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Facing digital reality

Regulation, product complexity, and insurers' large balance sheets have kept digital attackers from insurers' gates. That is changing, but in ways incumbents should embrace. They can flourish in the digital age—if they move swiftly and decisively.

Digital technology destroys value. That might sound counterintuitive given the extent to which it can make business systems more efficient—and companies are urged to embrace its many possibilities. Yet new McKinsey research shows that although digital technology propels some companies to become clear market winners, for many more its impact depletes corporate earnings and the overall value of an industry.¹ Consumers, not companies, are often the ultimate winners.

So it is likely to be in insurance. For a long time, the traditional insurance business model has proved to be remarkably resilient. But it too is beginning to feel the digital effect. It is changing how products and services are delivered, and increasingly it will change the nature of those products and services and even the business model itself. We firmly believe that opportunities abound for incumbent insurance companies in this new world. But they will not be evenly shared. Those companies that move swiftly and decisively are likely to be those that flourish. Those that do not will find it increasingly challenging to generate attractive returns.

A triple prize: Satisfied customers, lower costs, higher growth

The goal must be to meet customers' expectations, which have been transformed by digital technology. Customers want simplicity—one-click shopping, for example. They want

24-hour access and quick delivery, clear, relevant information about a product's features, particularly in relation to pricing, and innovative, tailored services designed for the digital age. They have the same expectations whatever the service provider, insurers included. And as Matthew Donaldson, CEO of UK-based BGL, the company behind the comparison site Comparethemarket, points out, although some insurers are holding back from the commitment needed to meet these expectations, demand must ultimately be satisfied.

Automation can reduce the cost of a claims journey by as much as 30 percent.

In the shorter term, fulfilling this goal is a chance for insurers to improve profits in their core business. Higher customer satisfaction, driven by the improved service and faster processing times that digitization delivers, is itself a driver of profit through increased customer retention.² At the same time, by digitizing their existing business, carriers can remove significant cost across the value chain, further increasing customer lifetime value. Automation can reduce the cost of a

¹ Jacques Bughin, Laura LaBerge, and Anette Mellbye, "The case for digital reinvention," *McKinsey Quarterly*, February 2017.

² Alex Rawson, Ewan Duncan, and Conor Jones, "The truth about customer experience," *Harvard Business Review*, September 2013, hbr.org.

claims journey by as much as 30 percent, for example.

There are revenue improvement opportunities too. The notion that insurance is a low-engagement, disintermediated category in which customer relationships can be delegated to agents and brokers is increasingly obsolete. Instead, digital technology and the data and analysis it makes available give insurers the chance to know their customers better. That means they can price and underwrite more accurately, and better identify fraudulent claims. They can also offer clients more tailored products—auto insurance that charges by the mile driven, for example. And they can offer them in a more timely manner. In an analog world, an insurer will be unaware when a customer holding a home insurance policy puts that home on the market. In a data-rich digital world, that need not be the case, and the knowledge that a home is up for sale becomes an opportunity to offer new home cover, new auto cover, and perhaps a life product to help cover a mortgage on the new house.

Longer-term growth opportunities reside in innovative insurance products and protection services. Concerns about cybersecurity will create demand from companies and even households for products that prevent and protect against the breach or loss of data, and damage that might ensue. And more products fit for a sharing economy will surely emerge—for homeowners who suddenly become hoteliers when

they take a guest through Airbnb, for example.

“Insurers of the future will play more of a risk avoidance role and less of a risk mitigation one.”

— Andrew Rose, CEO of US insurance comparison website Compare.com

This is all good news for insurers, particularly at a time when low interest rates and tighter regulation constrain performance. But while opportunities abound, there is no guarantee that today’s incumbents will be the ones to capture them. Digital is opening the gates to new attackers that will erode their advantages.

Attackers at the gate

Complex regulation was and remains a deterrent to new market entrants. So is the size of incumbents’ in-force books which, coupled with customers’ tendency in P&C and particularly life insurance not to switch providers, makes it hard for new entrants to rapidly capture market share. Moreover, incumbents have the advantage of large capital reserves, as start-ups seldom

want to take risk on to their balance sheets because of the capital they need to offset it. And they have the advantage of underwriting skills built on years of experience and proprietary data.

This resilience explains why the industry as a whole lags behind many other sectors in its digital maturity. But the situation is changing. Money now pouring into the industry suggests it is no longer regarded as impregnable. Venture capitalists globally invested \$2.6 billion in insurtechs in 2015, and nearly \$1.7 billion in 2016 (Exhibit 1). Although these newcomers are populating every part of the value chain, their focus to date has been on the more easily accessible slivers of the industry—mainly distribution, particularly in P&C

insurance (Exhibit 2). They are not about to overturn today's value chain. But there are longer-term trends afoot that might.

Eroding advantages

Insurers are threatened by three trends: a shift toward preventing risk rather than insuring against it, the increasing power of those companies that own and analyze data, and the investment of huge amounts of capital in insurance-related capital market instruments by institutional investors seeking high returns.

Risk prevention. Digital technologies that give rise to ever-increasing amounts of data and ever more penetrating insights might make for more accurate pricing

Exhibit 1

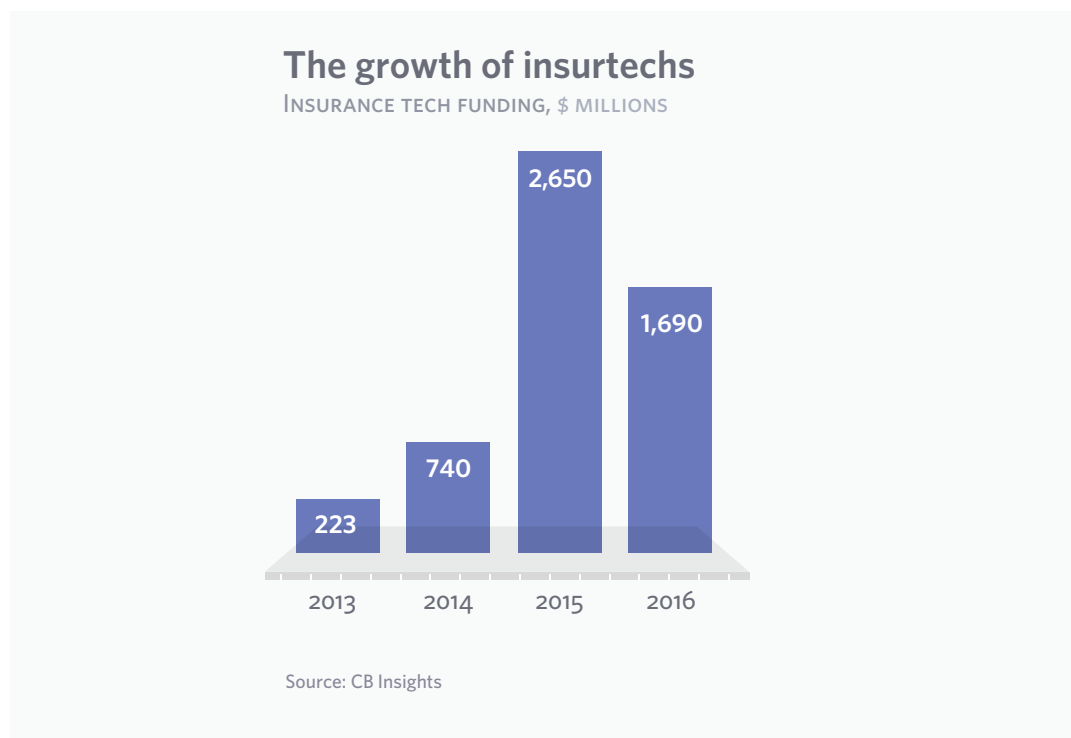


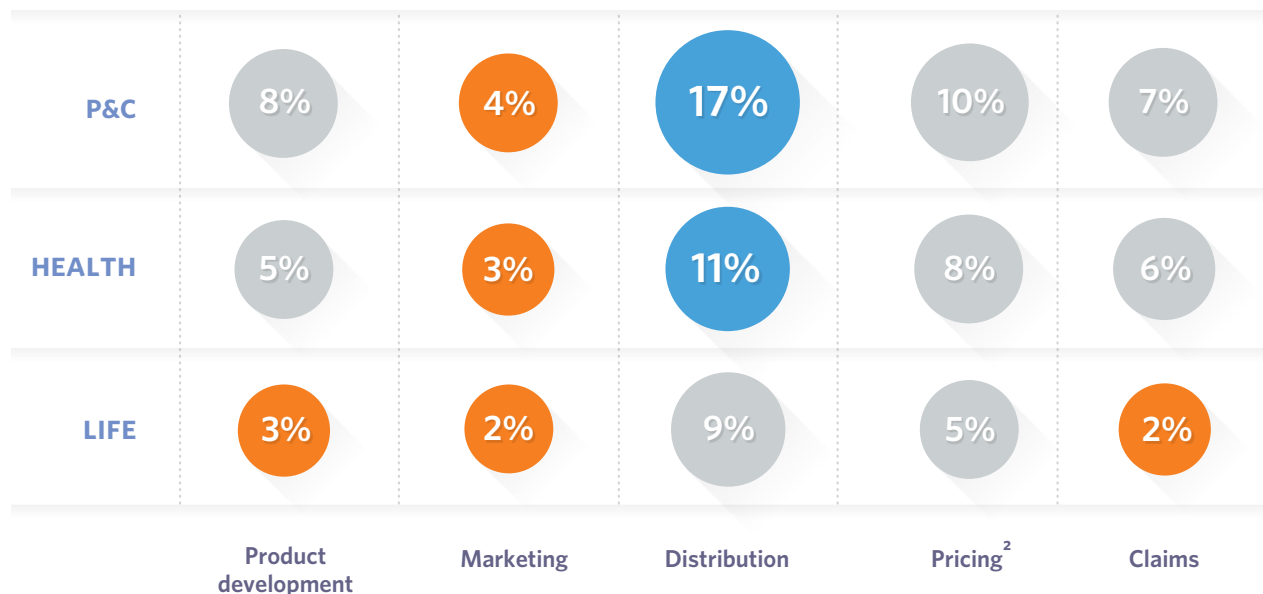
Exhibit 2

Where insurtechs are focusing

Number of innovations as % of total in the database ¹

Share of innovations in Insurtech database

● <5% ● 5-10% ● >10%



¹ -500 commercially most well-known cases registered in the database (excluding wealth management related innovations)

² Includes underwriting and policy issuance

Source: McKinsey Panorama Insurtech Database

of risk, but they also help mitigate risk, reducing premiums. Take auto insurance. Forward collision avoidance, blind-spot assist, and adaptive cruise control are already fitted in many new cars, making vehicles safer. Already, 20 percent of vehicles globally are expected to come with safety systems by 2020, reducing the number of accidents and thus the value of personal auto insurance policies. Entirely self-driving cars could become ubiquitous in the next two decades, at which point liability is likely to shift from individual drivers to manufacturers. In the United States, we estimate auto insurance premiums could decline by as much as 25 percent by 2035 due to the proliferation

of safety systems and semi- and fully-autonomous vehicles.

The same shift toward risk prevention is apparent in other sectors. In the home, sensors can send an alert to the owner if a risk of flood is detected, automatically shutting off the water system if there is no response, and in commercial properties, connected devices on manufacturing equipment can give owners early warning of maintenance requirements. Smart devices that monitor health are also increasingly popular. There are two main effects. Data from connected devices can be used to assess risk more accurately. But it is also a powerful tool to lower risk—to prevent accidents in the home,

reduce maintenance and downtime, or improve health. This logically leads to a model whereby consumers pay not for premiums in order to be compensated for damages they might incur, but for gadgets or services that predict and help prevent that risk. “Insurers of the future will pay more of a risk avoidance role and less of a risk mitigation one,” says Andrew Rose, CEO of US insurance comparison website Compare.com. The value creation from underwriting thus diminishes.

The power of data and its analysis. Data and analytics are changing the basis of competition. Leading companies use both not only to improve their core operations but to launch entirely new business models. Insurers have valuable historic data. Yet in a few years’ time, will they be able to keep pace and still add underwriting value when competing with newcomers that have access to more insightful, often real-time new data culled from the Internet of Things (IoT), social media, credit card histories, and other digital records? Knowledge about how fast someone drives, how hard they brake, or even (more controversially) what they get up to as displayed on social media is arguably more revealing data on which to assess risk than simply age, zip code, and past accident record. (Facebook recently moved to prevent its users’ online activity being used by insurers in the United Kingdom—proof of the potential power of access to good data.)

And what if those with the necessary data and analytical skills and platforms that reach millions—a Google or an Amazon—not only offered well-targeted, tailored products, but also began to cherry-pick low-risk customers? If they did so in significant numbers, the insurers’

business model, whereby premiums collected from low-risk policyholders contribute to the claims of high-risk ones, could fall apart.

Auto manufacturers are arguably close to changing the game for insurers. The fitting of connected devices as standard in cars is not far off, potentially giving manufacturers unique access to data that could accurately ascertain the risk of their customers, as well as ready-made access to drivers in need of an insurance product. How would incumbents fare in such an evolving ecosystem?

Leading companies are using data and analytics not only to improve their core operations but to launch entirely new business models.

Institutional investors. For more than a decade, large institutional investors have been pouring money into insurance-linked instruments on the capital markets in search of non-correlated returns and higher yields in a low interest rate environment, disintermediating reinsurers in the process. To date, they have focused mainly on reinsuring property catastrophe risk—a sum of \$70 billion in 2015. But now they have their eyes on the primary market. For the moment, interest centers on “short-tail” lines of business. Yet ultimately, why would, say, a large manufacturer of sensors that gathered

data about weather and soil conditions to optimize agricultural productivity not consider offering a crop insurance product to farmers, with the backing of investors? The data gathered would aid risk analysis, and payments could be triggered automatically (and cheaply) when sensors detected damaging weather conditions.

A large incumbent could more than double profits over 5 years by digitizing existing business.

Despite these potential threats, our view is that today's carriers, many of which have a century-old record of creating value for their policyholders and shareholders, remain in a strong position to flourish in a digital age. For the time being, they have expertise no one else has, making them valuable partners in the ecosystems that are evolving to offer consumers both risk prevention and risk mitigation services. They still have large balance sheets that enable them to underwrite large pools of risk. And they have the trust of policyholders who need to know their insurance company will still exist when they make a claim or their policies mature, perhaps decades from now.

But for many carriers, the window of opportunity is narrow. Once cracks appear, digital technology has the power to break business models within the space

of just one or two innovation cycles. Retail music, book stores, travel, and media are some of the high-profile sectors that have already felt its force, transforming their economics and sometimes toppling what were once industry heavyweights. The question for incumbents is therefore whether they are nimble enough to rise to the opportunities that digital offers. The evidence that they will need to move quickly is compelling.

Uneven distribution of rewards

First, digital diminishes value. McKinsey's global survey of a wide range of industries has shown that digital technology shrinks revenue growth at an average rate of 3.5 percent a year and growth in earnings before interest and tax (EBIT) at an average rate of 1 percent a year. For some industries, the figure is as high as 12 percent for revenue and 10 percent for EBIT.

Our analysis of auto cover, the insurance segment that has been first to feel digital's impact, suggests a similar dynamic is unfolding in the insurance industry. US auto insurers have already lost on average \$4.2 billion in underwriting profit a year over the past five, with expenses and losses consistently outweighing premiums. They should expect further annual profit declines of between 0.5 and 1 percent if they fail to use digital technology to improve efficiency and effectiveness.

In the shorter term, corrective measures could lead to huge profit improvements. By digitizing existing business, our research suggests, a large incumbent

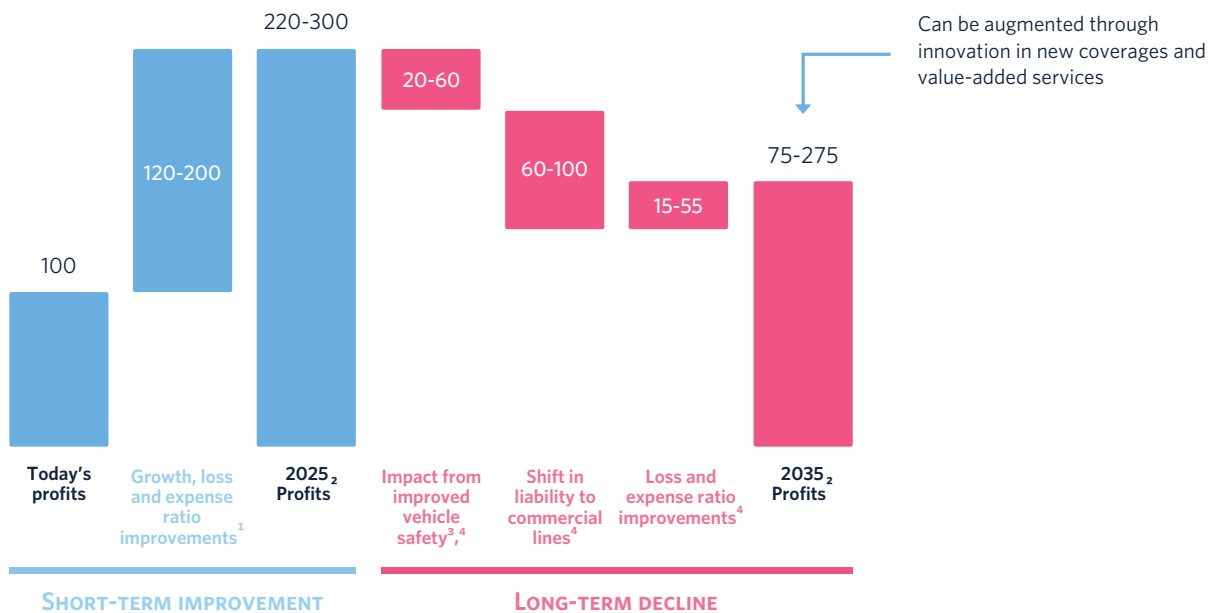
could more than double profits over the course of five years. In the longer term, however, earnings from traditional business will face headwinds as driving becomes less risky owing to the use of sensors and telematics or because, in the case of autonomous cars, liability is transferred to manufacturers. Fifteen years on, profits for traditional personal lines auto might fall by 40 percent or more from their peak (Exhibit 3).

Second, in a digital economy, the effects of a shrinking economic pie are compounded by the fact that the pie will not be evenly divided—the result of economies of scale and network effects. Hence, not all carriers will be able to sustain the performance described in the analysis above. For many, digital’s threats might well outweigh the opportunities. Again, the signs are already apparent. In direct auto insurance in Spain, Germany,

Exhibit 3

Profit projection for an auto insurer digitizing its business

Future profits as a percentage of today’s profits



¹ Assumes a 3 to 5 percentage point improvement in loss ratio, a 2 to 4 percentage point improvement in operating expenses, and a 6 to 8 percentage point improvement in direct sales conversions

² Includes growth in investment income as well premiums. Investment income modeled as a flat percentage of premium in each year

³ Includes impact of semi- and fully autonomous vehicles

⁴ Assumes a 25 percent reduction in premiums as a result of telematics and sensors and a 50 percent risk transfer to commercial product liability

Source: Digital and Auto Insurers Value at Stake Analysis, McKinsey, 2016

and the United States, a single player has captured the lion's share of profits, up to 70 percent, leaving a long tail of sub-scale, often unprofitable carriers competing for the remainder (Exhibit 4).

Third, the winners will be those that move decisively. Our cross-industry research showed that those companies that initiated disruption fared best, generating revenue and EBIT growth that was on average between one and two percentage points higher than that of more ad hoc responders. These companies made

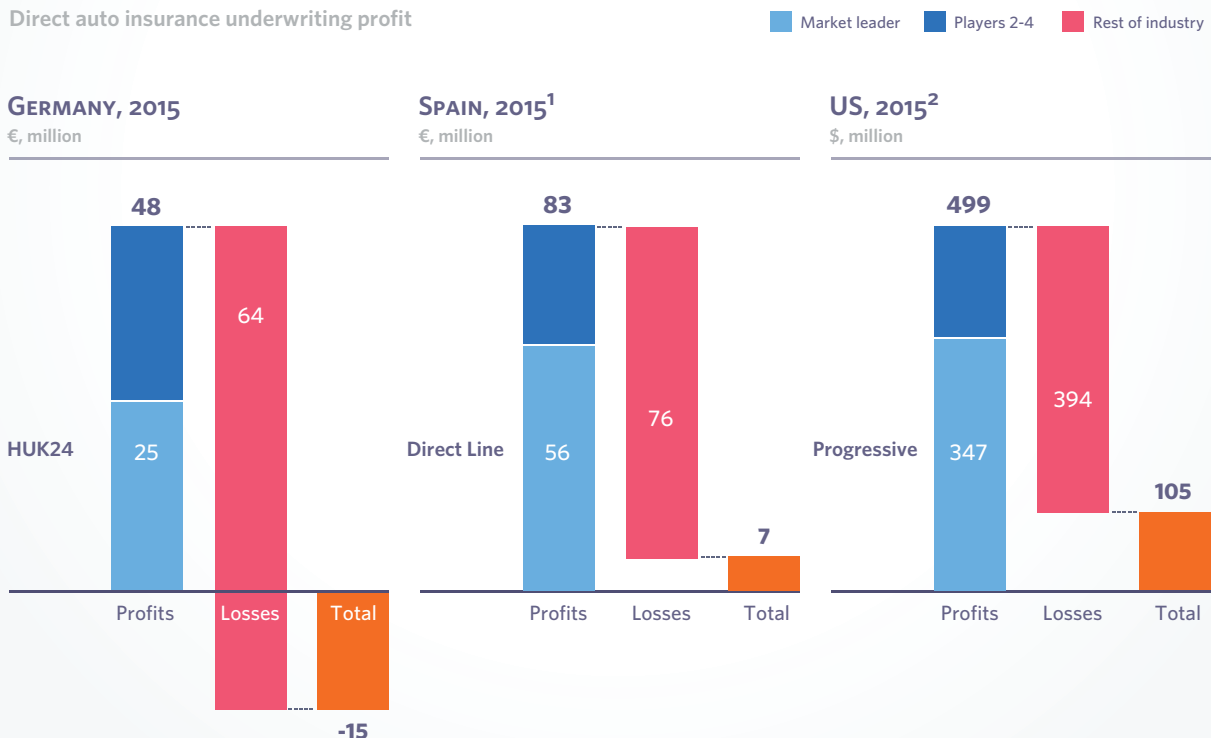
big bets—to innovate products or reshape the value chain, for example—rather than following in others' wake. In insurance, this is borne out by the companies featured in Exhibit 4: HUK24, Direct Line, and Progressive were all first movers.

A similar dynamic is likely to play out across the industry. Digital technology will take longer to disrupt more complex business lines, such as life insurance, and technological innovation may disrupt them in ways we cannot yet foresee. But given

Exhibit 4

The "winner-takes-all" effect

Direct auto insurance underwriting profit



¹ Does not include "other technical results"

² Includes results only for direct U.S. auto writers Progressive, USAA, GEICO and Amica

Source: INESE, McKinsey Insurance Database Germany, AM Best (statutory filings)

its impact to date in industry after industry, it would be foolhardy to bet against it.

What it takes to transform rapidly and at scale

Against this backdrop, we interviewed some 30 executives in incumbent and attacking companies to understand their views on how the industry is changing and how to respond. The single message most constantly repeated was the need for incumbents to accelerate their response (see box, “The need to commit to speed”). Most know they cannot afford to wait until evolving technologies turn the market upside down and the competitive advantages they enjoy today evaporate. If history tells them anything, it is that they need to get ahead of the curve. And they will need to do so at scale, ultimately transforming the entire business. What holds them back, however, is deciding how to address the challenge given its enormity.

The new value drivers

Success will be grounded in recognizing the drivers of value in a digital age. There are five of these.

Technological leadership and innovation. Winning companies will need to do more than follow technological trends and innovation. They will need to lead them. Innovation is a vital component of a digital transformation.

Customer ownership. Incumbents have not had to worry much about customer ownership. Their only competitors have been other insurers, and most have felt secure enough to cede customer contact to intermediaries. Today, however, customer access and “ownership” are keys to the

“I believe the consumer will win and that the desire for low-cost, transparent, high-quality digital services will have to be met.”

**– Matthew Donaldson,
CEO, BGL Group
(Comparethemarket)**

largest profits, and insurers must fight for them. Their success will depend upon offering superior products and services. Technical underwriting skills alone will not suffice.

Efficiency (cost savings) and effectiveness (higher returns). Digital technology puts margins under pressure as premiums fall under the weight of price competition and as new ways of mitigating risk emerge. Under these conditions, insurers will need to harness digital to make their operations more efficient, aggressively lowering costs. They will also need to make them more effective by, for example, improving the accuracy of their pricing and underwriting to improve loss ratios.

Scale and network effects. In a digital world, initial investments are sizeable but marginal costs are close to zero. Scale therefore matters. It also delivers network effects, helping to build a company’s access to more and better data, talent, and partners to the extent

VOICES: The need to commit to speed



“There are times when we talk to carriers about integrating a line of code into their app to integrate more into Facebook, and the answer we get is, ‘Well, our next release cycle isn’t for another eight months.’ The ability to speed up those release cycles is a variable that we see with those carriers that are not just talking the talk, but taking action.”
—Brad Auerbach, US industry manager, Facebook

“You have to believe that tomorrow somebody’s going to attack you. And you have to be acting very, very fast. The second that you slow down, somebody’s going to pass you. Insurance companies operate on slower timescales. You can’t do that. The market will pass you by.”
—Andrew Rose, president and CEO, Compare.com



“Companies need to commit to speed. Insurance is a highly regulated industry and it is not easy to move quickly, but the fact is consumers are moving at exceptional rates. So the companies that will stand out are the ones that are going to find ways to move a bit faster, at the pace of the people they’re insuring.”—Scott Simony, head of industry, Google

“We see some carriers that understand this is the beginning of a reinvention of the auto insurance model, but we also see many that are still scared of technology, a bit like the utility world was a few years ago, where people said, ‘You know what, I’m fine running my coal plants, I don’t want to know about all this renewable technology because it’s only going to hit in the generation after I retire.’ But car makers are adopting the technology quite rapidly. Five, ten years out we’re going to see some very, very major effects.”—Stefan Heck, CEO, Nauto



“Insurance companies that are really good at risk management are thinking traditionally—that if you spend enough time, one year, two years, thinking and planning, the outcomes you generate would be [the result of] the time spent. But the pace of change is so fast that by the time you have thought through things, the market may have already moved on.”—Naveen Agarwal, chief customer officer, Prudential

that it becomes a barrier to entry for others. Some companies have built hyper-scale data platforms that enable them to blur traditional industry definitions by spanning product categories and customer segments, creating new ecosystems and value chains in the process.

Speed and agility. The strength of an insurer's in-force book will not protect it indefinitely. Incumbents need to move quickly to compete with digital competitors that have the agility to keep pace with evolving technology and customer needs. That means letting go of slow decision-making processes and outdated ways of working, and adopting a new culture and talent base that is more comfortable with experimentation, testing and learning, and sometimes even with failing.

A roadmap for the future

These new value drivers will inform the roadmap insurers chart to transform their businesses and secure their future competitiveness. They will shape their strategy, helping them to understand the forces that are disrupting the industry. They will make clear the huge value to be created by digitizing their current businesses, as well as the imperative to innovate. They will demonstrate the need for significant investments in IT and a change in perspective whereby IT becomes a strategic function, not a cost center. They will make plain the new capabilities required to take full advantage of IT's potential, including automation, advanced analytics, and blockchain. And they will highlight the importance of culture and talent change if the transformation is to be successful.



Insurers should not underestimate the changes that digital will bring to their industry and the challenges they will pose. Neither should they overlook the significant short-term profit improvements that are within their grasp if they digitize their core businesses, nor shy away from innovating to be part of an exciting future that is unfolding for the industry. If they act decisively, they will be among its leaders. □

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