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*Insurance  
investment  
management*

**&**

*A Fit for Growth*  
approach to  
grow profitably



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# Executive summary



**Since the financial crisis**, mid-sized insurance investment managers (IIMs) — those with US\$100 billion to \$500 billion in assets under management — have struggled to increase revenues, even as margins have declined. Their performance is in stark contrast to that of large and small IIMs, which have seen annual net income growth of more than 20 percent, thanks to prescient investments in scale and expertise.

To tackle this problem, mid-sized IIMs need to apply a *Fit for Growth* approach, which involves clearly defining their value proposition to the market and building the capabilities they need in order to deliver on that value proposition. Six capabilities are particularly ripe for investment:

- An electronically integrated investment life cycle across asset classes and markets
- Enhanced reporting and analytics
- Leveraging internal or external utilities for the middle and back offices
- Digitization
- Data management
- Enabling capabilities, such as risk management and talent management

The fit for growth exercise should ultimately lead to a more streamlined, scalable operating model that can absorb new assets under management more efficiently and profitably. In our experience, this next-generation operating model delivers cost savings that range from 20 to 50 percent, and also helps companies increase revenue by 5 to 10 percent. Equally important, this process will leave companies more efficient and with the foundation in place to support future growth.

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# *Winners and losers*

In the years following the financial crisis, insurance investment managers (IIMs) slowly recovered from the steep losses they had incurred. By 2014, IIM assets under management (AUM) and revenue had finally returned to pre-crisis levels, according to Strategy& research. During that catch-up period, however, IIMs increased their asset base more slowly than the overall asset management industry — 7 percent each year from 2010 to 2014, versus 9 percent for the entire industry — due to slower growth in premiums and lower financial returns. (We project that IIMs will account for approximately US\$20 trillion of the \$100 trillion global asset management industry in 2017.)

But that mediocre growth rate masks a significant divergence in performance among IIMs, with clear winners and losers depending on their size and strategy. For example, larger players, with \$500 billion or more in assets, grew AUM by about 11 percent annually from 2010 through 2014 and boosted profits due to scale in an increasingly commoditized, price-sensitive business. Although this group posted just 5 percent revenue growth during that period, it grew net income by about 28 percent annually, primarily by leveraging scale to reduce unit costs.

Meanwhile, small players, with less than \$100 billion in assets, grew AUM by about 15 percent per year and boosted profits by focusing on higher-margin, specialized products, segments, and geographic markets, leading to 12 percent annual growth in revenue and 23 percent margin growth annually.

The struggling performers have mostly been among the midsized players — those with \$100 billion to \$500 billion in assets under management. These players, which saw annual AUM growth of only 4 percent, neither invested adequately to scale the business and lower costs nor specialized enough to gain pricing power. As a result, their revenue grew by just 1 percent and margins actually declined by 1 percent. Midsized players have also had the most difficulty containing costs. These IIMs have been hiring twice as fast since the financial crisis as they did before. This suggests they are relying on more manual processes to support additional growth and to cope with increased

regulatory requirements and product complexity across multiple geographies.

In our research and work with clients, we have found that IIMs with \$100 billion to \$500 billion in AUM generally have not invested enough over the last several years on new technologies to streamline processes, improve operations, and generate scale advantages. They continue to suffer from siloed organizations laden with costly customization, redundancies, and operational complexity.

On the bright side, midsized IIMs have an enormous opportunity to optimize their cost structures and transform their operating environment to better scale and support growth and improve profitability. Moreover, the successes of others — particularly the larger players — offer important lessons and show a path forward for those with aspirations for greater size and better profitability.

Senior leaders at many midsized IIMs recognize this challenge, and they are starting to put growth, scalability, efficiency, and technology at the top of their management agendas. They are also beginning to grapple with difficult questions:

- How do I explicitly link strategy to our growth agenda and cost transformation in a sustainable manner?
- What are the right technologies to support our future operating model?
- How do I electronically integrate investment processes?
- How do I efficiently meet evolving regulatory and compliance requirements? How can data-driven and analytics-driven insights help?
- How do we grow in a tax-efficient manner?

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# *The Fit for Growth framework*

The task of increasing efficiency and scale is often so overwhelming that simply knowing where and how to start can be difficult, if not paralyzing. To tackle these myriad issues and organize this transformation, we propose that IIMs follow a *Fit for Growth* framework, a process that senior leaders can use to explicitly link a company's strategy to its growth agenda and cost reduction initiatives in a sustainable manner.

The *Fit for Growth* framework begins with a clear understanding of the value proposition that distinguishes the firm from other companies (sometimes called a "way to play" in the market) and the critical capabilities that support that way to play. Winning firms align their strategic direction to the capabilities that make them unique. They make hard choices about differentiation and stick to them.

Ideally, companies can align three aspects in a coherent manner: a way to play in the market; a system of distinctive capabilities that reinforce one another and enable the company to deliver on this value proposition; and a chosen portfolio of products and services that all make use of those capabilities (*see Exhibit 1, next page*).

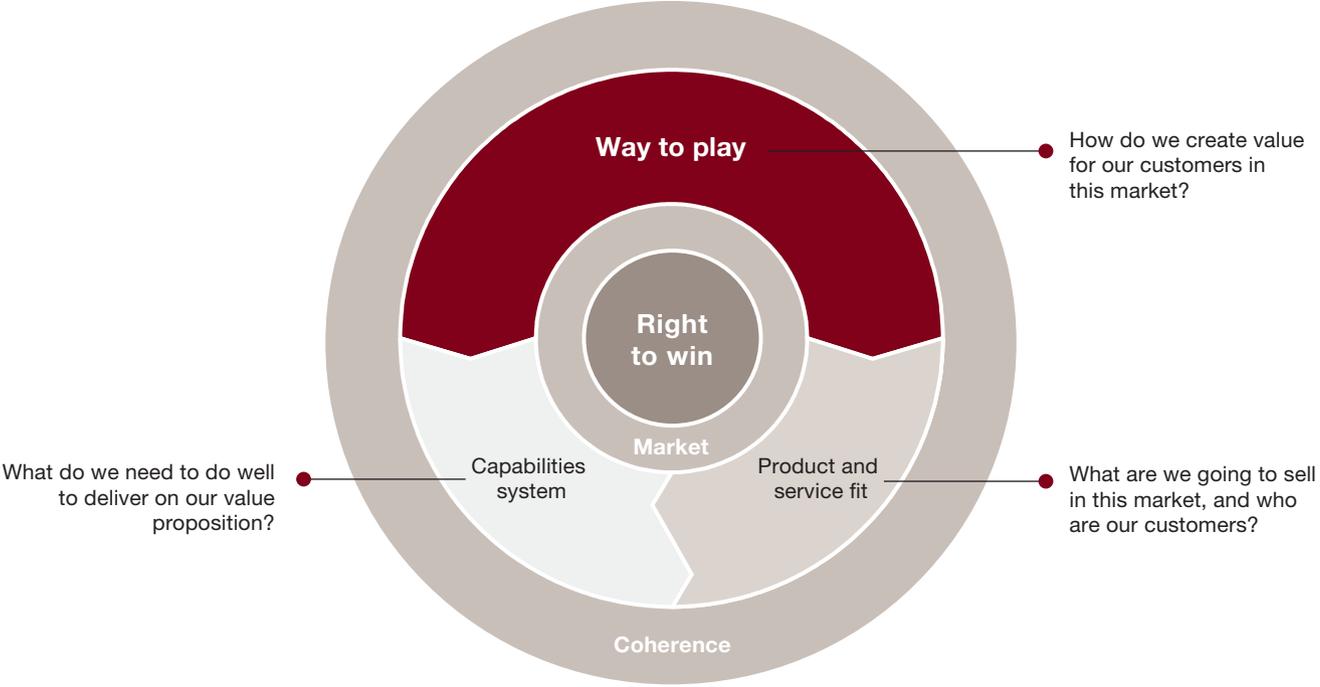
IIMs will have different ways to play depending on their business model (for example, those that focus exclusively on general accounts, those that also work with third parties, and more diversified players). But even companies within each category will need to differentiate themselves from competitors to succeed. With the right way to play in mind, a company can begin evaluating its current capabilities, redirect investments away from those that are not important, and reallocate those resources to the capabilities that are critical for the firm to win.

As a general rule, a company's capabilities fall into one of four categories. Most important are the differentiating capabilities (usually three to six) that make the company distinctive and build a sustainable advantage. The company should invest more than its competitors in these capabilities to develop and maintain best-in-class service levels.

*Winning firms align their strategic direction to the capabilities that make them unique.*

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*Exhibit 1*  
**A coherent strategy framework for IIMs**



Source: Strategy& analysis

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The second group of capabilities are those that all players in the industry need simply to operate. These are table stakes: areas where the firm needs to be only “good enough.” For this category, IIMs need to look for opportunities to increase efficiency and reduce costs.

The third group of capabilities simply keep the lights on — i.e., they are functions required for all organizations regardless of industry, such as HR, legal, and IT. The goal with this group of activities is to reduce costs as much as possible.

The fourth category of capabilities involves those that an IIM should stop entirely. This category includes projects and lines of business that no longer fit a company’s way to play (or maybe never did) and other nonessential capabilities that are draining resources.

The very process of categorizing activities in this way is transformational, as it provides a guide for the company:

- Reorganize for growth, with an organization model, processes, and systems to identify potential growth avenues and make the organization agile enough to pursue them.
- Transform the cost structure, with a clear pan-organizational cost agenda that requires deliberate choices about where to invest, from front line to back office.
- Invest in growth, through sustainable and differentiating capabilities paid for by funds freed up through the new cost structure.
- Enable change and cultural evolution, with an environment and culture that embed change in the company’s DNA and pave the way for a sustainable future.

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# ***Advanced IIM capabilities in action***

As noted earlier, some big IIMs have already invested successfully in advanced capabilities. Their example offers a guide for midsized IIMs about where to consider investing. Many large IIMs have made focused investments in the following six key capabilities:

**An electronically integrated investment life cycle across asset classes and markets.** To develop this capability, a company needs to focus on real-time scenario modeling capabilities with multi-asset class support, and real-time integration with middle-office and back-office data sources. It's critical as well to integrate flexible booking and automated controls to govern order generation and submission. Connectivity with multiple execution venues should also be a priority.

**Enhanced reporting and analytics.** This capability requires implementing industry-leading products and services for reporting, analytics and risk decision support, currency and cash flow forecasting, consolidated real-time exposure monitoring, and integrated regulatory reporting.

**Shared utilities for the middle and back offices.** In this case, companies need to streamline and transform processes using workload balancing, automation, and bundled outsourcing. They also need to sharpen internal resources to manage exceptions and reduce complexity.

**Digitization.** By digitizing the enterprise and embedding end-to-end, real-time controls, companies can reduce manual intervention, become more resilient, and improve risk management.

**Data management.** A top-notch data management capability depends on creating a single source of transaction data that can synchronize downstream to reduce reconciliations and data errors. By automating real-time data feeds, IIMs can offer customized valuation data and real-time pricing across asset classes.

**Enabling capabilities.** Finally, companies need to develop underlying support capabilities, including self-service functions, end-to-end collaboration, and the ability to support multiple statutory regimes across the globe.

Bear in mind: It's unrealistic — in fact, undesirable — to try to invest in all of the capabilities listed here. Instead, companies will focus heavily on some and set aside others based on their chosen way to play. The point is to choose which of these capabilities will best advance the company's value proposition and then focus resources accordingly, by applying the *Fit for Growth* framework.

In fact, it might be better to outsource some of these investment function capabilities to a third party, as even some large IIMs have chosen to do. Others have built up an institutional expertise in certain capabilities to the point where they could sell those services to other insurance companies, along with pension and annuities players. Similarly, some small IIMs with specialized capabilities are also selling services. By doing so, they have transformed the “investments function” from a traditional cost center to a revenue-generating business.

## ***The effect of the fiduciary rule***

The introduction of the Department of Labor's 2016 fiduciary rule — which requires that investment advisors act in their clients' best interest, rather than meeting the less stringent suitability standard — is one of the biggest regulatory changes in the wealth management industry in the past 40 years (since the 1975 deregulation of brokerage commissions). The rule will significantly affect the economics of insurance companies and wealth/asset managers, specifically product developers and distributors.

### ***Implications for product developers***

- Flows into non-permissible, complex products such as REITs, variable annuities, alternative investments, and structured products are likely to drop.
- Mutual fund flows are likely to shift from actively managed funds toward lower-cost, passive funds.
- Some mutual fund and annuities players will need to redesign their products, in favor of fee-based, lower-cost, simplified offerings.
- Smaller IIMs — especially active asset management players that have lackluster investment performance or proprietary distribution — will progressively be eliminated from distributor product shelves, resulting in lower effective pricing, more transparency, and changes in relative negotiating leverage.

### ***Implications for distributors***

- The rule will have the biggest impact on distributors, especially those operating under the old “suitability”

standard, captive distributors, or those receiving commissions.

- The volume of new annuity purchases will likely decrease.
- Pricing and implementation costs will go up in material ways, due to operations, technology, compliance, training, disclosures, and similar factors.
- Many smaller brokerages will not be able to afford the fixed costs required to meet the new standards, along with the added compliance and regulatory complexity, and will likely exit through buyouts from larger competitors. The effect will be more pronounced for independent broker-dealers, but smaller bank brokerages also face consolidation.

### ***Implications for providers***

- Providers will look to reduce the number of products in their lineup and create more turnkey offerings for clients. That, in turn, will allow them to shift to closed product architecture and reset economics.
- Providers with a registered investment advisor, along with clearing firms, will face operational and technological challenges to serve slow-moving clients and meet complex business requirements.

In all, there will be a significant rise in the amount of money in motion over the coming year, requiring IIMs to determine the right product mix, distribution partners, and capabilities. Players that are prepared can capitalize on these shifts and claim a disproportionate share of those assets.

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# *A new operating model emerges*

Ultimately, the *Fit for Growth* framework will lead companies away from a siloed, inefficient operation to a more streamlined, scalable enterprise that can absorb new AUM more efficiently and profitably. These companies will be able to standardize many processing activities across business units and concentrate them in a smaller number of lower-cost centers when possible. Each process area will have one global owner with full accountability.

*Exhibit 2* shows this new IIM target operating model. Some of the key characteristics of the model include a focus on core, differentiating capabilities; a slimmer organization as the company outsources some functions and digitizes others that are kept in-house; a common internal repository of data; more shared services across both client types and geographies (for example, no more replicating functions in the U.S. and Asia); and full connectivity from front to back (to make functions such as risk management and pricing and valuations more transparent across the enterprise).

As part of this front-to-back connectivity, we see a new middle-office function emerging that connects the front-office investments function (including portfolio management and trading) with the back-office finance and accounting function. This new function will provide “advisory” services related to investment accounting, investment accounting policy, investment tax, and capital management.

This partnership between investments and finance functions is increasingly important as insurance firms realize they need to measure not only performance against investment gains/losses, but also the total return that takes into account gains/losses, taxes, and the cost of capital. Furthermore, as IIMs diversify into more complex alternative asset classes, they need to understand the operational and financial implications, including investment accounting policies, how they align to investment strategies, and the operational impact of those choices. The goal of this new advisory service will be to bridge the typical gap between front and back offices by bringing together investment knowledge, finance and accounting skill sets, and business acumen.

*A new middle-office function will emerge that provides “advisory” services.*

*Exhibit 2*  
**Next-generation IIM target operating model**

**Front office**

Sales and marketing   Research   Portfolio management   Preventive controls

**Electronically integrated investment life cycle**

Connectivity engine   Quantitative analytics engine   Trading

**Shared utilities for middle and back offices**

Transaction management   Investment analytics   Trade processing engine  
 Reporting engine   Finance and accounting   Business support

**Common data stores**

Client and account   Security reference data   Non-security reference data  
 Positions and holdings   Pricing and valuations   Other

**Industry utilities**

Client reference data   Securities product reference data   Compliance (pre- and post-trade)  
 OTC processing   Securities processing   Cash, liquidity, and collateral management   Global payments  
 Asset servicing and tax operations   Reconciliations   Reporting   Fund services

**Enhanced reporting and analytics**

Risk engine  
 Pricing and valuation engine  
 Client services engine  
 Investment accounting and capital advisory

*Degree of digitization possible:*

- Low
- Medium
- High
- Full

Source: Strategy& analysis

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# *The revenue and efficiency potential*

In our experience, implementing this kind of next-generation operating model delivers revenue benefits of 5 to 10 percent and cost savings that typically range from 20 to 50 percent. More important, however, are the efficiency and capacity creation that can support future growth, in several ways.

**Client, product, and market tiering.** Firms can eliminate clients that generate little incremental revenue to reduce complexity, cost, and risk. (Roughly 80 percent of revenues are generated by about 7 percent of clients.) They can also tier clients in order to align service levels and cost-to-serve to the value of client relationships, and then optimize costs and workloads accordingly.

**Consolidation and productivity.** The new operating model enables IIMs to focus on P&L, rather than just revenue, and rationalize front-office locations and workforce productivity levels to reduce costs and increase profitability. Technology also creates opportunities to build capacity and improve the trading experience. And companies can restructure businesses to align with specific product and client segments.

**Differentiated processing.** By identifying and eliminating failed and revised transactions, firms can maximize straight-through processing (STP). They can also minimize waste from unnecessary or duplicate steps across the ecosystems, separate cleared STP flow from non-cleared flow, and standardize processes that are currently customized and inefficient.

**People.** Automation allows companies to scale back their physical footprint and reduce costs correspondingly. They can also redefine individual roles (such as eliminating sales traders), move toward knowledge worker-only profiles, and segment front-office roles between “machine operators” who supervise electronic platforms and traders who focus on higher-margin or niche areas.

**Data and technology.** Efficiency requires that companies create a single, shared repository of all key data (trade, risk, client, and other dimensions), along with an enterprise-wide “digital backbone”

supported by data-centric capabilities across functions. Achieving this will likely require that companies replace current legacy systems (such as risk and trade processing) with a new, service-based set of “engines” to digitize the enterprise.

**Utilities.** Finally, companies will need to streamline operational facilities for clearing and settlement, collateral management, and reporting through an integrated service offering. And they should further reduce costs by outsourcing certain middle-office and most back-office functions (such as processing and underlying technology) to industry utilities.

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# *Looking forward*

As recent trends in the IIM industry clearly show, revenues are on the upswing. But to handle the AUM growth profitably and reap its full benefits, many IIMs — particularly mid-sized companies — will need to transition to a more scalable model. That's not easy in today's global environment, when regulatory, product, and geographic complexities seem to mount by the day.

Clearly, every IIM requires a strong investment management team that delivers attractive risk-adjusted returns to its clients, optimized for internal versus third-party needs. But firms also need two additional characteristics: a clear business configuration — vision, product/client/channel mix, operating model, and performance metrics — and robust underlying capabilities to nurture the new business configuration and maintain coherence. The *Fit for Growth* framework is a way to orient the enterprise around these needs and to achieve profitable growth at the level of the world's top IIMs.

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