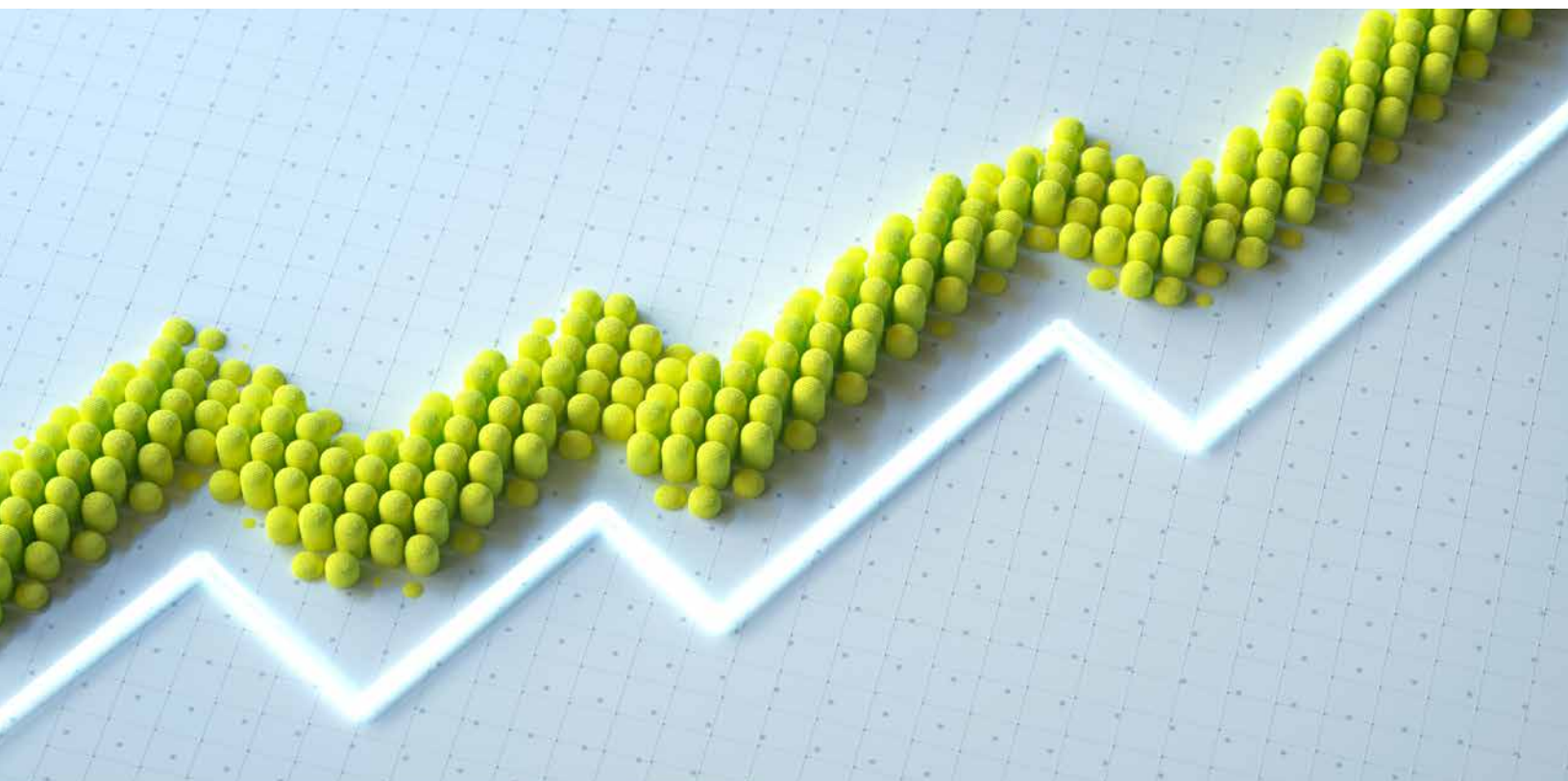


Insurance Practice

Should North American life insurers stop prioritizing share buybacks?

Repurchasing shares has been common among life insurers over the past decade, but companies that reinvest for growth and pursue M&A could be better off in the long term.

by Alex D'Amico, Jay Gelb, and Zane Williams



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Among US life insurance companies, share buybacks tend to be the preferred option for improving TSR. And equity analysts seem to clamor for buybacks: in the first half of 2022, during conference calls to discuss quarterly earnings results, the words “buyback,” “repurchase,” or “capital management” were mentioned more than 300 times in total for the 20 largest life insurers in Canada and the United States by market capitalization.

Buybacks are not a meaningful driver of long-term share price performance for life insurers, according to our analysis. And yet, of those top 20 North American life insurers, 18 conducted buybacks during the first two quarters of 2022, totaling \$14 billion—equivalent to the entire market capitalization of a top-ten life insurer.

In this blog post, we review the highlights of our recent research on the industry’s dominant capital deployment strategy to date—and the approaches beyond buybacks that could induce superior share performance.

Insurers’ overreliance on buybacks

When you hear Wall Street asking about life insurers’ “capital return as a percentage of free cash flow or earnings,” what they are really focused on is the pace of share buybacks. According to our analysis, over the past decade publicly traded life insurers in Canada and the United States have returned approximately \$275 billion in capital to shareholders through a combination of \$190 billion in share buybacks and \$85 billion in dividends.

The use of buybacks has been ubiquitous. Over the past ten years, 17 of the top 20 publicly traded life insurers in North America returned the equivalent of at least half of their market capitalization to shareholders through buybacks alone, according to our analysis. The appeal of buybacks is clear but often misguided:

- **Higher share price.** A reduction in outstanding share increases earnings per share; assuming the P/E ratio remains constant, the share price should rise. However, this doesn’t account for the value of the cash that has been paid out as part of the buyback¹ and the impact it has on valuations and P/E ratios. Furthermore, this outcome neither involves the management team making strategic decisions about company projects nor signals intrinsic value creation.
- **Market signals.** Analysts and investors have been conditioned for years into thinking that life insurers were best served by returning excess capital to shareholders rather than investing it in the business, because many of these companies have not consistently generated returns above the cost of capital.
- **Investor confidence.** Buybacks can signal that the management team believes the insurer has deployable excess capital, which can provide an important boost in confidence for investors who have doubts about an insurer’s reserves and capital adequacy.

Buybacks do not create value in and of themselves. They are “left pocket, right pocket” transactions that transfer cash from the balance sheet to shareholders, similar to a common shareholder dividend. While the shareholders that did not sell will own a larger share of the company’s equity, the life insurer itself becomes smaller and the value of the investors’ holdings remain the same.

Life insurers that primarily focus on share buybacks may also be taking an overly defensive posture, which McKinsey research on corporate resilience² has found tends to lead to median company performance. Offense-only stances deliver a mix of occasional wins plus some catastrophic failures. The best leaders and companies are ambidextrous—prudent about managing the downside while aggressively pursuing the upside.

¹ Richard Dobbs and Werner Rehm, “The value of share buybacks,” McKinsey, August 1, 2005.

² Cindy Levy, Mihir Mysore, Kevin Sneader, and Bob Sternfels, “The emerging resilient: Achieving ‘escape velocity,’” McKinsey, October 6, 2020.

Finally, while many life insurers that have repositioned their business mix tend to generate improved free cash flow, a significant portion of their buybacks have been financed by one-time events such as divestitures and reinsurance transactions. As a result, these companies are likely to face increasing tension between maintaining historical capital return levels and reinvesting in growth; once a company is on the buyback treadmill, it's difficult to exit.

majority of the most recent life insurer IPOs. The analysis found even less correlation over the past two years between the pace of share buybacks and TSR. This means that life insurers' path to increasing long-term TSR will not be primarily through maximizing share repurchases. (Notably, the lack of any long-term correlation between TSR and share repurchase intensity³ also extends beyond the life insurance industry.)

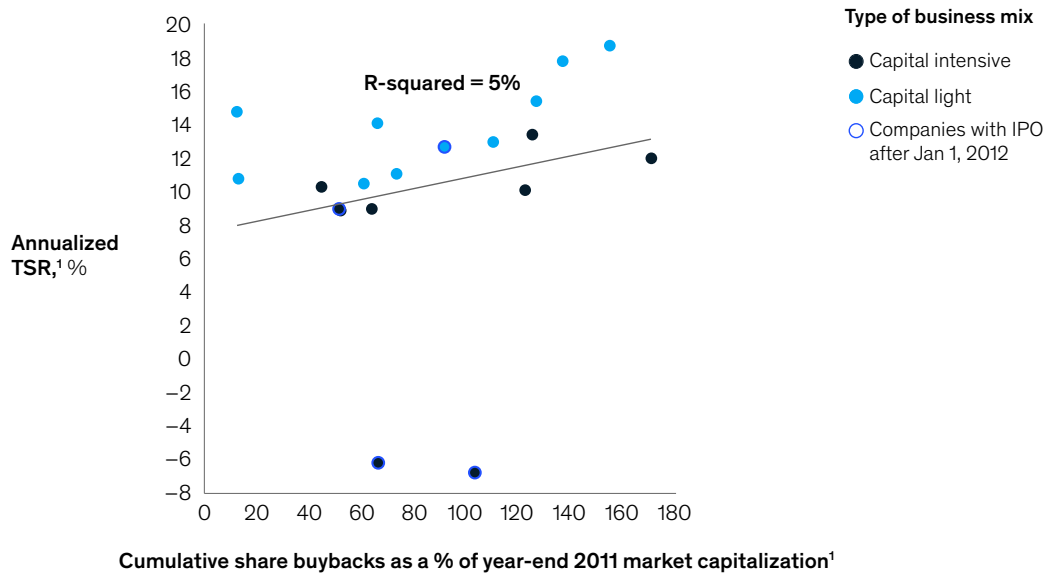
A better approach: Focus on capital intensity

Our analysis found only a modestly positive correlation between life insurers' share buybacks as a percentage of market capitalization and annualized TSR over the past decade, including the

Instead, the analysis suggests a life insurer's business mix (that is, capital light versus capital intensive based on earnings contribution) is a much clearer driver of long-term share price performance (Exhibit 1). Specifically, our regression analysis found an R² value of 5 percent, which demonstrates low correlation between buybacks and TSR.

Exhibit 1

Business mix is a more critical measure of long-term share performance than the pace of share buybacks is.



¹Dec 31, 2011–Sept 30, 2022.
Source: S&P Global

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³Obi Ezekoye, Tim Koller, and Ankit Mittal, "How share repurchases boost earnings without improving returns," McKinsey, April 29, 2016.

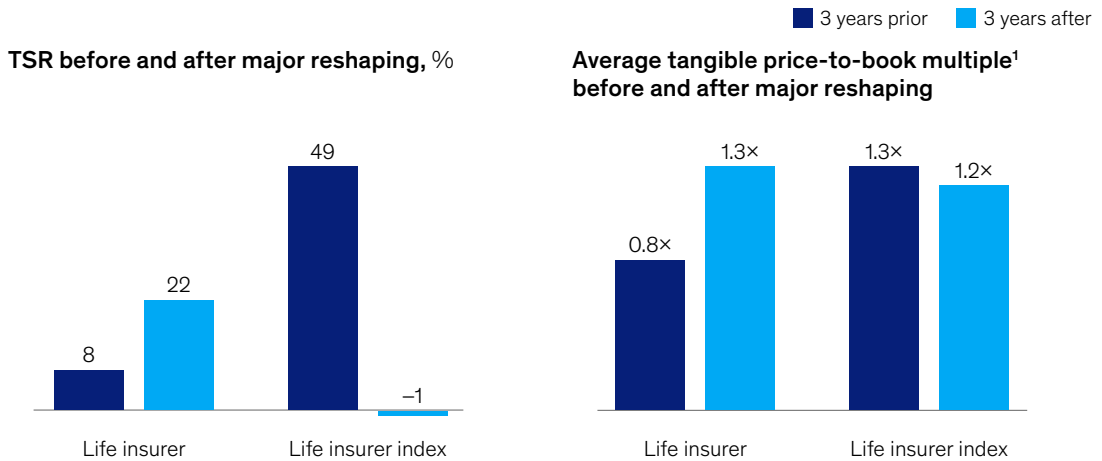
A capital-light strategy typically focuses mostly on products with little or no guarantees, such as employee benefits, protection-oriented life insurance, retirement services, and wealth and asset management. A capital-intensive strategy, on the other hand, involves a greater focus on products such as universal life, variable annuities with living benefits, or legacy products with robust guarantees. In general, the research found that capital-light life insurers generate above-average share price performance relative to the level implied by their pace of share buybacks. Meanwhile—despite that in several cases capital-intensive carriers have repurchased shares over the past decade equivalent to more than 100 percent of their market capitalization—life carriers with a capital-intensive strategy tend to generate below-average share price performance.

Among life insurers whose valuation multiples have expanded over the past five to ten years, at least several have shifted away from capital-intensive, opaque lines of business into capital-efficient, easier-to-understand lines of business. “Unbundled” business models⁴ can also promote value creation because they can lead insurance carriers to focus on sources of distinctive value creation while seeking partnerships or leaving other parts of the value chain to those with a more natural advantage.

There are examples of several leading life insurers meaningfully reshaping their business by exiting capital-intensive businesses and shifting the capital previously supporting these units into capital-light businesses with attractive margins and ROE profiles. Investors recognized these favorable shifts, which

Exhibit 2

A life insurer that took significant actions to reshape its business saw favorable results in its TSR as well as valuation multiples.



¹Tangible price-to-book multiple excludes accumulated other comprehensive income. Source: S&P Global

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⁴Ramnath Balasubramanian, Rajiv Dattani, Asheet Mehta, and Andrew Reich, “Unbundling value: How leading insurers identify competitive advantage,” McKinsey, June 9, 2022.

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were reflected in superior TSR as well as price-to-book valuation multiple expansion (Exhibit 2). These insurers also generate improved excess capital, which is returned to shareholders through dividends and buybacks—but clearly it was the changes in strategy that improved their positions, not the buybacks themselves.

While still a dominant capital-deployment strategy, returning capital to shareholders need not be the only one. In fact, share buybacks are typically the least value-additive approach that insurers can take with excess capital, trailing reinvesting in the business after fulfilling the company's promises to customers and other stakeholders.

Intuitively, business reinvestment drives organic growth by allocating capital to value-creating opportunities. Insurers have also seen success deploying capital in programmatic M&A,⁵ judiciously acquiring targets in-line with strategic priorities. These approaches can position an insurer to generate a return on equity exceeding their cost of capital while also accelerating top-line growth. The ability to generate such returns, as our McKinsey colleagues point out in *Global Insurance Report 2023: Reimagining life insurance*,⁶ is crucial if life insurers are to retain what's left of their relevance among global investors.

⁵ "Developing an effective M&A blueprint for insurers," McKinsey, March 7, 2022.

⁶ *Global Insurance Report 2023: Reimagining life insurance*, McKinsey, November 16, 2022.

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