Insurance Practice

Implications of coronavirus for North American life and annuities writers

As life insurers grapple with their response to COVID-19, key priorities are emerging to mitigate disruption of new business and in-force block management.

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During the COVID-19 pandemic, businesses are rightly focused on securing their employees’ and customers’ safety, as well as keeping their doors open with immediate business-continuity measures. As the effects of the crisis continue to unfold, it is hard to overstate the complexity of the challenge facing the North American life and annuities sector. Uncertainties around the rise and fall of transmission rates throughout 2020 mean that insurance carriers face unprecedented challenges that are likely to extend beyond the shorter-term remedies that many have already implemented.

In addition to urgent operational considerations, carriers must plan for potentially volatile morbidity and mortality rates. Second-order impacts can be as severe as first-order effects. Disability carriers, in particular, should be prepared for potentially heightened losses given the economic impact of the pandemic.

Beyond these challenges, COVID-19 threatens to adversely affect new business, disrupt in-force management and claims, erode portfolio returns over the medium to long term, drive credit migrations in investment portfolios, and lead to a fundamental rebalancing of risk-reward trade-offs across asset classes.

Operational disruptions across new business and in-force blocks
Both new business and in-force management will face operational disruptions in the coming weeks and months.

New business disruption
While it is still early days, we anticipate a decline in new total premiums sold by North American life and annuities writers due to three factors.

First, eroding macroeconomic conditions will likely reduce the appetite for higher-premium, more complex life and annuities policies that drive industry economics as well as group and work-site sales. This is the case even as increased traffic to online life insurance sites suggests a near-term spike in interest in life insurance products.

Second, carriers are taking more conservative postures on pricing and underwriting. The rapid decline in interest rates has kicked off a round of repricing for many products. In some instances, interest-rate volatility is causing carriers to suspend sales of certain long-duration products. In addition, to protect against adverse selection, carriers are implementing narrower underwriting guidelines to restrict the class of risk they are willing to insure.

Third, analog sales mindsets remain prevalent. Even though the industry has made—and continues to make—significant investments in digitizing the end-to-end sales funnel, many advisers still prefer the ritual of sitting in front of their clients and filling out paper forms. As a result, new-business and underwriting processes remain tied to paper applications and medical underwriting, particularly for high face-amount products. But given the implementation of widespread physical-distancing and shelter-at-home requirements, COVID-19 will lead to fewer sales meetings for advisers, disruptions to new-business processing, cancellations of medical underwriting exams, delayed collection of medical records, and reduced underwriting capacity.

Now is the time for carriers to lean forward on supporting intermediaries in two ways:

— Ensuring advisers can transact digitally through all steps of the sales funnel, from prospecting through policy issuance. Early evidence out of China suggests these digitization efforts can be highly effective, especially if they are undertaken as a permanent culture and tool shift, rather than a short-term fix.

— Working to expand the availability of fluid-free underwriting to obviate the need for medical exams where possible within risk tolerance levels. Early data suggests life carriers are moving quickly in this regard.
Carriers will need to continuously monitor new business pricing for rate-sensitive products until interest-rate volatility subsides.

In-force disruption
In-force operations, from call centers to claims processing to policy administration operations, have largely transitioned to work-from-home environments. As employees adjust to a new normal, delays and amended processes are all but inevitable. Functions that rely heavily on outsourced or offshored capabilities are experiencing more significant disruptions. The depth of the disruptions varies by country, relationship structure (captive versus joint-venture versus completely outsourced), and vendor.

Strategic product, pricing, and in-force management considerations
The pandemic also creates significant product, pricing, and balance-sheet challenges. Interest rates in the United States have dropped to Great Recession–era lows, pressuring carriers on multiple levels. In an environment where certain long-duration products are suspended, carriers will need to continuously monitor new business pricing for rate-sensitive products until interest-rate volatility subsides. In certain instances, rate-driven repricing could render certain products, such as income annuities, highly unattractive to consumers. Low interest rates also put pressure on in-force blocks with rate-sensitive guarantees—thereby reinforcing the strategic importance of in-force optimization.¹

Meanwhile, variable annuities with equity-linked guarantees could break their hedges if equity markets see another significant drawdown, thereby opening holes in balance sheets. Even if this does not occur, the cost of hedging is likely to increase until markets stabilize.

Furthermore, given that the COVID-19 pandemic could lead to a significant and protracted economic contraction, the industry’s investment portfolios could witness credit migrations not seen since the Great Recession. Such an event would lead to further balance-sheet challenges, such as declining reserve ratios.

Finally, while still unlikely, a severe economic contraction could create a crisis in financial markets, disrupting treasury operations and hindering carriers’ ability to perform daily functions, such as paying claims or collecting premiums.

A comprehensive response
At this point, most carriers have taken the requisite business-continuity steps to stabilize operations in the near term. Looking forward, several priority actions will be crucial for North American life and annuities writers.

Develop a strategy for the next 12 to 24 months and beyond. Carriers should first develop several macroeconomic scenarios and then feed them into a "sources and uses of capital" model. This model should integrate balance-sheet and business performance to provide an integrated view of capital and earnings over time under different scenarios. Armed with this insight, carriers can plan to navigate multiple scenarios over the next 12 to 24 months and develop a longer-term value-maximizing strategy for the post-coronavirus world.

Innovate the product portfolio. Many carriers will benefit from shifting to products that are more capital efficient. This rotation away from capital-intensive, rate-sensitive products with embedded guarantees have been underway for some time in Japan and Europe, where carriers have had to grapple with a more austere rate environment for years. Recent innovations include launching new unit-linked products with lower guarantees; deploying pocketknife-type products that evolve to meet the needs of the insured; and offering supplementary health products, including for cancer, critical illness, and hospital indemnity. Finally, challenges associated with medical underwriting should accelerate the advancement of products that can be priced and underwritten without an in-person medical exam.

Drive channel migration. Now is the time for carriers to digitize every step of the customer journey—from initial planning, to digital payment, to remote claims. In the face of COVID-19, some Chinese insurers rapidly adopted video and messaging apps to enable an end-to-end customer journey that facilitates customer authentication, face-to-face digital meetings, and application completion and execution. In some cases, carriers can see 30 to 50 percent more prospects on a weekly basis.

Accelerate the move to fee-based earnings. The past decade has seen carriers rotate away from balance sheet—based earnings and toward fee-based earnings from adjacencies such as wealth and asset management. Carriers currently pursuing initiatives to boost fee-based earnings may look to accelerate execution. All carriers should reassess their portfolios to determine whether to invest in new capabilities or markets.

Make in-force management a strategic priority. For many carriers, in-force management has been a second-order consideration relative to new business. However, optimizing the in-force book is the most significant lever for any carrier looking to rapidly improve performance. Reinsurance, buyouts, and closed-block transfers remain the fastest way to improve performance for most carriers. There is also now a large pool of private capital willing to buy these assets, which could result in improved pricing for carriers that want to get these blocks off their balance sheets. That said, carriers that opt to retain their books can consider a broader set of transactional, structural, and operational levers.² In the pre-pandemic rate environment, these opportunities were less attractive than divesting parts of or entire blocks. However, the current macroenvironment could fundamentally shift the cost-benefit analysis significantly.

Get serious on cost. Many carriers believe they have taken meaningful cost action since the Great Recession—but the data tells a different story. Frustratingly, since the financial crisis of 2008, the industry’s cost structure as a percent of premium has remained unchanged. Now is the time to take real action within core operations and beyond. Successful carriers will appoint a chief transformation officer who reports directly to the CEO, set bold targets, leave no stone unturned to

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² Balasubramanian, D’Amico, Jain, Milinkovich, and Purushothaman, “Maximizing the value of in-force insurance amid enduring low returns."
identify opportunities, adopt private equity—style incentives that reward superior performance, move with urgency, and marry transparency with individual accountability. Banking, telecom, consumer products, and other industries have successfully demonstrated the value of taking a zero-based budgeting mindset to reduce structural costs. Such an approach is applicable across the entire cost base.

**Assert strength.** Valuations for many firms in the life and annuities and adjacent spaces, such as wealth and asset management, have decreased significantly since mid-February. Carriers that find themselves in strong positions and able to take a long-term view can look to M&A to advance their strategic agendas. Potential opportunities include buying closed blocks for scale and entering new, capital-efficient markets. In pursuing these opportunities, it might be possible to partner with private-equity firms or offshore investors who are interested in putting capital to work in the sector.

**Upgrade talent and shift ways of working.** Given growing uncertainties and market volatilities, carriers could see an increased interest from digital and analytical talents that have historically gravitated to other industries but might now appreciate more stable employment prospects. Carriers also have a unique opportunity to reskill their employees to operate in a more digital world and embed new ways of working, such as the remote deployment of agile practices. While this is necessary in the near term to respond to the current situation, over the medium term this can help foster a culture of enterprise agility, too.

The COVID-19 pandemic will continue to test the economy for the foreseeable future. For decades, the North American life insurance and annuities industry has grappled with declining penetration rates and criticism over product complexity and commissions. The value of a guarantee has been lost on many consumers. Now is the time to reinforce the stability and peace of mind the industry provides consumers in times of crisis. Forward-looking carriers can learn from carriers in China, which responded to the onset of the pandemic through a variety of actions—including free or subsidized coverage to healthcare professionals and first responders, fast-track claims related to COVID-19, and charitable donations to groups affected by the outbreak. We are now seeing carriers in North America step forward and take similar actions.

One carrier recently committed to making free life insurance available to medical professionals in the carrier’s local communities. Over the long term, standing tall at this moment will reinforce the industry’s role as an integral and valuable pillar in our society for customers, employees, and policy makers alike.

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