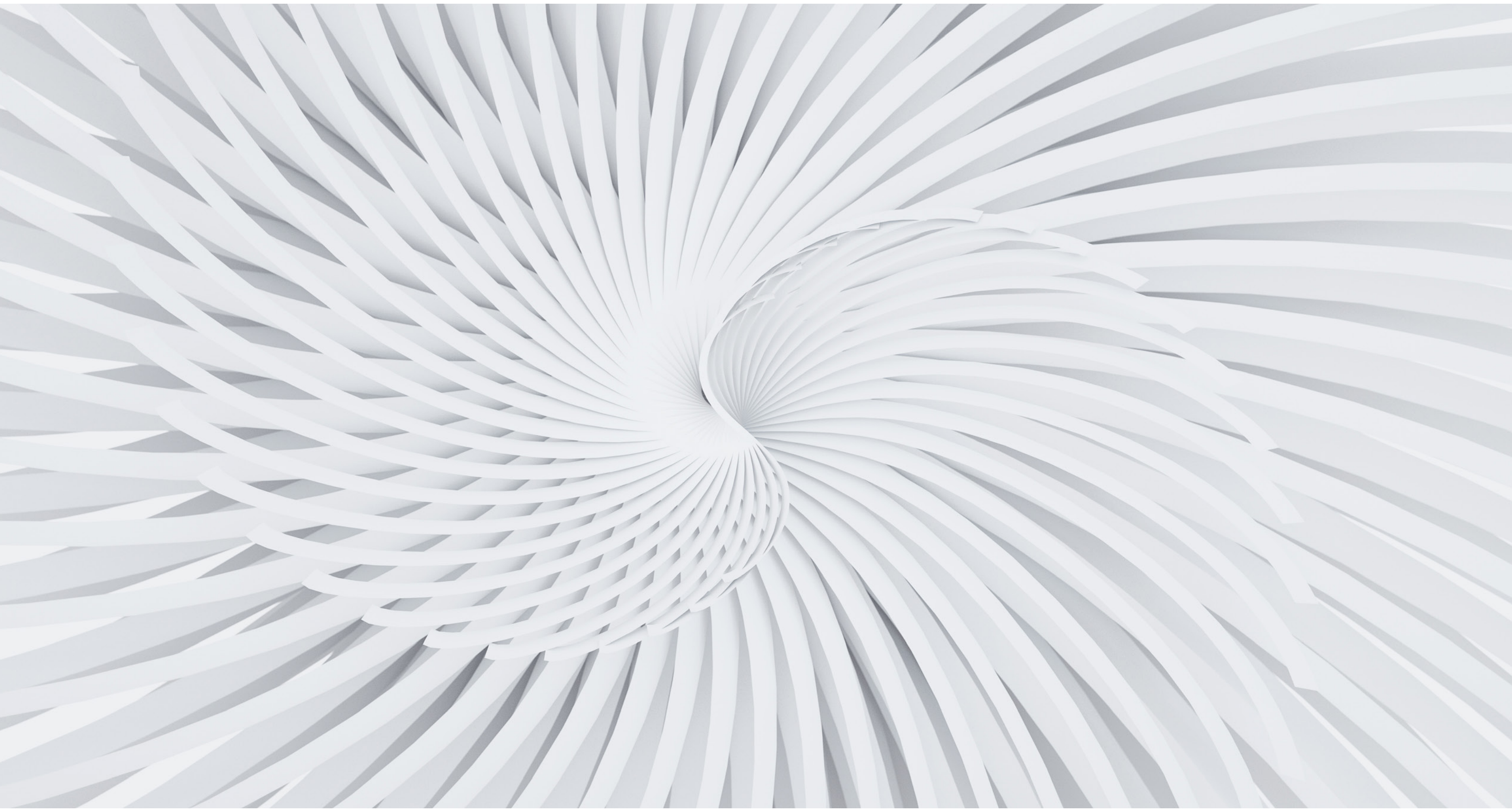
McKinsey & Company

Insurance Practice

Maximizing the value of in-force insurance amid enduring low returns

In-force optimization can deliver improved growth, higher margins, and lower capital requirements. To get there, US carriers can define a strategy around three potential levers.

by Ramnath Balasubramanian, Alexander D'Amico, Aditi Jain, Nick Milinkovich, and Karthi Purushothaman



April 2020

While most insurers tend to look toward new sales, new products, and new customer segments for growth, virtually every major life and annuities insurer has a large and highly fragmented set of in-force policies on its books that often accounts for roughly 90 percent of economic performance. Yet maximizing the value of in-force blocks—whether open or closed—remains a secondary priority for most US carriers.

But those carriers should reconsider. In-force optimization can deliver the trinity of economic advantages: improved growth, higher margins, and lower capital requirements. Realizing these benefits, however, requires carriers to marry a clear in-force strategy and best-in-class execution.

Minimizing the burden of long-duration policies priced during an entirely different era—particularly before the global financial crisis of 2008—will be fundamental to the viability of insurers worldwide. Japanese and European carriers have experienced prolonged low interest rates for the better part of the past two decades. While US insurers have been adapting to and planning for a low-interest-rate environment for the past several years, the Federal Reserve's active quantitative-easing interventions are likely to keep the ten-year treasury note well below 1 percent for the foreseeable future. As such, US insurers will have to deal with a sudden shock that will significantly challenge their profit-and-loss statements and balance sheets.

The ongoing health crisis caused by COVID-19 has put even more pressure on in-force blocks with rate-sensitive guarantees. Should we see further decline in equity markets, variable annuities with equity-linked guarantees could break their hedges, thereby opening holes in balance sheets (even if this does not occur, the cost of hedging is likely to increase in the near-to-medium term until markets stabilize). And a freeze in the credit markets could lead to deterioration in the quality and value of assets held in the insurer's general accounts and materially hurt earnings.

In many ways, this state of affairs represents a perfect storm for life insurers. Against this backdrop, the importance of optimizing in-force book management is elevated from an afterthought to a strategic imperative for many life and annuities writers.

Seizing the opportunity at hand: Three types of levers to optimize the in-force book

Three types of levers—transactional (such as strategically divesting part or whole books), structural levers (such as adjusting the product mix), and operational (such as outsourcing)—can provide insurers with the playbook they need to optimize their in-force book. Big, strategic transactional moves may have been the more attractive option when rates were better, but if exiting a block entirely is no longer viable, insurers can still pull several structural and operational levers to get more value out of their in-force book. Indeed, in our experience, insurers that optimize their in-force books through structural and operational levers stand to boost their internal rate of return boost by up to 60 percent (Exhibit 1). The levers that appeal to individual carriers will vary depending on the nature of their assets; in most cases, pulling several in tandem has a multiplier effect.

Transactional lever

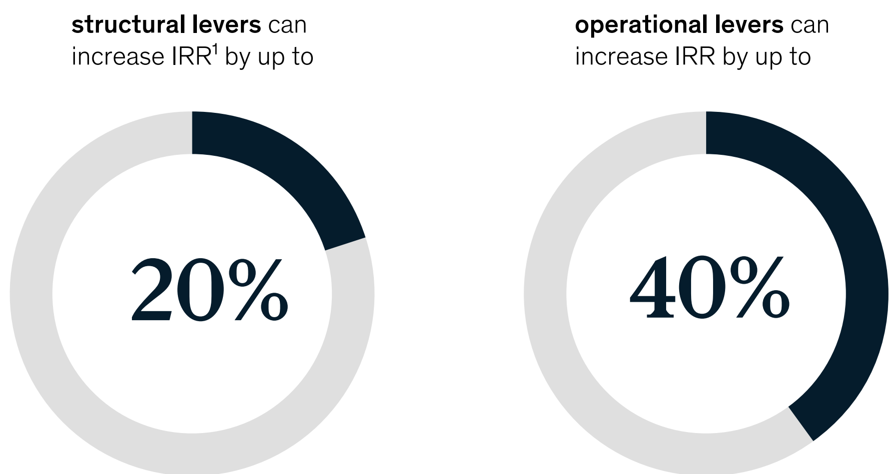
Selling off part or all of a block that is no longer profitable is, in some ways, the path of least resistance. Indeed, it entirely removes the risk from the insurer's books and negates the need for more surgical interventions. Carriers can typically sell a part of the block at 60 to 85 percent of their embedded value, with macroeconomic and financing conditions driving volumes and deviations. Even at such a discount to the embedded value, selling off all or part of a book can accrue long-term value for carriers by improving their solvency ratio or by freeing up capital to redeploy elsewhere—from investing in new business with higher profitability to increasing payouts or dividends.

Depending on desired balance-sheet exposure, carriers can choose to operate in a variety of archetypes ranging from pursuing straightforward reinsurance transactions, fully exiting both

Exhibit 1

There are three main value drivers behind effective in-force management.

For insurers that choose not to pursue transactional levers for a given book, employing



[1] Internal rate of return.

ownership and operations, retaining risk but outsourcing administration, to selling risk to one party and outsourcing risk to a third party (Exhibit 2).

The transactional lever has become increasingly viable as the set of potential buyers has expanded beyond reinsurers to an emerging field of book aggregators backed by new sources of capital, including private-equity firms, pension funds, offshore investors, and others looking to secure insurance assets. Moreover, some are willing to partner with carriers to de-risk their positions through creative structuring. For example, the carrier keeps some economic upside through retained minority interest and experience refunds.

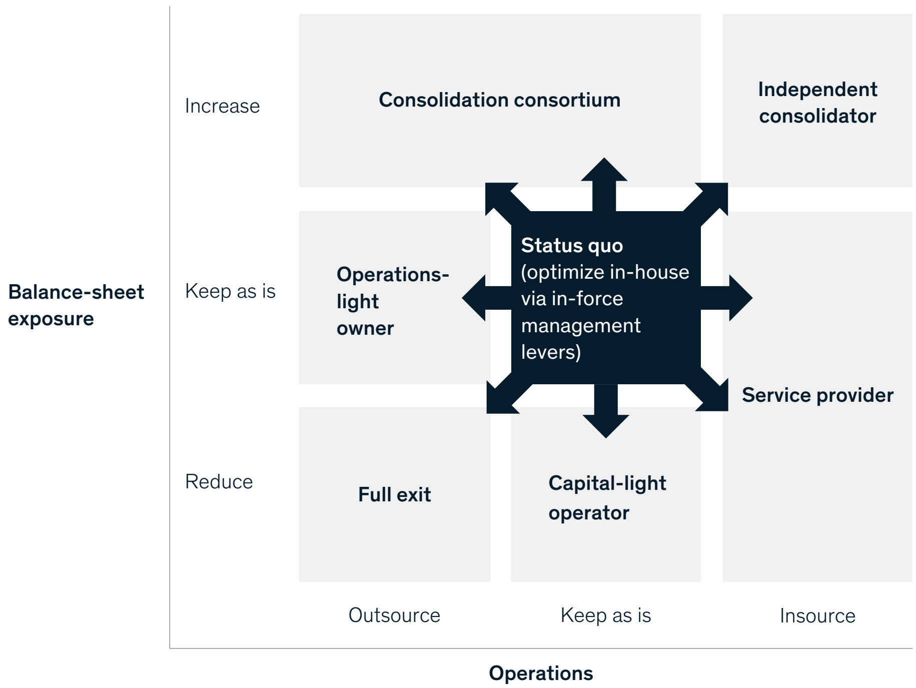
In the past two years, we have witnessed an acceleration of book transactions across life, annuities, and long-term care insurance in the United States. Examples include the Carlyle Group's acquisition of a majority stake in AIG's Fortitude Re business; Voya Financial and Hartford's carve outs and sales of their variable annuities block to a consortium of private-equity players; and Protective, RGA, and Wilton Re's continued block purchases and reinsurance transactions.

Critically, for this lever to be financially attractive for shareholders (or participating policyholders in a mutual), a carrier would need to believe one of several conditions: first, that alternative in-house optimization efforts—that is, structural and operational levers—would yield limited results. Second, that capital can be best invested elsewhere for higher perceived risk-adjusted return. Or third, that there are no crucial synergies between the block being divested and the rest of the business franchise.

Getting the most value from a transaction requires several capabilities. First and foremost, well-developed portfolio management is crucial to not only understanding which parts of the book to exit or keep and when but also to negotiating advantageous deal structuring. Other essential transaction-management processes to perfect include origination, diligence, pricing and valuation, legal structuring, and reorganization. Finally, it's important

Exhibit 2

Carriers choose different strategic postures depending on desired balance-sheet exposure and operating model.



to have an experienced regulatory compliance team to avoid unnecessary transaction delays.

Structural levers

Structural levers are primarily aimed at reducing capital requirements and improving asset allocation.

Alternative asset management. The emergence of private-asset direct origination platforms has redefined the set of alternative asset classes for carriers beyond hedge funds and private equity to include hard assets such as energy, infrastructure, real estate, and even pockets of private credit vacated by traditional banks after the financial crisis of 2008 (for example, private middle-market debt and consumer finance). This growing set of options allows insurers to solve yield-compression issues by diversifying their portfolios—some newer asset classes can deliver yields that are hundreds of basis points higher than treasuries. Some insurers are already pursuing such alternative asset-management approaches; for example, Allianz is investing more money in commercial property and infrastructure to boost its returns. Creative partnerships with asset managers can help carriers not only mitigate pressures in asset-liability management but also access high-value asset classes.

Strategic pricing. Thanks to advanced algorithms and new sources of data, carriers can now build a more granular understanding of their customers and their book liabilities, especially given the suite of interventions and engagement methods enabled by digital channels. Tapping into this information allows carriers to restructure policyholder contracts and tune current reserves to free up capital.

Carriers that develop a strategic pricing capability can not only optimize the pricing of their own books but also wield it as a competitive advantage to buy other undervalued books of business. And those that do so can transform from a seller under duress to a market-leading aggregator, buying undervalued blocks and generating additional returns.

Other structural enhancements. Numerous other structural adjustments that are often overlooked by carriers can improve the profitability of in-force books. Some of the most impactful adjustments include optimizing legal entities to restructure reserve requirements, splitting or merging segregated funds to optimize credit ratings, and reinsuring the investment longevity—that is, reserves held for high guarantees or consolidation of reinsurance.

Operational levers

Many of the more fruitful opportunities to optimize the in-force book are operational ones, such as outsourcing, improved productivity, higher customer retention, and so forth.

Strategic outsourcing and expense reduction. Over the years, traditional insurers have kept their end-to-end policy administration systems in house. These systems are often decades old and have been subject to myriad customizations, acquisitions, new product configurations, and other tweaks to accommodate an increasingly diverse set of policies and customer needs. For many life insurers, chronic underinvestment in legacy systems has resulted in upward of a dozen administrative systems—introducing both fragility and rigidity and causing carriers to incur additional maintenance and development costs.

Today, vendors have scaled enough that insurers can completely outsource policy administration while maintaining the primary customer relationship. Furthermore, a growing number of fintechs are available to handle a large volume of interactions with a better interface; it's increasingly more viable to take advantage of these existing interfaces that adhere to customer expectations in the digital age rather than updating archaic in-house technology and untangling inefficient, highly manual servicing processes. Other insurers may pursue outsourcing because declining volumes in certain segments have resulted in a subscale portfolio, limiting efficiency and creating an uneconomical cost structure. By engaging insurtechs and other third-party vendors with digitally native processing and customer service capabilities, many carriers can capture cost differentials as well as increases in customer satisfaction.

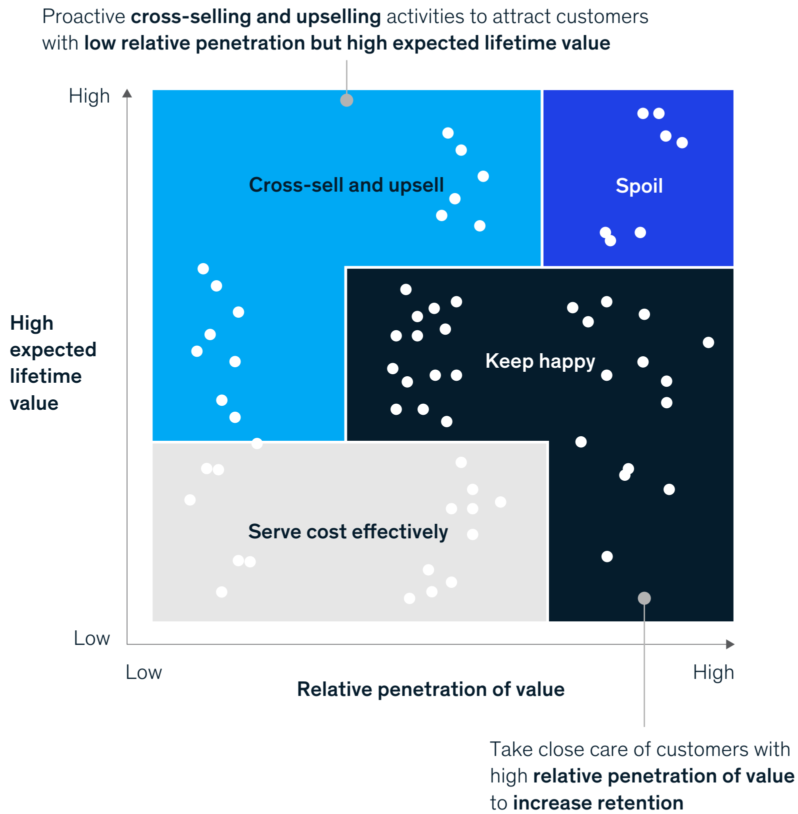
Like asset divestitures, outsourcing policy administration can quickly shift the economics of in-force blocks. In addition to cost and process efficiency, consolidating these platforms can have several downstream benefits—for example, agents interacting with a single system can enable a more seamless customer response, and digitization need not be constrained by legacy systems and can instead empower high degrees of self-service. The highest expenses and complexities in consolidating these platforms have typically been due to extraction and transfer of data, product features, and rule sets. Now, several technological advances in data-management software—such as natural language processing to extract, clean, and structure raw data, or simple no-code platforms to recreate rules through configuration—are lowering the cost and complexity of consolidation and creating new opportunities.

Furthermore, in-house productivity transformations to optimize unit costs can significantly reduce expenses to serve existing blocks. These transformations can be enterprise-wide and combine efficiency levers such as automation, digitization, lean operations, service-level-agreement adjustments, and so forth. Carriers can also target specific blocks or subsegments for expense reductions. For example, changing service models on orphan policies, which often have cumbersome legacy processes, can materially reduce the level of manual intervention.

Analytics-driven client relationship value maximization. The same granular understanding of carriers' customers and book liabilities that facilitates strategic pricing can also be used to improve client relationships. Indeed, recognizing a customer's lifetime insurance needs as well as their present and potential values can inform customer segmentation and targeting. For example, customers that have a high expected lifetime value

Exhibit 3

A value-based customer strategy starts with assigning present and potential customer value.



but low relative penetration of value are ideal for cross-selling and upselling with specific models that recommend the next product to buy (Exhibit 3).

Carriers can also proactively manage attrition by systematically deploying incentive programs and transitioning orphan policies to best-fit advisers—for example, agents that serve particular regions or customer segments. In recent years, emergent nontraditional external-data sources have led to highly predictive segmentation features. For example, zip code and support network, in addition to demographic age, can provide a strong indication of pre- and post-retiree utilization of retirement products. Individuals in active senior communities, for instance, may be more likely to learn from each other and use their benefits properly compared with those in more dispersed, heterogeneous geographical settings.

For blocks that require a fair amount of judgment, such as long-term care and disability, analytics can help in more-granular segmentation, triage, straight-through processing, better management of network utilization, and overall enhancement of cost-of-care and return-to-work outcomes. All these can substantially improve payout accuracy and reduce claims leakage.

Nudge to influence better outcomes. While advanced analytics (AA) can be used for expense reduction, it can also be used to generate more revenue—specifically when wielded to influence better outcomes for both the customer and the carrier. In the long term, AA nudging can allow carriers to dissect the block and reposition elements in a highly targeted way. To date, some of the key sources of value have been within annuity blocks and traditional protection products.

In annuity blocks, customers may act against their own interests and ultimately not use the benefit; meanwhile, the insurer continues to need to hold reserves and capital, assuming the customers will be more efficient than insights may indicate, thereby trapping value for all stakeholders for decades to come. Carriers can help customers make more optimal decisions—for example, weighing the option of converting an annuity into periodic payments during their lifetime rather than leaving behind a large estate—by revising distributors' incentives to help them do so.

The proliferation of highly interactive channels and customer-generated information provides the ability to influence customer behavior and quickly receive feedback on outcomes. These insights allow carriers to design new, interactive protection products and features for better policyholder outcomes. For example, the Discovery Vitality business model in South Africa has measurable impact on improving the wellness of existing customers by creating incentives to reward positive health behaviors (such as physical activity, nutrition, and weight loss). The potential value in morbidity-driven blocks like long-term care is significant, as sustained improvements in healthy behaviors can materially diminish claims uncertainty and costs. All this creates new sources of value—in the form of pricing, ecosystem partnerships, and so forth—that carriers can share with customers. It can also improve engagement, in turn increasing data flow on customers for further analytics. Such a cycle creates the much-needed moat for maximizing value from in-force customers.

Shift to a capital-light product mix. Given the persistent low-rate environment and the need for increased capital reserves on high-guarantee products, carriers will need to evaluate their current product mixes and guarantee structures. It might even serve carriers better to stop or modify certain contract terms, products, and features—such as focusing on protection products or shifting to new types of guarantees—and work to nudge customers toward capital-light products.

Getting started

To determine which levers are right for a given insurer's context, the first step is a basic diagnostic. Insurers need to find out what they don't know about their in-force book and understand it at the segment level—including value drivers, cost constraints, adviser composition, and client characteristics. Without this insight, any attempt to optimize the book will be isolated and less likely to succeed.

It's also important to remember that each lever can individually create value; however, when bundled together appropriately to address a block's unique characteristics, carriers can create outsized value. Coupling strategic lever deployment with best program-management practices will be crucial to success.

Finally, capturing this value requires a comprehensive approach with integrated leadership. Our experience is that a single senior executor (such as the CFO, the chief actuary, or the president of the life and annuities business) needs to be tasked with in-force optimization and given the necessary resources and decision rights to carry out an in-force strategy.

Any low-rate environment, particularly when coupled with an economic contraction that may stymie new product sales, pushes insurers to look for new sources of value. There are many options for optimizing the in-force book, from fully divesting to free up capital to taking a more surgical approach to structure and operations. Time is of the essence; the sooner US carriers get started, the more options they will have over the coming months and years.

Ramnath Balasubramanian is a senior partner in McKinsey's New York office, where **Alexander D'Amico** is a senior partner, **Karthi Purushothaman** is a partner, and **Aditi Jain** is an associate partner. **Nick Milinkovich** is an associate partner in the Toronto office.

Contact

For more information, please contact:

Ramnath Balasubramanian
Senior partner, New York
Ramnath_Balasubramanian@McKinsey.com

Alexander D'Amico
Senior partner, New York
Alexander_D'Amico@McKinsey.com

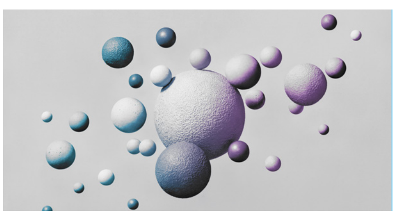
Aditi Jain
Associate partner, New York
Aditi_Jain@McKinsey.com

Nick Milinkovich
Associate partner, Toronto
Nick_Milinkovich@McKinsey.com

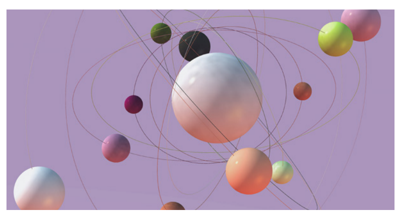
Karthi Purushothaman
Partner, New York
Karthi_Purushothaman@McKinsey.com

Further insights

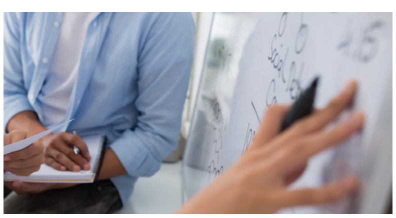
McKinsey's Insurance Practice publishes on issues of interest to industry executives. Our recent articles include:



The productivity imperative in insurance



Ecosystems and platforms: How insurers can turn vision into reality



Life insurance product innovation: What insurers can learn from leading tech and consumer companies

The insurance agency of the future: Building a digital service model