The European Life-Insurance Industry

Charting a new course to defeat market challenges
The life-insurance industry in Europe is at a critical juncture. While the nature of the industry protects against transitory downturns, it also hinders attempts to fight ongoing structural problems. Thus, when interest rates are low and the markets are weak over a long period of time—as has been the case for more than two years—insurers can suffer heavy losses on their longer-term guaranteed products. This paper explores the current state of Europe’s life-insurance industry and the challenges it must overcome to right the ship.

The financial crisis has battered the life-insurance industry, prompting questions about insurers’ ability to provide customers with a worry-free financial future. Europe’s life-insurance industry has been left with many of the problems Japan experienced a decade ago—and that still linger today (see sidebar: Will Western Europe Repeat Japan’s Life-Insurance Crisis? on page 4).

Initially, life insurers noticed little damage in Europe from the financial crisis. The industry normally operates under stable longer-term assumptions, and poor performance is less apparent than in short-term-oriented businesses such as banking and asset management. Over time, however, it became clear that the industry had been dealt a fairly serious blow. Because the industry often acted as a counterpart to some of the toxic investment products that spurred the crisis, nearly all insurers suffered losses. Some—such as Aegon and AIG—even needed government support. In addition, as central banks lowered interest rates, it accelerated what had already been a decade-long rate decline, hurting investment returns (see figure 1 on page 2). While some lower-rated southern European countries offered somewhat higher returns, these investments proved dangerous, as we learned from the example of Greece (see figure 2 on page 2). Not only was the industry hit by crisis-related losses, but measures taken to reverse those losses only made things worse. This, however, was only the tip of the iceberg.

**Beneath the Iceberg**

The life-insurance industry has shown little or no growth—often well behind GDP—in most European markets in recent years. Of the countries shown in figure 3 on page 3, only France has grown significantly, thanks to tax increases on mutual funds. In other countries—Belgium, for example—as tax benefits on life insurance were slashed, the number of premiums written nosedived. As a result, life insurance has lost share in the long-term savings market to other players, such as banks and mutual funds.
Figure 1
In the wake of the financial crisis, central banks accelerated interest rate cuts

Figure 2
The most attractive bond rates come with the highest risks

10-year government bond spreads over German bonds, 2010 (basis points)

Source: European Central Bank, September 2010

Source: Bank of England, June 2010
The growth slowdown can be traced to other factors that, when taken alone, are small, but when combined can have a major impact on the industry’s future. We group these factors into four categories (see figure 4):

Market environment. The insurers’ market environment is changing, and not just in terms of investments where low interest rates have left their mark.

Increasing regulatory pressures will have an impact on insurers’ overall mode of operation. This is exemplified by Solvency II, the European Union’s updated regulatory requirements that are expected to take effect in 2013. The impact
of Solvency II may be profound, as it will likely raise the required equity held by life insurers. Several quantitative impact scenarios—simulations designed to determine how much capital is needed to maintain solvency when investments are marked to market—demonstrate that some life insurers will need to increase capital from 10 to 300 percent (see sidebar: Solvency II: The Three Pillars on page 6).

Also, demographics are changing—not just in terms of Western Europe’s aging population, but also in international mobility and a growing Islamic population. Unlike other industries—banking, for example—life insurance has been quite slow in identifying these latter two demographic changes.

Customer preferences. The underperforming equity markets of the early-to-mid-2000s soured customers’ appetites for risk-taking. Specifically, there are fewer unit-linked contracts (a combination of insurance and mutual funds) as customers turn to guaranteed-income products. This slowdown is exacerbated by the public’s limited understanding of these products’ economic fundamentals and their underlying cost structures.

A second example can be found in complex mortgage products in which principal repayment is postponed but reinvested, usually into equity types of products. These offered maximum tax deductions for interest payments, while capital gains on equity-linked products were often tax-free. However, as recent market conditions left people with significant capital losses and debt, customers and lawmakers are demanding more transparency from insurers.

Distribution. Changes in customer preferences have affected how intermediaries are paid. Regulators have limited commissions on contracts, and some markets—such as the United Kingdom and the Netherlands—are transforming from systems based on producer-paid commissions to those based on consumer-paid fees. “Tied” agents (those who sell insurance for only one company) are also under pressure. In Italy,

Will Western Europe Repeat Japan’s Life-Insurance Crisis?

By the late 1990s, Japan had the largest life-insurance market in the world. But as the bubble burst on the Japanese economy, insurance companies there endured great difficulty.

On 25 April 1997, Japan’s Finance Ministry ordered Nissan Mutual to suspend its business. It was the first Japanese insurer to go bankrupt in five decades and sent shock waves throughout the industry. As a result, the Japanese market fundamentally changed. Seven small and mid-sized companies failed, while foreign insurers grasped the opportunity to expand quickly into the market. From 2000 to 2007 the number of mutual insurers declined from 14 to six. To increase solvency, insurers retained more earnings and capital increases.

There were four main reasons for the industry’s woes in Japan:

A shrinking market. The Japanese life-insurance market reached a saturation point, while economic turbulence combined with a loss of faith in the industry significantly reduced demand.

New entrants. While the economy faltered, foreign insurers were allowed to enter the market for the first time, increasing competition as market circumstances deteriorated.

A failing stock market. The Nikkei declined from more than 20,000 in March 2000 to below 8,000 in April 2003, creating huge capital losses.

Persistently low interest rates. Low interest rates reduced the yields that insurers could demand on their preferred investments to below the level they had to pay their customers.
they are being abolished in favor of “multi-tied” agents or brokers. At the same time, direct channels are emerging, mostly for simple products.

**Competitive position.** Several trends have undermined the competitive position of European insurers compared to other types of long-term savings, including asset management and pension funds with voluntary contributions. The financial crisis has tarnished the insurance industry’s image as a safe haven for long-term savings, and has left customers less certain than ever that their assets will be managed well. Additionally, one of the insurance market’s main engines—favorable fiscal treatment—is eroding as governments tighten budgets and grant fiscal advantages (once limited to insurers) to other suppliers of long-term savings products, namely banks. Furthermore, the industry’s established players are threatened by more flexible new entrants unburdened by legacy costs.

Granted, these issues are affecting some markets more than others, and, depending on local market structure, consolidation within some domestic markets may be needed. We believe the largest cost-reduction benefits will be reaped within individual jurisdictions, because covering many jurisdictions in one system is particularly difficult. Consolidation of operations has occurred for years, yet in many European countries there remain many options to consolidate further and reduce costs. Figure 5 shows market share of the five largest life-insurance groups.

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**Figure 5**

Market share of the top five largest life-insurance groups, by country

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*Note: All figures are for 2008 except Netherlands (2009).*
Charting a New Course

We’ve painted an ominous picture of Europe’s life-insurance industry, but there is reason for optimism. Recent positive numbers generated by some European insurers indicate that good management, along with improving macroeconomic conditions, can boost performance. Nevertheless, there is no time to waste—the industry needs to take immediate action to secure its own survival.

Plotting a new course requires focusing on strategic imperatives and strategic choices.

**Strategic imperatives.** There are two basic imperatives for survival: improving efficiency and sharpening the value proposition.

**Improving efficiency.** The “good old days” before the crisis may have disguised the fact that many insurers were operating inefficiently—with excessive or overlapping back-office functions, outdated legacy systems and inferior processing capabilities. Improving efficiency requires going well beyond eliminating waste in existing processes. True efficiency requires redesigning product portfolios, reducing product variants, simplifying legacy systems and migrating products into a few distinct variants. Simply put, insurers’ future competitiveness depends on their ability to manage complexity (see sidebar: Less Complex, More Competitive).

Also, consolidation in markets and functions can improve efficiency. Major cost reductions can be achieved through consolidation in the back office, product management, and branding and advertising. And as economic forces gain strength domestically, consolidation among markets will streamline the playing field; it is neither easy nor cost-efficient for a single system to cover multiple jurisdictions.

**Sharpening the value proposition.** Insurers do more than protect against risks such as death and loss of income—most also offer long-term savings. This element is no different than what pensions or mutual funds offer, except for the potential fiscal incentives for long-term savings through life insurance. Insurers that stress this point of difference, and create unique combinations of pure insurance (death, accident) and long-term savings, will have an advantage over these competitors. Appropriately structured, such products could generate income for years to come. And although the duration is much longer than typical

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**Solvency II: Three Pillars**

Solvency II provides a comprehensive revision of the European supervisory structure for insurers. It is built on three pillars:

**Pillar 1.** Requires market-consistent valuations (including technical provisions) and defines capital requirements. It employs a mark-to-market principle, which has applied to banks for years. This exposes insurers to short-term volatility on investments they may hold for the longer term, and will likely significantly increase the equity needed as a risk buffer.

**Pillar 2.** Deals with the qualitative aspects of a company’s internal controls, risk-management processes and approach to supervisory review.

**Pillar 3.** Ensures consistent supervisory reporting and disclosure across the European Union. Insurers must prepare to disclose more information publicly than they are currently required to do.

As Thomas Steffen, chairman of the EU’s Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), said, “Solvency II is not just about capital. It is a change of behavior.”
policies, given appropriate investment expectations this could be beneficial. For instance, many countries allow some form of fiscally advantageous liquid-wealth transfer. And because families today are smaller than in the past, there is a concentration of wealth, which further supports the advantage of long-term savings through life insurance.

**Strategic choices.** Several strategies can help life insurers remain successful in these turbulent times.

Life insurance has been long characterized by assertive, disciplined selling. This is perhaps best exemplified by Hamburg Mannheimer, now part of Ergo, which used to recruit only former military personnel for its sales force. Sales-force effectiveness can still carry the load, especially if companies add products such as investment funds to their portfolios. Legal & General in the United Kingdom is already doing this. Such a move requires thorough assessment of target segments, sales force upgrades and possible distribution agreements with banks.

The bank insurance model, once popular in Europe, lost some of its appeal during the financial crisis, as witnessed by the announced break-up of Amsterdam-based ING. Don’t underestimate the distribution power of banks for life-insurance products, however. It is still strong. In France and Belgium, for example, banks hold about 50 percent market share in life-insurance distribution, and banks in Germany and the Netherlands are nearly as active. Also, Optima, a financial advisory firm, offers a total audit of assets to place new insurance policies and mutual funds. Optima’s rapid growth in Switzerland and Belgium is evidence of the formula’s effectiveness.

The best distribution channels define specific service concepts around each channel. In line with today’s consumer practices, all service concepts should be multichannel and accessible using multiple technologies. The role of the various channels, of course, will be different for each concept as Zurich Financial Services has shown in becoming one of Europe’s largest financial service groups (*see sidebar: The Zurich Way*).

Finally, many insurers achieved scale by acquiring local competitors, but many failed to consider the full impact this added size could have on operations. The resources and capabilities were not available to organize and implement
The Zurich Way

Zurich Financial Services has grown from a small Swiss insurer to one of Europe’s major financial services groups. Total revenues were more than $70 billion in 2009, with $28 billion generated by its Global Life Insurance business. Despite tough times, Zurich maintained Global Life’s operating profits of more than $1.4 billion in 2008 and 2009. Zurich attributes its success to focusing on gaining global scale while maintaining excellence in operations. Throughout the current recession Zurich has prioritized growth without sacrificing margins, and searched for new markets in the Americas, Asia and in regions of Europe where it lacked a presence. Zurich recently purchased 50 percent of Caixa Sabadell, a Spanish life insurer. Growth is apparent in Zurich’s existing markets in its aggressive use of bank distribution and a sophisticated product range.

“The Zurich Way” operational-efficiency program designed to automate processes has saved the company more than $2.8 billion over the past three years. Many back-office functions are centralized, and single premium products are manufactured in Ireland and sold cross-border throughout Europe.

Today, however, new industry players are emerging: outsourcing companies. In some cases these outsourcers are cutting costs by focusing on operations and the scale they can offer by combining portfolios from multiple insurers. In the future, life insurers will have to choose which core competences they want to develop internally, and what their specific role will be in running their operations.

What’s Ahead?

A number of unfavorable macroeconomic forces have brought tough times to Europe’s life-insurance industry, but insurers can shape a strong future by focusing on their core products and thinking creatively about how to extend their portfolios. If nothing else, the industry’s basic service offering—protecting long-term income—has become even more relevant.

Capitalizing fully on future opportunities in the life insurance industry will require examining costs, reducing complexity, reaching sufficient scale and, importantly, responding to increased competition from mutual funds and asset managers by offering a wider range of differentiated products.

The life-insurance industry has weathered many bad storms in its four-century existence. By taking some bold steps, it can weather this one as well.

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