Back to the Future

The European Insurance Landscape

November 2003
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Back to the Future
The European Insurance Landscape

November 2003

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A Discussion Paper by The Boston Consulting Group
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Steeply declining stock prices and lingering low bond yields have driven the European insurance industry into a deep state of crisis. Recent capital market developments have revealed structural weaknesses in the industry that the "extraordinary" investment returns of the past once covered up. Many insurance groups are feeling the effects of the high financial risks they took during the booming nineties, and of underestimating the complexities of multidimensional business expansion.

A consequence of these conditions is that the rules for profitability in the industry have fundamentally changed. The solvency of more than a few major players is in jeopardy. In order to clean up balance sheets and generate adequate returns on capital, many insurers must dramatically improve technical performance in their core businesses.

How companies go about pursuing this goal will shape the European insurance landscape for years to come. Management teams that quickly understand the new rules, set the right targets, and persistently address the key initiatives for future success will emerge as winners. Companies that wait too long before they act will lose out, or at worst disappear.

This Discussion Paper addresses the management of international and local European insurance groups around five core issues:

1. How did the "Golden Nineties" transform the European insurance landscape?
2. How did the recent capital market developments change the rules for profitability?
3. What are the six key success initiatives for building a healthy future for the industry?
4. What are the principal characteristics of the emerging new landscape?
5. What questions must senior managers answer in order to design change proactively?

"Back to the Future: The European Insurance Landscape" is the first integrated publication based on comprehensive research activities by The Boston Consulting Group's Insurance Landscape team. It draws on a systematic analysis of all major European insurance markets and insurers, as well as on our experience in advising many industry leaders. The report covers:
the nine principal Western European insurance markets: Austria, Belgium, France, Germany, Italy, the Netherlands, Spain, Switzerland, and the United Kingdom. Together, these markets account for about 90% of total European premium volume.

- the top fifty European insurance groups in terms of each life, non-life, and total premiums.

- the leading insurers in each country, representing more than 80% of local life and non-life market volume.

This Discussion Paper is representing an overall framework for existing as well as planned publications that elaborate key success initiatives and answers to core management questions in more depth.

We hope this Discussion Paper will prove both informative and thought provoking in these extremely challenging times for the industry. We also welcome your comments and suggestions.
Acknowledgements
The authors would like to thank the many colleagues at The Boston Consulting Group who contributed to this Discussion Paper: in particular, Philip Crawford and Ellen Treml, for their help in preparing and editing the paper, and numerous other colleagues for their insights, critical thoughts and helpful discussions.

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The Nineties will be remembered as banner years for the European insurance industry.

- After initial pressure caused by deregulation, insurers were able to significantly expand their equity base, increase profits, and generate great shareholder value.

- Throughout the decade, players followed aggressive growth strategies along multiple dimensions. "Extraordinary" investment returns were the great enabler, masking structural flaws in the industry.

Now, at the beginning of the new millennium, the industry has fallen into a state of crisis. The rules for success have fundamentally changed.

- Most insurers were not prepared for the precipitous decline of stock markets and the continuation of low bond yields.

- Many groups suffered large losses in equity holdings and reserves. Major players have been forced to slash dividends and turn to investors to raise money. Rating agencies have downgraded the financial strength of most of the industry.

- Layoffs have been common, and senior managers have been fired. Confidence in the industry, from inside and out, is waning.

- The likelihood of far lower levels of investment return in the future means that insurers must vastly improve technical results. More fundamentally, insurers have to radically change the way they run their businesses.

The next decade will require a broader set of skills. Six key initiatives should be on top of senior management agendas:

- **Focus on attractive markets.** Earning potential is highly dependent on the attractiveness of individual insurance markets.

- **Build local leadership positions.** Scale and focus create competitive advantage and serve as a base for superior profitability.

- **Exit marginal activities.** Too much capital and management attention is still devoted to areas in which competitive advantage will likely never be achieved.
Achieve operational excellence. Assuring productivity along all elements of the value chain is critical in order to compensate for lower investment returns.

Realize group advantages. Adding value across countries requires a common logic across businesses and clear core competencies at the group level.

Develop a performance culture. Making the right decisions and motivating management requires a rigorous financial framework and consequent performance steering.

A reshaped European insurance landscape will emerge within the next decade

Insurers will increasingly focus on areas where they can achieve competitive advantage.

Managements will have to decide whether they want to compete in life, non-life, or both. They must also choose their countries of principle focus, and determine which functions should be outsourced.

Large groups that are not yet clearly positioned—about half the total—will have to redefine their business portfolios.

Life and non-life entities in various countries that are subscale—about two thirds of the total—will have to be either grown by acquisition, merged, or sold.

Senior managers must position their companies in the new landscape before the actions of competitors do it for them.

For most groups, significant change can no longer be a gradual process or an option. It has become mandatory if companies want to return to adequate solvency and profitability.

Raising essential questions and developing company-specific answers is a basis from which to proactively design the future of each organization, and initiate change.
The Nineties were very attractive years for the European insurance industry. The decade will be remembered as one of significant growth for all stakeholders: more premiums, more commissions, higher bonuses, greater policyholder benefits, and higher shareholder returns. After initial pressures caused by deregulation, most insurers were able to appreciably increase their equity base, lift profits, and create significant shareholder value (Exhibit 1). Several basic trends contributed to a very positive environment:

**Booming Investment Markets.** Insurers strongly benefited from extremely attractive investment returns. At the beginning of the decade, high interest rates generated a stable cash flow on fixed income assets. Then, as interest rates went down, stock markets provided “extraordinary” gains. Most insurers continuously adjusted their asset allocation, sharply increasing their share of equities. Investment results became the essential lever for overall performance, with insurers able to pay high returns to life policyholders, reduce non-life prices, and still generate high returns on equity.

THE NINETIES WERE EXCELLENT YEARS
Sample of 10 Major European Insurance Groups

<table>
<thead>
<tr>
<th>Equity (index)</th>
<th>1990</th>
<th>1995</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value</td>
<td>100</td>
<td>160</td>
<td>605</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net income (index)</th>
<th>1990</th>
<th>1995</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value</td>
<td>1x</td>
<td>2.5x</td>
<td>10.5x</td>
</tr>
</tbody>
</table>

| (1) Market capitalization at year end |
| Source: BCG Insurance Database |

Exhibit 1
Increasing Long-Term Savings. In light of projected demographic developments, the financial crisis of public retirement schemes became a hotly debated and politically sensitive subject in many European countries. Life insurers benefited greatly from increased demand for their products, which was often supported by tax incentives. European life insurance premiums grew by 12%–14% per annum during the late nineties.

Greater Consolidation. Mergers and acquisitions became an essential tool for growth among many insurance groups. Specific opportunities arose from a wave of demutualizations and large privatizations. By the end of the decade, it was almost impossible to find viable acquisition targets. Even operations with low profitability and marginal market share were not for sale, or only at very high valuations.

Pressure From Analysts and Investors. Financial analysts gained significant influence on business strategy and the setting of performance expectations. Without an inspiring growth story, it was all but impossible for shares to be rated a promising "buy" candidate. Senior managers adjusted their strategies, projections and activities accordingly, in order to please the markets.

Amid this environment, most insurance groups followed ambitious expansion strategies, often along the following multiple dimensions:

- **Home market penetration.** Many firms increased local market share through price competition, attractive policyholder promises, new distribution platforms, and acquisitions. The leveraging of local skills and the pursuit of scale advantages were underlying rationales.

- **International expansion.** Premium volume was generated across many foreign markets by investing in subsidiaries or acquisitions. A strong belief in achieving cross-border scale and synergies drove international growth strategies.

- **Bancassurance.** Companies built asset gathering and asset management capabilities that went beyond traditional insurance activities. Achieving synergies between the (life) insurance sector and the banking sector, both in distribution and in asset management, was the goal.

Between 1990 and 2000, Europe's top insurance groups achieved annual growth rates between 10% and 30% (Exhibit 2). The Swedish insurer Skandia, for example, increased its life insurance volume 11-fold through its long-term savings strategy. The French group AXA evolved from a local mutual insurer into a global group, increasing its premium volume by a factor of 10 and buying into several demutualizations and into the privatization of UAP. The Dutch groups AEGON and ING strongly expanded their life businesses through acquisitions in the United States and the United Kingdom, and Allianz and Generali built strong positions through acquisitions in selected European countries.

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1 Examples: U.K. (Scottish Mutual and Scottish Provident Institution, acquired by Abbey National; Scottish Equitable, acquired by AEGON; London Life and NPI, acquired by AMP; Clerical Medical, acquired by Halifax; United Assurance Group and Scottish Life, acquired by Royal London Mutual; Scottish Widows, acquired by Lloyds TSB; National Mutual Life, acquired by GE Capital; Scottish Amicable, acquired by Prudential; Norwich Union, merged into Aviva); Switzerland (Patria, merged into Helvetia Patria); Austria (Austria-Collegialität, merged into Uniaq).

2 Examples: France (AGF, acquired by Allianz; UAP, acquired by AXA; GAN, acquired by Groupama); Italy (INA, acquired by Generali).
Insurance groups created significant shareholder value (Exhibit 3). The market capitalization of public groups increased by an average of 25% per year between 1990 and 2000. Leading international life insurers increased their market value by more than 30% per year.

MARKET VALUES ROSE APPRECIABLY
The strategies of the nineties clearly transformed the European insurance landscape, with most players growing their life as well as international business. Many players increased their number of foreign markets, and some even expanded their brand positioning. Corporate visions and strategic thrusts reached far beyond traditional core markets to the pursuit of leading positions in international (or even global) financial services (Exhibit 4). Consider the following statements of purpose that were adopted:

- **AXA**: "Aims to be the world leader in financial protection and wealth management"
- **ZFS**: "A leading financial services organization providing financial protection and wealth accumulation solutions"
- **AEGON**: "A global financial institution in the field of banking, insurance and asset management".

### STRATEGIES OF THE NINETIES CHANGED THE PORTFOLIO MIXES

![Graph showing changes in portfolio mixes for Global insurers and Life groups.](Exhibit 4)

(1) Life insurance as percent of total premium
(2) Premiums outside home market as percent of total premium
Source: Annual reports; BCG Insurance Database

Meanwhile, several strategic plays started to become apparent (Exhibit 5). Many insurers grew both their life and non-life businesses internationally. Four (AXA, Generali, Allianz and ZFS) strove for global leadership. Some life insurance groups leveraged their skills internationally, while many (local) life insurers operated as part of a bank. Three players focused on industrial insurance. Only a few of the larger groups stayed exclusively within their home markets. Growth aspirations and international strategies were financed both by high profits in home markets and by high investment results.
By the end of the decade, however, it was clear that many insurance groups had allowed themselves to be excessively exposed to financial risks. Many had also underestimated the challenges of multidimensional expansion.
Interest rates declined steadily during the nineties, falling from 12% to 5% in the United Kingdom, 9% to 5% in Germany, and 6% to 3% in Switzerland. As a consequence, keeping promises to policyholders and compensating for technical losses by investing in bonds became more and more difficult for insurers. Conversely, equities (including private equity) seemed to offer the required performance. Bullish stock markets were strongly driven by optimistic economic outlooks and a continuing net inflow of money, much of which came from insurers (Exhibit 6).

But the precipitous decline in stock prices that began in the late nineties and the sheer persistence of low bond yields caught most European insurers by surprise. The industry began a tailspin, plummeting into the highly distressed state that it finds itself in today (Exhibits 7 and 8).
A DRAMATICALLY HIT INDUSTRY

Exhibit 7

Reserves and equity

S&P Financial Strength Rating

Reserves and equity

S&P Financial Strength Rating

(1) Sample of 14 major insurance groups
Source: Annual reports; BCG Insurance Database

Exhibit 8

MANY LEADING GROUPS ARE DISTRESSED

Examples

<table>
<thead>
<tr>
<th>Reported net loss 2002 (B€)</th>
<th>Capital increase (B€)</th>
<th>Failures</th>
</tr>
</thead>
<tbody>
<tr>
<td>ZFS: (3.2)</td>
<td>Allianz: 4.4</td>
<td>Equitable Life (UK)</td>
</tr>
<tr>
<td>Winterthur: (1.6)</td>
<td>ZFS: 2.6</td>
<td>Independent (UK)</td>
</tr>
<tr>
<td>RSA: (1.4)</td>
<td>Winterthur: 1.4</td>
<td>Mannheimer Leben (D)</td>
</tr>
<tr>
<td>Swiss Life: (1.2)</td>
<td>L&amp;G: 1.3</td>
<td></td>
</tr>
<tr>
<td>Allianz: (1.2)</td>
<td>Swiss Life: 0.8</td>
<td></td>
</tr>
<tr>
<td>ERGO: (1.1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aviva: (0.8)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Generali: (0.8)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Skandia: (0.5)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bâloise: (0.4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>L&amp;G: (0.3)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Annual reports; Company information
Its current condition can be described thusly:

- Most insurance groups have incurred huge losses
- Reserves and equity positions have fallen drastically
- Various groups have had to cut dividends or raise capital
- Rating agencies have downgraded most insurers' financial strength
- Life insurers have faced solvency issues
- Some life insurers have stopped writing guarantees
- Authorities, legislators and associations have had to define supportive measures
- Massive layoffs have been announced
- Many CEOs and top managers have been forced to resign their positions

Clients and shareholders, accordingly, have suffered greatly. Policyholder dividends have been slashed, and the share prices of many insurance groups have collapsed (Exhibit 9). Major public groups have lost almost two thirds of their market capitalization.

**INSURANCE VALUATIONS HAVE COLLAPSED**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>450</td>
<td>&lt;64%</td>
</tr>
<tr>
<td>580</td>
<td></td>
</tr>
<tr>
<td>402</td>
<td></td>
</tr>
<tr>
<td>206</td>
<td>&lt;19%</td>
</tr>
</tbody>
</table>

(1) Sample of 23 major insurance groups
Source: BCG analysis

Exhibit 9

---

1 Examples: Guarantee pool "Protektor Lebensversicherung" (Germany) or "Auffanggesellschaft BVG" (Switzerland); legislative changes that allow deferring recognition of asset impairments (Germany); increased recognition of future profits as "solvency credit" (U.K.).
Indeed, margin dynamics, and therefore the rules for profitability in the industry, have fundamentally changed (Exhibit 10). Low interest rates and reduced risk-taking capacities—leading to low equity exposures—combined with generally lower stock-market performance will result in significantly reduced investment returns in the near and mid-term.

These conditions are a far cry from those of the nineties, when many life insurers operated in effect as “leveraged hedge funds”. With up to 20 times their own equity as policyholders’ assets and a typical allocation in some countries of 25% in stocks, they were leveraging their own equity at a ratio of 1:5. Although they shared the upside with policyholders, the downside was fully borne by shareholders. Once investment returns got below the guarantees, insurers started to burn significant amounts of equity.

Non-life insurers made up for technical losses and high costs with superb financial gains. With a 10% investment return, a typical insurer could operate at a combined ratio of 115% and still achieve a 15% ROE. For the same ROE with a 5% or 3% investment return, the combined ratio must be improved to 100% or 95% respectively.

Today, however, the shortfall in investment returns must be compensated for by massively improved technical results, and by adjusted policyholder participation models in life insurance. More fundamentally, insurers must eliminate historic weaknesses and radically change the way they run their businesses. There are specific steps that can, and must, be taken.
Most insurers face huge challenges in their quests to conquer the crisis and generate the kind of returns that will enable them to prosper under the new rules of the game. In our view, six strategic initiatives should be atop the agendas of senior managers who wish to build successful futures for their organizations:

- Focus on Attractive Markets
- Build Local Leadership Positions
- Exit Marginal Activities
- Achieve Operational Excellence
- Realize Group Advantages
- Develop a Performance Culture

These endeavors are relevant to all European insurers, whether they are trying to maintain market leadership or rescue themselves from looming insolvency.

Focus on Attractive Markets

The earnings potential of insurance groups clearly depends, to a large extent, on the attractiveness of their markets. European markets differ widely in size and growth rates, but also—and more importantly—in terms of product mix, distribution networks, consolidation level, competitive price pressures, policyholder expectations, and regulatory environment. These factors have a significant influence on the profit level that can be achieved in a specific market, and on the skills that are needed to be successful. Management must thus develop a thorough understanding of market characteristics, dynamics and own capabilities in order to successfully refocus their portfolios. Circumstances also differ depending on whether the company is primarily focused on non-life, life, or both types of businesses.
Non-Life Insurance

Overall, across Europe, market characteristics and profitability in non-life businesses have varied widely by country (Exhibit 11 and 12).

REGIONAL CHARACTERISTICS IN NON-LIFE

<table>
<thead>
<tr>
<th>Size(1)</th>
<th>Growth(2)</th>
<th>Loss ratio(3)</th>
<th>Cost ratio(4)</th>
<th>Consolidation(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>77%</td>
<td>8.3%</td>
<td>D</td>
<td>74.7%</td>
</tr>
<tr>
<td>UK</td>
<td>74.5%</td>
<td></td>
<td>CH</td>
<td>74.8%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>NL</td>
<td>23.8%</td>
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<td></td>
<td>A</td>
<td>76.8%</td>
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<td></td>
<td></td>
<td></td>
<td>UK</td>
<td>77.5%</td>
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<td>D</td>
<td>26.8%</td>
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<td>F</td>
<td>43.6%</td>
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<td>NL</td>
<td>3.6%</td>
<td>B</td>
<td>79.2%</td>
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<td>I</td>
<td>31.2%</td>
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<td>E</td>
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<td>17.8%</td>
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<td>CH</td>
<td>13.4%</td>
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<td>B</td>
<td>9.6%</td>
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<tr>
<td>A</td>
<td>6.7%</td>
<td>A</td>
<td>0.2%</td>
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</table>

(1) Premium (€), 2001
(2) Annual premium growth (1998–2001)
(3) Average 1998–2001
(4) Cumulative market share of top 5 local insurance groups
Source: ISIS; Swiss Re sigma; BCG Insurance Database

Exhibit 11

Germany is the largest European non-life market. It is characterized by relatively low historic growth, but has a very attractive price/loss profile. It is also a highly fragmented market, with few players having truly efficient operations. Achieving necessary cost reductions will be particularly difficult for smaller German insurers, while larger players can create sizable value with a "market consolidator" strategy.

The small Swiss non-life market has also experienced low growth, and has an attractive price/loss profile. But although the market is highly consolidated, its insurers are even less efficient than those in Germany. Market leaders should leverage their competitive advantage and set new benchmarks for operational excellence, while small insurers might join forces or become part of a market leader.

Spain, meanwhile, shows a very different picture. It has comparatively high growth rates, an extreme level of fragmentation, and unattractive loss ratios. But it has the lowest cost ratios in Europe. The Spanish market leader Mapfre, and smaller mutuals, have converted their structural advantages into comparatively low distribution costs. Despite recent premium increases in the market, foreign players that lack such advantages may need to reconsider whether doing business in Spain is viable.
Life Insurance

National market characteristics and profitability patterns are markedly different in life businesses (Exhibit 13 and 14).

The United Kingdom is by far the largest market, for example, while the small Belgian market has achieved one of the highest growth rates and the most attractive technical margins. Belgium is also highly consolidated and efficient, and its market leaders will continue to use their advantaged cost position to penetrate clients and expand distribution channels. Smaller players will have a hard time staying profitable.

In Spain, profitable growth has been captured almost exclusively by bancassurance players, which have leveraged their distribution advantages. Further consolidation in Spain will likely be driven by the banking industry.

German and Swiss life insurers have long found it difficult to generate adequate returns. Contributing factors have been high payout ratios to policyholders (driven both by competitive pressures and by regulation), as well as high cost ratios. Insurers in these countries will need to adjust participation models and reduce costs significantly in order to regain profitability. Insurers without multi-channel distribution will be at a distinct disadvantage.

Overall, there is a wide range of market attractiveness and required skills in life insurance across Europe.
REGIONAL CHARACTERISTICS IN LIFE

Exhibit 13

A BROAD RANGE OF MARKET ATTRACTIVENESS IN LIFE INSURANCE
1998–2001

Exhibit 14
Build Local Leadership Positions

Virtually all European insurers need to increase profitability. Empirical evidence shows that sufficient scale and clear focus raise profit potential. Moreover, our research suggests that critical size for either a life or non-life operation is about 5% in market share, or €1 billion in premiums in any given country. We have observed that building local leadership positions creates competitive advantage and enables superior profitability. Based on scale and focus, three distinct positions can be pursued and achieved (Exhibit 15):

- Market Leader, with a dominant position in both life and non-life insurance
- Life Producer, which exploits multiple distribution channels
- Non-Life Mutual, which places its focus on pursuing attractive client segments

THREE LOCAL LEADERSHIP POSITIONS
Basic Strategies and Sources of Competitive Advantage

Market Leader
Market leaders hold a dominant position of more than 5% market share in both the local life and non-life markets. Their competitive advantage is based on superiority in marketing and pricing, a broad product range that supports sales force effectiveness as well as customer bonding, and economies of scale across products, distribution channels and clients.
Market leaders also achieve high brand awareness. They are attractive partners for banks and other distribution channels, and preferred employers for top talent in management and staff. Market leaders typically convert their advantages into lower combined ratios (Exhibit 16).

MARKET LEADERS CAN ACHIEVE SUPERIOR RESULTS

In the nine Western European countries we analyzed, 29 local insurers qualify as market leaders. They generate about 30% of the total life and non-life premium volume, and belong to 19 different insurance groups.

Life Producer

Leading life insurers are often “pure plays.” They base their competitive advantage on several attributes: sleek product design for the benefit of policyholders and shareholders, access to efficient third-party distribution channels (often banks), and economies of scale in operations, IT and investment management. They are highly focused and therefore achieve better transparency regarding true product profitability. These characteristics typically translate into lower costs (Exhibit 17).
Currently, 22 life insurers across Europe have more than a 5% share in a local market, and they generate 29% of Europe’s life insurance premiums. Roughly two thirds (15) of them belong to a bank.

LIFE PRODUCERS ACHIEVE LOWER COST RATIOS

Non-Life Mutual
Non-life insurers have often grown their businesses within specific population groups, and are still organized as mutuals. Their competitive advantage is based on narrow client focus (typically residents of rural areas, or civil servants that provide better risk profiles and easier retention), low costs due to restricted overhead, and focused distribution. The lure of their offerings often stems from lower prices, which are based on cost and risk advantages (Exhibit 18). Although their prices sometimes lead to higher loss ratios, mutuals can more than compensate for this through their low cost base and absence of dividend payments to investors.

Currently, 69 major insurers are organized as mutuals, generating 20% of Europe’s non-life premiums.

1 The legal form “Mutual” varies across markets. Typical examples are “Versicherungsverein auf Gegenseitigkeit” (Germany), “Mutuelle” (France), “Mutua” (Spain) and “Genossenschaft” (Switzerland).
In summary, it is safe to say that not all local leaders have yet exploited their potential competitive advantages. Most insurers do not even possess any structural advantage. Only one third of Europe's local life and non-life entities command sound positions as market leaders, life producers or non-life mutuals that allow them to achieve superior results.

Simply put, this means that two thirds of all local insurance entities in Europe need to expend extra effort in order to generate adequate returns. Otherwise, they will destroy value. These companies are either subsidiaries of international insurance groups or independent local players. Senior managers of such organizations must review their positions and decide whether they can compensate for structural handicaps. Pressure from policyholders for operational excellence, and from shareholders for adequate returns, will influence their decisions and likely lead to further consolidation.

**Exit Marginal Activities**

The history of the insurance industry shows clearly that synergies from multidimensional expansion efforts rarely materialize. Achieving scale or added value across countries and/ or different businesses is usually just a vision that rarely becomes reality. Among the reasons are that portfolios typically involve a broad set of operations that encompass different cultures and legal systems, and include a high proportion of sub-critical units.
In addition, most insurers run fully integrated business models in which virtually everything is done in-house. This creates enormous complexity, which is both difficult to manage and costly.

Therefore, it is only when companies focus their attention and capital on specific countries, businesses or activities in which they already have competitive advantage (or in which they possess deep knowledge and experience that can create advantage quickly) that they will be able to grow profitably and generate value for their shareholders. Each link in the value chain must be challenged, even for core units. A fundamental question, one that is already posed frequently in many other industries, must be asked: Could an outside provider perform this activity better or at lower cost?

Let us examine some of the ways in which insurers might refocus their businesses:

Exiting Countries
Most European insurance groups have international or even global portfolios. Most are also highly fragmented, consisting of many sub-critical country units that have severe structural disadvantages. Only six groups—Allianz, AXA, ING, Aviva, AEGON and Fortis—achieve more than €1 billion (combined life and non-life) in annual premiums per foreign market. And even these portfolios are significantly influenced by a few very large operations. Many groups such as Mapfre, ERGO, BNP, Groupama, Wiener Städtische and Uniqqa operate in up to 20 foreign countries with below €100 million in premiums and local market shares under 1%. It is almost impossible to manage such positions profitably, and the complexity they impose on corporate centers is enormous (Exhibit 19).

FOREIGN PORTFOLIOS ARE HIGHLY FRAGMENTED

Exhibit 19

(1) Per country unit, life and non-life premiums combined, 2001
Source: Annual reports; BCG Insurance Database
In most cases, foreign operations have been significantly less profitable than home-market activities, or have even recorded losses. In 2001, for example, AXA generated 76% of its premiums outside France, but only 41% of its profits. ERGO’s foreign business (about 19% of its total) accounted for a mere 2% of its overall profit. And Allianz’s foreign activities (about 68% of its total) lost money and reduced the company’s overall profit by 27%.

Ironically, now that many insurers have decided to sell their subscale subsidiaries, very few buyers have the capital to acquire them. Some operations cannot be sold because the resulting write-off on book value would further deteriorate the capital outlook for the seller. Alternative ways to solve this dilemma may be mergers of international groups or swaps of complementary portfolios to eliminate sub-critical positions and create new local leaders. In general, however, more players need to adopt strategies that concentrate on their core countries (Exhibit 20).

### PLACING FOCUS ON CORE COUNTRIES

#### Selected Strategies

**Aviva**  
- “We will ... concentrate on markets where Aviva can achieve a leading position”

**Zurich**  
- “... is now focusing on core profitable markets in the US, Switzerland, Germany, Italy and Spain, and has dropped its plan for global dominance”

**Winterthur**  
- “Focus on home market Switzerland and selected European countries ...”

**RSA**  
- “Our primary markets will be those where we already have a significant capability, presence, scale and solid reputation”

**Fortis**  
- “Fortis’ strategy is ... to develop growth platforms in Europe in selected activities in order to acquire leading market positions”

**Swiss Life**  
- “Focus on core life units Switzerland, France, Germany, Netherlands, Belgium/Lux. Non core are ...”

**Bâloise**  
- “…Bâloise will focus on the core markets Switzerland, Germany, Austria, and Belgium/Lux.”

Source: Annual reports; Company information

Exhibit 20

### Exiting Businesses

Similarly, some companies have started to question whether they want to keep all existing businesses in their portfolios. The main trigger points for these decisions are capital requirements, strategic fit, minimum size, and of course, profitability. For example, reinsurance and industrial insurance require considerable capital, and subscale life operations have become a challenge for non-life insurers (just as subscale non-life activities are burdening some life players). Banking and third-party asset management require different skills and cultures. Many companies have begun to divest themselves of unprofitable, non-core businesses (Exhibit 21)
Outsourcing/Insourcing Activities
Local market leaders achieve critical size and synergies across lines of business, client segments and distribution channels to build competitive advantage along the entire value chain. They can benefit by offering their operational systems to other insurers through insourcing agreements. Players without scale or scope advantages should focus their attention on core activities and gradually start outsourcing in non-core areas.

Large life insurers, for example, can gain by focusing on their factory, utilizing the third-party distribution channels provided by banks, brokers and other sales organizations. They can also produce "white label" products that other players brand. Access to efficient distribution may require elements of control through partnerships, joint ventures or ownership. Mutuals, for their part, should continue to produce their own non-life products, but increasingly insource offerings from life producers. They can also outsource their (typically sub-scale) asset management activities to banks or reinsurers. All of these scenarios concern a critical initiative in today's climate: concentrating on core competencies (Exhibit 22).

Moreover, a set of new market participants will likely emerge that focus on only a small part of the value chain. Banks will increasingly sell (life) insurance products using their branch networks as (open) distribution platforms, or by leveraging their own insurance companies. Focused distribution organizations such as AWD (Germany), Mediolanum (Italy) or St. James's Place (UK) can gain significant market share based on their broad choice of products and marketing skills. Retailers such as Marks & Spencer (UK), Carrefour (France), Migros (Switzerland) and Tchibo (Germany) can use their regular contact with customers to distribute insurance products produced by cooperative partners. Asset managers that specialize in insurance assets can offer asset liability management capabilities, as well as a full set of investment services tailored to the insurance industry.
Achieve Operational Excellence

Focusing on attractive markets, building local leadership positions, and exiting marginal activities are becoming prerequisites for success in the European insurance industry. But these initiatives are not all that is needed. The insurance sector must also become more efficient, and in certain aspects more professional. In order to reduce dependency on capital markets and reach a technical break-even point, most insurers need to significantly reduce costs and adjust their pricing structures. This picture is shaded differently in each of the two major insurance categories: non-life and life.

Non-Life Insurance

Achieving a technical break-even point (a combined ratio of below 100%) typically requires cost ratios between 20% and 25%. In 2001, average cost ratios in many countries were significantly higher: 28% in Germany and Switzerland, 29% in the United Kingdom, 33% in Belgium, and 34% in Austria. The total cost saving needed to reach an average ratio between 20% and 25% for all players across Europe's core markets amounts to more than €9 billion.

A few leading insurers, in fact, are well below the 20%–25% benchmark. Such players enjoy high profitability in today's high-price environment. But institutions above the benchmark—and there is a wide range of cost performance among players—risk becoming unprofitable if they do not reduce costs significantly (See Exhibit 23).
Life Insurance
Between 1998 and 2001, the average return on equity in European life markets was 10%, based on a profit margin of 0.6% at an assumed solvency margin of 6%\(^1\). Profitability in some markets—Belgium, the Netherlands, Italy, and Spain—was much higher. For the markets that performed less admirably, the cost saving required to achieve an average return on equity of 10% amounts to about €6 billion (assuming investment returns and policyholder participation at the 2001 level).

A few leading insurers have adjusted their products, organized their distribution channels and shaped their processes to achieve adequate returns. But as in the non-life segment, the majority of companies still have a long way to go to reach a sufficient level of performance.

**Realize Group Advantages**

Despite European harmonization efforts, local insurance markets are still very diverse. Insurance is, for the most part, still a local business. And having many small positions in various markets does not usually add up to

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\(^1\) i.e., 1.5 times the minimum margin of 4% of technical reserves for traditional business
a sizeable group. There are few synergies in having, say, a property and casualty insurer in one country and a life insurer in another.

The fact is that most corporate centers today act as "financial holding companies" for their business units, and there is little value added across countries. Accordingly, some head-office functions are finding it increasingly difficult to justify their costs. Creating value across countries requires a common logic across businesses and functions as well as clear group competencies along the management of performance, risk, assets, processes and people. Today, many international groups seem to be unclearly positioned (Exhibit 24).

INTERNATIONALLY MANY GROUPS SEEM TO BE UNCLEARLY POSITIONED

Exhibit 24

In our view, there are three strategic paths to creating value across country markets (Exhibit 25). One is to become a Multi-Market Leader, replicating in other core markets the life and non-life dominance that has already been achieved in the home market. Another is to become an International Life Group, leveraging key competencies across core life markets. A third path is that of the Industrial Insurer, serving corporate clients in several markets and achieving geographic diversification of risk.

Multi-Market Leader

Only two insurance groups today have successfully realized the strategy of a true multi-market leader across the principal Western European markets: Allianz with five local market leader positions (and a significant presence
in all other markets), and Generali, with four market leader positions and two further significant country units (Exhibit 26).

A few other groups have a reasonably good base from which to grow into a multi-market leader: AXA, with two market leader positions and strong positions in three other countries, and the Swiss groups ZFS and Winterthur, with leadership positions in their home market and significant presences in some other countries. Aviva and Fortis, each with two market leader positions, will most likely focus only on life insurance across Europe.

International Life Groups
Three insurance groups focused on life products currently generate the majority of their premiums outside their home markets: the Dutch insurers ING and AEGON, with strong subsidiaries in Europe, the United States, and other overseas markets; and Skandia of Sweden, which has numerous integrated international units.

Aviva and Fortis could potentially join this group if they exit international non-life activities. A few other life groups generate a significant share of their premiums outside their home markets: Prudential (UK), which operates in Asia and the United States; Swiss Life, which focuses on five European markets; and the Spanish banks BBVA and Grupo Santander, which participate in Latin American bancassurance.

The majority of international life insurers operate small foreign subsidiaries or branches without significant cross-border added value, but typically with high management complexity.
Industrial Insurers

Traditionally, most non-life insurers have offered industrial insurance as one of their business segments. But very few have achieved the capability and international reach to be a preferred underwriter for large corporations and brokers, which is necessary in order to be profitable in soft markets.

At present, a broad reassessment and consolidation is taking place in this segment. The leading groups, Allianz and AXA, are centralizing service to international clients in specialized units such as "Allianz Global Risks" and "AXA Corporate Solutions."

Industrial insurers such as Gerling, HDI and RSA are facing significant performance problems, and are reviewing their portfolios and underwriting standards. Several international insurers have already exited this market or particular parts of it.

Develop a Performance Culture

Financial planning, target setting and controlling can be very complex processes for insurers. The reasons are myriad. First, non-life profits depend heavily on estimates of future claims payments, which of course are impossible to predict exactly. Large claims and natural catastrophes pose a special challenge due to their "low frequen-
cy/ high severity" nature. And life results are strongly influenced by long-term projections of future mortality, longevity and disability, which have become increasingly difficult to assess with the desired degree of accuracy.

In addition, assumptions about investment returns—which have generally become more volatile—contribute greatly to product profitability, particularly for long-tail life and non-life products. The allocation of expenses and cost of capital to products, businesses and country units is very complex, given joint infrastructures, diverse distribution channels, and ambiguity surrounding "true" capital requirements.

Yet there are few major industries in which transparency is so low, accountability so fragmented, and responsibility for results so diluted as in the insurance sector. Making the right decisions on the business mix, ensuring that pricing is in line with real cost and risks, and motivating management to achieve its full potential are therefore critically important. Such efforts require a rigorous financial framework and consequent steering of all management processes (Exhibit 27). These include:

- strategy development, based on a clear understanding of which businesses need how much capital and generate which level of returns
- planning and budgeting for operational and functional units, based on key performance indicators
- regular financial controlling and monitoring, to proactively direct the business
- personal incentives, to encourage the desired employee behavior.

STEERING FINANCIAL PERFORMANCE REQUIRES AN INTEGRATED FRAMEWORK

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<th>Financial drivers</th>
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<td>▪ Asset/liability risk</td>
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Exhibit 27
The profitability and solvency of many European insurance groups is clearly in jeopardy. The dramatic investment losses of the past few years have severely hurt annual results and wrought havoc on balance sheets. Although financial markets may indeed rebound to a more "normal" range of returns, the root causes of the overall malaise in the industry run deep and need focused attention. Among them:

- Significant parts of the capital invested in marginal businesses provide below average returns and often losses
- Low operational efficiency causes insufficient technical results in many cases
- Processes to manage technical and financial risks are often underdeveloped, not well integrated between decision makers, and too slow
- The transparency needed to optimize pricing and guide performance is often insufficient
- The expenses of corporate centers are often higher than the value they generate

Senior managers, in order to help their companies confront this crisis, will therefore have to implement radical changes. They will need to develop and communicate a strategic logic and clear performance targets for their group that can guide both long-term decision making and day-to-day operations. They will also need to position their companies in a way that generates sustainable profits, based on clear competitive advantages. When this is not possible, the sell-off of non-strategic units or even a full merger with another organization should be considered.

Furthermore, core competencies must be identified and developed across groups to create value, with emphasis on areas where advantages of scale are evident and outweigh the cost of complexity. Where there are no synergies across countries or businesses, the corporate center must be kept to a minimum. Managers need to actively consolidate their core markets, organically or by acquisition.

Taking these actions will dramatically alter today’s highly fragmented European landscape. We expect the most successful European insurers over the next five to ten years to break down into the following groups:

- Three to five Multi-Market Leaders, with leading life and non-life positions in several European markets
- Three to five International Life Groups, focusing on a few core markets, with clear group competencies
Three or four Industrial Insurers that will dominate this market segment, most likely as part of multi-market leaders (and reinsurers)

Two or three Local Market Leaders per country, with leading positions in life and non-life business, and a clear focus on their home market

Three or four Life Producers per country, working in close cooperation with banks and other distribution partners (or non-life insurers)

A varying number of Non-Life Mutuals in several countries, focused on non-life business and on niche groups in their home markets

Many Independent Distribution Companies offering superior advice and open-platform products, and an increasing number of Third-Party Providers offering specific parts of the insurance value chain.

This structure leaves a very long list of insurance companies and subsidiaries that will not be able to earn their cost of capital, expand their businesses, or offer attractive jobs. Many of Europe's leading insurance groups will have to redefine their portfolios and limit the scope of countries in which they pursue competitive advantage. This process will fundamentally challenge and change the future of marginal country units, which will be either grown by acquisitions, merged with other operations, sold, or put into run-off.

Now is the time for senior management teams to act. Asking the right questions and making the tough decisions will help insurers avoid repeating the mistakes of the nineties, which the high investment returns of that decade succeeded so well in covering up.
Change is no longer an option but a must in order to return to adequate solvency and profitability. Change is the basis for future growth and value creation. For some insurers, it has become a prerequisite for survival.

Many first steps have been taken. Some companies have raised new capital, adjusted policyholders’ dividends and agents’ commissions, increased prices, reduced costs, and divested non-core units.

The senior managers of every European insurance company must define their organization’s desired future and decide on the best way to achieve their goals based on available skills and resources. Managers must position their companies within the new landscape before competitors’ actions do it for them. The ongoing consolidation process will offer many new possibilities to those with proactive strategies.

The following Management Questionnaire intends to guide senior managers in determining the path that their own organizations should take.
MANAGEMENT QUESTIONNAIRE TO DESIGN CHANGE

1. Focus on attractive markets
   - What are key the characteristics and major trends in each market?
   - What are the expected profit levels for each relevant business?
   - What are the performance benchmarks of local leaders?
   - What are the key requirements for executing winning strategies?
   - What are our core skills in each market?

2. Build local leadership positions
   - Do we focus on clear "core" markets/units?
   - Do we have sustainable leadership positions?
   - Do we have measurable competitive advantages?
   - Do we convert advantages into superior profitability?
   - Do we need to strengthen our "core" market positions?

3. Exit marginal activities
   - Which markets and businesses are "non core" for us?
   - Which players are better owners for our "non core" operations?
   - Which exit strategy creates the most shareholder value?
   - Which businesses or services should we out/insource?
   - Which partners are best providers for "non core" services?

4. Achieve operational excellence
   - What is the return on (required) capital of each business unit?
   - What is the relative performance compared to market peers?
   - What are the main areas of operational strength and weakness?
   - What are the key levers to becoming the best-practice benchmark?
   - What is the additional value potential of being best-in-class?

5. Realize group advantages
   - What is the strategic logic for our group?
   - What are our core competencies at the group and local level?
   - What is our added value across core markets and businesses?
   - What is the value of each unit belonging to our group?
   - What is the best governance model for leveraging our core competencies?

6. Develop a performance culture
   - Do we have a common understanding of performance management?
   - Do we have clear financial targets and performance indicators?
   - Do we have adequate planning, budgeting and controlling processes?
   - Do we adequately ensure optimal performance orientation?
   - Do we have effective accountability and incentive systems?
Top Insurance Groups

WHO'S WHO
Europe's Top Groups, 2001

(1) Incl. savings-type premiums
Source: ISIS; Annual reports; BCG Insurance Database

Exhibit 28
Local Insurance Landscapes

- UK
- Germany
- France
- Italy
- Spain
- The Netherlands
- Switzerland
- Belgium
- Austria

UK: LOCAL INSURANCE LANDSCAPE

Market share life (%)

Note: UK life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are £173.3 / 74.5 and 46% / 59%

Source: ABI; Swiss Re sigma; BCG Insurance Database

Exhibit 29
GERMANY: LOCAL INSURANCE LANDSCAPE

Note: German life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are € 63.1 / 77.2 and 41% / 43%
Source: Hoppenstedt; Swiss Re sigma; BCG Insurance Database

Exhibit 30

FRANCE: LOCAL INSURANCE LANDSCAPE

Note: French life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are € 85.3 / 43.6 and 54% / 57%
Source: L’Argus; Swiss Re sigma; BCG Insurance Database

Exhibit 31
ITALY: LOCAL INSURANCE LANDSCAPE

Note: Italian life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are €47.1 / 31.2 and 57% / 64%
Source: Giornale delle Assicurazioni; Swiss Re sigma; BCG Insurance Database

NETHERLANDS: LOCAL INSURANCE LANDSCAPE

Note: Dutch life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are €24.4 / 17.8 and 67% / 49%
Source: Assurantie Magazine; Swiss Re sigma; BCG Insurance Database
SPAIN: LOCAL INSURANCE LANDSCAPE

Note: Spanish life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are €22.0 / 19.4 and 43% / 38%
Source: INESE; Swiss Re sigma; BCG Insurance Database

Exhibit 34

SWITZERLAND: LOCAL INSURANCE LANDSCAPE

Note: Swiss life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are €22.3 / 13.4 and 79% / 72%
Source: BPV; Swiss Re sigma; BCG Insurance Database

Exhibit 35
BELGIUM: LOCAL INSURANCE LANDSCAPE

Note: Belgian life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are B€13.6 / 9.6 and 74% / 59%
Source: CDV/OCA; Swiss Re sigma; BCG Insurance Database

AUSTRIA: LOCAL INSURANCE LANDSCAPE

Note: Austrian life / non-life total premiums (2001) and cumulative top-5 group share of relevant market are B€ 5.9 / 6.7 and 66% / 72%
Source: VÖ; Swiss Re sigma; BCG Insurance Database
If you would like to discuss the implications of this Discussion Paper for your company, please contact one of the leaders of The Boston Consulting Group’s European insurance practice:

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