How to win in insurance: Climbing the power curve

A small group of winners captures much of the economic profit in the insurance industry. New research quantifies just how far ahead the leaders are—and what other insurers can do to catch up.

by Alex D’Amico, Mei Dong, Kurt Strovink, and Zane Williams
Every year, at insurance companies around the world, strategic planning processes unfold. They aspire to set bold new direction but frequently yield incrementalism and strategic inertia—in insurance, and in just about every other industry. In fact, research by our colleagues shows that economy-wide, in multidivision companies, the amount of capital allocated to each business unit from one year to the next is nearly identical; the mean correlation is .92.

There are myriad reasons for this, ranging from risk aversion to corporate politics to the Quixotic quest for the perfect strategy that does not exist. And there’s also an empirically substantiated way out: recognize that strategy is about playing the odds. Not every decision is going to result in a win—but companies that increase their batting average, so to speak, are more likely to succeed. Strategy is probabilistic, not deterministic. That, too, is the case in every industry, according to a multiyear research effort by our colleagues that culminated in the 2018 publication of *Strategy Beyond the Hockey Stick*.

We recently extended and deepened this research by taking a deep dive into the insurance industry.¹ Our work confirms that insurers can take concrete, evidence-backed actions to move them in the right direction and, cumulatively, improve their odds of long-term success. Purposeful, bold moves aimed at shifting resources, boosting underwriting margins and productivity, and delivering on a series of programmatic M&A deals can dramatically improve an insurer’s odds of reaching the top quintile of economic profit over a ten-year period.² While these moves may sound instinctive, many companies fail to pursue them rigorously. In fact, these moves are most powerful when undertaken in combination, at or beyond the thresholds of materiality described in this article and illustrated with examples from leading insurers in Asia, Europe, and North America. The point isn’t that there’s a magic formula for achieving strategic differentiation. Rather, by taking a hard look at the potential of your key initiatives to achieve bold results in these areas, you can get a realistic forecast of the odds that your strategy will transform performance.

**Understanding the power curve and how to apply it**

Our analysis of the economic profit of 209 insurers across geographies from 2013 to 2017 identified a power curve—proof that economic profit is unevenly distributed among insurance companies (exhibit). The top 20 percent of insurers created an annual average of $764 million in economic profit during that period. In contrast, the middle 60 percent produced an average of only $26 million in economic profit. And while those middle insurance companies didn’t create or destroy much value, the bottom 20 percent destroyed a staggering $976 million per company per year. This pattern was similar to the universe of all companies studied by our colleagues.³

These findings may come as a wake-up call to insurers that find themselves outside the top quintile—but embarking on an effort to move up the power curve is difficult. The odds of companies in the bottom quintile from 2003 to 2007 moving to the top quintile over ten years were 17 percent, and

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² Economic profit is defined as “the total profit after the cost of capital is subtracted.” For more, see Bradley, Hirt, and Smit, *Strategy Beyond the Hockey Stick*, 2018, p. 109.
³ For more on how the power curve applies to companies across sectors, see Bradley, Hirt, and Smit, *Strategy Beyond the Hockey Stick*, 2018.
the odds of companies in the middle moving to the top were nearly 10 percent. Yet it is still possible for insurers to move up the power curve and, in doing so, substantially increase the amount of value creation.

How to move up the power curve

Our research shows that moving up the power curve requires a laser focus on the factors that have an outsized impact on success, measured as economic profit. These factors are grouped into two categories: foundational factors and bold moves.

Foundational factors

These factors set the starting point for the carrier and for the external environment it interacts with, but they are not always within the carrier’s control in the near term (for more, see sidebar “Endowment and trends”):

— *Endowment* refers to an insurer’s current starting point in the market—its size, financial flexibility, and past investment in technology and product development.

— *Trends* refer to the headwinds or tailwinds in the insurer’s markets that make it easier or harder to move up the curve. This includes both geographic exposure and industry trends.

Bold moves

After examining more than 40 potential levers, our research found that a company’s positive trajectory can be most explained by five bold
Endowment and trends

Understanding where your company stands in relation to the top performers in your industry provides a valuable perspective on how to make progress. While these factors are often outside of an insurer’s immediate control in the near term, learning how to work with them is important.

**Endowment**

**Size.** To be among the leaders in value creation, insurers benefit from sufficient scale. Size amplifies the effects of performance improvement in absolute terms, making progress along the power curve more likely. From 2013 to 2017, for example, top-quintile insurers had an average of $17 billion in common equity.

**Financial flexibility.** Carriers that readily commit more resources to attractive growth opportunities are more likely to move up the curve. For insurers, this flexibility can be assessed through debt-to-capital measures and regulatory capital levels such as risk-based and Solvency II capital ratios. We found that insurers with debt-to-equity and regulatory capital ratios in the top 40 percent of the sector are more likely to increase economic profit.

**Investment in product development.** While insurers rarely set budgets for systematic R&D as firms in other industries do, successful insurers have a culture of innovation and a history of continuously improving product development capabilities. Innovation in this context includes vertical integration and horizontal expansion—for example, by combining the insurance business with adjacent spaces, such as healthcare and retirement communities.

**Trends**

**Industry trends.** The economic and competitive environment an insurer is exposed to affects its prospects for growth and profitability. Examples of industry trends include headwinds, such as persistently low interest rates or declining fertility rates for life insurance, and tailwinds, such as increasing demand for cybersecurity protection among property-and-casualty (P&C) carriers. In addition, some industry trends have an ambiguous impact—for example, safer passenger cars on the roads and more technology for risk prevention in homes, offices, and factories might lead to auto and home insurance slowing while potentially improving the profitability of carriers. One of the most important matters for insurers is understanding tailwinds and headwinds. Over time, riding tailwinds and mitigating headwinds within the portfolio is a key part of good strategy.

**Geographic trends.** In addition to industry dynamics, the differing economic environments within the countries in an insurer’s footprint also affect the ease of moving up the power curve. In mature markets, the insurance industry is highly competitive and exemplified by low growth. Yet averages mask just how dynamic these mature markets can be. In the United States, for example, the overall annuities market has been stagnant over the past five years. During that time, however, fixed index annuities sales grew by 14 percent while variable annuities sales declined by 5 percent. At a regional level, emerging Asia and Latin America are the growth leaders across the P&C, life, and health segments. Emerging Asia’s five-year growth has been 13 percent for P&C, 14 percent for life, and 33 percent for health, while Latin America has delivered 21 percent, 15 percent, and 23 percent for the same segments.

In some instances, companies can predict industry trends and use them to their advantage; deploying a combination of purposeful moves will help an insurer reposition its business to get ahead of trends.
moves (for more, see sidebar “Behind the original power curve research”):

- Dynamically shift resources between businesses.
- Reinvest a substantial share of capital in organic growth opportunities.
- Pursue thematic and programmatic M&A.
- Enhance underwriting margins.
- Make game-changing function improvements in productivity.

These efforts are underpinned by endowment and trends and are controllable elements of strategies that increase an insurer’s odds of moving up the power curve. While the scale of these efforts required to affect a carrier’s position on the curve can be described as bold, they are not reckless. Instead, these moves must be strategic and made with conviction.

How insurers should pursue the five bold moves

While the five bold moves may seem intuitive, and many companies may already be doing them in some form, two factors set these actions apart. First, magnitude and intensity matter; these efforts force insurers to break free from their standard processes of investment and initiative prioritization. Even if a company is doing something in each of these dimensions, how much it is doing often makes a difference. In other words, strategy is not only about the directionality of moves but also their materiality. For example, the data show that a company must be in the top 30 percent of the industry in margin improvement or cost reduction to maximize its odds of moving up the power curve.4 This threshold parallels our findings across industries that dynamic resource reallocators gain approximately three to four more percentage points of total return to shareholders each year compared with low reallocators.

Second, the impact of these moves is cumulative. Companies that employ three or more of these moves in concert are likely to be propelled up the curve. Our findings show empirically that companies that focus on multiple moves over time can learn from and adapt to them, reaping even further benefits.

**Bold move #1: Dynamically shift resources between businesses**

Some carriers offer customers too many legacy products that do not produce meaningful profit. These legacy products take attention away from distribution, product development, and policy administration. Instead, companies should reallocate capital to higher return-on-equity (ROE) activities and away from lower-ROE lines of business. Proactive measures are critical given the sector’s highly competitive pricing environment.

Resource allocation should also be employed across various strategic lines, not just products. Based on our research, the threshold for outperformance is the reallocation of 60 percent of surplus generated over a decade. Insurers that optimize their business mix accordingly have a better chance of improving their odds of ascending the power curve.4 This threshold parallels our findings across industries that dynamic resource reallocators gain approximately three to four more percentage points of total return to shareholders each year compared with low reallocators.

For example, a global life insurer based in Europe evolved from a Europe-centric company around 2005 to one with an international focus a decade later. The company identified new opportunities—the significant protection gap in Asia and the transition of US baby boomers into retirement—and reallocated capital to new, high-return business segments. Due to the refocus on business in Asia and the United States, the carrier’s international earnings grew three times faster than those from Europe over the past ten years. It is now in the top quintile of the insurance industry’s power curve.

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Other companies have increased economic profit by divesting underperforming assets. In the wake of the financial crisis of 2007–08, we saw a number of companies exit underperforming businesses through closed-block transactions through either legal entity sales or reinsurance transactions. These transactions were with organizations that were more natural owners of the distressed assets by virtue of their capital structures or business models. These back-book transactions, when thoughtfully structured, have freed up capital that helped move sellers up the curve. For example, in 2017, a US-based life insurer sold its closed blocks of individual fixed, indexed, and variable annuities, which represented around 30 percent of its capital. These transactions allowed the insurer to continue focusing on its capital-light businesses.

**Bold move #2: Reinvest a substantial share of capital in organic growth opportunities**

Reinvesting earnings in profitable and well-performing businesses is a reliable way to increase economic profit, but finding these opportunities has been challenging for many insurers over the past ten years. Companies meet the threshold in this area if they are in the top 20 percent of the industry by strategic reinvestment relative to new business premiums; typically, that means spending 1.7 times the industry median.

Often considered innovators in the industry, companies that achieve this high ratio of reinvestment to sales have a track record of introducing disruptive products and services, enabling them to grow faster than their peers. Indeed, these insurers are successful at finding accretive internal rates of return. And as they push the boundaries of new offerings, they are often able to achieve higher margins (and ROEs) thanks to the reduced competition at the vanguard.

One Chinese insurer created a wholly owned technology subsidiary, which has separate management, governance, and infrastructure. Through this entity, the insurer invests 1 percent of its revenue each year into new ideas to support its property-and-casualty (P&C), life, and health segments. From 2012 to 2016, the company’s economic profit grew at a compound annual growth rate of more than 50 percent, allowing it to move significantly up the power curve.

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**Behind the original power curve research**

In *Strategy Beyond the Hockey Stick*, a McKinsey research team analyzed the performance data of more than 2,300 companies across industries, using economic profit as the barometer for success.¹ These findings helped define the power curve, which refers to a representation of the uneven distribution of economic profit across companies. Further, the team found that having a broad view of different industries and the strategies employed helped pinpoint which moves make the biggest impact on a company’s economic profit and its position on the curve over time. Indeed, a company’s trends and endowments (what a company starts with, such as size and financial flexibility) can contribute significantly to its odds of success. The team discovered, however, that five bold moves, especially when pursued in combination, had the greatest odds of moving a company up the power curve. Endowments and trends may give companies an advantage, but bold moves are what can help them beat the odds.

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Bold move #3: Pursue thematic and programmatic M&A
The third move centers on the use of programmatic M&A, an important approach for insurers with financial flexibility and access to available targets. A programmatic approach to M&A focuses on executing a series of deals in which no individual deal is larger than 30 percent of market cap but in which the total over ten years is greater than 30 percent of market cap. This is often done in thematic areas of technology and capability building or in extensions to new product lines and geographic markets. Typically, programmatic M&A outperforms both pursuing very large transactions and avoiding M&A altogether. By using a series of small, thoughtfully curated transactions to advance innovation and growth, programmatic acquirers have several advantages: they can simplify integration, avoid competitive bidding, and facilitate the exploration of new opportunities without committing large amounts of capital up front. This approach to M&A also enables more effective acquisition of new capabilities, such as digital and analytics.

To overcome an aging population and domestic competition, a multiline insurer based in Asia decided to extend its product offerings to international markets without committing too much up-front capital. To do this, the insurer undertook a series of programmatic acquisitions, focusing on companies with select products in promising geographies. In the United States, for example, the company made several acquisitions that added access to the global market and key capabilities, including specialty P&C and group employee benefits. In the early 2000s, profits from the insurer’s international business accounted for 3 percent of total profits. By 2018, that share increased to 45 percent. The result was that the company, which was in the bottom quintile of the power curve over 2003–07, was in the top quintile ten years later.

Bold move #4: Enhance underwriting margins
The fourth bold move involves making ROE improvements through better underwriting and lower loss ratios—a particularly important objective given how, as a core competency of all insurers and particularly in the P&C segment, underwriting efficiency can serve as a differentiating factor that leads to higher economic profit. Insurers accomplish these results either through privileged access to particular customer segments or better use of customer or risk data through analytics. Benefits from productivity improvement are often reinvested to improve product margins. To maximize the odds of moving up the curve, companies need to be in the top 30 percent of the industry by gross underwriting margin.

A North America–based P&C insurer expanded its underwriting and portfolio services using machine learning, which improved its risk selection and

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pricing sophistication and reduced its loss ratio by up to 3 percent. Analytics tools developed in-house predicted the frequency of large property losses in North America. The company also increased the rigor of its portfolio management and exited certain large commercial line property accounts in North America—for example, it terminated relationships with brokers of high loss ratios to focus instead on top-decile accounts. This company’s move up the power curve, which has just begun, is already showing impressive momentum.

**Bold move #5: Make game-changing function improvements in productivity**

Insurers feel continued pressure to reduce costs because of increasing price transparency, the effects of digitization, and low interest rates. Indeed, new entrants are closing the gap on incumbents: McKinsey Insurance 360° research shows that digital attackers have a 40 percent advantage. It’s generally recognized that even though the loss ratio has the greatest leverage, insurers benefit significantly from improving efficiency, lowering expense ratios, and increasing revenues per employee. Many executives in the industry believe that a dramatic wave of efficiency and retooling will crest in the next three to five years, and many are embarking on these high-ambition, enterprise-wide efficiency journeys now.

Our research shows that to maximize the odds of entering the top quintile, companies should aim for a cost improvement that is in the top 30 percent of the insurance industry.

One global multiline insurer, for example, embarked on a transformation effort that focused on digital technologies to improve productivity. In 2015, the insurer announced that an essential part of its agenda was to become digital at its core, with the ambition of generating at least €1 billion in productivity improvements annually by 2018. To reach its goal, the company undertook several efforts, including a two-speed IT architecture to react quickly to changing customer preferences and a harmonized global operations model with shared service centers as key enablers. As a result, the insurer has achieved strong performance across the board, with ROE in 2018 across P&C, life, and asset management that exceeded 2015 performance. Further, the company was able to maintain its position at the top of the power curve even as almost half of its peers moved downward after the financial crisis.

Most of the carriers discussed in this article deployed at least two out of the five bold moves. The odds of moving up the curve become exponentially larger as insurers pull more levers, while a strategy that does not incorporate any of the moves will likely fail. Indeed, the CEO, CFO, other senior executives, and board members can often use these bold moves as a test of strategies brought to them by their teams. Strategies that neglect to engage these actions typically have a nearly one in ten chance of succeeding, compared with one in two (or better) for those that do.

Rather than thinking about strategy as primarily a matter of frameworks and broad themes, leaders should ask themselves what they are doing to make bold moves along the five dimensions that matter and whether efforts already underway are truly significant. The extent of the moves matters a great deal—materiality matters, not just directionality. And CEOs are in a unique position to calibrate materiality; this, in fact, is one of the greatest aspects of their role and a productive means of challenging their teams. If proposed plans don’t meet the required threshold of activity to bend the odds of moving

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up the power curve, they are likely not aggressive enough. What often gets in the way is a resource allocation process hindered by social dynamics. Other common obstacles include a lack of objectivity on opportunities and an insufficient understanding of critical thresholds needed to move the needle. As a result, too many companies simply check the box on certain priorities while investing too little in the ones that truly matter.

Improved economic profit is within reach for insurers that can adjust their business models in the face of an efficient market and inject a newfound objectivity into their strategic processes. Indeed, insurers that have a favorable endowment, navigate industry and geographic trends, and make bold moves will be in a good position to climb the power curve.

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