South Africa Life Insurance Insights Report 2012

nmg CONSULTING

Executive Summary

The South African life (risk) insurance market is one of the most dynamic, innovative and fragmented risk markets in the world. There is a strong history of product, channel and business model innovation, an overwhelming focus on quality and an extremely diverse range of competitive and business model approaches.

In high net worth (HNW) and affluent segments, distributors and product providers have capitalised on high risk awareness and a limited safety net (relative to comparable insurance markets). In contrast to peer broker markets (the UK, Canada and increasingly Australia) which have drifted towards price-based competition, commoditised products and streamlined service, South Africa has gone to the opposite extreme with non-price factors driving flows as well as operational and service complexity. In many ways these industry dynamics are positive: customers have a genuine choice of product and benefit structures, and distributors, insurers and reinsurers generate sufficient returns to justify continuing investment back into the business.

However innovation around product, pricing and risk acceptance not only drives differentiation but also creates complexity and capacity issues in a market where supply-side gaps are becoming more pronounced (across distribution, technical and service functions). Complexity drives cost down the chain, not solely into operations but also into sales and distribution. The result is a range of highly differentiated, high cost and high complexity models. While this may be supportable for HNW and affluent demographics and for the broker channel, it will be hard to extend to mass affluent and mass market demographics where most insurers see the real growth over the medium term.

One could go further still and argue that the broker market receives too much attention from insurers. In reality the broker market is smaller and declining faster than industry statistics suggest with margins significantly below market average. This is primarily driven by an uneven regulatory environment. Where the industry standard hits commission caps (for life risk but not for investments in South Africa), there are clear incentives for semi-aligned models such as NetCo over broker. This creates the polar opposite to international experience where the best and most productive advisers seek out non-aligned broker channels. Most insurers participating in the broker market should do so because there is little choice and sub-optimal insurer positioning in the broker market is actually rational in the context of broader participation strategy (even if this is not deliberate).

This report outlines key learnings from our first formal BQM study interviewing over 100 leading intermediaries in the South African life (risk) insurance market, as well as recent strategy consulting engagements in life insurance markets including South Africa, the UK and Australia. As befits a first report, we have started with a series of outside-in observations that go some way to describing why the South African market remains an outlier:

1. High risk awareness and a limited safety net creates an 'insurance-friendly' market
2. Fragmented client demographics and distribution prevent one-size-fits-all supply models
3. Successful new entrants challenge incumbents and the tendency towards oligopoly
4. Demand dynamics and high target returns drive multiple approaches to risk management
5. Pricing power hides future cost challenges created by excessive risk complexity

High risk awareness and a limited safety net creates an 'insurance-friendly' market

South African demand dynamics are highly supportive of life insurance sales and profitability:

- A large, but fragmented population creating a set of economically viable segments rather than a single homogenous market
- A high level of risk awareness driven in part by high rates of accidental death and 'dread disease'
- Continuing high inflation and financing rates impacting future life event costs and funding options
- A limited safety net in the form of public health, retirement, family or disability support systems
- Strong cultural support centred around specific risk needs such as business insurance (linked to entrepreneurial lending in HNW and affluent segments) and funeral insurance (in mass affluent and mass market demographics)

All these factors combine to create a strong demand for insurance and a willingness to pay a premium for value factors (whether these are perceptions of safety and stability, flexibility around risk acceptance or product and service fit). In many of the markets we cover, high price and high value positioning is typically niche, but in South Africa it is possible to be an at-scale, mainstream player commanding a price premium based on product or risk differentiation.

Figure 1 – NMG Life Risk Study – Product Size and Growth

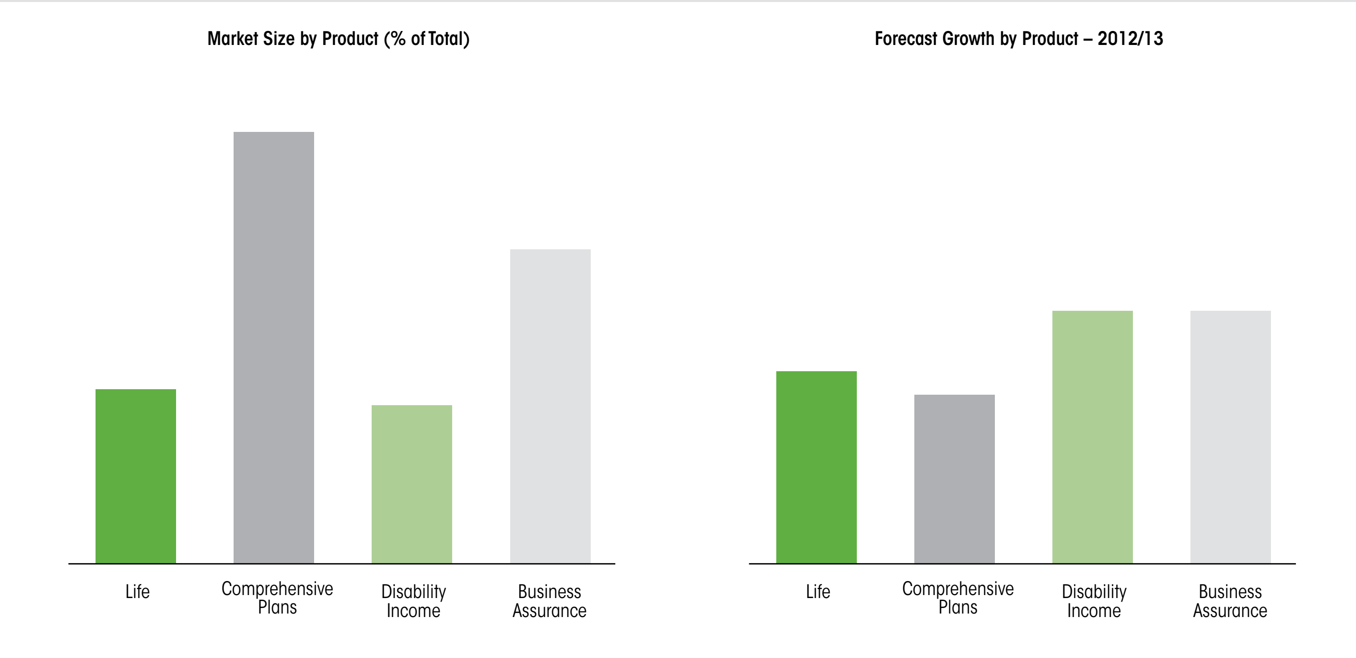
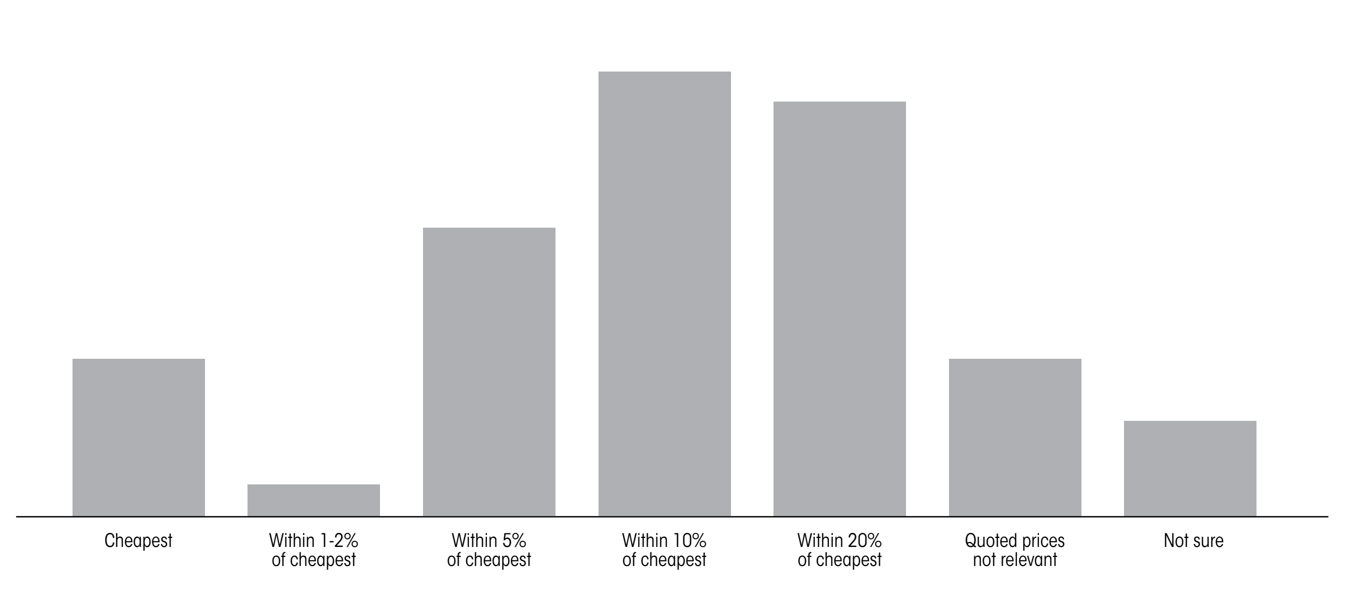


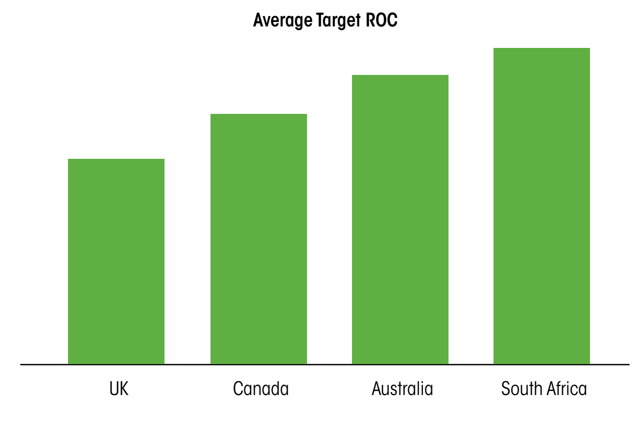
Figure 2 – Intermediary Willingness to Recommend Price Premiums



However despite high aggregate industry returns, product margins in the broker channel are far from spectacular. This leads us to hypothesise that key players are either not accurately pricing the risk or cost complexity associated with their points of difference or the level of discontinuance implicit when participating in non-aligned channels.

Figure 3 – Market Profitability in UK, Canada, Australia and South Africa

% Expecting to Meet Target Return			
82%	53%	100%	100%



Fragmented client demographics and distribution prevent one-size-fits-all supply models

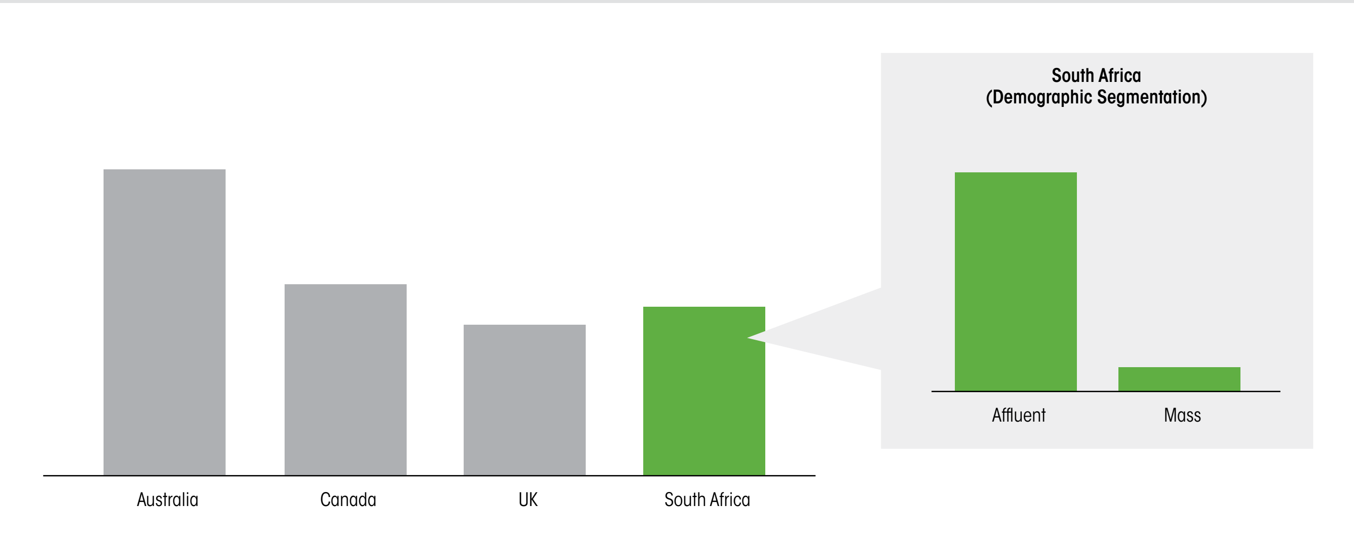
It is difficult to generalise about a single insurance market in South Africa, given the level of socio-economic fragmentation and differentiation between economic and demand attributes in different segments. While aggregate risk insurance penetration is low by global standards, penetration into HNW and affluent customer segments (our focus in this report) is significantly above peer levels.

Of course high current penetration is a double edged sword, supporting current market size but potentially mitigating against future growth. Total new life risk business of approximately US$1bn for South Africa compares to US$1.4bn for the UK market, and 2-year sales growth of +8% in South Africa compares favourably to -1% in the UK. However our analysis of re-broking frequency and drivers suggests that genuine growth attributable to new customers via the broker channel is very limited. So for broker-focused insurers, growth will need to come from market share or margin improvement, or from transporting elements of the proposition into new geographies or faster growing demographic segments.

Every distribution method (productive agency, IFA and IFA-like models, bancassurance and direct/affinity channels including developed retailassurance channels) is represented in South Africa, and in a number of cases on a best practice basis. While we have focused in this report on the IFA, IFA-like models and bank channels that serve more affluent customers, we acknowledge that performance in these segments cannot be viewed in abstract. Instead, performance in the broker market must be considered in the context of participation strategy more generally, specifically in regard to tied and aligned channels relevant to a broader demographic base.

All of the above points mean that individual channels are relatively small scale, so it is puzzling that this fragmentation is compounded within the broker channel. In contrast to the investment market, large national firms (the top 10% of firms in our sample) generated less than 50% of new business, compared to 80–90% in international broker markets. The long tail of firms with less than 5 advisers accounted for the majority of sales which

Figure 4 – Retail Life Insurance Penetration (New Business per Head)



suggests that the economics of advice distribution look good even at relatively small scale (which is no surprise given case sizes and relative ease of sale). However fragmentation presents challenges around distribution cost and, given the current regulatory environment, we expect future consolidation and an accelerating shift from broker to alternative advisory models such as NetCos.

This expectation is substantiated by our analysis of adviser productivity where alternative semi-aligned models such as franchise or NetCo deliver the greatest new annual premium per adviser.

Figure 5 – Move to Alternative Models

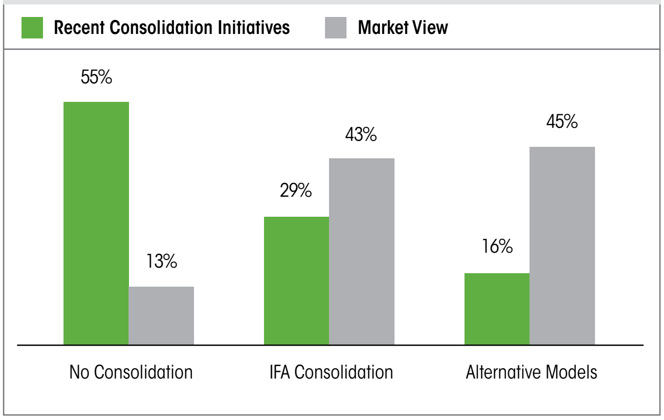


Figure 6 – Intermediary Market Concentration (NMG Sample)

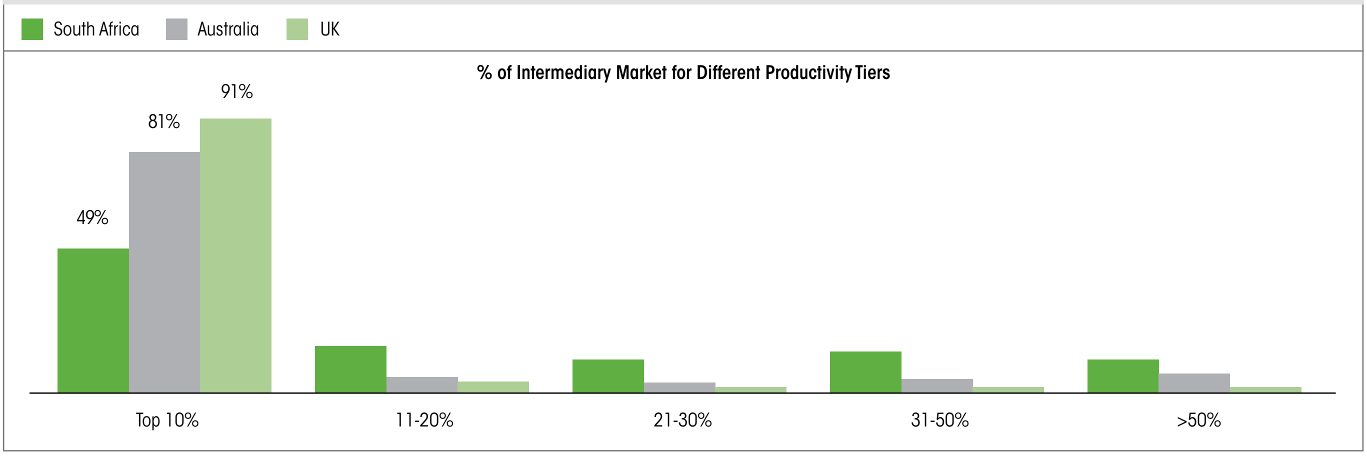
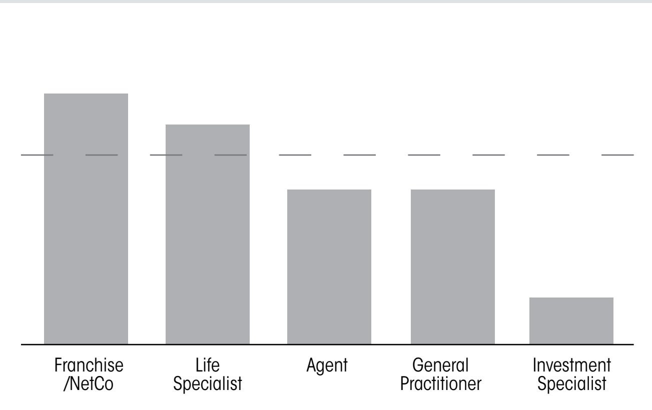


Figure 7 – Adviser Productivity by Intermediary Segment



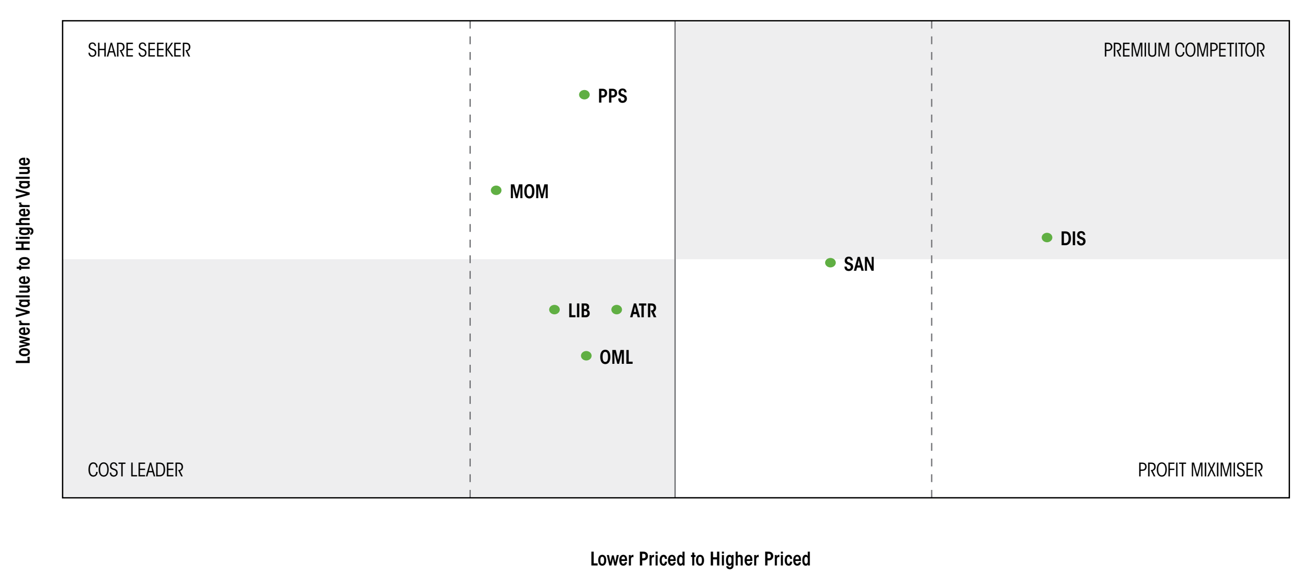
One key implication of demand-side fragmentation (across channels and across the broker market) is that it appears to prevent one-size-fits-all supply models. Most major insurers participating in peer markets are analogous with the same core resourcing models, basis for risk management and cost structures. Yet in South Africa there is an unprecedented degree of differentiation in business model and organisational strategy. We will explore insurer strategies and implications in subsequent themes but at this stage we observe that fragmentation of demand facilitates fragmentation of supply.

Successful new entrants challenge incumbents and the tendency towards oligopoly

In most of the markets we cover incumbency matters: the longest established insurers dominate relationships and market share even without leading on capability or competitiveness. But in South Africa and in spite of the value placed on size and financial strength, low barriers to insurer entry have allowed a consistent stream of new entrants targeting broker and direct channels.

These relative new entrants (including specialist subsidiaries of large institutions) have been broadly successful in displacing the incumbents. In fact, our analysis shows the top-3 insurers ranked on broker perceptions of value (non-price) competitiveness are all fairly recent entrants when compared to the long-established brands.

Figure 8 – Perceived Price / Value Positioning (Independent Broker Segment only)



So how sustainable is it for the major insurers to consistently lag in the broker channel? Some of the poorly rated insurers on price/value believe the whole market is stuck in an uneconomic paradigm and that certain players will blow up, returning the industry to more profitable norms. We have heard similar stories in a range of international markets but the reality is that aggressive pricing for volume against a significant fixed cost base remains compelling. While there have been blow-ups, examples are rare and history suggests that the poorly positioned sceptics would be better off reconsidering their own participation in the broker channel.

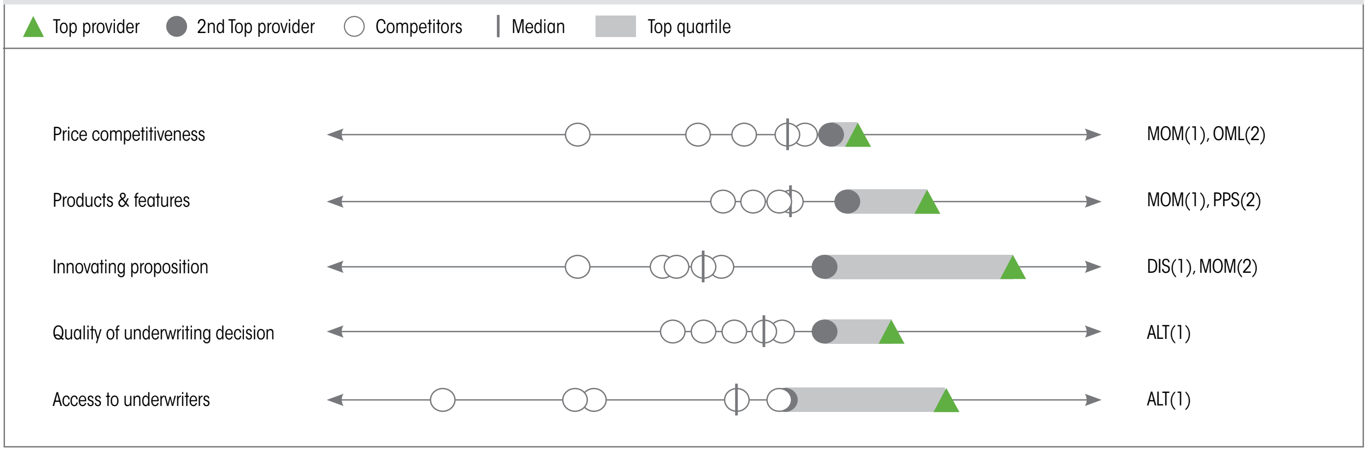
In the UK and Australia the broker (IFA) market is such a significant component of total industry premium and growth that underperformance there leads to underperformance generally, at least for the larger players. But in South Africa the broker market receives a disproportionate amount of attention relative to current volume and future growth prospects. Failure to lead in the top-end broker channel is not a mortal blow, provided the insurer is making the right investments (for example around product simplification and automation driving cost and pricing) to lead in mass affluent and mass market channels where margins are in any case likely to be higher for insurers with the right distribution and manufacturing cost structure. We see the greatest challenges for those providers caught in the middle, unable to point to capability and organisational alignment at the top or the bottom end of the market.

Demand dynamics and high target returns drive multiple approaches to risk management

One of the common characteristics in global life insurance markets (including the UK, Canada and Australia) is that the major insurers tend to converge in terms of risk management approach and more specifically the relative emphasis on managing product features and benefits, underwriting processes and pricing. So for example in the UK, the largest life insurers have tended towards streamlined underwriting (with high exclusion rates) and commoditised products, but with a very high degree of sophistication in pricing (derivation and frequency). In Australia insurers are far less sophisticated on pricing, and seek to differentiate around product features and more recently around underwriting (albeit with a lack of certainty about future implications). In Canada, insurers have tended to balance product, underwriting and pricing measures.

However in South Africa we have seen insurers approach the problem with totally different strategies around product, underwriting and price. Product is highly differentiated with Momentum leading on coverage and features and Discovery on innovation. Underwriting models are equally diverse with Discovery focused on preferred lives, PPS on professionals and Altrisk on impaired lives. On price, Momentum leads on process and sophistication while Old Mutual leads on quantum based on scale and operational efficiency. So not only is there more evidence of differentiation, but insurers have also chosen to differentiate on distinct risk parameters.

Figure 9 – Risk Management Differentiation by Leading SA Insurers



The result is unprecedented diversity amongst the top insurers, which supports a very high degree of price variation. Furthermore, there are also a number of adverse side effects:

- With just 1 – 2 insurers leading on each risk parameter there may be limitations on industry experience and certainty in predicting outcomes
- The model relies on a high degree of technical depth (across actuarial, underwriting and claims) that South Africa will struggle to maintain if experienced, highly commercial actuaries continue to leave for international markets without adequate new supply
- The model requires significant investment to build proprietary systems and processes (given that vendor solutions will not work) but has limited scope to spread fixed costs via expansion into emerging customer segments or international markets (without significant adaption)
- Perhaps most importantly, the approach drives a degree of complexity through operations, sales and distribution which reduces economies of scale and cost efficiency overall, with implications for the pricing and delivery of risk to clients and to profitability

Pricing power hides future cost challenges created by excessive risk complexity

We have highlighted that the degree of risk complexity in this market drives a lack of transparency and certainty, technical dependencies that are unlikely to be sustainable and operational and distribution complexity which must ultimately drive poor cost and service outcomes. An adequate discussion of any of these requires an entire report but we have chosen to focus on the cost and efficiency point where we can evidence outcomes in our 2012 study.

While South African insurers (like peers in other markets) have made significant investments in automation, broker feedback indicates minimal uptake of online technology or impact on service citations. Furthermore, anecdotal evidence from insurers suggests that these initiatives have not delivered the promised cost reductions in most cases. Service citations in our study were actually better than in comparable broker markets but primarily because insurers have continued to increase resourcing (typically in distribution). This gets the job done, but it introduces complexity and key person dependencies which are reflected in the continuing strong citations for broker consultants (BCs). Brokers admit that they use BCs for service rather than sales (and most insurers admit the same) but this creates unsustainable cost structures that are poorly aligned to underlying business dynamics. The expense of hiring BCs and the fact that incentive structures are aligned to sales (in a market where re-broking generates sales but limited net growth) highlights the potential cost impact.

Figure 10 – UK, Australia and South Africa Aggregate Service Citations (across Speed, Accuracy and Responsiveness factors)

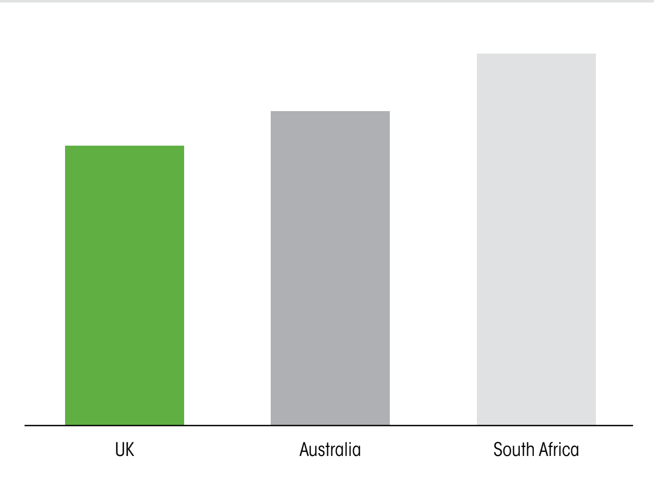
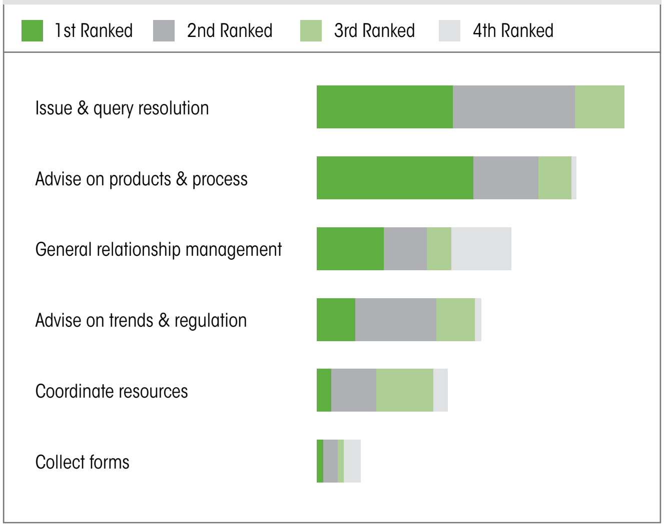


Figure 11 – Key Intermediary Requirements from Broker Consultants (BCs)



Today these issues may be manageable given the lack of emphasis on price and therefore generous gross (risk) margins to pay for the associated costs. However this may change with any shift in experience which impacts risk margins, cost of capital or reinsurance or with regulatory change which drives increasing price-focus. We wonder how ready insurers are for an industry scenario which places greater emphasis on cost.

About NMG

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NMG's evidence-based consulting programmes use interviews with key clients and intermediaries as a basis to analyse industry trends, competitive positioning and capability. Established programmes exist in wealth management, life insurance and reinsurance across North America, the UK and Continential Europe, Asia Pacific, South Africa and the Middle East.

Our Insights reports are published annually, drawing on our research and consulting experience, to help product providers make key decisions on topical, industry-level issues, as well as helping distributors to make informed decisions on their future use of providers.

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