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The Life Journey Japan: Charting the Course to Value

Financial Services Practice

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The life insurance industry in Japan, in aggregate, delivers returns for investors that are consistently below its cost of capital. While some carriers have created significant value, others are dragging industry returns down to below zero. What are the winners doing differently?

In the 1980s, Japan's life insurance carriers enjoyed a boom in asset growth in excess of 20% per year. More than 90% of Japanese households had life insurance, and the amount held per person was at least 50% greater than in the United States. Furthermore, many Japanese were using whole life insurance as saving vehicles, thanks to the product premium's tax deductibility and high guaranteed rate of return. Low workforce participation rate for Japan's women, and the resulting necessity for households to have plans in place in the event of a husband's death, also spurred high life insurance penetration.

Thanks to a significant presence in the international financial market, Japan's life insurers were also beneficiaries of a boom-time economy in which all assets were increasing in value. Nissay, the biggest Japanese insurer, was in fact the largest holder of U.S. Treasury Bonds during this period.

But the industry's reliance on the spread between the rate guaranteed to policyholders and the rate of investment return would come back to haunt it in the next decade. When this spread turned negative in the 1990s, Japan's life insurance industry began delivering returns below its cost of capital. In aggregate, the industry has since destroyed value to shareholders (Exhibit 1). Seven large insurers have gone bankrupt and the industry has rapidly consolidated: between 1996 and 2005, the number of life insurers in Japan dwindled from 44 to 38.

Industry profitability did modestly recover for a short period in the mid-2000s, thanks to a fortuitous set of circumstances that eased the negative spreads: a natural turnover of insurers' in-force books; government intervention and regulatory restructuring that allowed them to adjust in-force policy guarantee rates; and a slight improvement in economic conditions. Subsequently, the 2008 economic downturn more than wiped out these marginal gains.

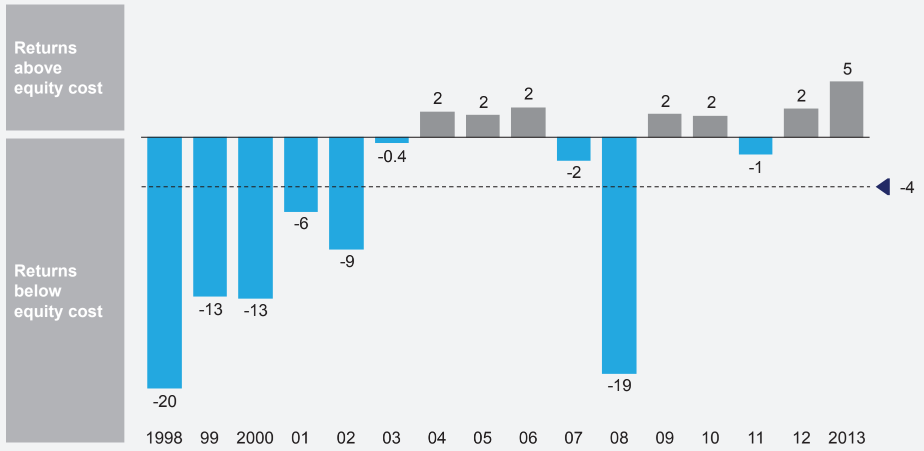
Japan's insurance industry is not alone in being highly dependent on economic tailwinds for strong performance. The pattern wherein the life insurance industry generates modest returns in positive market environments but loses even more ground during downturns has become quite familiar globally. As the insurance industry's risk profile is growing, its performance is becoming more tightly linked to market cycles. This becomes especially challenging in more mature markets like the United States and Japan where institutional investors like private equity and pension funds crowd-out insurers from the more lucrative investment deals, forcing them to strengthen their liability risk management skills as the primary driver of value creation.

Exhibit 1

The industry has returned less than its cost of equity since the 1990s with limited shareholder value creation

Life industry performance (1998-2013): Capital cost in excess of return

ROE[1] – COE; Percent



1 ROE estimated as net surplus (including realized capital gains adjusted dividend reserves) divided by average net assets adjusted unrealized securities gain and loss; Cost of equity estimated by calculating industry beta for life insurance companies and utilizing capital asset pricing model (CAPM). Excluded all policy dividends for Mutual companies

SOURCE: Japan Life Insurance Association; Bloomberg

A wide gap between leaders and laggards

While the overall economic performance of the industry is weak, some insurers have been able to outperform the market consistently and deliver substantial returns. There is a wide spread in value creation among the 20 largest insurers in Japan[1]. Between 2002 and 2013, carriers in the top quintile increased in value by 9 to 18% annually, while those in the bottom quintile only increased from -3 to 2% – implying a nearly 21 percentage point spread difference in adjusted book value growth between best and worst performers (Exhibit 2).

This significant spread begs the question: What do the winners do differently? Do they offer a more attractive product mix? Do they execute better within product lines? Do they achieve higher investment returns?

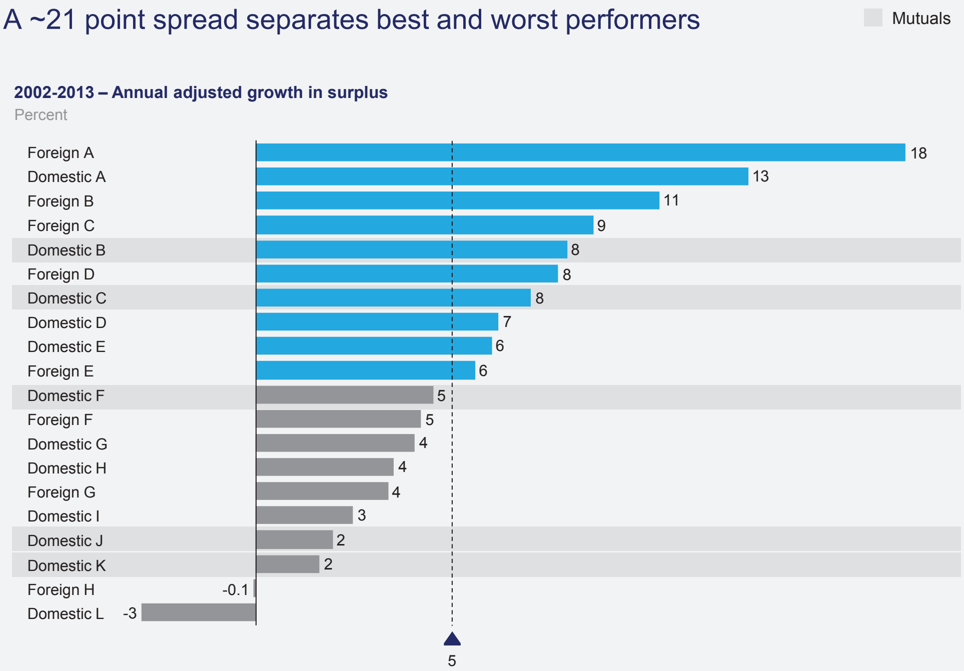
McKinsey recently launched an extensive research project – *The Life Journey* – to develop fact-based answers to these questions. We analyzed publicly available data for Japan's life insurance industry since 1998, and for the top 20 life insurers since 2001. This was followed by interviews with industry analysts and executives, and detailed analysis of eight carriers that represent 60% of the market in gross premiums, to gain a better understanding of the underlying drivers of performance. The analysis indicates the gap between the best and

1 **Apples-to-apples performance metric for value creation.** The most revealing performance metric is growth in adjusted statutory book value – the ability to grow surplus, adjusting for dividends to shareholders and capital transactions. It is relevant for all carriers because it rewards profitability as well as growth. It measures the success of public carriers, since "price-to-book" is a common way to value them, and mutuals, as they strive to grow their surplus. It also correlates well over time with other measures, including return on equity, total return to shareholders, and economic value creation.

Exhibit 2

A ~21 point spread separates best and worst performers

2002-2013 – Annual adjusted growth in surplus
Percent



SOURCE: Japan Life Insurance Association, McKinsey analysis

worst performing life insurers is driven primarily by carriers' ability to manage liability risk – and not by their ability to manage asset-based investment performance (Exhibit 3).

Many factors contributed to the performance differential among the top 20 insurers, but none has proved more important than skill in managing mortality and morbidity risk, which has delivered most of the industry's profit. This is an especially striking conclusion, because life insurers invest modest resources in developing innovative approaches or honing skills in pricing or selecting risk. Interestingly, carriers' performace in managing asset-based investments was inversely correlated with their overall performance on creating value: between 2002 and 2013, the top-performing insurers in terms of surplus growth were 14% below the industry average in returns on asset-based investments, while bottom performers were 1% above the industry average.

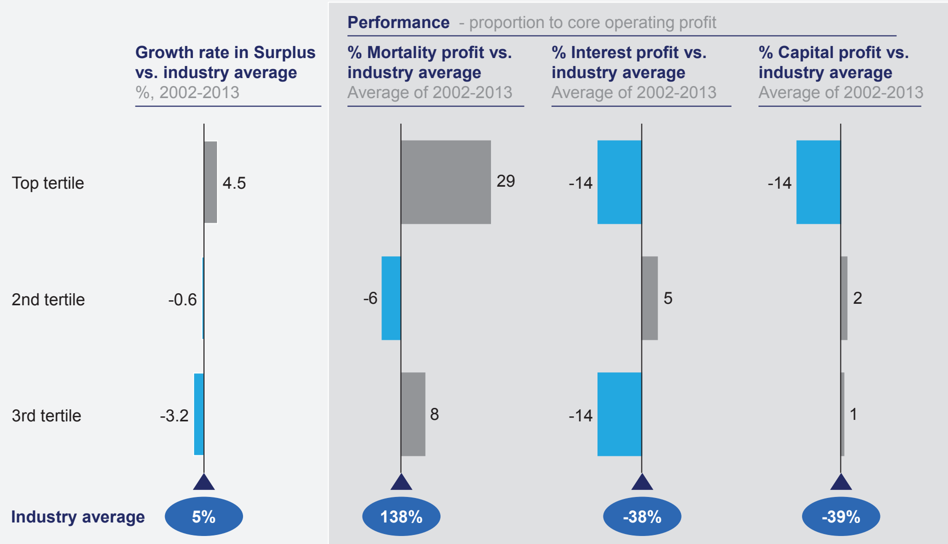
Accident and health products have disproportionately created more value than individual life and annuities. Having said that, product mix has only marginally impacted performance as even carriers with the more attractive *product mix* have eroded value by competing on price or commissions, while those with a seemingly less attractive product mix have captured value through differentiation. Career distribution has created more value than third-party channels. Size has not seemed to matter.

The search for profitable growth

Despite challenging demographic, macroeconomic, and regulatory trends, Japan's life insurance carriers face a number of attractive growth opportunities, primarily in the areas of new products and new markets.

Exhibit 3

Mortality risk is the strongest driver of performance



SOURCE: Japan Life Insurance Association, McKinsey analysis

Product opportunities

As financial responsibility shifts from the government to individuals – and as a growing number of individuals demand services superior to those covered by national health insurance and pension systems – two product opportunities stand out.

1. **Medical insurance.** Medical insurance is among the fastest-growing opportunities. The number of in-force policies grew at an 11% compound annual growth rate between 2001 and 2012 and this growth is expected to continue at a strong pace. Medical care costs are projected to rise from $410 billion in 2009 to $600 billion by 2025. In addition, government reforms will lead to significant opportunities for carriers. For example, a policy change in 2003 increasing the ratio of out-of-pocket medical expenses for company employees from 20 to 30% caused a spike in gross premiums. Over the next 5 years, the medical system is likely to undergo further reforms that will increase copayment levels.

2. **Retirement solutions.** The next generation of Japanese retirees, now aged between 40 and 55, does not have the same level of savings as previous generations; nor can these citizens expect the pension benefits that match those received by their parents' generation. This looming need for post-retirement financial services products represents another important opportunity for insurers. Importantly, 60% of retirees are open to shifting some or all of their assets to a new financial institution, according to a recent McKinsey Personal Financial Services survey. To date, however, Japan's financial institutions have yet to satisfy this demand for retirement advice, as 94% of the nation's adults report that they do not have an official financial adviser, according to the same McKinsey survey. This means that insurers – or other financial services institutions –

that can build a brand around the retirement theme and develop a holistic retirement approach stand to gain access to a burgeoning market. To succeed in delivering new value propositions and services, it is imperative for carriers to revamp their channels to provide financial advice tailored to specific customer needs and situations, and replenish their product line with flexible products suited to this end.

Emerging market opportunities

Research suggests that developing countries – with their expanding economies and low life insurance penetration – will account for almost 60% of global life insurance growth. Japan's life insurers are therefore looking to developing markets as a source of potential growth. They face a number of challenges: inward-looking, domestic mind-sets, regulations, a scarcity of management talent, and a lack of in-depth experience with consumer behaviors that differ from those in their domestic market. Even so, some players are building strong positions to drive growth, profit and valuations through acquisitions, joint ventures, and long-term organic development. (This positioning was given a strong prompt by the 2011 industry deregulation in Japan, which enables insurers to acquire companies that own non-financial-services subsidiaries, and to acquire more than 10% of a target's total assets.)

Four imperatives for life insurers seeking growth

Japan's life insurance industry has languished in the doldrums over the last decade, albeit with some notable outperformers. Now, however, a select number of growth opportunities are emerging. To take advantage of these potential growth pockets, however, Japan's life insurers must raise their game, tailoring products and revamping their distribution skills to meet the needs of consumers and confront challenging macroeconomic and regulatory environments. As a foundation for successful growth, life insurers must focus on 4 areas:

1. **Improve risk and capital management skills.** As noted earlier, Japan's high-performing life insurers excel not through top-line growth, but because of their superior liability management skills. Insurers with the discipline to focus on value growth rather than premium growth make better decisions, and will continue to outperform. Carriers must set clear parameters regarding risk appetite and establish robust metrics to manage capital and govern risk. Winners will also build more flexibility into product designs and pricing, to make fewer long-term guarantees and to share risk with their customers.

2. **Reinvent the way the company works, leveraging data analytics.** In a low-growth, low-interest rate environment, efficiency is paramount. To improve efficiency ratios, insurers should commit to investments in digitization, lean distribution, and data analytics, to better managing existing clients. The ability to analyze large pools of internal transactional and external consumer data to drive business insights is increasingly becoming a competitive advantage. These skills will enable insurers to capture value in key areas of their value chain: lead generation, risk management, pricing, and claims. With a better understanding of their existing customers, insurers can improve cross-sell and up-sell performance.

3. **Leverage the in-force book and existing customer relationships.** The in-force book accounts for the lion's share of profits, revenues, and operating costs for insurers, but in our experience, senior management focuses most of its attention instead on new business. To unlock the hidden value of the in-force book, carriers need to capitalize on

pricing, fee, and asset-allocation flexibility, pursue cross-selling and customer behavior management techniques, improve operational efficiency, and grow persistency through deep understanding of customers and agents.

4. **Expand distribution capabilities and cut distribution costs.** The single biggest source of costs for today's life insurers is distribution. As they pursue stronger margins, insurers must manage the increasing costs of commissions, technology, and sales compliance. There are many ways to improve performance in distribution, such as using deep analytics to identify leads and marketing opportunities, tailoring service offerings to agents based on their needs, increasing financial planning uptake, and building product expert, wholesaler, and sales teams to drive agent performance. A successful distribution model for the future will require not only a more efficient one-to-many approach to deliver advice at lower unit cost (for example, leveraging social media), but also seamless multichannel capabilities to serve the emerging "hybrid" consumer that researches options and collects price quotes through 1 channel, binds the policy through another channel, and manages the policy through yet another channel. In addition, insurers will need to build their competitive advantage to attract talent and create appealing career tracks to retain top agents and reduce turnover.

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In our analytical journey, we were surprised by the extent to which the industry's performance has deteriorated and the magnitude of difference in individual carrier performance, driven largely by the ability to manage risk. For Japan's life insurers, the challenge is straightforward: stable, attractive returns will only come to those that fundamentally rethink the industry's value proposition. Future leaders will focus on excelling in those areas that have proven to distinguish winners from laggards: risk and capital management.

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