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The Life Journey Indonesia
Winning in the most attractive life insurance market in the world

Financial Services Practice

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Indonesia is the most attractive life insurance market with high profitability and growth, but not everyone wins in this market. What do the winners do differently?

For much of the new century, life insurance returns in Indonesia have surpassed those in other Asian markets. The success has been supported by favorable market conditions. Yet penetration remains low, and some of these conditions are changing. To keep pace with the evolving Indonesian market, companies will have to understand these shifts and how to find the most promising growth opportunities.

As part of a continuing effort to guide insurance companies in Indonesia and throughout the region through the changing landscape, McKinsey has taken a close look at how the best companies have managed to succeed. The study focused on Indonesia's top 20 life insurers and included in-depth regional analysis. We also interviewed industry analysts and executives in the market, and examined performance using a new metric: adjusted growth in surplus.

MEASURING PERFORMANCE

The most revealing metric for the health of life insurance companies is growth in adjusted statutory book value, in essence the ability to grow surplus, adjusting for dividends and capital transactions. This metric—adjusted growth in surplus—is relevant for all carriers because it accounts for profitability as well as growth. It also correlates well over time with other measures, including return on equity, total return to shareholders, and economic value creation.

The metric measures the success of public carriers, which are commonly valued based on price-to-book ratios, as well as mutuals, which strive to increase their surplus, and provides a comparable measure of success across both types of companies.

This enables an objective comparison of the performance of individual insurers in Indonesia, and a broader comparison of companies in the sector in India, China, South Korea, Japan, the United States and other countries.

McKinsey's analysis showed that some market features that have supported industry returns in Indonesia – in particular the regulatory environment and distribution networks – are evolving as the economy matures. In addition changes in demographics and consumer behavior will present new challenges and opportunities. The study spotlighted six imperatives that must be appreciated to keep pace with these market changes.

BUILDING ON SUCCESS

Since soon after the turn of the century, the life insurance industry in Indonesia has been consistently profitable, delivering aggregate returns in excess of its capital costs (Exhibit 1). With one exception, returns have covered the cost of equity since 2003, peaking at almost 14 percent in 2009. The exception came in 2008, when returns were 5.4 percent below the cost of equity, largely from the fallout felt everywhere from the burgeoning global economic crisis. Even then, the market still significantly outperformed its Asian peers.

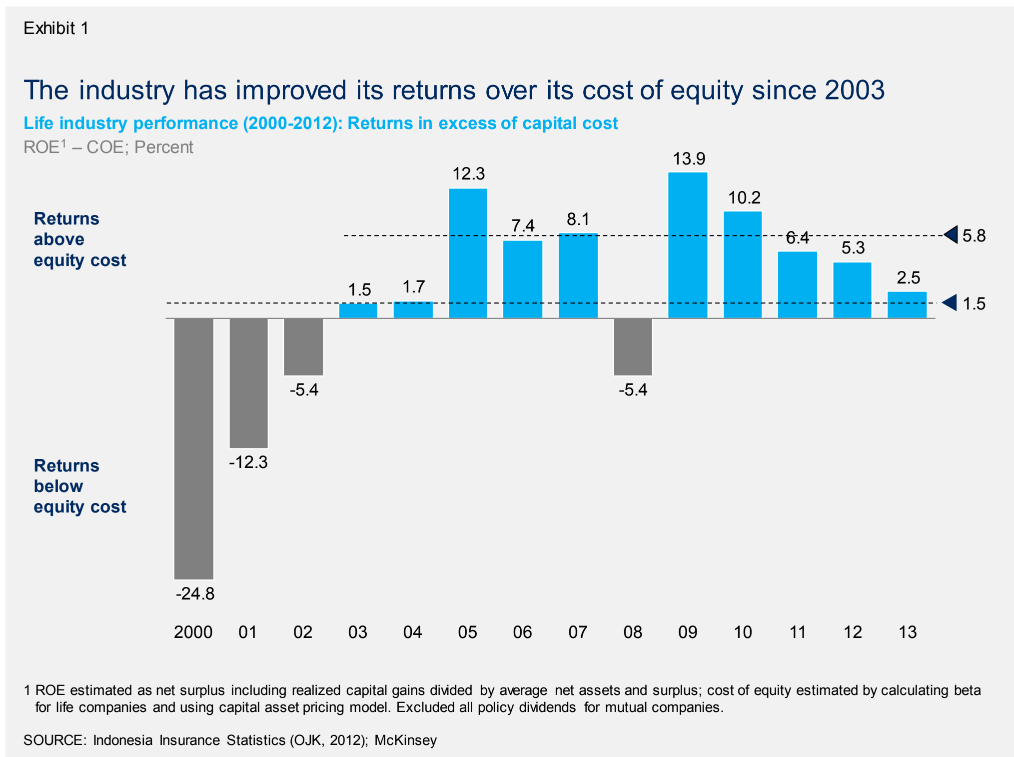


Exhibit 1

The industry has improved its returns over its cost of equity since 2003

Life industry performance (2000-2012): Returns in excess of capital cost

ROE[1] – COE; Percent

1 ROE estimated as net surplus including realized capital gains divided by average net assets and surplus; cost of equity estimated by calculating beta for life companies and using capital asset pricing model. Excluded all policy dividends for mutual companies.

SOURCE: Indonesia Insurance Statistics (OJK, 2012); McKinsey

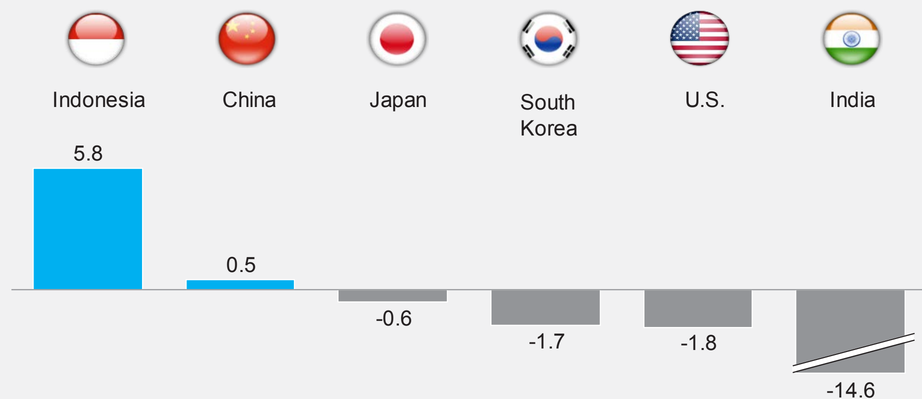
In the decade from 2003 to 2013, corporate profitability among Indonesian life insurers was much higher than those in the biggest Asian markets (Exhibit 2). On average during this period, returns in excess of capital cost were 5.8 percent in Indonesia, compared with 0.5 percent in China. In other large Asian markets – India, Japan, and South Korea – returns over the period didn't cover costs of capital.

Exhibit 2

Most other Asian markets are generating returns below capital cost

Life industry performance: Returns in excess of capital cost

Average spread between ROE and COE, 2003-2013 (percent)



SOURCES: McKinsey Life Journey papers on the US, Japan, South Korea, Indonesia, China and India

The industry's success has been supported by a healthy domestic economy and stable market. Indonesia's economy has grown by 5 percent a year or more for most of the past decade, reaching 6.3 percent growth in 2007[1]. In addition, household income levels in Indonesia are rising, and every year about 5 million people – the equivalent of Singapore's entire population – enter the consuming class, which we define as those earning $3,600 a year or more. Both trends are expected to continue.

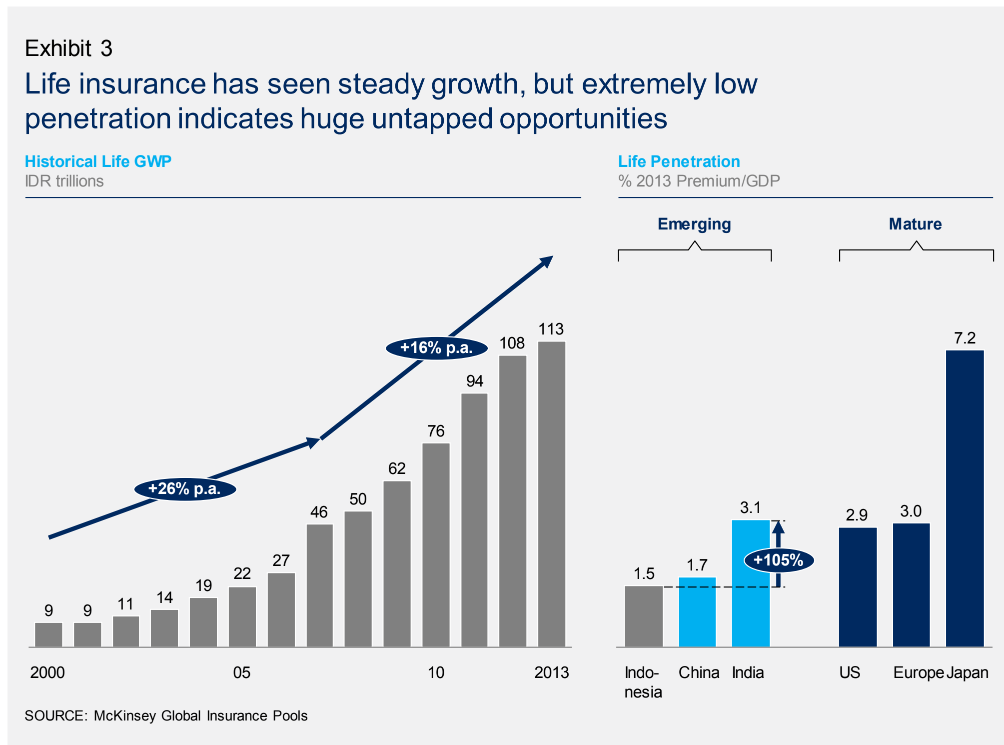
Life insurance returns have also benefited from a relatively stable industry structure. Life insurance penetration in Indonesia is only 1.5 percent, much lower than other emerging Asia markets such as India where penetration is about 3 percent. Such low penetration allows life insurers in Indonesia to compete for market segments and geography, rather than use price to lure away other companies' customers. (It also highlights the country's growth potential.) Adding to market stability, Indonesia consumers tend to be loyal to their brands, with surveys showing that in some general consumer categories as many of three-fourths of the respondents have a preferred brand in mind.

In addition, the market is dominated by large multinational carriers with sophisticated pricing skills and a strong focus on profitable growth. Although improvements have been made, bureaucratic complexities and infrastructure shortfalls have also traditionally created barriers to entry for the industry, stifling competition.

Third-party distribution networks have also been more profitable for life insurers in Indonesia than in most other markets. Between 2007 and 2012, adjusted annual growth in surplus from third-party distributors – particularly banks – was 44 percent, compared with just over 30 percent for dedicated agents (Exhibit 7). This success is due in part to the fact that as banks grew alongside the insurance industry in Indonesia, they were more interested in building relationships with multinationals than in maximizing profits.

1 Data from World Bank

In this environment, life insurers have thrived. From a very low base, gross written premiums in Indonesia rose by about 26 percent a year between 2000 and 2007 (Exhibit 3). Even after such remarkable growth, gross written premiums continued to rise by about 16 percent a year from 2007 to 2013.

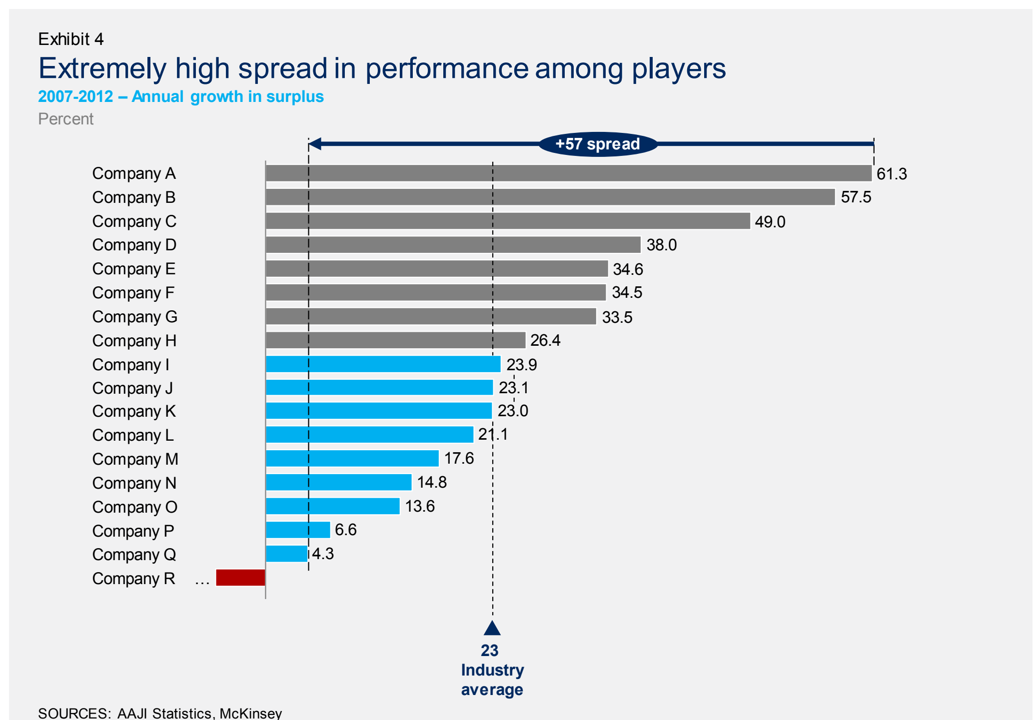


There is little indication that industry growth rates will decelerate significantly. Indeed, we expect the market to grow by more than 10 percent annually over the next five years, pushed primarily by the country's relatively low penetration rates. McKinsey research has shown that less than 10 percent of consumers in the country have made long-term financial plans, fewer than 1 percent have considered buying complex financial products, such as equities or mutual funds, and only about 3 percent consider life insurance a source of retirement income.

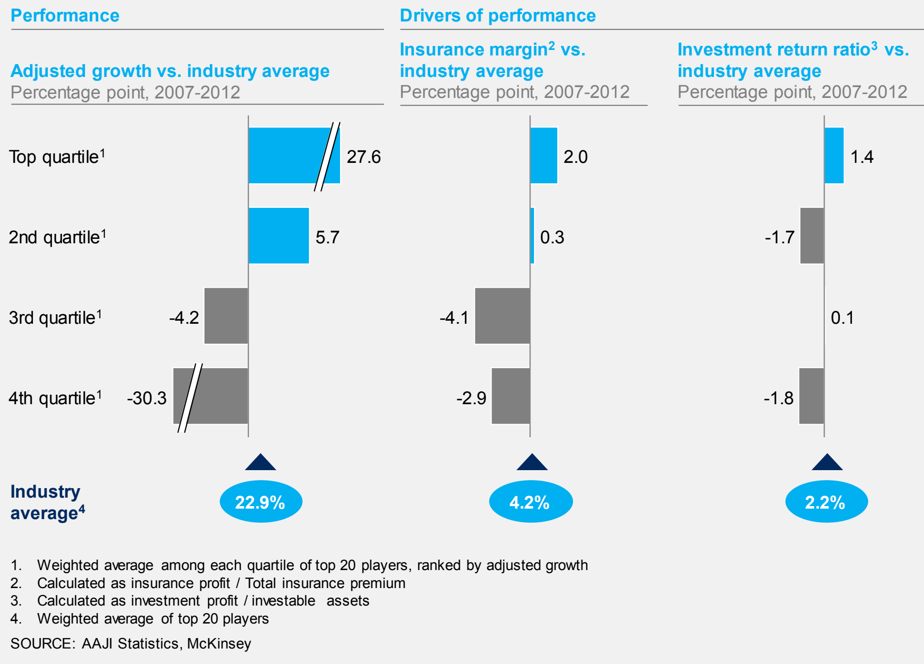
SIGNIFICANT PERFORMANCE GAP

The Indonesian insurance industry remains in the early stages of development. Although the country has the largest economy in Southeast Asia, even its largest life insurer would not be counted about the top 20 globally. But even in its nascent phase, top performers have clearly emerged from the pack.

Generally, life insurers in Indonesia are doing well, and most are creating annual surplus of more than 10 percent. But by examining the 20 largest companies, McKinsey research showed a wide gap – one of the widest in Asia – between the top performers and the lowest (Exhibit 4). Between 2007 and 2012, the seven best-performing companies expanded their surplus by more than 30 percent a year, with the top two increasing their surplus by about 60 percent a year.



A closer look showed that the primary difference between the top and bottom performers was their capabilities in managing risk from core insurance business (Exhibit 5). Average insurance margin for the top companies was 2 percentage points above the industry average in Indonesia between 2007 and 2012, while margins for the bottom companies were 2.9 percentage points below average. Top performers were also the only group with a positive investment return ratio.



The gap is starker using adjusted growth in surplus, which takes into account dividends and capital transactions. With this metric, annual growth for the top five companies in the study between 2007 and 2012 was 27.6 percentage points above the industry average, while growth for the bottom five was 30.3 percentage points below the average.

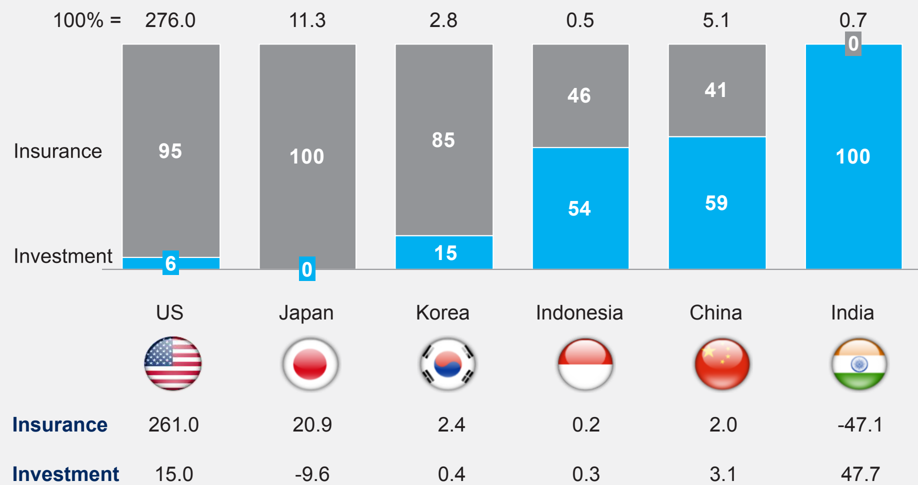
McKinsey experience and research have shown that all markets have significant performance gaps between the top and bottom companies, but the factors behind these change as markets mature (Exhibit 6). In more developed economies, such as those in Japan and the United States, the better companies derive greater value from superior skills in managing the core insurance business. Life insurers in emerging markets like China and India generate the bulk of their value from asset management, - i.e., investments.

Exhibit 6

Value creation shifts from investments to core insurance business as markets mature - Indonesia shows high maturity among emerging markets

Contribution to earnings before taxes, extraordinary losses and dividends

Percent, USD billions annual average



1 Analysis includes all carriers who publicly report this information which account for 65% of the total market in gross premium

SOURCE: McKinsey Life Journey papers on US, Japan, South Korea, Indonesia, China and India

The research suggested that Indonesia is about midway into the transition from relying on investment to relying on core insurance management to deliver value. This market maturity, compared with China and India, is linked to the dominance of highly skilled multinational companies and points to a continuing shift in Indonesia toward superior underwriting capabilities.

NEW CHALLENGES AND OPPORTUNITIES AHEAD

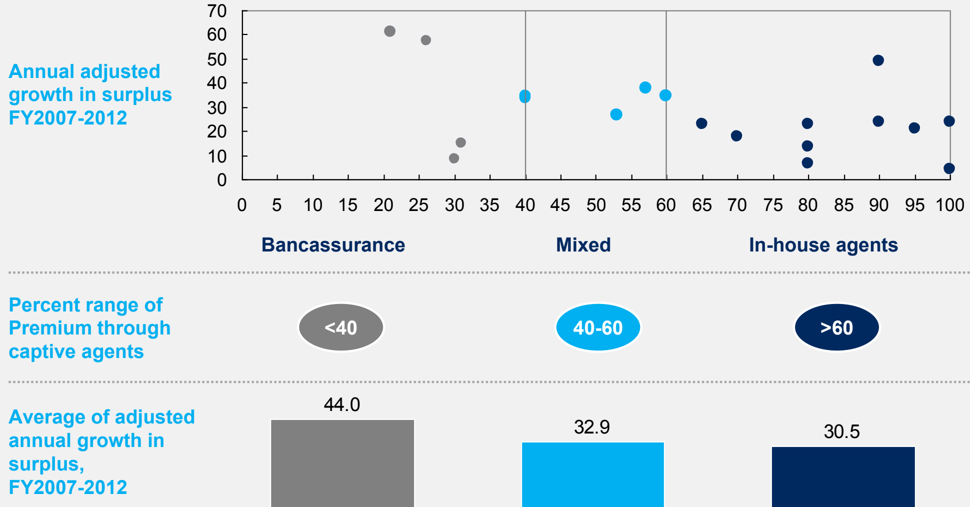
The market that has delivered exceptional returns to life insurers in Indonesia is shifting. Potential changes to distribution networks and the regulatory regime could create a less favorable environment, while demographics and consumer behaviors are evolving to create new opportunities.

Life insurers in Indonesia sell most of their products through dedicated agents, but the bulk of their profitability comes from third-party distributors, particularly banks (Exhibit 7). While banks were once eager to form partnerships with multinational insurers, the market is becoming more competitive, and, as seen in other Asian markets, banks are beginning to use their market power to boost their own profits. As a result, margins in bancassurance networks are likely to decline.

Exhibit 7

In Indonesia, while career distribution is the main channel, bancassurance has created more value

Percent



SOURCE: Press search; McKinsey

Meanwhile, the agency channel remains relatively simple and unsophisticated. Most carriers still rely on part-time, untrained agents who focus on a small circle of friends and family for marketing and sales. As the market evolves, leading carriers will likely expand their distribution channels to accommodate online shoppers and wealthier, more sophisticated segments that demand higher levels of service.

Regulatory changes could also encourage companies to enter the market and increase competition. Already, Indonesia ranks in the middle ranges for the World Bank's index of the ease of doing business, and the government is taking steps to streamline regulations further. For example, foreign investors can now apply for permits at a one-stop service center instead of going through several different ministries and agencies.

Although Indonesian consumers tend to be more loyal to their favorite brands than people in other markets, new companies could take advantage of another market characteristic: consumer preference to do business with domestic companies. Also favoring domestic entrants, local expertise can be a distinct competitive advantage in reaching a market of about 250 million people across three time zones who speaking more than 700 languages.

But along with these challenges, interlinked changes in demographics and consumer behavior are creating new opportunities for nimble life insurers, particularly focused on increasing wealth, a greater need for financial security, and demand for medical insurance.

An emerging middle and affluent class

The middle and affluent classes in Indonesia are expanding. Each year, more than 5 million people cross threshold into the consuming class by bringing their annual incomes above

$3,600. Between 2010 and 2030, the consuming class in Indonesia is expected to grow from 45 million to 135 million. At the same time, Indonesia is undergoing rapid urbanization, and more than 70 percent of its population is expected to be living in cities by 2030, compared with about 53 percent in 2011.

Rising incomes will trigger other changes relevant to life insurers. For example, McKinsey research has shown that as wealth increases, consumers become more savvy in handling their finances and look for more sophisticated financial products. A 2014 survey showed that about 70 percent of households with incomes of between $4,600 and $9,200 have at least $1,000 in personal investments, mostly in managed funds or pension plans.

Internet and smartphone penetration has also increased in parallel with rising incomes. Indonesian consumers will become more accustomed to researching products and prices before speaking with salespeople. Although McKinsey research has shown that fewer than half of Indonesia's affluent consumers go online to conduct financial business, digital transactions will likely become more common.

All in all, wealthier consumers will expect a better experience from their insurance providers – and competitive prices. They may become more willing to switch carriers to access a wider range of products and knowledgeable and helpful sales staff. Recruiting, training, and distribution networks could all be affected.

Protection focus

As personal income grows, demand for individual life policies should also rise sharply, especially considering the current penetration of only 1.5 percent. The increase will likely be driven by protection products. Although products linked to investment funds have been popular in Indonesia, peaking at 68 percent of net premiums in 2012, the market shifted suddenly in 2013, when life products –term, endowment, and annuities – accounted for about 57 percent of net premiums and unit-linked products fell to about 42 percent (Exhibit 8).

Exhibit 8

Net premium for Indonesia life insurance industry by products

IDR T, Percent

SOURCE: Indonesia Insurance Statistics (OJK, 2012); McKinsey

McKinsey experience in other markets suggests that protection will become a huge opportunity in Indonesia over the next three to five years, especially for carriers with innovative new products and digital distribution systems. Products that combine investment and protection features are also likely to gain popularity as more consumers consider retirement planning.

Medical insurance

Life insurers in Indonesia should also watch the growing demand for medical insurance and expand their product portfolio as necessary. As income grows, demand for better healthcare also rises. Despite the recent introduction of a national health care program in Indonesia, private medical insurance to supplement the national offer is likely to continue to grow substantially. The national program, launched in 2013, has yet to be funded sufficiently to meet the country's needs, and while it will likely dampen demand for private medical insurance among the lowest-income groups, middle class and affluent segments will continue to want private policies. In addition, the launch of the national program has raised overall awareness of the benefits of medical insurance.

Overall private and public expenditures on healthcare in Indonesia amounted to about 3 percent of GDP in recent years, much lower than 4 to 6 percent seen in regional peers, such as Thailand and Vietnam, and well below the 8 percent seen in many developed markets, such as South Korea and the United Kingdom. Pushed by the implementation of the national program and expected infrastructure improvements, healthcare spending in the country is expected to reach about 5 percent of GDP by 2020, or almost $20 billion annually.

Much of the expected increase in private spending will be linked to private medical insurance, an auxiliary product that could be offered by the largest life insurers. Between 2007 and 2012, private medical insurance penetration in Indonesia grew on average by about 20 percent a year, albeit from a very low base. By 2020, the private medical insurance market will likely reach about $2 billion a year, growing on average by 13 percent annually over the period.

Lower income households are likely to rely primarily on the national program, even though it has gotten off to shaky start, but higher income households will probably want more. Many of these wealthier consumers already go to other markets, such as Singapore, for medical care to avoid the frustrations with the local infrastructure and quality of care. As the quality of domestic care improves, much of this spending could shift back to Indonesian healthcare providers, adding to the demand for medical insurance.

IMPERATIVES FOR GROWTH

In this environment, life insurers in Indonesia face multiple challenges as they try to build on recent successes. They must understand how the factors that contributed to their growth are changing. They must recognize the opportunities presented by shifts in demographics and consumer behavior. And, finally, they must strive to penetrate the market more deeply before potential challengers establish footholds.

Life insurers will need to re-examine their business models to meet new demands in

the market, overcome the challenges, and seize the opportunities. McKinsey analysis spotlighted six areas that could be crucial to continued growth:

1. **Risk- and capital-management skills.** Indonesia's high-performing life insurers excel in managing core insurance business, not top-line growth, and those that look beyond premium growth and focus on value will continue to outperform. The best performers rely on 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 their customers.

2. **A more sophisticated professional agency model.** The single biggest cost for life insurers is distribution, and they must make sure these funds are spent effectively. Carriers should move toward hiring and training full-time professional agents to provide more sophisticated advice to affluent consumers and replace under-qualified agents. They should also adopt digital tools to help lower costs and meet consumer demands for online access and competitive pricing.

3. **Core capabilities in data analytics.** As the industry matures and competition increases, margins could be at risk. To maintain profitability, insurance companies must invest in and refine their core capabilities, such as underwriting, pricing, and in-force book management. Data analytics will help unlock these opportunities. Insurers will need to scrutinize public and proprietary data to price accurately, capitalize on fee and asset allocation better, pursue cross-selling opportunities, reduce fraud, manage customer behavior, and improve operational efficiency.

4. **New ways of working with digital tools.** Indonesian consumers are becoming more digital, crossing boundaries between the physical and virtual worlds as they make purchase decisions. Marketing innovations that use social and other digital media, allow direct business such as online product customization and purchasing, and offer multichannel experiences are no longer optional in any market.

5. **Driving value in bancassurance.** Banks in Indonesia have been more willing to share profits with insurers than banks in other markets, but the situation is changing. Insurers may still be able to maintain margins in bancassurance by focusing on three priorities: partnering with banks to train their employees in cross-selling and up-selling using the field-and-forum approach; increasing ticket sizes for select products; and exploiting data analytics in collaboration with the banks to identify promising leads

6. **Building trust.** Public confidence in the financial industry was shaken by the Asian financial crisis in the late 1990s and again by the global financial crisis of 2008. Insurers can work with the government officials to increase transparency, protect investors from default, and educate consumers about the wide range of safe investment opportunities beyond bank deposits. Insurers can also improve recruiting and training standards, building a professional sales staff that can communicate better with customers and build trust.

Success in Indonesia will also require substantial capability-building. The nation has only 200 actuaries, for example, but needs about a thousand. Life insurers could attract people to the industry by building public awareness and outreach programs, such as "Insurance goes to campus."

The industry faces a perennial challenge in recruiting top talent. Indeed, in a recent survey, almost two-thirds of Indonesian employers said they had difficulties filling professional positions. To improve recruitment, insurers should also refine the value propositions they offer potential hires. Promises of autonomy, professional growth, and financial opportunities, for example, can be strong incentives for recruits. Even seemingly trivial tweaks in messaging can reframe the importance of a position, such as advertising for "financial advisors" rather than "insurance agents." Non-traditional channels, such as social media, can also expand the pool of applicants.

Most of all, life insurers will need a "through the cycle" mindset and a long-term commitment to the business in Indonesia. They have enjoyed a favorable market over the past decade or so, but to seize major new opportunities and continue their robust growth, they will need to understand how the market is changing and the new challenges on the horizon.

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