McKinsey&Company

The Life Journey India

Financial Services Practice

The Life Journey India

Financial Services Practice

While India is riding a wave of extraordinary economic growth, the country's life insurance sector is still at a nascent stage and its contribution to value-creation has been minimum. How can life insurers deliver on the promise of profitable growth?

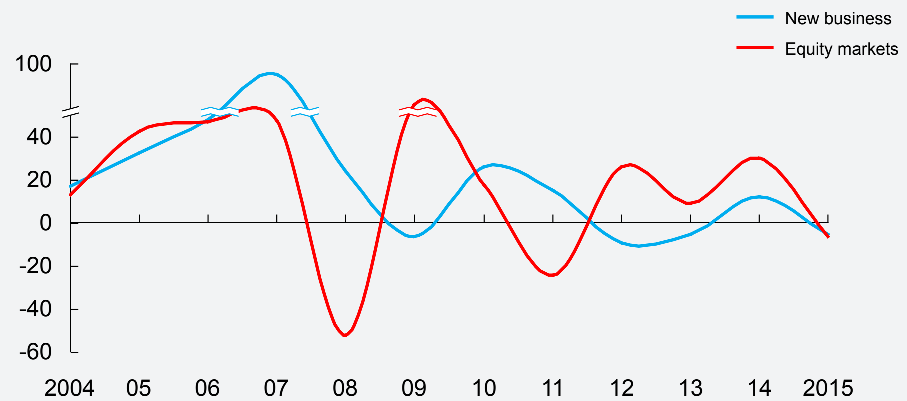
With its stable government, managerial and technical talent and expanding middle class, India is poised for many years of strong economic growth. The prospects for the insurance industry should be extraordinarily good, since Indian consumers' risk coverage is low even by emerging market standards.

Unlike other markets, however, growth in India's life insurance industry is correlated more closely to equity market performance (Exhibit 1) than rising GDP. And profits remain elusive: for more than a decade, the private industry has delivered overall returns far below the cost of capital (Exhibit 2) and even below the returns in other Asian markets (Exhibit 3).

Exhibit 1

Growth in life insurance in India correlates closely with equity markets

Growth of private sector life new business premium and equity markets
Percent



Sources: Reserve Bank of India; McKinsey

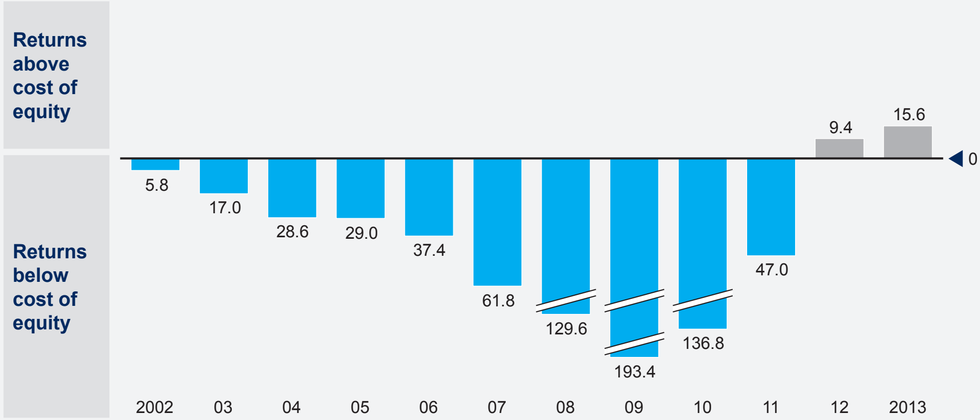
Even the bright spots are mostly illusory. Between 2011 and 2014, for example, private life insurers in aggregate generated positive returns, but our analysis shows that this rebound was driven primarily by surrenders and lapses on unit-linked investment products (ULIPs) as equity markets weakened. New businesses also declined, ironically buoying industry earnings as life insurers reduced financial strain incurred from the significant acquisition costs incurred in the first year of selling a new policy.

The industry's negative returns are no surprise, since most Indian private life insurers have chased volume by building large sales forces with significant fixed cost infrastructure and who focus on selling low-margin ULIPs. And rather than trying to build the skills of agents to sell higher margin protection products as affluency rises, many carriers continue to chase top-line investment-focused growth in the hopes of building scale and growing their way out of the profitability challenge.

Exhibit 2

Private-sector life insurers[1] have delivered returns far below the cost of capital

Returns in excess of cost of capital
USD Millions



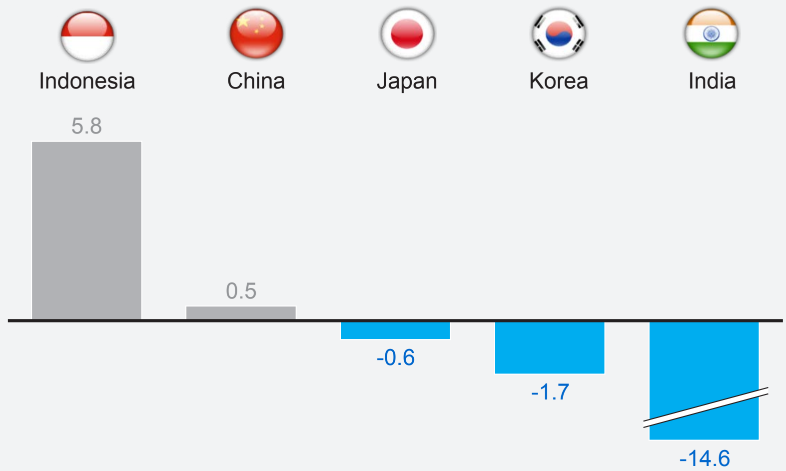
1 ROS = Statutory net income (including realised capital gains) divided by average capital and surplus. We estimated the cost of capital by using an equity beta of 1.2 for life carriers, which results in cost of equity of 13.5%-14.0%.

Sources: IRDA; company financial reports; McKinsey

Exhibit 3

The life industry in India has underperformed relative to other Asian markets

Returns in excess of capital
Average spread between cost of equity COE and ROE, 2003-2013 (percent)



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

This model may not work. Volume growth can create some value in bancassurance in situations where the channel is proprietary and unit acquisition costs are lower – as it is in the case of Indian life insurers with exclusive bank partners, often with cross-held equity. Indeed, investors continue to reward Indian life insurers for building top-line growth, mostly in their bancassurance business. However, our global research shows that a significantly larger opportunity for value creation belongs to those who make the strategic shift to create value in agency by selling a greater share of protection products.

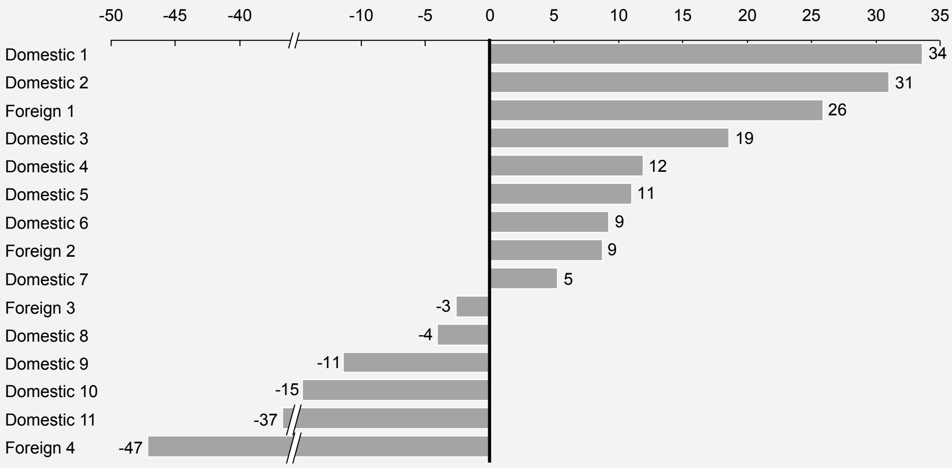
A WIDE GAP BETWEEN LEADERS AND LAGGARDS

Although the industry as a whole has destroyed value for more than a decade, our calculations show that three carriers grew their surplus by an average of more than 25 percent per year during that period (Exhibit 4).

Exhibit 4

An 81 percentage point spread in annual growth in value separates best and worst performers

Annual growth in book value adjusted for capital infusions and dividends[1]
2002-2013, percent



1 Excluding LIC; foreign companies classified as up to 49% foreign ownership (there are no pure foreign players)
Sources: IRDA; McKinsey

McKinsey research into value-creation amongst the 15 largest insurers in the market reveals an 81 percentage point spread in book value growth between the top and bottom performers from 2002 to 2013. During this period, the book value of insurers in the top quartile grew by 19 percent to 34 percent compounded annually as opposed to -11 percent to -47 percent for those in the bottom quartile. (To arrive at this conculsion, we made signficant adjustments to reported returns, as explained in the sidebar.)

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.

The wide spread in value creation is not unique to India – carriers in Japan showed a 28 percentage point spread in annual growth rates in book value, for example, the spread amongst the top 30 US carriers is 13 percentage points, and China’s are separated by as many as 55 percentage points – but the variation in performance raises important questions.[1] What do the winners do differently in India? Do they offer a more attractive product mix? Execute better within product lines? Achieve higher investment returns?

We launched a research effort – The Life Journey – to develop fact-based answers to these questions in India. We analyzed publicly available data for India’s life insurance industry since 2000 and for the top 15 life insurers since 2003, and we interviewed more than two dozen industry analysts and executives.

Our research revealed that none of the private insurers in India are creating value as per the market potential. This is because they are all serving a miniscule segment of consumers, mainly to meet narrow investment needs. But even within this confined space, they demonstrate a significant spread in performance which is driven largely by distribution strategy.

While most carriers offer affluent consumers a similar product mix, including a high share of investment-focused ULIPs, a few have outperformed the industry by investing in their distribution channels. The leaders tend to focus on bancassurance, for example, and leverage strategic and exclusive partnerships with banks to leverage their scale, footprint, and brand to grow maket share and profit margins.

The implication is that while life insurers carriers can grow value by learning from industry leaders who are doing well in bancassurance, the overwhelming value creation potential lies in rethinking the industry’s value proposition to serve the protection needs of a much larger segment of the population. To grow value, life insurers in India must create, market and sell more protection products.

McKinsey’s analysis of life insurers around the world reveals that whilst all markets show a significant performance gap between the top and the bottom players, the major driver of this performance gap depends on the economic maturity.[2] For example, in more mature

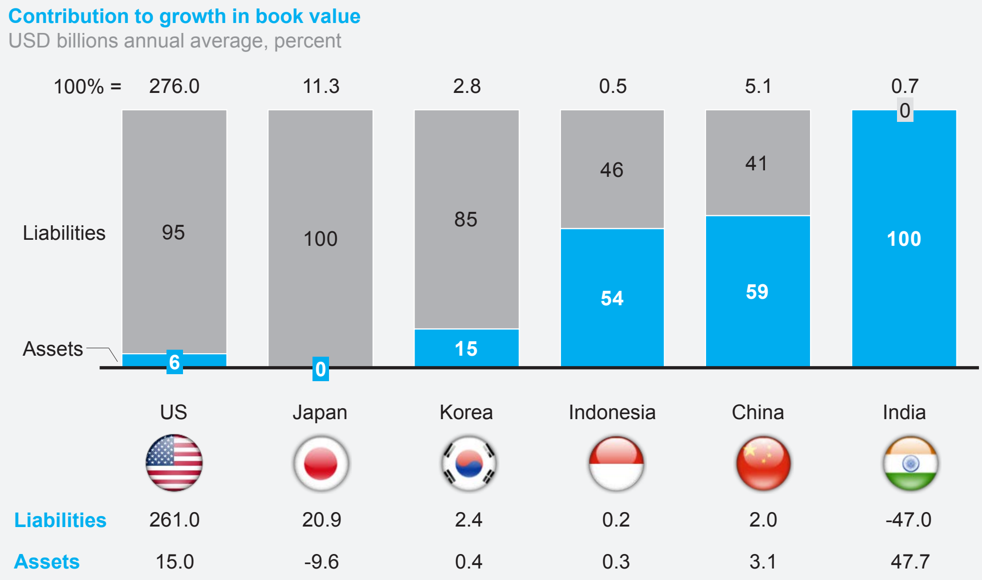
1 The Life Journey series.

2 The Life Journey series.

economies such as the US and Japan, higher-performing life insurers generate value through superior liability risk management; those in emerging economies such as India, meanwhile, rely almost entirely on asset management. In other words, as markets mature, the basis of value-creation shifts from assets to liabilities (Exhibit 5). Investment management remains a significant source of earnings in every market, of course, but carriers find it increasingly difficult over time to differentiate their performance purely on this basis.

Exhibit 5

Value creation shifts from assets to liabilities as markets mature



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

We expect that as the institutional asset management market matures in India, it will erode life insurers' ability to deliver high returns on the asset side of the balance sheet and force them into building capabilities that create value on the liability side.

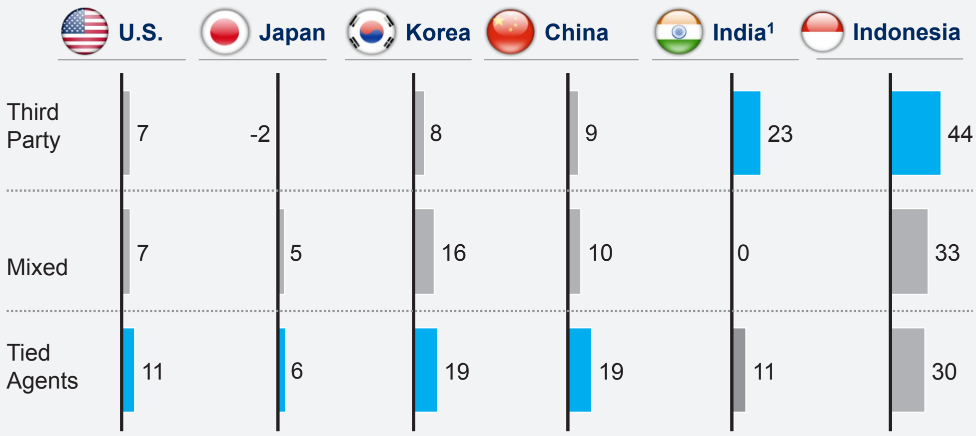
Korea, China, Indonesia and other emerging markets have already begun to undergo this shift. We believe that in the next decade life insurers carriers in India will create value consistently only by mastering liability management: pricing and selecting risk more wisely, designing more protection products and building the distribution skills to sell them.

Relative to other markets, the Indian insurance market is also unique in how channels stack up in value contribution. In another markets except Indonesia, tied agency creates more value than third parties including bancassurance. In India, third-party channels – bancassurance accounting for the overwhelming majority of it – create more value than agency (Exhibit 6). In fact, bancassurance is now the largest channel for India's private-sector insurers, constituting about 55 percent of the market (Exhibit 7) and contributing to surplus growth at a rate that is 50 percent higher than that in agency.

Exhibit 6

Value creation by type of channel

Average adjusted annual growth in book value
Percent

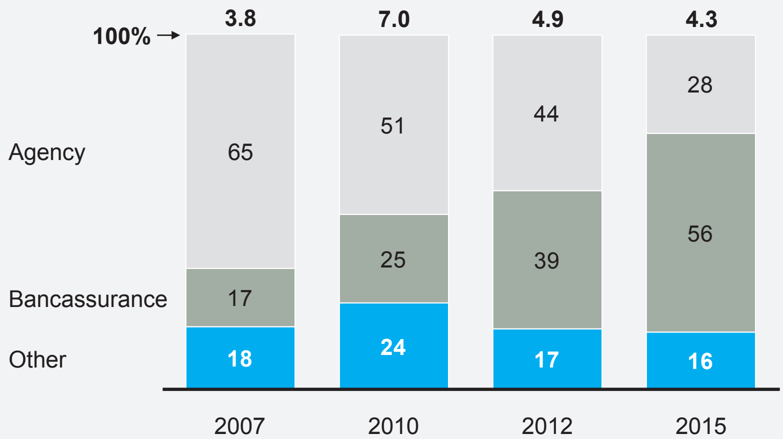


1 Includes 8 of top 10 private life insurance carriers for which data is available through public sources
Sources: McKinsey Life Journey papers on Japan, Korea, Indonesia, China and India

Exhibit 7

Bancassurance is the dominant sales channel among private-sector life insurers in India

India individual life new business premium sales by channel (private sector)
USD billions, percent



Sources: IRDA; McKinsey

THE SEARCH FOR PROFITABLE GROWTH

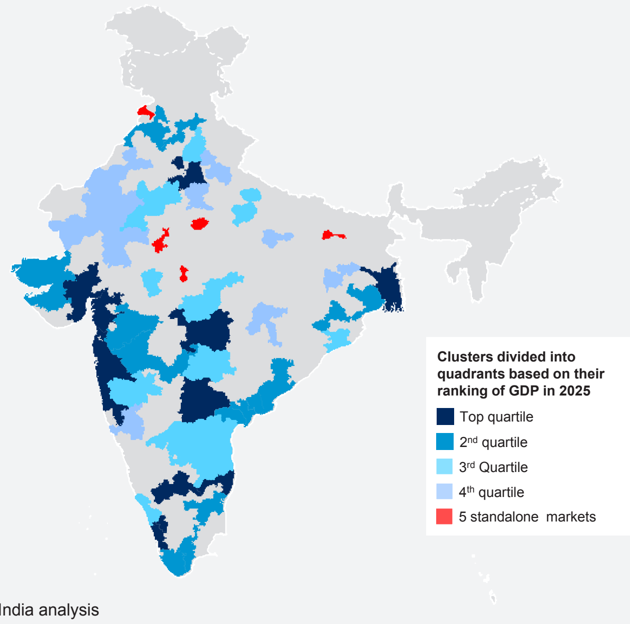
In what may be the world's most promising insurance market, we see the largest untapped potential in two areas: growing pentration in a few specific geographies and unleashing latent demand for protection products.

'Go granular' to identify high growth geographies

The Indian economy will grow rapidly in the years ahead, but the gains will vary widely by geography. We expect 44 clusters and five stand-alone regions to account for over three-fourths of India's incremental GDP growth by 2025 (Exhibit 8). Opportunities in mid-sized cities, such as Kochi and Surat, will be larger than those in major cities like Mumbai and Delhi.

Exhibit 8

Fewer than 50 metropolitan clusters and five standalone markets will deliver 80% of incremental GDP through 2025



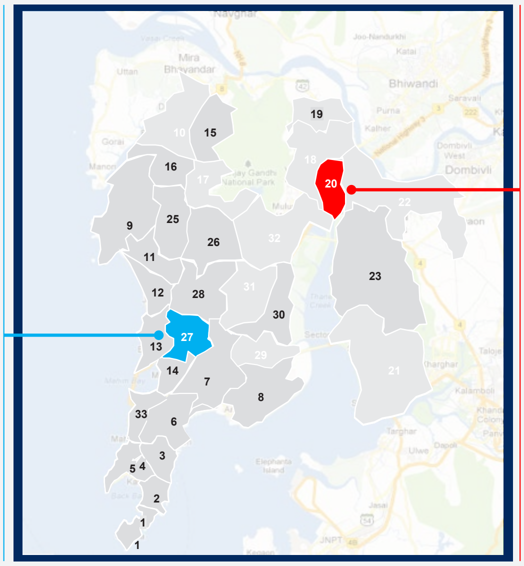
Source: Insights India analysis

Even within cities, insurers must use a micro-market lens to allocate resources and build distribution capacity (Exhibit 9). Mumbai, for example, has 33 distinct micro-markets across more than 150 wards, of which eight will account for three-quarters of the city's growth in the next decade.

Exhibit 9

Each micro-market requires a customized approach

	Kurla stn. – Santa Cruz	**Khopat – Kopari**
Households	110,000	110,000
Area	10 sq. km.	10 sq. km.
Affluence index	1.4	0.7
# of affluent HHs	60,000	30,000
Average affluent HH income	INR 1.7 Mn	INR 3.5 Mn
Average age	27	35
Profile	Salaried	Business
NBP CAGR FY12-16	13%	5%
FY16 NBP (Core)	310	180



Sources: Indicus data; McKinsey

Shift from investment to protection

As affluence rises, demand for protection, pensions, annuities and long-term care products will provide significant opportunities for growth.

Around the world, managing "poolable risk" – mortality and morbidity – is the single biggest driver of value-creation in life insurance, but India remains highly underpenetrated in terms of risk and protection products. In level of sum assured to GDP ratio, India is at 50, while Thailand is at 96, Malaysia 149, Korea 166, and the US at 270.

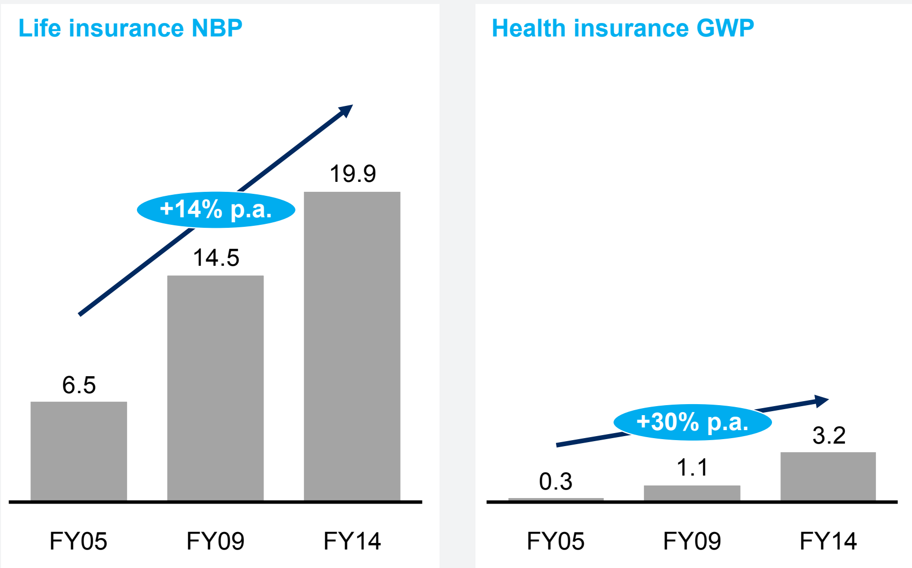
Demand for these products in India has already begun to grow sharply (Exhibit 10), with the accident and health segment leading the way. This market has historically been dominated by non-life players, but life carriers can capture a sizeable share of this market with innovative products and services and, most important, a distinctive value proposition of advice and service through the agency channel.

The penetration of retirement products is also extremely low, but Indian consumers across segments are increasingly concerned with the risks they face in retirement (Exhibit 11). As their awareness grows, consumers will expect better yields, more security, and a steady source of post-retirement income that life insurers are uniquely positioned to provide.

Exhibit 10

Demand for life and health insurance is growing rapidly

USD billions



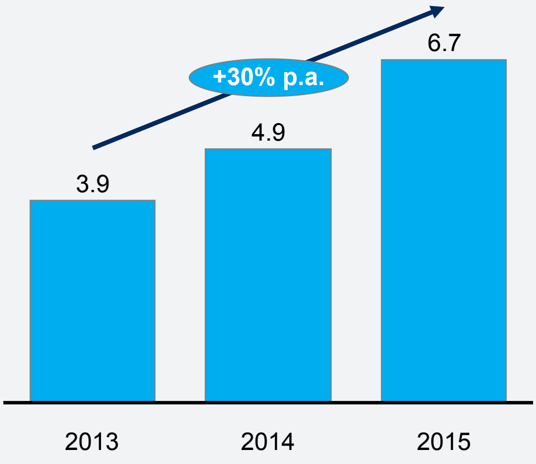
Sources: IRDA; McKinsey

Exhibit 11

Individual annuities and pensions are growing rapidly

Individual annuity and pension - NBP

USD Billions



Source: IRDA

FOUR IMPERATIVES FOR LIFE INSURERS SEEKING VALUE GROWTH

To ride the wave of growth in India and deliver sustainable value in the years ahead, we believe life insurers will need to strengthen their capabilities in four key areas:

1. **Expand capabilities in agency and lower costs.** Sales forces in India range from the rare professional teams serving the affluent to the ubiquitous part-time sales people who concentrate on the mass market. We believe that to grow value, insurers need to first prioritize customer segments – based on profit pool size and growth, and their own competitive advantage. Then, based on the size of the opportunity, starting point and appetite for risk and time to maturity, each carrier should align on an agency strategy. The levers it chooses to drive agency performance will depend on this strategy.[3]

   Regardless of the strategic footprint life insurers choose, they must also invest in a few areas, including tailoring service offerings to agents based on their needs, increasing financial-planning uptake, building product-expert, wholesaler, and sales teams to drive agent performance, and building capabilities - such as using analytics to identify leads and define marketing opportunities. In addition, life insurers in India must rethink the frontline manager model to improve effectiveness and significantly lower fixed costs.

2. **Reinvent relationships with customers and distributors by using digital tools and analytics.** Indian consumers are becoming more digital, crossing boundaries seamlessly between the physical and virtual worlds in their decision journeys. Marketing innovations using social and digital media, including online product customization and purchasing and multichannel experiences, are becoming requirements for life insurers to remain competitive in India. In addition, with increasing competition, efficiency will become even more important. To improve efficiency ratios, insurers should invest in digitization, lean distribution, analytics and better management of in-force customers. These skills will help make advances across the industry value chain: sales, product design and pricing, risk selection, claims and service.

3. **Build risk and capital management skills.** As described earlier, to grow value and outperform the industry, India's life insurers will need to excel in managing liability risks The winners will 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 design and pricing to make fewer long-term guarantees and find more innovative ways to share risk with policyholders.

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, 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.

---

3 For details, see "Maximizing Value from Agency in Asia" published by the McKinsey Financial Services Practice in 2015.

For India’s life insurers, the challenge is straightforward: stable, attractive returns will come only to those who fundamentally rethink the industry's value proposition and shift focus on serving the protection needs of broader share of the population by building capabilities to effectively manage liability risk and by building a more efficient and effective distribution model.

The Life Journey series

McKinsey Financial Services Practice

The Life Journey US; 2013

The Life Journey Japan; 2014

The Life Journey China; 2015

The Life Journey Korea; 2015

The Life Journey Indonesia; 2015

CONTACT

For more information about this report, please contact

Renny Thomas
renny_thomas@mckinsey.com
+91 22 6630 2063

Vivek Agrawal
vivek_agrawal@mckinsey.com
+81 3 5562 4411

Peeyush Dalmia
peeyush_dalmia@mckinsey.com
+91 22 6630 2147

Authors: Vivek Agrawal, Peeyush Dalmia, Alessia de Bustis, Sandeep Kumar

Financial Services Practice
January 2016

Design contact: GCO NewMedia
www.mckinsey.com