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Insurers' digital reality—fewer premiums, more competition

Incumbents should consider partnerships and find new value-added services.

by Tanguy Catlin, Johannes-Tobias Lorenz, and Christopher Morrison

For a long time, insurance proved resistant to digital technology's disruptive power. Complex regulation, the capital reserves required to underwrite insurance, and underwriting skills and proprietary data built on years of experience kept the industry protected. But these barriers are rapidly eroding.

For the most part, the main threat is not from insurtechs, the nimble new tech start-ups that have thus far focused on property-and-casualty (P&C) insurance, as well as marketing and distribution, and into which venture capitalists have poured $4.4 billion in the past two years. Far from toppling the system, these fledgling businesses are in the main, helping incumbents to provide better services, with only 9 percent aiming to oust them (Exhibit 1).

Longer-term trends, on the other hand, are already upending the traditional business model of insurers and destroying value in the process. Exhibit 2 shows how far an incumbent car insurer could improve profits over the next eight years by harnessing digital technology. Better data will make pricing more accurate and help detect fraud, while automation could cut the cost of a claim by as much as 30 percent. Thereafter, however, with forward-collision avoidance, blind-spot assist, and adaptive cruise control already common

features in new cars, safer vehicles will reduce risk and lower premium income. In the case of entirely self-driving cars, manufacturers may assume the risk for what was previously a personal liability. The result of these changes could be that over the course of a decade, insurers' profits fall precipitously.

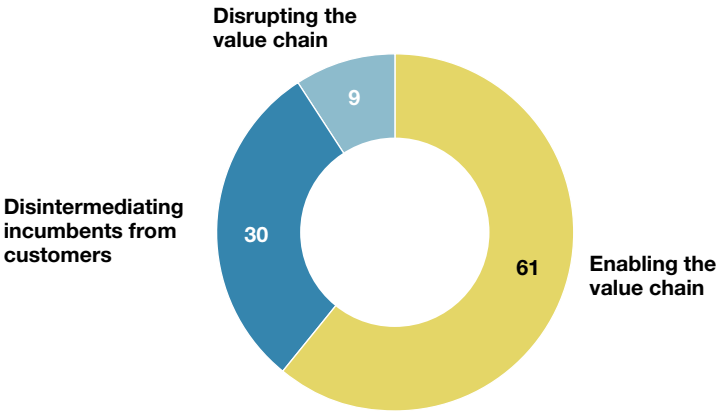
The same shift toward risk prevention is apparent in other insurance segments. In the home, sensors can shut off the water system if they detect a risk of flooding. In factories, connected devices on manufacturing equipment can alert operators to a maintenance issue. Smart devices that monitor health are increasingly popular. It is now possible to imagine a business model built not so much on the premiums consumers pay to protect themselves against damages they might or might not incur, but on gadgets or services that predict and help prevent risk.

Some of the expected decline in premiums will be offset by further efficiencies. But two other trends are significant. First, thanks to economies of scale and network effects in a digital economy, companies that move fast tend to take a greater share of a shrinking economic pie. Not all carriers, therefore, will be able to sustain the performance described earlier. The signs are already apparent. In direct auto insurance in Germany, Spain, and

Exhibit 1

Only 9 percent of insurtechs aim to oust incumbents.

Focus of insurtechs in the insurance value chain,[1] %



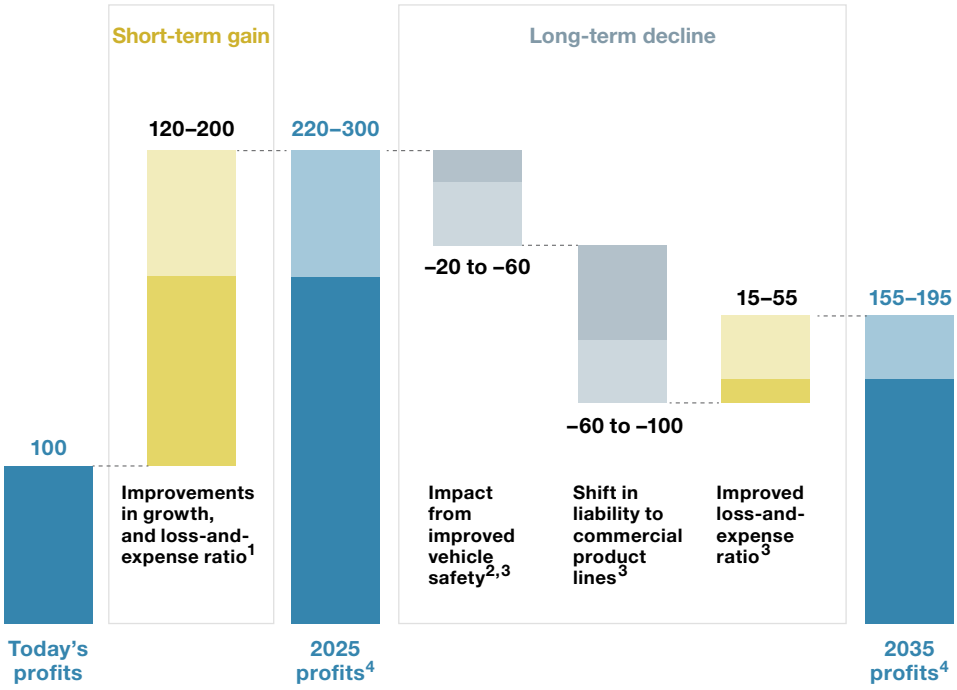
[1] Insurtechs are insurance businesses, usually start-ups, that use technologically innovative apps, processes, or business models; 2016 data based on some 500 commercially well-known cases.

Source: Panorama by McKinsey

Exhibit 2

Digital technology may increase profits for an auto insurer in the short term but lead to a long-term decline.

Future profits as a % of today's profits, digitizing the business, auto-insurance example



[1] Assumes improvements of 3–5 percentage points in loss ratio, 2–4 percentage points in operating expenses, and 6–8 percentage points in direct-sales conversions.
[2] Includes impact of semi- and fully autonomous vehicles.
[3] Assumes a 25% reduction in premiums as a result of telematics and sensors and a 50% risk transfer to commercial product liability.
[4] Includes growth in investment income as well as premiums; investment income modeled as a flat % of premium in each year. Profits for 2035 could drop to 75% of today's or rise as high as 275%.

the United States, a single fast mover has captured the lion's share of profits, leaving subscale, often unprofitable carriers competing for the remainder (Exhibit 3). Second, in a digital economy, those companies that own and analyze data are increasingly powerful. Insurers might have valuable historical data, but will they be able to compete with players that are able to gather real-time data from sensors in cars and homes, or from social media, credit-card histories, and other digital records? Knowledge about how fast someone drives, how hard they brake, or what activities they share on social media is arguably more helpful to assessing risk than age, zip code, and past-accident

record. And what if those with the data and analytical skills and with platforms that reach hundreds of millions—an Amazon or a Google—not only offered well-targeted, tailored products but also began to cherry-pick low-risk customers? If they do so in significant numbers, the underlying principle of traditional insurance—that premiums collected from low-risk policyholders contribute to the claims of high-risk ones—may no longer hold.

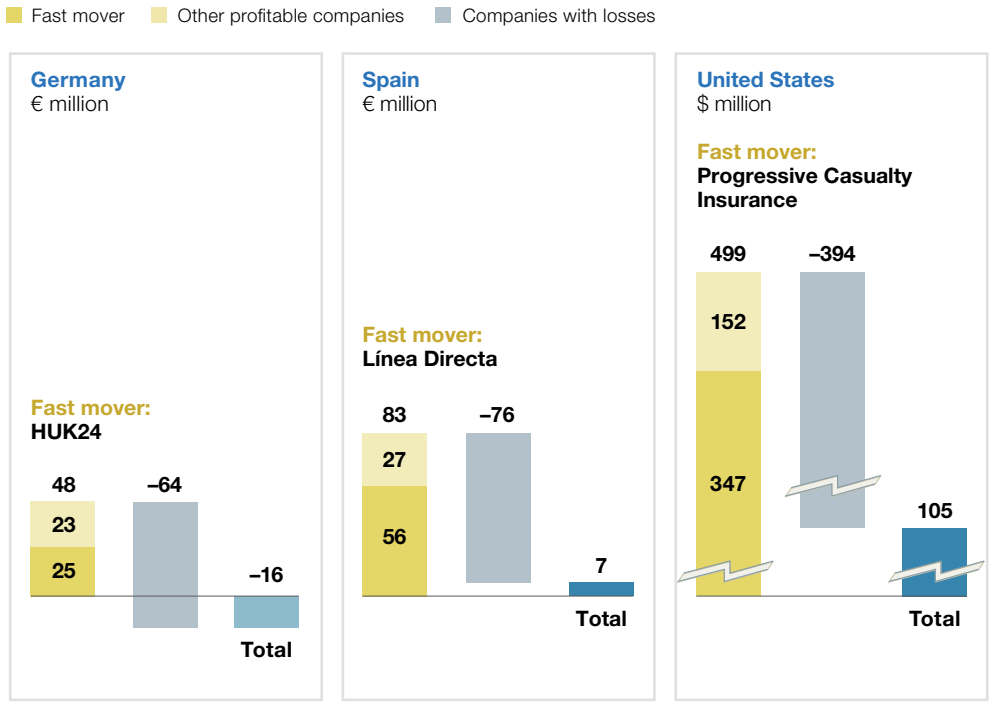
How will incumbents fare in this new world, where the focus is increasingly on risk prevention and insurers no longer have a monopoly on relevant data or customer access?

The answer no doubt lies in the speed with which they digitize existing businesses, using the enormous cost savings and newfound skills in areas such as analytics to drive new sources of growth. Growth will come from

Exhibit 3

Not all carriers will benefit from digitizing—a single fast mover may take the lion's share of profits.

Share of underwriting profit for pure direct auto insurance,[1] 2015



[1] For Germany, n = 13; Spain, n = 5; United States, n = 4.

Source: A.M. Best; Inese Wilmington Risk & Compliance; McKinsey analysis

new products fit for a digital age: cybercrime insurance, for example; supply-chain insurance facilitated by tracking sensors; "micro insurance" for farmers in emerging economies, made affordable once claims adjusters can use data analytics to determine if weather conditions have damaged crops and once they no longer have to trek to remote locations to assess claims; and "shared economy" products for car owners who suddenly become cab drivers or home owners who become hoteliers each time they respond to demands from an Uber or Airbnb user.

In addition, incumbent insurers should consider partnerships to offer new, value-added services, be they part of a cybersecurity package offered by software providers or part of a package for car owners offered by an ecosystem of companies that might include telematics providers and car manufacturers, as well as those offering roadside assistance, car repairs, or car rental. Cracks may have appeared in the old insurance business model, but a new one is in the making. Q

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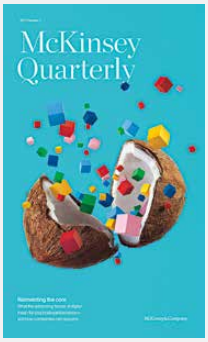
For the full version of this article, see "Time for insurance companies to face digital reality," on McKinsey.com.

For more on how insurtechs are disrupting the insurance sector, see "Insurtechs—The threat that inspires," on McKinsey's Digital Insurance site, digitalinsurance.mckinsey.com.



Another take on digital reinvention

"McKinsey research suggests that the more aggressively companies respond to the digitization of their industries—up to and including initiating digital disruption—the better the effect on their projected revenue and profit growth."

For more, see "The case for digital reinvention," from *McKinsey Quarterly* 2017 Number 1, also on McKinsey.com.