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The Life Journey Korea

Financial Services Practice

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Overall, the life insurance industry in Korea delivers returns below the cost of capital, but some carriers are creating significant value. What are the winners doing differently?

For over two decades, the Korean life insurance industry has grown at an extraordinary average of 13% per year, pausing only in 1998 during the Asian financial crisis. The industry is now on track to have over 700 trillion KRW (640 billion USD) in assets under management in the next few years.

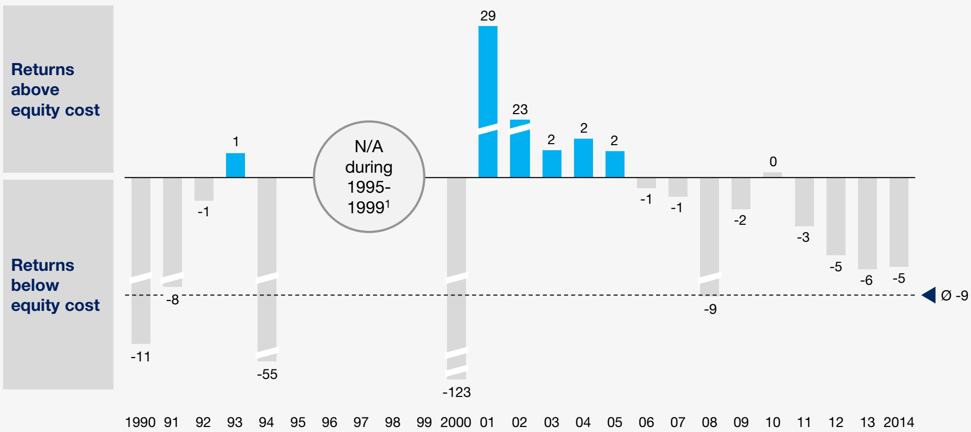
But the industry as a whole has not used its assets wisely. Instead, it has destroyed shareholder value in 19 of the 25 years from 1990 to 2014, as shown in Exhibit 1. Why has the industry performed so poorly? And have some carriers performed better than others and created value? If so, what have they done differently?

Exhibit 1

In Korea, life insurance sector has destroyed value

Life industry performance (1990-2014); Returns in excess of capital cost

ROE – COE[1]; Percent



1 ROE not available during 1995 to 1999 due to the industry-wide negative equity
COE estimated by calculating the global industry beta and utilizing capital asset pricing model (11.28%)

Source: Korea Insurance Development Institute; Capital IQ; Team analysis

To answer these questions, we launched The Life Journey, which began with research into publicly available data for Korea's life insurance industry since 2003. We focused on the top 16 life insurers and conducted a broader regional analysis. We also interviewed industry analysts and executives, and conducted in-depth research on eight insurers who jointly represent more than 60% of gross premiums in Korea, to gain a better understanding of the underlying drivers of performance.

The analysis reveals that there is a significant spread in Korean life insurers' track record of value creation and that the gap between the best-and worst-performing life insurers is driven primarily by their ability to manage liability risk, not their investment performance.

LIFE INSURANCE IN KOREA: A BRIEF HISTORY

To understand how we got here, it's worth a quick review of the life industry's evolution in Korea.

Between 1990 and 2000, its aggregate assets under management (AuM) grew from KRW 30 trillion (26 billion USD) to 100 trillion KRW (90 billion USD), an average annual growth rate of 13%. The industry recorded net losses in each of those years except 1991-1993, and the total equity of the industry fell below zero between 1995 and 1999. In other words, the total liabilities exceeded total assets. During the financial crisis at the end of the decade, many carriers went out of business.

After the crisis, the life insurance sector briefly entered a "value-creating" phase, with ROE exceeding the COE for five consecutive years, but this was driven at least in part by restructuring and "the denominator effect" of reduced equity.

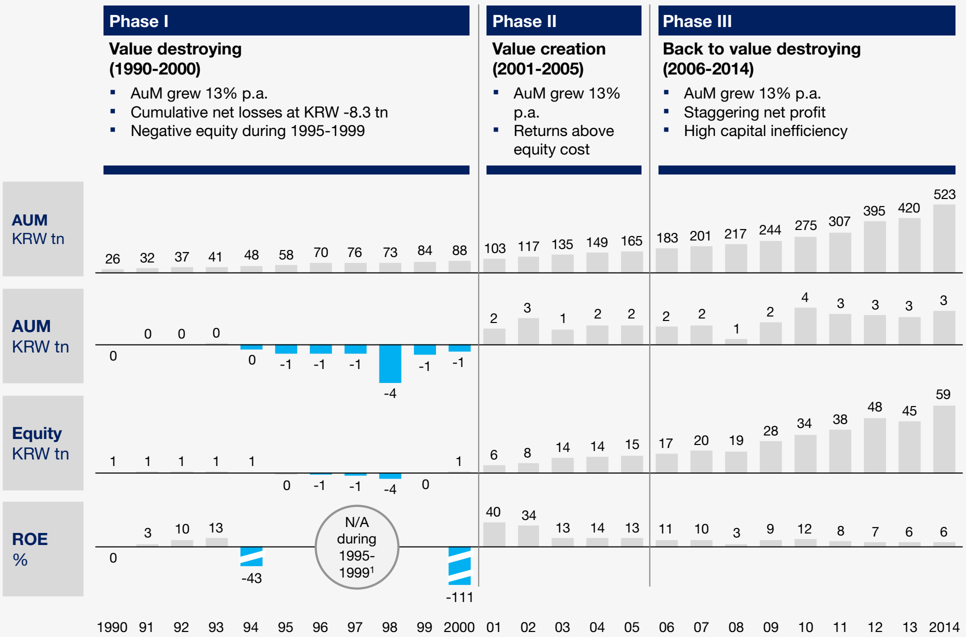
Korea's insurance industry is not alone in its dependence on economic tailwinds. In markets around the world, the life industry generates modest returns in positive economic environments but loses ground in more difficult times. For example, giant Japanese insurers, which many Korean insurers benchmarked in the past, have seen their accumulated gains wiped out during similar downturns.

A tough economy does not explain the persistent struggles of the Korean life industry as a whole, however. Since 2006, assets under management have returned to double-digit annual growth, reaching 523 trillion KRW (475 billion USD) in 2014, as shown in Exhibit 2, but the industry has continued to deliver returns well below its cost of equity.

This shortfall is due in part to the pursuit of volume without regard for value. For example, many domestic insurers sold products with interest rate guarantees as high as 7.5% that consumers saw, correctly, as attractive. With benchmark rates having fallen to about 1.5%, those carriers are now paying the price with negative spreads that have significantly eroded the industry's overall profitability.

Exhibit 2

Three phases of Korean life insurance sector's volume-driven evolution



1 ROE not available during 1995 to 1999 due to the industry-wide negative equity

Source: Korea Insurance Development Institute; Capital IQ; Team analysis

A WIDE GAP BETWEEN LEADERS AND LAGGARDS

While the overall performance of Korea's life insurance industry is poor, some insurers have consistently outperformed the market and delivered substantial returns.

Between 2003 and 2014, the industry in aggregate achieved 9% annual surplus growth, meaning that its statutory book value increased by 9% every year, correcting for dividened payouts and any equity injections. Carriers in the top quartile increased in value by almost 25% annually, while those in the bottom quartile increased less than 5%—a nearly 20 percentage-point spread in adjusted book-value growth between best and worst performers.

Measuring the performance of a life insurer

We believe the most revealing metric to measure growth in the value of a life insurer is growth in adjusted statutory book value — i.e., the ability to grow surplus adjusting for dividends to shareholders and capital injections. Adjusted growth in surplus is a relevant metric for measuring the performance of life insurers carriers because it accounts for profitability as well as growth. Adjusted growth in surplus allows for an "apples-to-apples" comparison between mutuals and stock-traded carriers since "price-to-book" is a common way to value stocktraded carriers and mutuals as they strive to grow their surplus, and it correlates well over time with other measures including return on equity, total return to shareholders, and economic value creation.

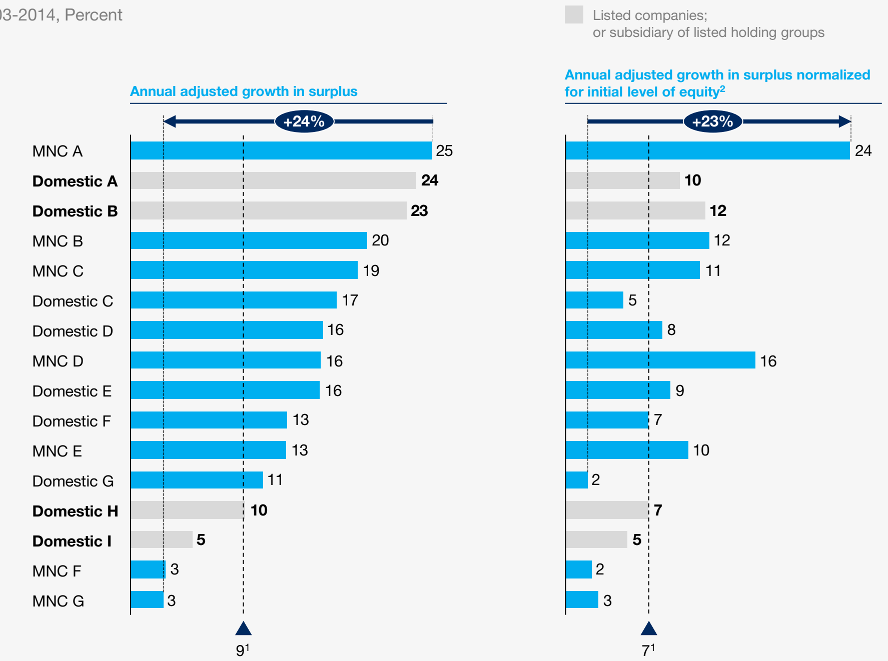
The industry's seemingly high growth in surplus and some carriers' outperformance were due in part to their unusually low equity baselines after the Asian financial crisis of 1998-2000 and the "credit card crisis" of 2002-2003.

The left side of Exhibit 3 shows an exceptionally high annual surplus growth among all carriers, mostly due to very low equity values in 2003. To compare carriers on an apples to-apples basis, McKinsey developed a normalized approach that considers Korean companies' uneven level of equity and estimated normalized initial equity values based on fixed "premium/equity" ratio equal to top three players in 2003. Those normalized results are shown on the right side of Exhibit 3. While many companies saw high surplus growth after 2003, most used the surplus for recapitalization rather than providing returns to shareholders or policyholders.

Exhibit 3

Wide spread in life carriers' performance

2003-2014, Percent



1 Industry average (weighted)
2 Starting Equity value normalized and adjusted based on a fixed "premium/equity" industry ratio in 2003
Source: Financial Supervisory Service, McKinsey analysis

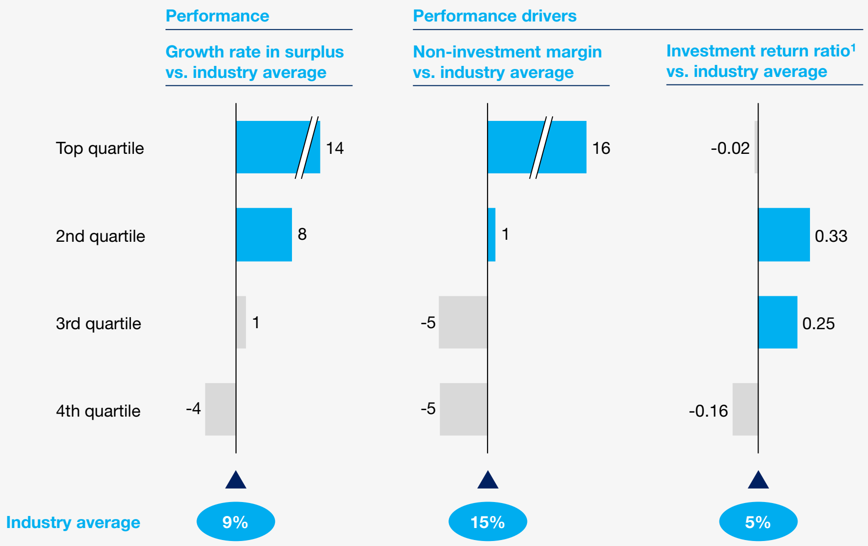
Our research shows that while many factors contributed to the value creation differential among the 16 insurers, none has proved more important than the ability to manage mortality and morbidity risk, which has delivered most of the industry's profit, as shown in Exhibit 4.

This is striking because few life insurers spend much time looking for innovative new approaches or honing skills in pricing or selecting risk. Carriers' performance in managing asset-based investments had no correlation with their overall value-creation performance: between 2003-2014, the top-performing insurers in terms of surplus growth performed below the industry average in returns on asset-based investments, while bottom the second- and third-quartile performers earned returns in excess of the industry average.

Exhibit 4

Liability management drives Korean life insurers' performance

2003-2014, Percent



1 Investment return over AUM

Source: Financial Supervisory Service; McKinsey analysis

While we've found significant performance gaps between top and bottom carriers in every market we've analyzed, what drives the gap varies depending on the market's maturity. Life insurers in Japan and the US generate over 90% of their earnings from liability management—selecting, pricing and underwriting risks—while those in China and India rely on asset management for majority of earnings generation (Exhibit 5).

Korea's life industry is in the middle of this continuum—for the last decade, it has made about 15% of its earnings by managing assets. Around the world, we see that as a market matures, life carriers generate an increasing share of earnings through liability management. That's partly because the investment landscape in mature markets is more open, transparent and crowded with sophisticated investors, including hedge funds, pension funds and sovereign wealth funds, that compete for the most lucrative deals. Meanwhile, regulations limit life insurers to relatively narrow, low-risk investment options that make it more difficult to differentiate themselves.

As Korea's life industry matures, it is inevitable that carriers will find it more difficult to achieve distinctive investment returns and be forced to focus more on liability management to create value.

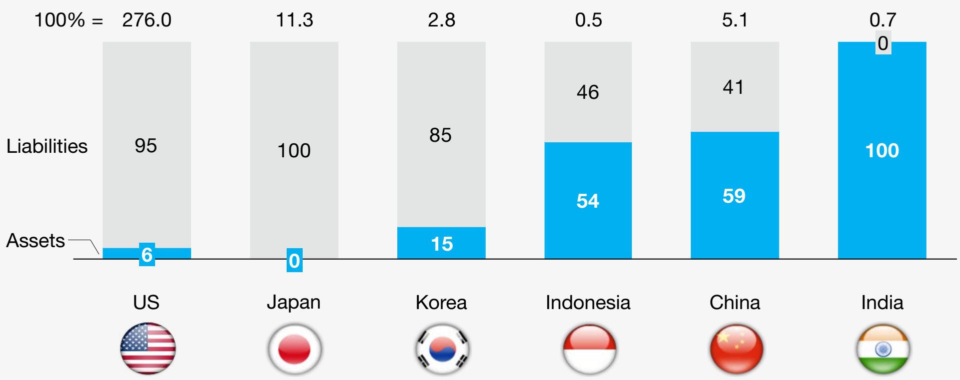
In order to win in this market, carriers should therefore invest to reshape their business model and enhance liability management capabilities to better prepare for the value growth journey. This mindset shift represents a return to basics: What the life insurance industry does best is select and price poolable risk, especially morbidity and mortality risk. The carriers that get these basics right outperform.

Exhibit 5

Value creation shifts from assets to liabilities as markets mature

Contribution to earnings before tax, extraordinary loss, and dividends provisions

USD billions annual average, percent



	US	Japan	Korea	Indonesia	China	India
Liabilities	261.0	20.9	2.4	0.2	2.0	-47.0
Assets	15.0	-9.6	0.4	0.3	3.1	47.7

Source: McKinsey Life Journey papers on Japan, Korea, Indonesia, China and India

THE SEARCH FOR PROFITABLE GROWTH

Despite challenging demographic, macroeconomic and regulatory trends, Korea's life insurance carriers have several growth opportunities, primarily in new markets and products.

Every year, hundreds of billions of dollars flow into Korean personal financial assets market. A large share of this "money in motion" now flows into simple retirement products, including single-payment savings. But members of the "silver segment" are demanding protection and sophisticated support to manage their living risks. As financial responsibility shifts from the government to individuals—and as a growing number of people demand services superior to those offered by national health and pension systems—two opportunities stand out as especially attractive:

Health insurance

Korea is a relatively mature market, with universal coverage provided by the National Health Insurance Corporation (NHIC). But healthcare spending is is expected to rise at 10% per year as the population ages. We expect it to cost 200 trillion KRW (180 billion USD) annually by 2020 or 11% of GDP, up from 7.8% in 2013. Much of the burden will fall on individuals, since NHIC's coverage is broad but limited: patients will pay about 45% of healthcare expenses out of pocket.

The Ministry of Health and Welfare aims to increase NHIC coverage to the OECD average level of 70% or higher, but this would create substantial deficits. Consumers' anxieties about the government's plans and projections have already begun to drive double-digit growth in private health insurance, reaching over 40 trillion KRW (35 billion USD) of total gross written premium, similar to the total NHIC spend in 2014. While life insurers have offered critical illness products since 2002, demand is now rising for products that cover specific prevalent risks such as cancer, stroke, and cardiovascular diseases. More consumers are also looking for coverage for environmental diseases such as atopy, rhinitis and long-term nursing care, which NHIC does not cover sufficiently. Long-term nursing may also expand the scope of the health business, leading to the convergence of insurers, hospitals and other care providers.

Retirement solutions

Korea's National Pension Service, the world's third-largest, is the subject of growing demographic concerns. Projections suggest that without changes, the Service will not have enough funds to meet its obligations by 2060. Consumers are aware of the problem, but few have found solutions. According to a 2014 McKinsey survey, most Koreans understand that the national pension will not cover their retirement expenses and do not have the financial resources to close the gap. This looming need for postretirement products represents another important opportunity. Insurers—or other financial services institutions—that can address consumers' concerns about retirement will gain access to a burgeoning market. We believe the most successful carriers will be those that revamp their distribution to tailor financial advice to specific customers and create flexible products suited to this end.

FOUR IMPERATIVES FOR LIFE INSURERS SEEKING VALUE GROWTH

To take advantage of these growth opportunities, Korea's life insurers must raise their game, tailoring products and revamping their distribution skills to meet the needs of consumers and confront a challenging macroeconomic and regulatory environment. We recommend that they focus on four areas:

1. **Build risk and capital management skills.** Since our research shows that liability management is the most important skill, we believe that insurers with the discipline to focus on growing value rather than premium will make better decisions and 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 share more risk with customers.

2. **Reinvent relationships with customers and distributors by using digital tools and analytics.** Korean consumers are among the world's most digitally savvy, crossing boundaries seamlessly between the physical and virtual worlds in their decision journeys. Marketing innovations using social and digital media, and direct business, including online product customization, purchasing and multi-channel servicing are becoming requriements for life insurers to stay competitive in Korea. In addition, in a low-growth, low-interest-rate environment, efficiency is paramount. Insurers should therefore invest 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 uncover business insights is increasingly becoming a competitive advantage. These skills will enable insurers to capture value in key areas, including 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 we found that most senior managers in Korea's life industry focus disproportionately on managing new business. To unlock the hidden value of the in-force book, carriers need to move from "managing" to "monetizing" the in-force book and pull key profitability improvement levers: increasing revenues and technical profit by stemming leakage, enhancing asset-allocation flexibility, pursuing cross- and up-selling and customer behavior management, and improving operational efficiency.

4. **Expand distribution capabilities and lower distribution costs.** Among the essential distribution capabilities will be delivering advice and helping consumers understand their risk needs before they purchase protection products. As they pursue margins, carriers will need to manage their biggest source of costs, distribution, including commissions, technology and sales compliance. To drive agent performance, they can tailor service offerings to agents based on their needs, increase financial-planning uptake, and build product expert, wholesaler, and sales teams. (For details, see "Maximizing Value from Agency in Asia" published by the McKinsey Financial Services Practice in 2015)

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 (using social media, for example) but also seamless multichannel capabilities to serve the emerging “hybrid” consumer who researches options and collects price quotes through one channel, binds the policy through another, and manages the policy through yet another channel. Insurers will also need to build their competitive advantages to attract talent and create more appealing career tracks to retain top agents and reduce turnover.

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In the years ahead, the success of Korea’s life insurers will depend on skills unique to the industry: managing poolable risk. We expect the outperformers to find new ways to price and select risk in high-value customer, product and channel segments, especially in a marketplace where most insurers continue to focus solely on managing investment returns or pursuing growth for its own sake.

The Life Journey series

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The Life Journey US; 2013

The Life Journey Japan; 2014

The Life Journey India; 2015

The Life Journey China; 2015

The Life Journey Indonesia; 2015

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