A vision for European life insurance: The time for bold actions has come

To survive and thrive in the coming years, European life insurance players must adapt by embracing six bold moves.

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The European life insurance industry is a cornerstone of the European savings and retirement ecosystem, with €6 trillion in assets as of 2016. However, the industry is approaching a critical crossroads. Given life insurers’ traditional reliance on fixed-income investments, nearly two decades of low interest rates have taken a toll on profits: the sector is now barely covering its cost of capital. Without the promise of healthy investment returns and attractive guarantee levels, the value proposition of life insurance as a savings tool is being fundamentally challenged. As a result, according to the McKinsey Global Insurance Pools, the overall gross written product (GWP) growth of the industry has been flat (0 to 1 percent), while new business has been shrinking and stabilizing at low levels in most markets.

Moreover, the industry’s focus on serving affluent individuals has stymied growth. Previous McKinsey publications have outlined how the global life insurance industry must adapt to capture the mass and middle markets. In the European market, this adjustment involves reacting to changing circumstances for pensions and healthcare while staying ahead of competitors. As radically lower interest rates and more stringent regulation create a level playing field with asset managers, life insurers must develop a new vision, and role, for the insurance industry in Europe’s long-term savings space in the coming decades.

Developing and acting upon this vision will require insurers to go beyond tactical and reactive efforts in distribution, operating models, and products to encompass six bold moves:

- Innovate around the customer proposition.
- Speed up distribution reform.
- Simplify the expense base and operations, reevaluating the sourcing partnerships equation.
- Stimulate the metabolism of an agile insurance organization.
- Optimize the back book.
- Shape the regulatory space.

Insurers who react on the vanguard will have a huge advantage in tapping the mass and middle markets for life insurance and outperforming their competitors.

Demand is growing—but industry response has fallen short

In all major European markets, life insurance is a cornerstone vehicle for long-term savings among affluent customer segments. However, demand for long-term savings is growing and increasingly filtering down to the mass market.

The primary catalyst of this growing demand is that people are living longer; the global mortality rate is falling steadily and life expectancy continues to rise. By 2023, according to our analysis, 70-year-olds will be almost 40 percent more likely to live through the year than 70-year-olds in
1983. Meanwhile, the absolute growth in retirees is not being offset by high birth rates. Therefore, most Western countries are witnessing aging populations.

This additional burden on European states has led most governments to reduce pension provision (Exhibit 1). In every Western European market except the Netherlands and Spain, the proportion of salary replacement people can expect to receive from their pensions (both state and mandatory private) is falling, in some cases dramatically. In France, pension salary replacement plummeted from 98 percent in 2005 to just 67 percent in 2014; the same year in Germany, people received just 53 percent of their salaries as a pension. To help ensure European retirees can not only survive

### Exhibit 1

**Net replacement rates in public pensions have decreased across nearly all European countries.**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>82.5</td>
<td>101.3</td>
<td>18.8</td>
</tr>
<tr>
<td>Turkey</td>
<td>113.2</td>
<td>98.0</td>
<td>−15.2</td>
</tr>
<tr>
<td>Spain</td>
<td>88.7</td>
<td>89.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Italy</td>
<td>89.3</td>
<td>82.2</td>
<td>−7.1</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>78.4</td>
<td>69.4</td>
<td>−9.0</td>
</tr>
<tr>
<td>France</td>
<td>98.0</td>
<td>66.9</td>
<td>−31.1</td>
</tr>
<tr>
<td>Belgium</td>
<td>82.7</td>
<td>64.2</td>
<td>−18.5</td>
</tr>
<tr>
<td>Sweden</td>
<td>90.2</td>
<td>63.9</td>
<td>−26.3</td>
</tr>
<tr>
<td>Switzerland</td>
<td>71.4</td>
<td>61.4</td>
<td>−10.0</td>
</tr>
<tr>
<td>Poland</td>
<td>60.6</td>
<td>54.0</td>
<td>−15.6</td>
</tr>
<tr>
<td>Germany</td>
<td>61.7</td>
<td>53.4</td>
<td>−8.3</td>
</tr>
<tr>
<td>OECD average</td>
<td>84.1</td>
<td>74.5</td>
<td>−9.6</td>
</tr>
</tbody>
</table>

1 Public pension (pillar I) and mandatory private pension (pillar II) for male low earner.
2 According to 2014 GDP (excluding Russia).

Source: Organisation for Economic Co-operation and Development; McKinsey analysis
but thrive, the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA) have been pushing for the creation of a pan-European Personal Pension (PEPP) product—which would have a significant effect on the life insurance industry. For more, see sidebars “The impact of the pan-European Personal Pension product on the European life insurance market” and “Flashback: The impact of the 401(k) on the US life insurance market.”

In addition to retreating from pension provision, European states are also carefully weighing public healthcare expenditure. In some markets, per capita expenditure is still rising, though slower than in previous years. In Greece, Italy, and Spain, however, healthcare expenditure per capita fell from 2010 to 2015 by between 2 percent and 10 percent a year, depending on the country.4

This combination of declining pensions and flagging state healthcare spending is forcing more Europeans to look for additional or alternative retirement funds. Indeed, in this context, only the wealthy are confident that they can retire in financial comfort; a 2017 McKinsey Insurance Practice Survey shows a clear drop-off in confidence among lower-income brackets compared with middle-class and affluent populations in Germany.

This confluence of circumstances produces a tremendous demand for protected saving solutions among the mass market. For example, the same 2017 survey found that among approximately 1,000 adults in each France, Germany, and the United Kingdom, half said they were most interested in a protected savings product (Exhibit 2). In general, demand for such guaranteed products was highest among lower- and middle-income brackets, while individuals in higher-income brackets indicated more willingness to invest in products with no protection but higher upside potential.5

**Life insurers face several challenges in the European market**

This robust customer demand may seem like a boon for life insurers, who are well placed to capture their fair share of the mass and middle markets. However, for some time now European insurers have also been facing several fundamental challenges, each of which hampers growth.

**Low investment returns.** Low interest rates continue to place enormous strain on life insurers’ balance sheets as investment income declines. The temporary but repeated shift to negative ten-year government bond yields in Germany and Switzerland, for example, raises vexing questions for the industry in those markets. Still, insurers are reluctant to materially change their asset allocations, such as corporate and government bonds, that will not deliver robust, long-term returns for future retirees.

Healthcare expenditure per capita fell from 2010 to 2015 by between 2 percent and 10 percent a year.
Indeed, fixed-income corporate and government bonds, which are favored by regulators, still account for upward of 80 percent of investments among many players (Exhibit 3). As a result, in 20 to 30 years, customers will find that life insurance products—while providing full or partial capital protection every year—will contribute little to their retirement income. Meanwhile, other types of long-term savings funds are more likely to diversify their portfolios; in one example we studied, a pension fund in Canada and a university endowment in the United States allocate just 22 and 4 percent, respectively, to corporate and government bonds. In the coming years, with the continuation of a low rates environment, insurers will need to take on more risk to boost returns. In doing that, they will need to adjust their business models to significantly refocus efforts toward investment and asset management, which have been neglected in the age of government bonds and fixed income.

Exhibit 2  Some customers, particularly those in lower-income brackets, prefer protected savings options over nonprotected options with higher upside.

Protected savings capital guaranteed  No protection, higher upside potential

N = ~1,000 interviewees per country

<table>
<thead>
<tr>
<th>Income (£), in thousands</th>
<th>France</th>
<th>Germany</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;25</td>
<td>36</td>
<td>42</td>
<td>40</td>
</tr>
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<td>25–50</td>
<td>48</td>
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<td>50–75</td>
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<tr>
<td>75–150</td>
<td>61</td>
<td>66</td>
<td>72</td>
</tr>
<tr>
<td>&gt;150</td>
<td>84</td>
<td>69</td>
<td>72</td>
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</tbody>
</table>

Source: McKinsey Insurance Practice
Increasing customer expectations. The bar for service quality and channel availability has been rising dramatically, shepherded by innovative digital players in the B2C arena. European customers, like those in other mature and emerging markets, are putting pressure on life insurers to deliver a customer experience at a higher level—requiring change management, investments, and transformation.

Unsustainable expenses. Compared with other industries, life insurance has not yet structurally addressed its operating costs. In Europe, for example, our research has revealed that banks have lowered their efficiency ratio by seven points over the past few years, while life insurers’ costs (cost to net written premiums) have been flat over the same period. In a recent poll, insurance executives estimated the necessary midterm cost reduction for the industry at 35 percent, which is far from realizing the current aspirations of most cost programs (10 to 15 percent). A disappointing record of managing costs further compounds the obstacles.
The impact of the pan-European Personal Pension product on the European life insurance market

In 2013, following a mandate by the European Commission, the European Insurance and Occupational Pensions Authority (EIOPA) began developing the foundational regulatory and consumer protection measures to undergird a single market for personal pensions in the European Union.

EIOPA recommended the development of a standardized pan-European Personal Pension Product (PEPP). Offered by a variety of authorized providers to complement state pensions, the PEPP will be portable across borders and available to employed, self-employed, and unemployed individuals in the European Union’s 28 member states.

The introduction of PEPP will affect the traditional European life insurance market in two significant ways:

1. Limiting inflows. With product features such as charging caps, mandated employer contributions, and tax exemptions, a PEPP is likely to serve as an attractive alternative to traditional life insurance products.

2. Exerting pressure on profitability. If PEPP charges are low, life insurers will experience increased pressure on fees and charges for life insurance products.

Intensifying competition from asset managers and digital attackers. Life insurers are not the only show in town when it comes to retirement products. Recognizing the market is far from saturated, asset managers are tapping into life insurance value pools, while digital technology companies with more customer touch points, such as Amazon and Google, are building stronger relationships and finding new inroads to engagement, profit, and sales.

Challenging and uncertain regulatory environments. In Europe, the introduction of the Solvency II Directive has brought a significant drop in the solvency ratio and the return on equity. The effect of Solvency II is compounded by the current low interest rates, and it also makes insurers vulnerable should there be changes in rates, as the Solvency II ratio levels are affected even by small fluctuations.

Industry response has been insufficient

The industry has made some strong shifts in distribution, operating models, and products—but there are downsides to these moves, and many of them fail to evolve the industry.

The introduction of the Solvency II Directive has brought a significant drop in the solvency ratio and the return on equity.
Product catalogues are adopting capital-light savings solutions and protection. Over the past decade, some life insurers have shifted their new business to focus on capital-light products (alternative guarantees, hybrid, and unit-linked, among others). However, this change puts insurers in direct competition with asset managers that have a significant competitive advantage in this area and often operate at lower costs. In parallel with this shift, insurers have also doubled down on core protection products (death, disability)—but the product volume is, by nature, restricted, and margins are shrinking due to heightened competition. For example, consider the decline of premium levels in Germany and the United Kingdom, both of which are characterized by a retail protection market, as well as in Switzerland, which is characterized by a corporate protection market. For example:

- **Germany:** From 2009 to 2014, German insurers saw a decline of 20–25 percent in premium rates on new business.

- **Switzerland:** From 2007 to 2014, Swiss insurers saw a 20–25 percent decrease in premium rates on new business.

- **United Kingdom:** From 2012 to 2016, UK insurers saw a decline of 5–10 percent in premium rates on new business.

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**Flashback: The impact of the 401(k) on the US life insurance market**

When the US Congress passed the Revenue Act of 1978, it amended the Internal Revenue Code to introduce the 401(k) plan: a tax-qualified, defined-contribution pension account plan. A 401(k) enables employees to designate a percentage of their salary as a pre-tax contribution to their retirement account, up to a certain limit each year (as of 2018, that limit is $18,500). Employers can also make contributions to the fund on the employee’s behalf. Over the years, 401(k) plans have been administered by employers as well as third-party outsourcers, and the assets are invested in mutual funds overseen by asset managers.

As a result, life insurers in the United States have been forced to either transform their business model, moving into asset management to incorporate 401(k) offerings, or focus on risk protection such as term life or annuities. At the end of 2017, US defined contribution plans held $7.7 trillion in assets, of which $5.3 trillion were in 401(k) plans served directly by asset managers. Insurers that did not build in-house asset management skills or did not acquire third-party asset managers are today out of 401(k) markets. A similar market change is expected in Europe as soon as pan-European Personal Pension Product becomes effective, taking out of the life insurance market space a big portion of asset under management potential and forcing life insurers to either focus on risk business solutions or move toward the asset management space.

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Partial digitization of distribution, limited by traditional channel footprint. Most players have experimented with at least partial digitization of distribution (for example, digitally enabled agent tools, digital bancassurance). However, due to the restrictive start-up resource cost to go digital in the short term, the bulk of new policy volume continues to be generated through traditional channels (except in front-runner countries such as the Netherlands and the United Kingdom), keeping the long-term costs high and deterring disruptive innovation.

Operating model changes. Some insurers have rolled out lean process management, IT transformation, and new approaches such as robotics—but the management, regulation hurdles, and upfront investment needed for this type of evolution have deterred many players. The share of operating costs dedicated to digital technologies grew slightly from 2012 to 2017, moving from 26 to 29 percent, but this shift is not transformational, and the figures are much lower than in the property and casualty industry; true structural cost reduction is limited and yet to come.7

Bold moves are needed today, more than ever, to reboot European life insurance for growth

Restoring profitable growth for the European life insurance industry will require overcoming the industry’s legacy weaknesses. We believe six key levers will help insurers successfully reboot their operating model.

Innovate around the customer proposition

European insurers must respond to customer needs and expectations around flexibility, personalization, and relevance. To enhance flexibility, one solution could be product bundling across the verticals of health, insurance, retirement, and wealth management—for example, allowing customers to pledge savings-oriented insurance policies against a mortgage underwritten by the insurer. To enhance personalization, insurers could, for example, develop a product allowing customers to adjust how their premiums flow into different types of protection as they get older—for example, building up the share that goes toward chronic care coverage (Exhibit 4). To enhance relevance, insurers could retain their core competence of offering some downside protection for retirement solutions—for example, through hybrid products, which marry unit-linked products to a guarantee of 80 to 85 percent of the invested capital. This feature remains the only defendable differentiator compared with asset managers.

Restoring profitable growth for the European life insurance industry will require overcoming the industry’s legacy weaknesses.
Exhibit 4  As they age, customers’ risk appetites shift away from mortality and income protection toward health and long-term care.

<table>
<thead>
<tr>
<th>Need-based allocation of monthly insurance budget</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly premium, %</td>
<td></td>
</tr>
<tr>
<td>100</td>
<td></td>
</tr>
<tr>
<td>90</td>
<td>Life insurance is most valuable during earlier life stages, when employees have not accumulated enough assets to provide for their dependents.</td>
</tr>
<tr>
<td>80</td>
<td>Long-term care insurance is increasingly relevant after age 45 as the risk of chronic morbidity diseases increases.</td>
</tr>
<tr>
<td>70</td>
<td>Disability insurance is relevant only during productive life and will decrease in value after age 55 as retirement approaches and this type of insurance will replace income for a relatively short time.</td>
</tr>
<tr>
<td>60</td>
<td>Cancer/critical illness and personal liability insurance are equally relevant throughout productive life.</td>
</tr>
<tr>
<td>50</td>
<td></td>
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<tr>
<td>40</td>
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</table>

Source: McKinsey Insurance Practice

Another area of opportunity could be returning to the fundamental promise of risk-sharing: *mutualization*. By offering incentives for policyholders to qualify as low-risk, life insurers can align the interests of both parties, offering lower rates or other benefits in return. Several European insurers already practice mutualization, and this idea could enjoy a renaissance across the industry, with far-reaching implications for insurers’ ability to make asset allocation and product design choices—such as investing in high-risk assets.

**Speed up distribution reform**

Three distribution platforms—employer distribution to employees (B2B2C), B2C, and direct to consumer (D2C)—hold promise for the future.

**Worksite**: In Europe, B2B2C (worksite) distribution is enjoying a comeback, thanks to digitization. Pension providers and benefit consultants have launched various digital solutions (for example, pension advisory applications, planning tools) to convert group policyholders to customers. There is no clear winner yet, but the opportunity is apparent. The McKinsey survey performed in Q1 2017 on 3,000 customers in France, Germany, and the United Kingdom found that between 15 and 20 percent of respondents would trust their employer as the best adviser for retirement saving choices.
**B2C:** According to our research, the share of direct, digital sales volume in Europe is hovering below 5 percent but is bound to grow in the coming years. Half the population in Europe already uses internet-banking services, and digital natives will become the core target segment for life insurers in about ten years. Comparable product categories (for example, wealth management) are already on this route in other markets. In the United States, digital advisory has already captured more than 15 percent of the overall managed asset volume.

**D2C:** If we accept that part of the sales process must always happen through human interaction (even in the far future), then insurers must double down on digitizing the agency network to reach consumers directly. For example, insurers can manage leads through advanced analytics and social media tools or launch intuitive product navigators and advice tools to be used on the road. Another route could be to enhance phone advisory by following the banking industry’s recipe in mortgage advisory centers.

**Simplify the expense base and operations, reevaluating the sourcing partnerships equation**

Changing client needs and expectations present an opportunity to invest in radically simplified processes and back-end expenses. Many carriers are evaluating a holistic set of levers, yet in 2016, only three of the top 15 life insurers reduced their general expense base; the others saw increased or flat expense levels. In addition, carriers have opportunities to evaluate how to better strategically source contractors, partnerships, and vendors across the life insurance value chain. As commoditized, pay-for-usage digital services expand, companies should reevaluate what they do in-house and what is cheaper and easier to outsource.

**Stimulate the metabolism of an agile insurance organization**

Resetting the customer proposition and distribution model requires unprecedented change for insurers. To succeed, they must increase agility—that is, balance speed with structure—within their organizations. While a full transition to an agile setup with capacity-based planning, squads, and tribes might seem far fetched, insurers need a fresh talent influx to shift the culture and support a focus on speeding up the company’s metabolism (for example, faster, bolder innovation in product and servicing) and putting the customer—not the agent or the broker—in the center.

Changing client needs and expectations present an opportunity to invest in radically simplified processes and back-end expenses.
Optimize the back book

Insurers still have many options to improve the efficiency of their existing business. Introducing lean operations and overhauling legacy IT systems are a good start, but there are enormous cost savings to be made from digitizing existing high-touch processes and simplifying the product shelf, both for new business and the existing portfolio. Enhancing back-book management can free up valuable resources to be channelled toward growth.

Shape the regulatory space

Insurers must move from a defensive play to proactive collaboration with regulators. To do so, they can fine-tune Solvency II requirements so alternative asset classes that deliver higher returns are economically viable by measure of capital requirements. Insurers should also

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IFRS 17: Opportunity or threat?


IFRS 17 redefines the approach to calculating technical reserves as present value of future insurance cash flows, discounted at rates reflecting the current market interest rates structure. At day one, expected profit is amortized over the duration of the contract, while expected loss is accounted immediately.

In most Continental European countries, where interest rates have decreased significantly, use of market interest rates to discount cash flows in the technical reserve calculation will most likely increase the value of liabilities on the balance sheet. This new standard provokes some concerns from market players, particularly those based in France, Germany, Italy, and Spain. Other countries have raised additional concerns regarding the volatility of accounting results by using a “close-to-market consistent approach.”

IASB chairman Hans Hoogervorst, discussing the benefits of IFRS 17 in a speech last year, said “The standard will bring clear principles for revenue and profit recognition, making the insurance industry better comparable to other financial companies, such as banks and asset managers.” He also cited other benefits to the new standard such as the disclosure of technical liabilities at a fair value, the increased comparability among countries, the greater consistency between profit and customer service provision, and ad hoc reporting of unprofitable contracts from day one.

From a market player standpoint, the new standard is expected to (a) disrupt the way insurers look at profit and cash generation (especially for life players), and (b) force the market to enter a new phase of heavy implementation that will affect actuarial models, IT systems, and reporting, as well as require significant allocation of personnel and relevant costs.

This new journey is expected to continue through until at least 2021 (potentially beyond in the event that the go-live is postponed) and will represent the next big regulatory chapter for insurance markets in Organisation for Economic Co-operation and Development (OECD) countries, following the go-live of Solvency II barely more than 12 months ago.

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prepare for the rollout of the PEPP, which would level the playing field between different types of providers, as well as IFRS 17, which would open up the “black box” of current insurance accounting but could potentially inject more volatility into balance sheet results (see sidebar, “IFRS 17: Opportunity or threat?”).

Living through challenges: A huge opportunity for insurers who can react fast

The European life insurance market is in a deadlock. The challenging macroenvironment is undermining the sustainability and attractiveness of traditional life savings products. In addition, a generic, follow-the-leader strategy around unit-linked and protection products will not be viable in the long run due to competition from asset managers as well as regulatory headwinds.

To break out of the current position, insurers must fundamentally rethink their value proposition; doing so presents an opportunity to rethink the business model end-to-end. The players that succeed will be best positioned to own a significant chunk of the market and outgrow their competitors.

A few main themes are core for life insurers to work on and kick-start the change:

1. **Expand the asset portfolio**: Move away from government bonds and fixed-income assets by creating distinct differentiation in asset management and evolving the asset portfolio to create alpha return, and sustain the business with attractive customer return. Equip and strategize for serving customers on the cusp of the next pension reforms that will arrive in Europe and will transform the life insurance market—as the 401(k) did in the United States.

2. **Decrease expenses**: Rethink the distribution model and operations to simplify the operating model and digitize main processes. On average, digital players have 50–70 percent lower administration costs per GWP compared with established players. Furthermore, we found players with recently modernized IT had 40 percent lower operational costs compared with players with legacy IT.11

3. **Reinvent the distribution model**: Move from a commission-based push model to a value-add advice model, especially for pension products based on an individual or voluntary basis.

4. **Build or harness growing ecosystems**: Secure customers’ points of contact on growing ecosystems through moves, acquisitions (for example, Ping An with multiple companies, Generali with Welion), and partnerships (for example, AXA with Oscar).

5. **Be agile**: Take inspiration from the growing insurtech industry and modernize the way of operating, for example, moving from departmental silos to agile way of working, and from a hierarchical organizational structure to be a skills-based organization—that is, one with critical roles throughout the organizational chart rather than only in upper management.
The life insurance industry will continue to play a vital role in the European economy. Adaptable carriers will be poised to prevail and outgrow regardless of their current position in the market. Charles Darwin’s evolution theory is an apt analogy; it is the species that adapt, not necessarily the strongest, that survive. ■

5 The exception is the >€150,000 income bracket in the United Kingdom, which exhibited an almost even split in preference for protected savings and nonprotected savings products.
10 McKinsey analysis based on annual company reports.
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