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Insurance Practice and Leap by McKinsey

Future of insurance: Unleashing growth through new business building

To compete with digital players, traditional insurers should consider building their own new digital businesses. Markers across four critical areas can show if insurers are on track.

This article was a collaborative effort by Simon Kaesler, Ari Libarikian, Brian Quinn, Pia Schlüter, and Felix Schollmeier, representing views from McKinsey's Insurance Practice and Leap by McKinsey, McKinsey's business-building practice.

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Evolving customer trends and rising competition from an array of digital players are pushing insurers to digitize quickly. Customers are increasingly turning to digital channels to fulfill a variety of needs, a trend that has only accelerated amid the COVID-19 pandemic.[1] And the direct insurers in the market—insurtechs, digital insurance attackers, and even large tech platforms—have several advantages over more traditional insurers, such as their ability to scale quickly, launch products fast, and employ top tech talent.

To compete in this environment, incumbents should consider building their own digital businesses. Doing so can be challenging, however, as digital ventures operate differently from traditional insurance companies. For instance, incumbents must leave behind legacy IT models and pivot their focus from investing in sales and marketing teams to investing in digital channels to support acquisition, perhaps even alienating their sales force. Despite these challenges, various traditional global insurers have already built and scaled new digital businesses. A 2020 McKinsey analysis of the top 20 European insurers by measure of gross written premiums (GWPs) showed that the share of insurers with a digital business increased from 1 percent to 70 percent in just five years; the same analysis for the United States showed 20 percent of insurers have a digital business, up from zero.

Insurers that want to launch their own digital business should observe how digital attackers operate in four areas—customer acquisition, data and analytics, state-of-the-art technology, and talent—to draw comparisons and see how to support their new business. Insurance companies that can successfully emulate attackers and innovate can leapfrog competitors.

Digital attackers in the insurance industry

From aggregators, to insurtechs, to noninsurance platforms, specialized digital attackers are dismantling all areas of the value chain, taking shares of revenue away from incumbents. Traditional insurers that want to contend with digital players must be keenly aware of how the market is changing—and how their competitors are responding.

Insurtechs have more flexibility than traditional insurers

McKinsey research finds that approximately 66 percent of insurtechs specialize in select parts of the value chain, such as data collection, while less than 10 percent aim to disrupt the full business model. Despite a decrease in venture funding in the first quarter of 2020 compared with the first quarter of 2019, insurtech financing is still significantly higher compared with the first quarters of previous years. US-based property-and-casualty (P&C) attacker Lemonade raised $480 million pre-IPO and $319 million at its 2020 IPO, and US-based motor insurance attacker Root Insurance raised more than $500 million within five years of its 2015 launch.[2] Berlin-based wefox Group has attracted more than $260 million since 2015 as well. This relatively steady stream of capital investment enables insurtechs to design greenfield IT architecture, giving them significant technological advantage over incumbents, many of which are frequently saddled with legacy systems that have not been modernized or replatformed. Newer technology also helps insurtechs more easily attract top digital and tech talent.

While traditional insurers may have steadier profits, insurtech shareholders tend to value accelerated growth over steady profitability. This approach gives attackers the freedom to sustain an unhealthy combined ratio[3] beyond 100 percent for a longer period while focusing on fast-paced exponential growth.

Reinsurers are investing in new players

Because insurtechs do not have the large balance sheets to sustain black swan events,[4] reinsurers are seizing this opportunity to invest in digital attackers that depend on them for risk coverage.

[1] Jason Bello, Shaun Collins, Ralf Dreischmeier, and Ari Libarikian, “Innovating from necessity: The business-building imperative in the current crisis,” April 16, 2020, McKinsey.com.
[2] Brian Deagon, “Lemonade IPO more than doubles as trading begins, raising $319 million,” *Investor’s Business Daily*, July 2, 2020, investors.com; “Lemonade,” “Root Insurance,” and “wefox Group,” Crunchbase, accessed November 4, 2020, crunchbase.com.
[3] A combined ratio is the ratio of the sum of incurred losses and expenses divided by earned premiums.
[4] A black swan event is a negative economic event that is very difficult or impossible to predict.

The world's largest reinsurers have set up or invested in entities that can enable insurtechs and managing general agents (MGAs) to sell insurance and related products, expanding their customer base. Munich Re, for instance, set up Digital Partners, which acts as a specialist provider for insurtechs and is frequently a co-investor in insurers, MGAs, and brokers during financing rounds. Hannover Re is an investor in finleap, the Berlin-based company builder that built a flourishing insurance and finance ecosystem and recently won Ping An as an investor. And Swiss Re built iptiQ, a dedicated B2B2C insurance platform that provides partners, or other platforms with access to certain customer segments, the opportunity to sell insurance products—ranging from complex life insurance to home products—online.

Platforms, ecosystems, and aggregators are gaining market share

Large platforms and ecosystems are starting to offer insurance to customers at the moment of need, a crucial advantage over incumbents. For instance, global furniture giant IKEA partnered with iptiQ to offer home insurance to its customers. Other examples of ecosystems include travel insurers partnering with online travel agencies, Apple Care acting as electronics and warranty insurance, and Tesla bundling motor insurance with its car sales. These collaborations can also boost earnings before interest, taxes, depreciation, and amortization (EBITDA) and increase customer retention.

Insurance aggregators are also increasing market share in almost all regions, especially in major European markets such as the United Kingdom, Italy, and Germany, where certain P&C segments are significantly affected by price-comparison websites (Exhibit 1). As of 2019, for instance, aggregators in the United Kingdom captured 55 percent of direct GWPs in the market.

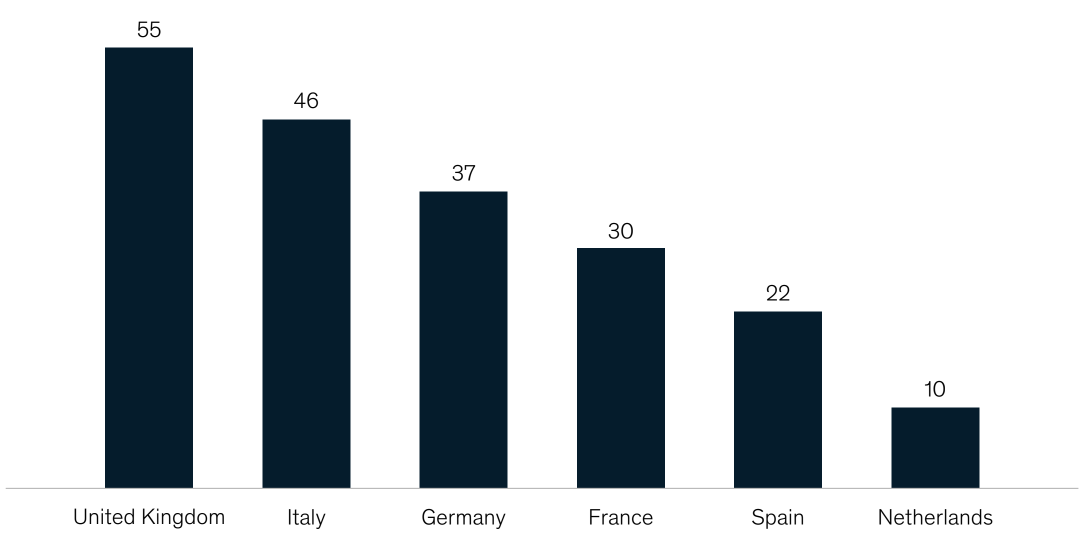
This trend has also reached the United States, as evidenced by the $100 million round of investment led by private equity in the aggregator Policygenius in early 2020.[5] While aggregators can be sales channels for insurers, they can also pose threats

[5] Katherine Chiglinksy, "KKR-led funding round gives $100 million to startup Policygenius," Bloomberg, January 30, 2020, bloomberg.com.

Exhibit 1

The United Kingdom's market has the biggest share of aggregators in the direct market.

2019 direct gross written premiums, %



Note: Figures will not sum to 100%.

by squeezing margins and competing for access to digital customers.[6] For instance, motor-insurance GWP volumes sold via aggregators have grown more than 8 percent year-over-year in both Europe and the United States (Exhibit 2).

Whether viewed in combination or individually, the advances of these digital players reinforce the need for insurers to compete beyond their core businesses.

How will your digital business measure up?

Incumbents should assess their digital business across four main areas to see how they compare with digital attackers and forward-thinking peers. While each area has different elements to consider, hiring the right people into the right roles is a critical component of success.

Customer acquisition is digital

Most digital attackers gain customers primarily, if not entirely, via digital channels. This approach has significant implications for the sales and marketing team's direction and capabilities. While the combined ratio of a digital attacker will not necessarily look different from that of the parent insurer, as both still have acquisition costs, *how* acquisition expenses are allocated differ. Direct distribution, for instance, requires investment in digital marketing and digital sales channels instead of hiring, running, and managing a sales force. And since most attackers operate via direct online channels, a significant portion of their acquisition expenses go toward digital channels, such as paid search marketing, display ads, or social media, rather than into sales commissions.

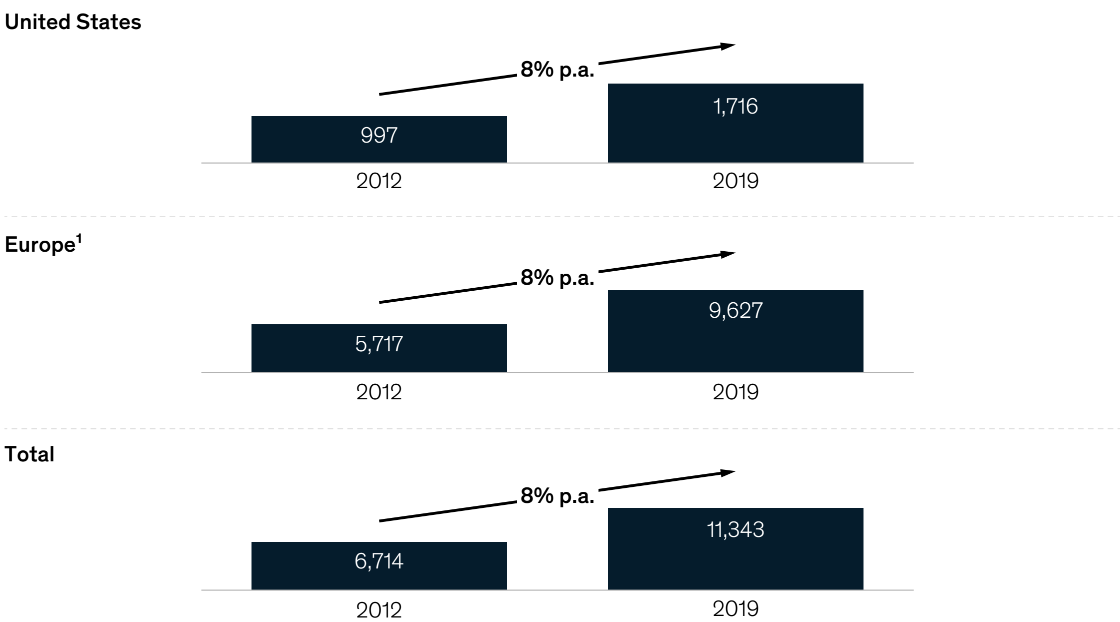
Furthermore, an attacker's sales and marketing team more closely resembles that of a large

[6] Simon Kaesler, Johannes-Tobias Lorenz, and Felix Schollmeier, "Friends or foes: The rise of European aggregators and their impact on traditional insurers," December 10, 2018, McKinsey.com.

Exhibit 2

Aggregators' importance in motor insurance is increasing globally.

Gross written premiums, € million



Note: p.a. = per annum.
[1] Analysis limited to France, Germany, Italy, the Netherlands, Spain, and the United Kingdom.
Source: McKinsey Global Insurance Pools Multi-Access Survey; McKinsey Auto Buyer Survey USA

e-commerce retailer than that of a traditional insurer. Team members have interdisciplinary skill sets, such as data science and expertise in conversion optimization, to improve the end-to-end lead and sales processes. Hyperpersonalization—providing highly personalized content, products, and services—is another way attackers get creative with customer acquisition. For instance, an attacker might send tailored communications to an existing or potential customer about homeowners insurance if the data show that person is interested in buying a house. Having data scientists on the marketing team makes it easier to mine for these kinds of data. (To learn more about what insurers can learn from their peers, see sidebar, "Learning from insurance peers.")

Traditional insurers should ensure their new digital business has sales-force talent with expertise in areas such as performance marketing, user experience design, analytics, conversion optimization, and hyperpersonalization, all of which support digital customer acquisition. In Brazil, for example, Caixa Seguradora launched the digital insurer Youse, which offers motor, home, and life insurance products. By hiring the right talent, investing heavily in digital customer acquisition, and providing a comprehensive user experience and onboarding journey, Youse acquired more than 100,000 customers by its third year.[7]

Data, analytics, and artificial intelligence are core competencies from the start

For attackers, advanced capabilities are not add-ons; rather, they are carefully considered and integrated into a launch plan. Indeed, many digital attackers develop a comprehensive customer data model before launching. These players may also add external third-party data to their existing data sets to help develop a stellar pricing model, focused on accurate, dynamic, and tailored pricing.

[7] Deborah Ponciano, "Três anos de seguro tipo vc," Youse, April 4, 2019, start.youse.com.br.

Learning from insurance peers

Learning from digital attackers is a critical step in building new digital business. However, incumbents should not overlook what they bring to the table. Drawing from our observations of insurers that have pursued digital business building, there are several takeaways traditional insurance companies should keep in mind:

— *Don't underestimate time to scale.* Many business cases run out of time and resources when pursuing large projects, such as new business building. Incumbent insurers, however, often have a bigger balance sheet than digital attackers, so they have some flexibility in terms of time and costs. Insurers should ensure project costs include a buffer in case the timeline extends and clarify the forecast benefits to justify the time required to scale.

— *Lean on existing brand equity to support customer acquisition.* Direct acquisition without an established brand or accelerators is expensive and working-capital intensive. Building a business on existing user bases is a huge competitive advantage, especially if the brand is trusted.

— *Apply customer-service experience.* Even though customers are increasingly turning to digital channels, don't underestimate the value of human interaction in digital models. Customers appreciate the option to call a human-assisted support line, which can be a differentiator.

Access to data about customer behavior, such as behavior when filling out quote forms, and additional user data, such as devices used and location, can help attackers customize individual customer journeys. Attackers can also use data to calculate an updated customer lifetime value for the marketing team and dynamically adjust pricing to optimize conversions or profitability in real time. Finally, artificial intelligence can help automate data collection and claims processing, improve retention prediction, or even optimize marketing budgets across multiple channels.

When launching their digital businesses, insurers might hire specially trained data scientists and specialized developers in addition to actuaries. Incumbents can also use the wealth of data already at their fingertips to give their new digital business a head start against digital attackers that do not have the backing of an established insurer. Absolute Insurance in Russia, for instance, developed and launched Mafin, Russia's first direct P&C insurer with a cutting-edge, mobile-first user journey and a claims process powered by artificial intelligence.

State-of-the-art technology on the cloud

Digital attackers often run part or all of their infrastructure in the cloud. Rather than buy and run one large, monolithic software platform, they connect multiple platforms, vendors, and third parties through more nimble connections such as microservice architecture. To quickly adapt to changes in the market and ensure they own the full customer journey, most attackers fully develop and own the front end themselves. The core insurance system, however, could come from an established vendor and use other elements, such as chat or custom-care software, from a software-as-a-service (SaaS) provider.

Traditional insurers are often tempted to reuse existing legacy software in their new digital businesses. In many cases, however, these systems burden the new venture by enforcing inflexible existing processes and data models, which is why many attackers opt for more modern, flexible solutions—often running their entire infrastructure in the cloud. In 2019, for instance, andsafe launched its own digital attacker in Germany with its whole infrastructure and core insurance built and stored in the cloud. Whether an insurer is building a new business from scratch or within its core, hiring the right IT architects, DevOps engineers, and full-stack, front-end, and back-end developers ensures smoother build-outs of IT infrastructure.

Talent and adaptable ways of working

Unlike traditional insurance companies, many successful digital insurance attackers are run by digital entrepreneurs rather than insurance executives. Digital attackers also have flatter hierarchies, which provide greater transparency into work outcomes, foster open discussions among colleagues, and encourage a willingness to challenge the status quo and embrace new ideas, much like in a Silicon Valley start-up. Many attackers also build agile working models that support quick test-and-learn approaches. Agile methods such as Scrum—a proven framework used by big tech firms and many digital noninsurance players—or objectives and key results are also commonly employed. These approaches enable efficient collaboration to support complex product development amid uncertainty.

These flexible working approaches can also help attract and retain top digital talent. The winning talent combination, however, is a mix of outside noninsurance digital experts and people with deep insurance knowledge, the latter often coming from the incumbent sponsoring the attacker. Insurers that invest in hiring a good balance of digital and traditional insurance talent could see the benefit to core business down the line. Over time, talent from an insurer's digital business venture might transition over to the core insurance business, especially if incumbents adopt more flexible ways of working.

Never has the need to digitize been more critical, given evolving customer behavior and the ever-increasing competitive threat. By observing established digital attackers, incumbents can uncover valuable lessons when building their own digital businesses. Indeed, insurers that take this path will soon gain confidence and realize that they can innovate and generate impact beyond writing more GWPs or leveraging new digital channels—helping them leapfrog competitors.

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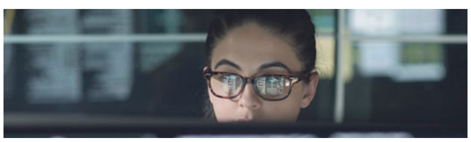

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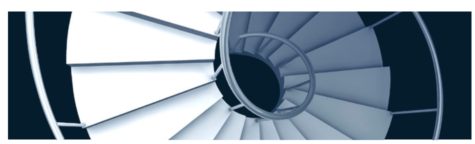

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