary source of competitive differentiation. The more interesting questions will focus on how to create additional value from distribution. Indeed, some insurers are already looking at their captive distribution as value-creating hubs and sources of fee-based earnings through the sale of wealth management and third-party protection products.

Going forward, we anticipate that public insurers will also report their earnings from distribution as a stand-alone segment, as they seek the higher multiples investors offer on this part of their earnings.

Operations and technology

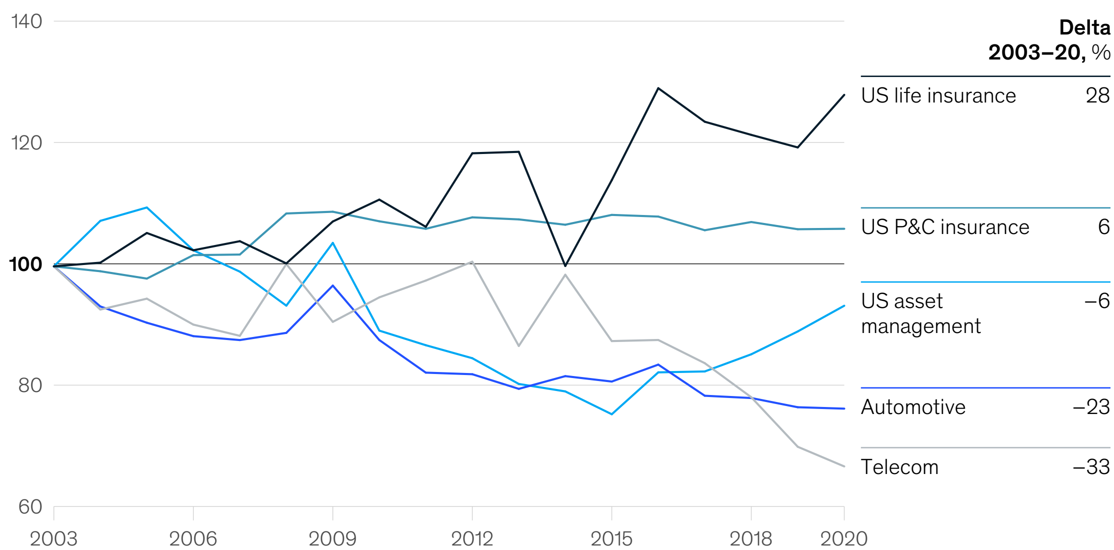
Life insurance is one of the very few industries—within and outside financial services—that have seen cost ratios increase over the past 20 years (Exhibit 4). Yet this headline does not tell the full story.

There is a wide disparity in efficiency across life insurers. According to McKinsey's Insurance 360° performance benchmark, top-performing North American life and annuity insurers have half the expense ratio of their bottom-quartile peers. Technology and operations-related costs, which have grown faster than other categories, represent a big part of the difference in performance.

Exhibit 4

Compared with other industries, US life insurers have not structurally addressed costs.

Cost efficiency evolution[1] **by industry,**[2] % total SG&A expenses and revenues, normalized at 100% in 2003



[1] Indexed; expressed as SG&A expenses as % of revenue.
[2] Based on large global players for which continuous reporting is available: 28 players in insurance (10 composite focus, 9 life focus, and 9 P&C focus), 10 telecom players (including AT&T, China Telecom, and Vodafone), 8 road and rail players (including DSV, Japan Railway companies, and Russian Railways), 10 automotive players (including Ford, Toyota, and Volkswagen), and 10 airlines (including American Airlines, Air France–KLM, and Emirates).
Source: S&P Capital IQ; McKinsey analysis

Market dynamics and trends
Complex legacy-technology systems and platforms are the biggest bugbear for almost all life insurers. They create complexity, increase costs, and hinder insurers' ability to launch new products and manage existing portfolios. Many insurers have tried to address their legacy-technology problems by outsourcing to technology providers. In most instances, however, performance falls far short of promise: insurers are beset by issues of delayed transitions, significant cost overruns, and service levels that fail to meet expectations. This often creates a vicious cycle.

One of the greatest challenges insurers face in modernizing their technology pertains to older blocks, where many investments are fundamentally uneconomical. Technology investments on back-book policies (particularly closed blocks) will amortize over a shrinking number of policies—and such investments will not fuel future growth. While technology investments are uneconomical, current technology platforms are becoming obsolete, with fewer and fewer programmers available to maintain these legacy platforms. The status quo is clearly not viable.

Building competitive advantage
The choice for insurance carriers in addressing operations and technology is not straightforward. Operations is core to the touchpoints along the insurance customer journey, and insurers want to continue to own their client relationships. Companies that want to maintain such ownership and make it a source of competitive differentiation will need to ensure that their technology investments are accretive and tackle the challenges they face head-on.

These insurers will need to develop a new set of robust and distinctive capabilities, including the following:

— modern cloud-first approaches to managing applications and data

— AI and advanced analytics to tackle complex issues across data extraction, premium calculations, reserving, and operational tasks

— the ability to attract and retain a different type of technology talent, including engineers, developers, and data scientists

— a culture of software engineering and more agile ways of working through tighter collaboration between business and technology

For most insurers, building these capabilities on their own will be difficult and require significant bandwidth—taking focus away from their core business. This will create an impetus for the next generation of technology service providers to offer a more modern, customer-centric, integrated, end-to-end solution to serve both open and closed blocks.

The road ahead

Life insurance unbundling is already under way. Insurers are making deliberate choices across the value chain, building new capabilities, and shifting their business models. And while the pace of unbundling may be up for debate, it will continue nevertheless.

In the decade ahead, we believe the majority of insurers will make their assessments and see that they can be distinctive in only one or two parts of the value chain. There will be a small handful of insurers that will build the capabilities and have the scale required to be distinctive in all the components—these will be the only integrated end-to-end insurers.

Unbundling will also lead to the blurring of boundaries between traditional competitors and more fluid competitive dynamics. Insurers will have to think beyond the "zero sum" approach and welcome new collaborative partnerships with different stakeholders in the spirit of creating greater "shared value." In fact, insurers competing head to head in one area of business could end up being partners in another area where they have complementary capabilities.

Putting it all together, we believe three life insurance archetypes will emerge: product origination specialists, balance sheet specialists, and integrated insurers (Exhibit 5). For these purposes, we assume that the insurer retains some level of product development. Our model excludes pure-play distributors, operations and technology providers, and asset managers.

Product origination specialists. These insurers will have distinctive customer insights, risk assessment, product development, and underwriting capabilities with privileged access to distribution (either affiliated or independent). While they may develop several products of varying capital efficiency, they will only retain the most capital-efficient products (for example, simple protection) on their own balance sheets. For more capital-intensive products, they will work with capacity providers via coinsurance, reinsurance, or white-labeling arrangements.

Insurers in this archetype will predominantly seek strong partnerships in asset management and selectively build certain investment management capabilities in-house. They will also increasingly unbundle operations and technology to specialists. We anticipate many public insurers will gravitate toward this model given investor expectations of simpler business models and more stable, predictable, and capital-light earnings streams.

Balance sheet specialists. These insurance carriers will have distinctive risk assessment capabilities and will marry this expertise with their strong balance

Exhibit 5

Life insurance unbundling is likely to lead to the emergence of three major archetypes in the industry.

● Required area of distinctiveness ◐ Possible area of distinctiveness ○ Not an area of distinctiveness

	Product origination specialists	Balance sheet specialists	Integrated insurers
Product development, risk assessment, and underwriting	●	◐	●
Balance sheet capacity	◐	●	●
Distribution	●	○	●
Operations and technology	○	○	○
Asset management	○	●	●
Primary sources of distinction	• Product development, including pricing, underwriting, and claims • Distribution access	• Asset management • Balance sheet capacity • Underwriting, risk assessment, and claims management • Investment risk management	• Capabilities across the value chain • Strong capital position
Primary valuation metrics[1]	• Price to earnings • Return on equity • Fee-based revenue %	• Price to free cash flow • Surplus capital	• Price to book • Price to free cash flow • Return on equity
Most likely candidates	• Public insurers • Mutual insurers	• Private capital–backed platforms • Mutual insurers	• Public insurers • Mutual insurers • Private capital–backed platforms

[1] All insurers will also have to consider the financial impacts of long-duration targeted improvements (LDTI), which are likely to emphasize free cash flow as a valuation metric.

sheet capacity to absorb various risk types. They will have the leading asset management talent in the insurance industry, with distinctive asset origination capabilities—either in-house or via relationships with specialist asset managers (at times, acquiring stakes in such managers as well). Additionally, they will make deliberate choices about their risk tolerances and marry their investment expertise with leading risk management capabilities. Their distribution—where they source products and assets—will primarily come from institutional partnerships (such as funding agreements, pension risk transfer, and flow reinsurance) or inorganic sourcing (such as the acquisition and divestiture of legacy blocks). These insurers will also likely fully unbundle their operations and technology functions. This archetype will largely be relevant for privately held insurers (for example, mutual insurers or private capital–backed platforms) with access to long-dated, permanent capital sources.

Integrated insurers. Insurers that fall into this archetype will be few and far between; they will represent the high-water mark in terms of distinctive capabilities across the insurance value chain. They will be characterized by strong capital positions, either through scale or through structural capital advantages. They will have select sources of distinctiveness across general account asset management and distribution, though they may still look to unbundle operations and technology, given the challenges we cited earlier.

However, many insurance carriers that have the capabilities to be integrated insurers will still evaluate each of their business units independently and find one of the previous two archetypes to be most appropriate for some of their businesses, while retaining the integrated model for others. This model will have a mix of select public, private, and mutual insurers that are able to build these capabilities.

What insurers can do now

Some insurers may find that they are already migrating toward one of these archetypes. For others, it will require nothing less than a transformed business model. But the stakes couldn't be higher. Indeed, our research suggests that the top 20 percent of life insurers capture 97 percent of the economic value within the industry.[9]

To get started, insurers must first *reassess* each of their businesses and identify in which parts of the value chain they are most distinctive. Then, they must *reimagine* how they can maximize value from that part of the value chain while leveraging distinctive capabilities for others. Finally, they must *reengage* with all of their stakeholders—employees, customers, and investors—to bring them along on their unbundling journey.

As insurers make decisive choices to participate in specific parts of the value chain, they will continue to build distinctive capabilities and reorient their business model. In doing so, they will form a sustaining source of competitive advantage; insurers that do not build such capabilities will find it increasingly challenging not only to compete but to survive.

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[9] Alex D'Amico, Mei Dong, Kurt Strovink, and Zane Williams, "How to win in insurance: Climbing the power curve," McKinsey, June 18, 2019.

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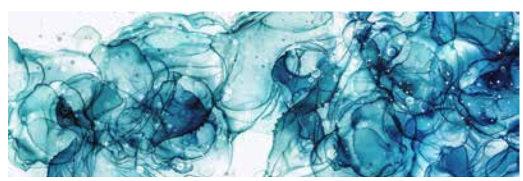

The productivity imperative for US life and annuities carriers