The Future of Life Insurance

How to weather the perfect storm of an uncertain economic outlook, evolving customer demands, and increased regulatory oversight
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1 Highlights

Even before the recent financial crisis, the life insurance industry was experiencing a consistent shift in customer trust and demand. The crisis and its aftermath have served as a catalyst to accelerate this trend. The global life insurance industry penetration\(^1\) has seen a consistent drop over the last five years. Moreover, customer trust in the insurance industry is currently among the lowest when compared to trust in other industries.

The changing landscape of the life insurance industry and the after-effects of the financial crisis are causing a perfect storm of legislative changes, customer demands, and economic uncertainty. These in turn are causing significant challenges for insurance companies now and in the future. This perfect storm is having a significant impact in three key areas for insurers:

- **Product portfolios:** Largely driven by the increased need of customers for transparency, the typical product portfolio of a life insurer is shifting away from complex, unit-linked products towards basic and more transparent products with guarantees.
- **Competition:** With this increased demand for less complex products, the life insurance industry has seen new, non-traditional players enter the market, increasing the competition in the industry.
- **Costs:** The convergence of less complex products and more competition has driven average insurer income levels down, and forced many insurers to look to cost reduction and efficiency measures.

The way forward for insurers requires a new focus on product approach, distribution strategy, customer service, and innovation, especially in customer service:

- **Product approach:** Bundled products that are basic, address customers’ overall wealth management needs, and provide guarantees seem to be emerging as the preferred products for leading insurers.
- **Distribution strategy:** To sell these basic products, insurers need to strive for a distribution strategy that is balanced between agents and direct channels, especially internet and mobile phone.
- **Customer service:** With limited opportunity for differentiation in products and distribution, firms need to focus on serving customers better.
- **Innovation:** In addition to devising innovative strategies in products, pricing, distribution, and customer service, life insurers may also need to revisit their operating model to enhance brand and sourcing strategies.

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\(^1\) Global life insurance penetration refers to global premiums for life insurance industry as a percentage of global GDP.
2 The Changing Landscape of Life Insurance

2.1 Decreasing Investment in Life Insurance

Overall global life insurance premiums increased by 6.4% in 2010 after witnessing a consistent drop over 2007-2009. The life insurance market was severely affected by the financial crisis as premiums dropped 1.5% annually over 2007-2009. The sales for unit-linked products in particular declined significantly as customers became more skeptical after the sharp falls in the global equity markets and their inability to show a sustainable recovery outlook. However, sales for basic life insurance products with guarantees rebounded in 2010, contributing to the recovery in life insurance premiums.

Since 2009, the global life insurance industry seems to have recovered from the crisis, but this has been primarily driven by Asia Pacific which witnessed a growth of 14.1% from 2009 to 2010. The premiums for the Americas and Europe, which represent 63% of global premiums, still remain below 2007 levels.

Exhibit 1: Global Life Insurance Penetration, 2004—2010

While life insurance premiums witnessed an uptrend in 2010, the global life insurance penetration witnessed a consistent decline from 4.6% in 2006 to 4.0% in 2010. Regionally, while Europe, Asia, and North America have the highest penetrations, these rates declined over the period of 2006-2010. This fall in life insurance penetration signifies that the growth of the life insurance industry is declining with respect to overall economic growth.

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2 Sigma Report, Swiss Re, May, 2011
3 Sigma Report, Swiss Re, May, 2008–10
2.2. Changing Customer Trust and Demand

Even before the financial crisis, the life insurance industry witnessed a consistent, negative shift in customer trust and demand. The crisis and aftermath have further accelerated this trend.

Customer trust levels in the insurance industry are one of the lowest when compared to other industries. Only 50% of customers had trust in the financial services sector as a whole and 52% had trust specifically in insurers. Among college-educated customers comprising the top 25% of household income across the globe, these two sectors were the least trusted.4

However, other industries such as technology (81%) and automotive (69%) perform well on the customer trust parameter. The after effects of the financial crisis coupled with an uncertain economic outlook are causing decreasing levels of trust in financial services overall. The insurance industry—life insurance in particular—is suffering from low trust due to heavy investment portfolio-related write-downs.

Low customer trust in the life insurance market is affecting the sales of life insurance, with demand shifting towards less complex products with fixed returns. This lack of trust is also driving customer demand towards greater transparency around product features and costs. Moreover, low customer trust may be a significant driver behind declining insurance penetration and a slower post-crisis recovery in premium volume.

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3 Drivers and Challenges Leading to a Perfect Storm

Capgemini has identified three main drivers of the perfect storm in life insurance:

- **Uncertain economic outlook**: The financial crisis caused a drop in the positive returns from the investment portfolio for life insurance companies, sometimes resulting in negative returns overall. Slow growth and uncertainty is lowering demand for life insurance.

- **Changing customer demands**: Post-crisis, customers are looking for less complex products with guarantees. Customers are also demanding increased transparency around overall costs and commissions paid to agents.

- **Shifting regulatory requirements**: Legislation is being put in place across various regions to increase transparency and reduce overall costs by maximizing fixed costs and moving from commission-based compensation to fee-based where the fee is paid by the customer.

### 3.1. Uncertain Economic Outlook

Net investment returns for life insurers suffered a steep decline during the core financial crisis period (2007-08). Many life insurance markets experienced negative net investment income returns during the crisis. The non-life insurance sector witnessed greater overall stability on investment returns relative to the life insurance sector due to lesser exposure to the markets.

The negative returns on the unit-linked products led to an erosion of customer trust and confidence. Overall, the ability of life insurers to manage this investment was also under customer scrutiny, which negatively affected the top-line of the insurers. Moreover, uncertainty in the economic outlook for 2011 and beyond is further driving down the demand for long term products, such as life insurance, thereby impacting the revenues for insurers.

In fact, insurers witnessed an impact on both fronts as the drop in investment income had a major affect on the bottom-line, and the negative returns on the unit-linked products caused a decline in top-line income.

### 3.2. Changing Customer Demands

Pre-crisis, the demand for life insurance and annuities products with guarantees had been increasing because customers desired safer returns after the 2001 equity market crash. However, after the recent financial crisis, the rise in demand was steeper for products with guarantees. The selection rate for guarantees offered\(^5\) on variable annuities in the U.S. increased from 53\% in 2007 to 72\% in 2009\(^6\) as customers sought to hedge against the risk of low or negative returns from the market.

While customer demand for products with guarantees increased, these products had a negative impact on life insurers during the crisis. Many life insurers incurred negative returns on their own market-based investments but had to provide

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\(^5\) Selection Rate of Guarantees for Guarantee Option Offered refers to the number of annuities for which a customer opted for the guaranteed return option (as opposed to no guarantees) divided by the total number of annuities which provided the guarantee option and were sold to customers.

\(^6\) Emerging Risks in the Marketing and Distribution of Life Insurance and Annuities, LIMRA/Milliman, 2010
guaranteed rates of returns on products with guarantees. Going forward, insurance companies will have to factor this impact into their product design to ensure that they can fulfill customer demand but minimize the negative impact on their bottom-line. In addition to products with guarantees, customers are demanding less complex products which are easy to understand.

Customers are also looking for greater transparency around products and costs. They expect insurers to provide complete details of the components of the product and its impact on them. Post-crisis, customers are more alert to price differences and are more likely to compare competing life insurance products before making a purchase decision. The increased availability of product information on an insurer website or aggregator\(^7\) has further aided the customer research. This comparison of competitor products by customers is driving the prices for simple products down, thereby forcing life insurers to reduce costs to be competitive in the market.

### 3.3. Shifting Regulatory Requirements

Post-crisis, regulations and legislation across all regions have posed significant challenges for life insurers.

**North America**

North America has recently experienced significant regulatory changes including the Dodd-Frank Act reforms that created a Federal Insurance Office to provide recommendations on improving insurance regulations. A suggested move towards principles-based regulations in both the U.S. and Canada is leading to enhanced regulations but greater flexibility for insurers while implementing these regulations. Also, Canada is implementing Phase II of the International Financial Reporting Standards which require all life insurers to de-link their valuations of liabilities—unpaid present and future claims—from assets.

**Asia Pacific**

Asia Pacific regulations are moving towards a more risk-based approach. The Japan Financial Services Authority is considering revising its Solvency Capital Standards to be in line with the Solvency II approach for enhanced risk management. Also, life insurers in countries implementing International Financial Reporting Standards Phase II (like Japan, Hong Kong, and New Zealand) are expected to face significant challenges related to capturing and reporting financials in the near future.

**Europe**

Europe is currently preparing for the Solvency II directive which is scheduled to be implemented in 2013. With the implementation of Solvency II, European insurers will have to comply with enhanced requirements on risk management and capital adequacy. Moreover, in-line with similar regulations in other European countries, the Netherlands Bank Mortgage and Pensions Savings Act ended insurers’ competitive advantage over banks by enabling comparable tax advantages in the banking system. In the U.K., the Retail Distribution Review is set to be implemented in December 2012. This law states that advisors will need qualifications to do business and will not be able to accept commissions from insurers. Advisors are expected to stop pushing products from insurers, which might lead to a drop in premium volumes.

Also, similar to the U.S. and Canadian reforms, the U.K. regulator has suggested moving towards principles-based regulation.

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\(^7\) Aggregators refers to a web site or computer software that aggregates a specific type of information from multiple online sources.
4 Impact of the Perfect Storm on the Life Insurance Industry

The perfect storm of uncertain economic outlook, changing customer demands, and shifting regulatory requirements means life insurers must:

- **Modify product portfolios**: The unit-linked products which were popular pre-crisis witnessed significant decline in demand due to negative returns. At the same time, demand for products with guarantees has been increasing over the past 5-6 years. After the financial crisis of 2008, the demand for products with guarantees increased further but the customers are looking for less complexity.

- **Prepare to face further competition**: Competition has increased in life insurance as new companies enter the industry to take advantage of the demand for less complex products which has lead to price sensitivity. Additionally, the crisis resulted in a decreased wallet share and drop in performance for life insurers. Meanwhile, in some markets banks are entering the life insurance space.

- **Reduce costs and increase transparency**: Demand for less complex products and increased competition has forced life insurers to lower prices. This has caused an increase in cost reduction efforts as insurers strive to maintain or increase profits. Due to declining trust, customers want increased transparency in costs and pricing when investing and the internet has become the preferred place to research life insurance products.

4.1 Changing Product Portfolio

The life insurance product portfolio is witnessing a shift from complex, unit-linked products to simpler products. The unit-linked products generated low or negative returns for customers during the crisis. Life insurance firms are now seeing a shift away from demand for unit-linked offerings. The ratio of unit-linked premiums to total life insurance premiums dropped significantly in many regions. For example, in Europe it fell from 30% in 2007 to 18% in 2009. Customers are avoiding unit-linked products due to uncertainty in the markets and the desire for less complex products.

If and when investment markets experience a robust recovery and the economic outlook improves, customers may again opt for unit-linked products, but demand is expected to be subdued for at least the next few years.

Customers are also demanding products with guarantees. To cater to shifting customer demand, life insurance firms have to at least partially shift their product portfolio towards basic products with guarantees.

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4.2. Increased Competition
The entry of banks into the life insurance industry, decreasing demand for life insurance in many markets, and changing product portfolios have led to increased competition in the life insurance market. Various regulatory changes and increased customer demand for basic products have enabled banks to offer competing products in the life insurance industry. In addition, increased competition in the banking sector has pushed banks to offer competing insurance products at lower prices, further increasing the competition with traditional life insurance companies.

Furthermore, banks have started pushing their own products through the bancassurance distribution channel, which is an attractive channel for insurers in Europe and some parts of Asia Pacific. This is causing reduced sales for life insurers from the bancassurance channel.

Life insurers face an uphill task to overcome this increased competitive environment and may benefit from transforming their operating model and cost structure to be better positioned to offer lower prices and still remain profitable.

4.3. Cost Reduction
The need for life insurance companies to reduce costs is driven by four factors: shifting market trend towards simpler products; increased competition; customer demand for increased transparency; and reduced capital and investment income.

Customer demand for less complex products and more transparency is creating an expectation and need to reduce costs. Since attaining top-line growth would be a challenge due to the shifting trend towards simpler products, insurers are expected to focus on bottom-line growth over the next few years.

Insurers offering a wide array of products might face challenges in offering simple products at low cost compared to insurers offering only basic products. The cost pressure for life insurance firms was enhanced by the financial crisis, which resulted in reduction of capital and decreased investment income. Furthermore, increased competition is leading to a reduction in prices of life insurance products. To retain margins, insurers may need to reduce costs further to deal with a low-income environment.
5 The Path Forward for Life Insurance Firms

To weather the perfect storm, insurers need to focus on products, distribution, customers and competition. Capgemini has found that a focused product approach combined with an enhanced distribution strategy and customer service approach can help insurers gain a competitive advantage.

5.1. Focused Product Approach
The perfect storm is shifting the focus of life insurers towards getting the right product portfolio. Customers are increasingly demanding an enhanced set of attributes in a life insurance product, including:

■ Basic features with less complexity so they are simple and easy to understand
■ Access online or through other means to various options related to the product such as investment choices and details around product price
■ Guarantees around minimum returns for cash value components
■ Maximization of tax benefits
■ Bundle of both life and pension products to enable holistic financial planning

Regional Impact
To capture this shift in demand and the changing demographics of an aging population in North America and Europe, life insurers are expected to increasingly focus on basic variable annuities with guarantees. While the North American market already has considerable sales of variable annuities, this trend is new to European markets.

In Asia Pacific, the demand for these annuities in mature and aging economies like Japan and Korea are expected to increase. For emerging countries with younger populations like India and China, the demand for basic unit-linked products with guarantees is expected to further increase.

Source: Capgemini Analysis, 2011

Exhibit 2: Capgemini’s Recommended Path Forward for Life Insurance Firms

Focused Product Approach + Enhanced Distribution Strategy + Embracing Customer Service Approach

Enables Tackling Increased Competition and Uncertain Future
The Future of Life Insurance

Transparency
To provide increased transparency, insurers have started rolling-out self service portals which let customers compare products and price as well as obtain or update detailed information around a purchased policy.

Financial Planning
Life insurers may benefit by providing bundled products to customers which would provide all these attributes and enable holistic wealth planning for the customers. This will enable top- and bottom-line growth for insurers.

Bundled products can address overall wealth management needs of customers while also enabling top- and bottom-line growth for insurers.

With the change in product portfolio, it is imperative for life insurers to devise an enhanced distribution strategy to accommodate the new product approach.

Exhibit 3: Basic Bundled Product Incorporating Features Desired by Customers

The ability of a life insurer to incorporate all the features desired by a customer within a bundled product is the key to gaining market share across regions. It is important for life insurers to understand the financial needs of an individual while designing or selling a bundled product to a prospective customer.

Life insurers can get help from agents and intermediaries to understand market and customer needs in order to better design these products. Moreover, a wealth management solution typically has higher profit margins when compared to a pure life insurance product.

5.2. Enhanced Distribution Strategy
The changing product portfolio and the emergence of new channels are expected to bring a shift in the distribution strategies for life insurers. Many markets across the globe are experiencing a transition from a commission-based to a fee-based structure for agent compensation, leading to enhanced distribution strategies by insurers.

With the emergence of technology, channels such as the internet and mobile phones are expected to gain market share over existing channels. However, at the same time, technology is expected to help agents serve customers better and provide them the opportunity to capture additional sales.

The new generation of customers—those under 40 years old—prefer the do-it-yourself approach for gaining knowledge about a product. Hence, they are more likely to compare products online and also find it convenient to buy online. Life insurers can use social networking sites to increase the popularity of their brand or products among under-40 customers by using social media-focused advertising campaigns such as sharing promotional videos or organizing contests on social networking sites.
While the focus of life insurance distribution is shifting towards these new channels, agents and brokers are still expected to contribute significantly to the sales of life insurance, especially for group and medium-complexity products. Hence, life insurers need to maintain a healthy balance between agent-focused and internet/mobile phone distribution strategies.

While implementing an enhanced and balanced distribution strategy, life insurers may face resistance from various stakeholders, but they will have to put customer needs first while deploying these changes.

5.3. Embracing the Customer Service Approach

With limited scope for differentiation on basic products and associated distribution channels, firms are increasingly focusing on customer service to retain and attract new customers. Traditionally, life insurers have concentrated on product design but the industry is expected to move towards customer service as the focal point with all other functions in support.

With the increasing shift towards a buyers’ market and a customer-service model approach, insurers are expected to concentrate on core operations and outsource much of the rest in an attempt to reduce operational overhead and increase business agility.

5.4. Tackling Increased Competition

In addition to designing innovative strategies for products, distribution, and customer service, life insurers may need to revisit their operating model to tackle increased competition.

Exhibit 3: Basic Bundled Product Incorporating Features Desired by Customers

While innovative strategies in product, distribution, and customer service are important to outperform the competition, insurers may also have to revisit their operating model.

Innovative Strategies

To create an uncontested market space, a life insurance company can create innovative strategies in product design, pricing, distribution, and customer service—or a combination of these areas.

- **Product Design.** Life insurers may strive to create a unique product to change the market landscape similar to the impact achieved by Apple’s iPod® and Amazon’s Kindle® in the music player and e-book reader markets. However, since customers are mostly looking for basic products, it will be difficult to devise a significantly unique product in this space.
Customer service and distribution are the areas with highest potential for innovative strategies in life insurance.

- **Pricing.** Life insurers can innovate in pricing by having a pricing structure that varies based on a particular customer segment. An excellent example is micro-insurance which involves an innovative pricing strategy with daily, weekly or monthly payments that is quickly becoming popular among the emerging nations in Asia and Africa.

- **Distribution.** Over the past few years, life insurers have explored innovative ways to sell insurance using the internet and mobile phones as these technologies have matured. A good example of this trend is mi-Life from MTN which helps low-income individuals in Ghana to buy life insurance over the mobile phone. The initial policies only cover funeral costs because funerals are an elaborate and expensive affair in Ghana culture.

- **Customer Service.** Innovative customer service is a key element for success going forward. Customizing products, leveraging technology to provide transparency, educating customers about financial planning, and leveraging the internet and social media to understand customer behavior and needs are some innovative ways to deliver better service and increase customer satisfaction.

Life insurers can start creating innovative strategies by targeting the areas of customer service or distribution, since the potential for innovation in these areas is high.

**Enhanced Operating Model**

Life insurance firms need to enhance their operating model to deal with the increasing competition in the market. Many firms have already started taking significant steps in this direction.

Some existing large life insurers have set up a separate entity or brand to sell basic products. This separation allows an insurer to design and sell products at a comparatively lower cost. It also provides the opportunity to utilize the economies of scale of the larger corporation to share common services and lower costs.

In addition, many companies have been fine-tuning their sourcing strategy to reduce operational cost and enhance business agility. The key decision for sourcing strategy revolves around retaining or transferring a business or activity. Insurers can break up the value chain and then define the core and non-core activities based on their overall strategy and the impact on people, process, and technology across these areas.

If an insurer retains a business activity, they can either look to update or renew all activities internally, possibly with the help of a vendor, or outsource some applications and update the remaining applications in-house.

If an insurer opts to transfer a business activity, they can outsource the system operations to a third party administrator or the complete process to a business process outsourcing vendor. The use of outsourcing services varies based on the region. Most U.S. and U.K. insurers outsource asset management and middle and back-office operations. European insurers have started catching up with this trend. Asian firms tend to keep asset management in-house and outsource the back-office operations to the third party vendors.

If an insurer chooses to transfer a business or activity completely, they can consider selling that business portfolio to another insurer.
6 Conclusion

Life insurers today are faced with a tough situation and need to act quickly to remain competitive in the market. To respond to rapidly changing market needs, life insurers must ensure their company is innovative, flexible, and agile.

For most life insurers, it will be a long journey to tackle current challenges in the industry including the development and implementation of multiple strategies. A good starting point is to concentrate on customer servicing and realignment of operating models.
7 References

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