

The Life Journey China

Financial Services Practice



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The life insurance industry in China, in aggregate, delivers returns for investors that are consistently below its cost of capital. While some carriers have created significant value, others are dragging industry returns down to below zero. What are the winners doing differently?

China's life insurance market, after 20 years of unprecedented growth, is poised to become the world's third largest. Value creation remains another story. The industry's aggregate returns over the last decade have exceeded the cost of equity by just half of one percent (Exhibit 1), far less than lower-risk investments. The industry seems to oscillate between bursts of high growth and contraction as it issues attractive guarantees and piles up long-term risks and is then forced to face the consequences.

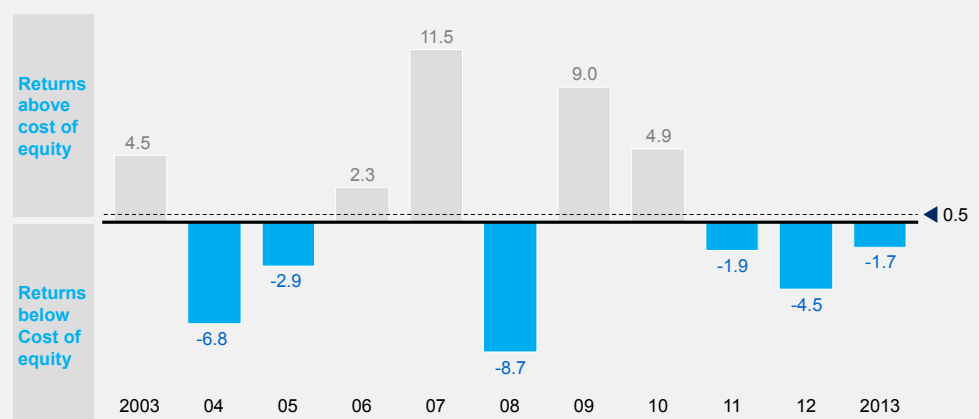
The industry's poor performance at the aggregate level, however, obscures some great success stories of carriers that have navigated the changing marketplace wisely, creating significant value for shareholders and policyholders. We expect a handful to further widen their lead in the next few years by transforming their business models to adapt to a new marketplace and grasp big opportunities while the stragglers falter and even disappear.

Exhibit 1

Returns fluctuate widely and have barely broken even

China's life industry performance (2003-13); return in excess cost of capital

ROE¹ – COE, percent



¹ Capital asset pricing model (CAPM) used to calculate market cost of capital

Sources: China insurance yearbook; Bloomberg; McKinsey analysis

LIFE INSURANCE IN CHINA: A BRIEF HISTORY

To understand the life insurance market in China today, and to think about the industry's prospects for the next few years, it's worth taking a brief look at the three recent phases of market development.

The first phase—explosive growth—began in 1990 as shown in Exhibit 2. Many insurers adopted a “land grab” mentality, focusing entirely on growing share. They scaled salesforces quickly and pushed high-yield products with guaranteed returns of 8% or more.

Those guarantees and large salesforces with low productivity and high fixed costs drove returns down and forced carriers to rethink their singular focus on growth. In the second phase, beginning in early 2000s, leading insurers started to demutualize, shifting more of their attention to profit and value creation. Many firms consolidated salesforces and cut volume to improve profitability.

In the third phase, as broader macroeconomic growth over the past 5 years boosted incomes and demand, the major insurers once again shifted to building distribution channels and expanding product offerings. Many turned to bancassurance in attempts to grow without adding salespeople, but this approach has added little or no value, since banks own the customer relationships and therefore demand favorable terms and take the lion's share of margins.

The question of whether to pursue volume or value arises in industries of all kinds around the world. So far, however, many life carriers in China have failed to find a workable balance, instead pursuing one at the expense of the other, moving from agency to bancassurance, for example, and failing to expand margins. Some have also failed to think carefully about risk, which includes all drivers of product profitability, such as product terms and conditions, guarantees, pricing and underwriting.

Many carriers have paid a high price. The 2008 financial crisis, for example, devastated equity market performance and led to a significant decline in growth and profitability in the industry. Notwithstanding a short recovery in 2009-10, growth since the crisis has slowed significantly.

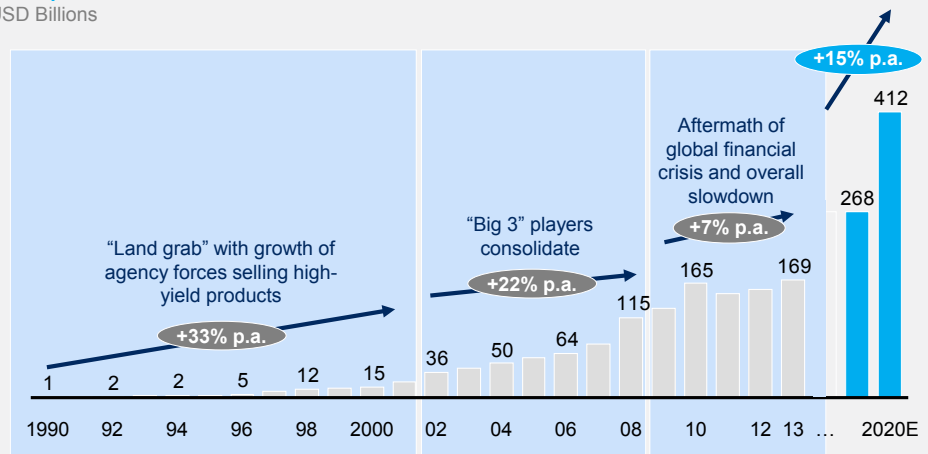
We believe that the life insurance industry in China is now entering a yet another phase and expect the industry to recover and return to double-digit growth over the next five years, as shown in Exhibit 2. This historic shift presents big opportunities for carriers who can learn to meet the needs of the world's most digitally-savvy consumers. As hundreds of millions of people move their insurance shopping online, carriers have opportunities to turn to digital distribution, reduce dependence on banks, and grow profitably by making more targeted investments in building agency salesforces.

Attackers have already begun tapping into this rich marketplace, presenting grave threats to insurers who cannot move quickly enough. Like banks, some of these attackers already own the customer relationships, and as they begin selling insurance products as commodities, they will take most of the value and leave carriers with the risk.

Exhibit 2

Three distinct growth phases in the evolution of the life insurance market in China

Gross premium
USD Billions



Sources: CIRC, Almanac of China's Finance and Banking; Forecast based on McKinsey Global Insurance Pool

The question for life insurance in China is no longer whether to pursue volume or profit but how to drive scale, market share, and growth to create value. Once again, we expect that a few carriers will adapt quickly, choose the most profitable investments, and outperform their peers by wide margins.

A WIDE GAP BETWEEN LEADERS AND LAGGARDS

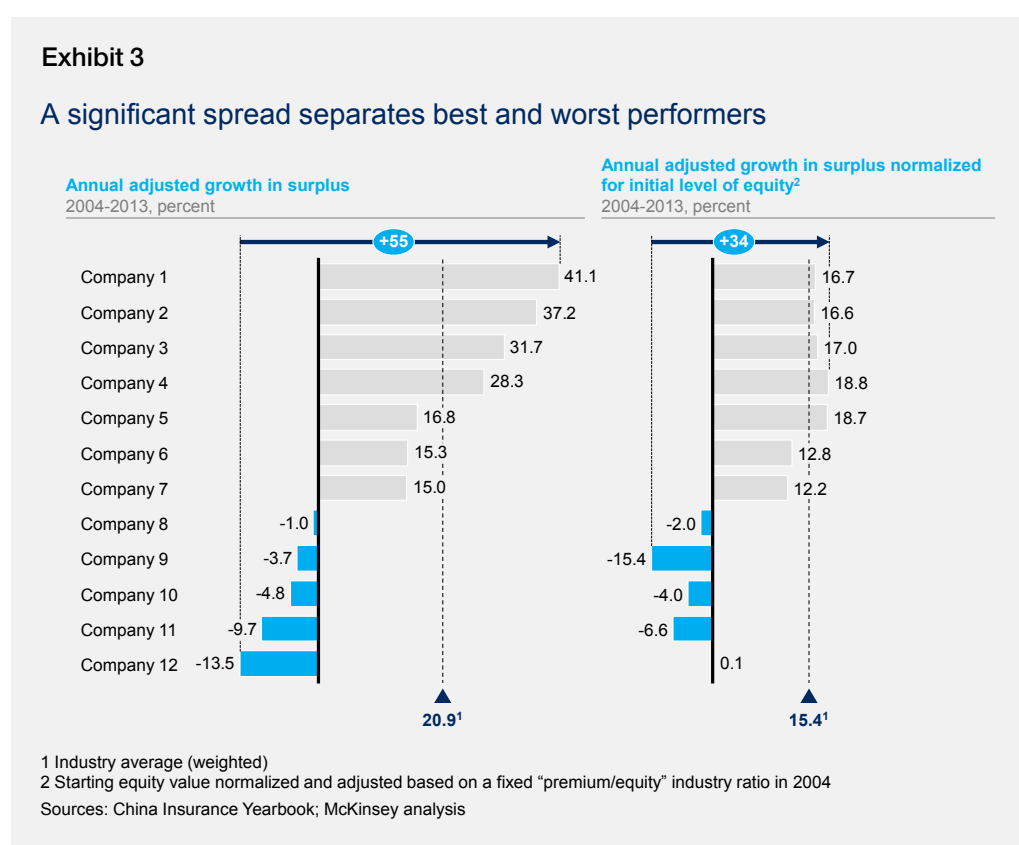
It is instructive to see who has grown value in life insurance in China in the past 15 years and why, and how some of these qualities might provide opportunities for value growth in the future.

There is a wide spread in value creation among the 12 largest insurers in China. While the overall economic performance of the industry is weak, some insurers consistently outperform the market and deliver substantial returns. Between 2004 and 2013, those in the top quartile increased in value by 30 to 45% annually, while those in the bottom quintile decreased by -15 to -5% — a nearly 55-percentage-point difference in adjusted book-value growth between best and worst performers, as shown in Exhibit 3.

Looking at the performance of China's life carriers through a traditional lens obscures some important truths about why some carriers deliver dramatically better results because each one has a different starting position. In 2004, in fact, China Life represented 85% of the market's total equity, so it could not double or triple its share the way a smaller company could — while all other companies had relatively low equity values and therefore showed disproportionately high growth rates.

To compare carriers on an apples-to-apples basis, McKinsey developed a “normalized” approach that considers Chinese companies’ different stages of growth in 2004 and estimated normalized initial equity values based on a fixed “premium/equity” ratio equal to top three players in 2004. Those results are shown on the right side of Exhibit 3.

But even with a normalized view, the best performers have still delivered annual growth rates in value that are 34 percentage points more than the worst performers.



What have the winners done differently? Offered a more attractive product mix? Executed better within product lines? Achieved higher investment returns?

To answer these questions, we launched The Life Journey, which began with research into publicly available data for China’s life insurance industry since 2003. We focused on the top 12 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 60% of gross premiums in China, to gain a better understanding of the underlying drivers of performance.

The analysis reveals that the primary difference between China’s higher-and lower-performing life insurers is skill in managing liability risk. Top-tertile Chinese companies showed above-average insurance margins of over 1.0 percentage point while insurers in bottom tertile returned below-average results of -4.8 percentage points (Exhibit 5).

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 stock-traded 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.

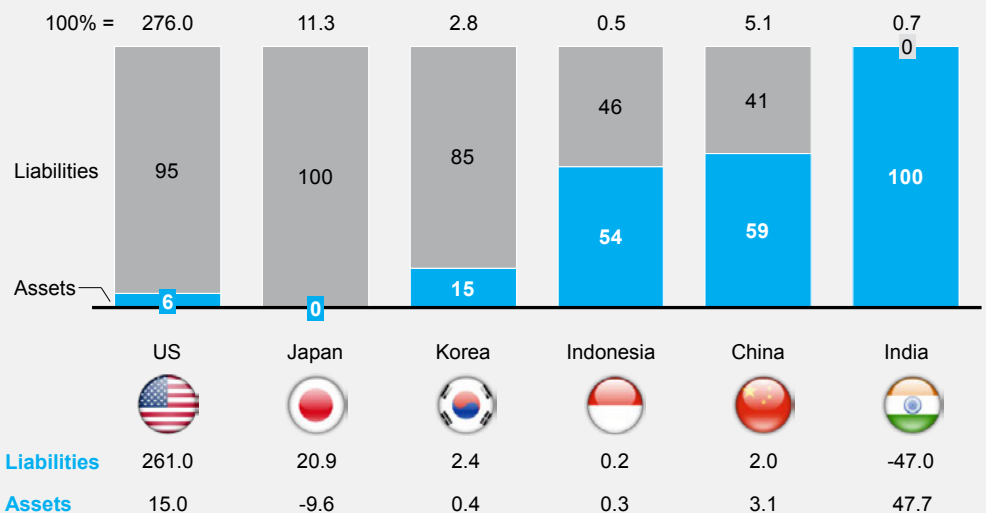
Investment management, while a substantial source of earnings (Exhibit 4), is not a real differentiator of performance (Exhibit 5). This is not surprising because, until recently, China strictly limited insurers to only the most conservative investments.

Exhibit 4

Value creation shifts from assets to liabilities as markets mature

Contribution to growth in book value

USD billions annual average, percent

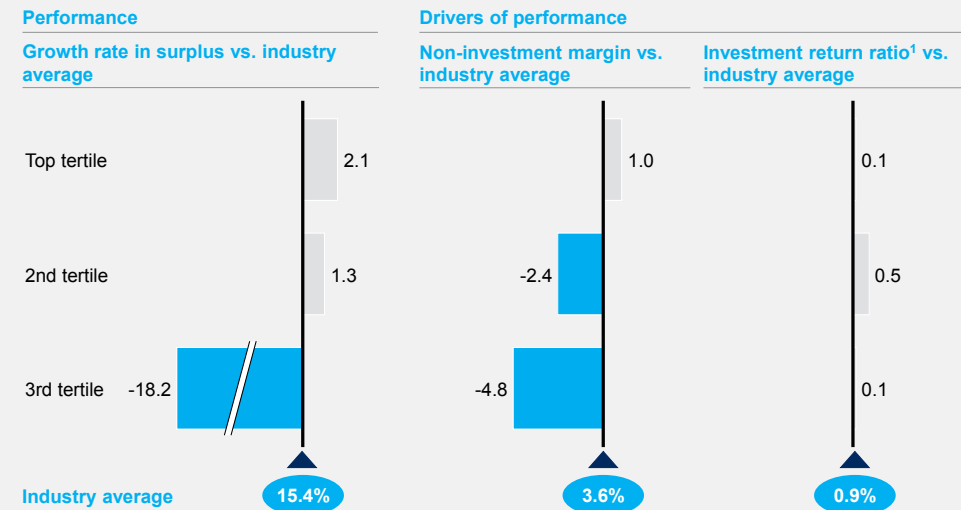


Sources: McKinsey Life Journey papers on Japan, Korea, Indonesia, China and India

Exhibit 5

Liability management drives China life insurers' performance

2004-2013, percent



¹ Investment profit / investable asset (estimated by 91% of total assets)

Sources: China Insurance Yearbook; McKinsey analysis

What do these outcomes mean for Chinese insurance executives looking to the future? McKinsey's analysis of insurers around the world reveals that while all markets show a significant performance gap between the top and the bottom insurers, the major driver of this performance gap depends on the maturity of the economy.

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For example, in more mature economies such as the US and Japan, higher-performing life insurers generate value through superior liability management; those in emerging economies such as India, meanwhile, rely heavily on asset management. As markets mature, in other words, the basis of value creation shifts from assets to liabilities (Exhibit 4). China's regulators are in step with this shift; the State Council on Accelerating the Development of the Modern Insurance Service Industry is calling for life insurers to further develop and strengthen their liability management skills.

In other words, while liability risk management and investment skills both help drive earnings, risk management is the main driver of performance differentiation for value creation in life insurance in China. Further, based on similar research across life insurance markets globally, we believe that this balance will shift even more towards liability risk management excellence as the Chinese economy matures.

THE SEARCH FOR PROFITABLE GROWTH

To succeed in the rapidly growing life insurance market in China, carriers must focus on three big areas of opportunity:

An emerging – and urbanizing – middle class

Continued economic growth is leading to the rapid expansion of families with household disposable income between 16,000 and 79,000 USD. We estimate that this “mass affluent” segment will account for half of gross life premiums by 2020 — up from about 25% in 2013.

Based on “voice of the customer” research, mass affluent consumers are mostly young, highly educated and professional, and demand more protection and investment products from insurers. About 60% buy insurance for protection, and 25% as an investment. They demand better experience, including trust-based financial advice and consultation. The research also suggests that few agents today have the skills or knowledge to meet the expectations of mass affluent consumers — presenting significant opportunities for insurers who can recruit, train, and retain high-quality agents.

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If China’s urbanization increases from 47% in 2010 to 59% by 2020 as expected, more than 200 million people will move into cities. In fact, demographers expect more than 25 Chinese cities to join the global top 200 in terms of GDP by 2025 (Exhibit 6). These urban dwellers represent the mass market today, and they will nourish the emerging middle class in the years ahead. To meet the needs of this new customer segment, insurers will need to reconsider their value proposition and distribution capabilities, and have a clearly articulated geographic footprint strategy.

Medical and health insurance

Medical insurance is among the fastest-growing opportunities for life insurers in China. Gross written premiums for total health insurance grew by about 20% each year between 2007 and 2013, and we expect growth to continue at a double-digit pace for years to come.

While the government offers coverage to 98% of citizens, quality, service, and coverage depth do not meet the demands of the emerging affluent class, who save small fortunes in cash to get the medical care they need in case of illness—opening a large opportunity for private insurance companies.

We expect China’s overall healthcare spending to grow from 0.4 trillion USD in 2012 to 1.4 trillion USD in 2020, a compounded annual growth rate of about 16%. We also expect huge increases in spending on supplementary products and value-added services, such as doctors’ appointments, check-ups and second opinions, and access to networks in Hong Kong, the US, and other countries.

Exhibit 6

Previously unknown cities in China are becoming significant economic players

Global top 200 cities in China Ranked by GDP in 2025

- New entrants into global top 200
- Already in 2010 global top 200

By 2025, will exceed nominal 2010 GDP of ...

- Los Angeles (USD731 billion)
- Singapore (USD222 billion)
- Bogotá (USD84 billion)



Source: McKinsey Global Institute

In addition, government reforms, such as adjusting hospital incentives to control treatment costs and the development of community health-center networks, should increase insurers' ability to manage claims, reduce fraud, and improve profitability.

Local governments are also shifting portions of public health insurance management responsibilities to private insurers. For instance, the state-owned People's Insurance Company of China is now managing part of URBMI, a medical insurance system in the Pinggu district of Beijing.

Retirement solutions

The share of Chinese aged 45 and older is expected to grow at about 3% per year over the next five years, while the number of younger people will continue to decline. These demographic changes will fuel demand for retirement income products.

The Chinese government has signaled its intention to strengthen the country's retirement safety net (as explicitly stated in the 12th five-year plan by the State Council and the China Insurance Regulatory Commission) by encouraging commercial retirement income coverage.

The government is also introducing tax policies favorable to corporate and individual pension or annuity products to promote retirement income protection that supplements public pensions. Changes of this kind are likely to increase demand for savings and retirement products, as they have in many European markets and the US, with its 401(k) retirement-savings regime.

The next generation of Chinese retirees, now between the ages of 40 and 55, are likely to have more savings than previous generations. For insurers, this growing demand for post-retirement financial services products represents a significant opportunity.

A recent McKinsey survey¹ shows that the Chinese are increasingly aware of the need for retirement plans. A quarter of those surveyed have a separate retirement plan, and more than a third have included retirement in their long-range financial plans, compared to only 21% and 28% respectively four years ago.

The growing awareness of retirement needs, combined with the increasing savings of retirees, represent significant opportunities for life insurers who can build a retirement brand and develop a holistic retirement approach. Total Chinese AUM of corporate annuities reached 94 billion USD in 2013, having grown at 19% per year for the past five years. Given the tax benefits provided by the Chinese government in 2013, we expect AUM to continue to grow at 20 to 30% over the next three to five years.

To tap into this opportunity, insurers will need to deliver new value propositions and services, revamp their channels to provide financial advice tailored to specific customer needs and situations, and retool products.

¹ McKinsey Personal Financial Survey, 2015

FOUR IMPERATIVES FOR LIFE INSURERS SEEKING VALUE GROWTH

To tap into China's new opportunities for profitable growth, life carriers should strengthen capabilities in four key areas:

- 1. Reinvent relationships with customers and distributors by using digital tools and analytics.** Chinese customers are becoming more digital, 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 and purchasing and multichannel experiences, are becoming requirements for life insurers to remain competitive in China.

In addition, with increasing competition, efficiency will become even more important for life insurers in China. To improve efficiency ratios, insurers should invest in digitization, lean distribution and data analytics, and better management of in-force customers. These skills will help them make advances in key areas of the industry value chain: sales, product design and pricing, risk selection, service and claims. With a better understanding of their existing customers, insurers can also improve cross- and up-sell performance.

- 2. Build risk and capital management skills.** As noted, China's high-performing life insurers excel in liability management. To grow value, life insurers must define robust parameters regarding risk appetite and strengthen metrics to manage capital and govern risk. Life insurers must also build more flexibility into product design and pricing to make fewer long-term guarantees and find innovative ways to share risk with policyholders.
- 3. Expand distribution capabilities and lower distribution costs.** A successful distribution model will require not only a more efficient one-to-many approach to deliver advice at lower unit cost (by leveraging 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, makes the purchase through another, and manages the policy through yet another channel. In addition, life insurers must develop approaches such as using analytics to identify leads and define marketing opportunities, tailoring service offerings to agents based on their needs, increasing financial-planning uptake, and building product expert, wholesaler, and sales teams to drive agent performance. (For details, see "Maximizing Value from Agency in China" published by the McKinsey Financial Services Practice in 2015)

4. **Leverage the in-force book and existing customer relationships.** The in-force book accounts for a large share of profits, revenues and operating costs for insurers in China today, and this share will only increase as the industry matures. To unlock the hidden value of the in-force book, carriers need to capitalize on pricing, fee and asset-allocation flexibility, pursue cross-selling and customer behavior management, and improve operational efficiency.



In our analytical journey, we were surprised not only by how challenged the industry's performance has been, but also by the magnitude of difference in individual carrier performance, driven largely by the ability to manage liability risk. For China's life insurers, the challenge is straightforward: stable, attractive returns will come only to those who fundamentally rethink the industry's value proposition to lead in the digital era while they continue to excel in risk and capital management.

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 Korea; 2015

The Life Journey Indonesia; 2015

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