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Navigating Through Uncertainty in U.S. Commercial Insurance Distribution

Financial Services Practice

Introduction

The distribution of commercial lines insurance in the U.S. is facing a number of shifts that could alter the dynamic between insureds, brokers and carriers. In order to continue to thrive in the changing landscape, and maintain their partnerships with brokers and end clients, property-casualty (P&C) insurers will need to enhance the value they deliver and develop new services that meet the evolving needs of brokers and insureds. It will be an uncertain time, but for those carriers able to adapt, it will also be a rewarding one.

The overall commercial lines risk mix in the U.S. is rebalancing, as new risks such as cyber-attacks emerge. At the same time, corporate insureds are retaining more of the risks that they traditionally transferred to carriers. Greater transparency on the cost of risk and more sophisticated internal risk management functions are raising the bar for carriers to deliver more sophisticated and personalized offerings. Finally, large brokers, which already capture a significant portion of the total value in the industry, are gaining greater scale and building advanced capabilities. As these changes take hold, the lines between brokers and carriers—already somewhat porous—will begin to blur, with brokers taking on more risk consulting and carriers evaluating opportunities to bypass brokers and go direct to insureds, particularly in the small commercial segment.

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Brokers: Building on Current Strengths

Brokers have captured a significant share of value in the U.S. commercial lines market in the past decade, delivering total return to shareholders of more than 10 percent, while carriers have delivered between 3 and 5 percent. Based on a number of trends, brokers appear likely to continue to earn a large share of the total value in the industry.

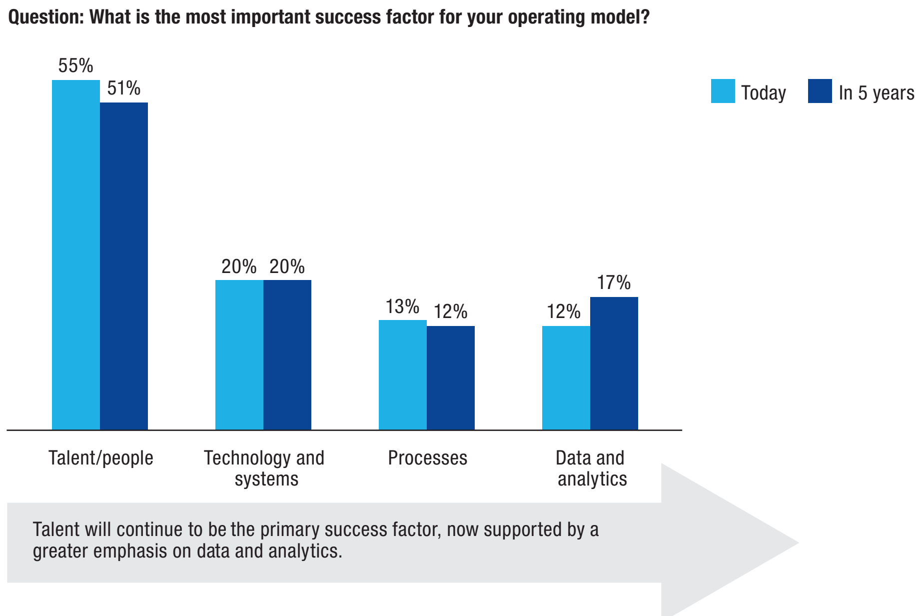
- **The big are getting bigger.** Large brokers continue to grow through mergers and acquisitions, with over 451 transactions announced in 2015—194 involving brokers in the top 25 by brokerage revenue. The share of total U.S. commercial lines premium controlled by the top 10 brokers increased almost 10 percent between 2007 (34 percent) and 2014 (46 percent). This consolidation will likely continue as the largest brokers continue their aggressive inorganic growth plans. Scale allows brokers to launch efficiency programs that can fund increased growth and consolidation. Few small brokers can provide access to big portions of a market segment, while brokers with a large presence in a market can more easily influence carrier terms and pricing.

- **Corporate insureds are seeking more risk management consulting and expertise.** Corporate insureds are retaining more risks on their balance sheets, aided in part by increased transparency into the cost of risk through data and improved analytics. This increased risk retention changes the balance of needs for insureds. While on one hand insureds are becoming more sophisticated in terms of risk management, they also need more tools with which to evaluate and manage risk. Risk managers and decision-makers at corporates are increasingly relying on a broad set of firms—including brokers, risk consulting firms and carriers—to provide this support. Given their more direct relationships with most insureds, brokers are well-positioned to take on this role.

- **Data has transformed broker risk insights**. A number of large brokers are investing heavily in deriving risk insights from data, and as they collect and centralize information about client needs and the pricing of risk, the commercial lines market is becoming more transparent. This increased transparency can drive price-based competition and enable brokers to generate further insights that fuel innovation in product design and market growth in a virtuous

Exhibit 1

For carriers, the shift to data and analytics capabilities will be critical



Source: McKinsey Broker Survey, 2016

cycle. According to a recent McKinsey survey of middle-market brokers, the importance of data and analytics to the broker operating model is expected to grow faster than any other component (Exhibit 1), a finding with strong implications for the kind of talent that brokers hire (e.g., data analysts). Again, brokers, with access to data for large numbers of clients, have a competitive advantage here.

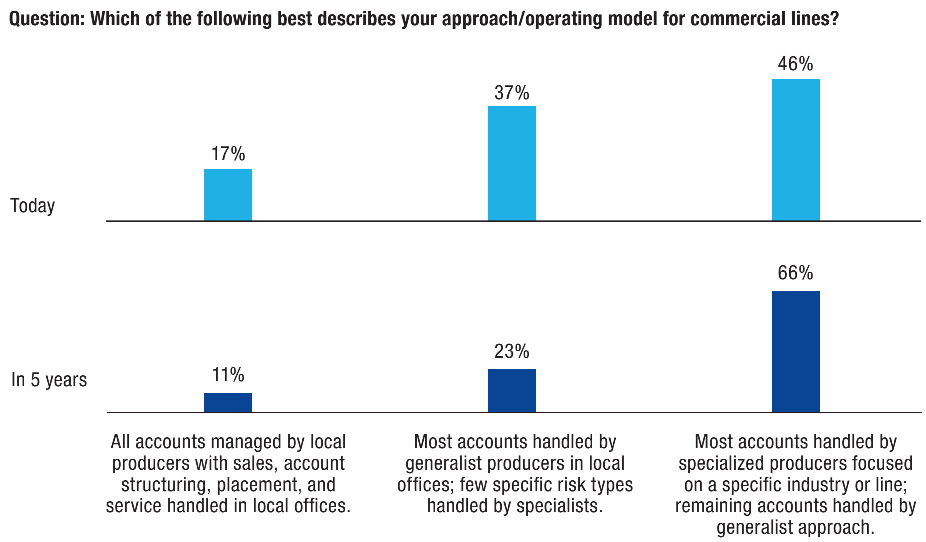
Against the backdrop of these trends, even the largest brokers are now undergoing rapid change, becoming more specialized and ramping up their capabilities in advice and analytics.

- *Specialization*: Brokers are building targeted expertise and specialization in key industry verticals and lines of business. Major players are also taking a global approach to certain industries in order to deliver tailored product and industry knowledge in local markets. Two-thirds of the middle-market brokers surveyed by McKinsey expect to shift to a more specialized model in five years, with producers focused on targeted industries or lines, compared to 46 percent that take this approach today (Exhibit 2).

- *Advice and analytics*: As corporate insureds retain more risk and invest in more sophisticated risk management functions, brokers are responding by investing in moving up the value chain to provide advisory support on risk retention decisions, captive management and claims consulting. While advanced analytics in insurance has historically focused on underwriting and claims, forward-looking brokers are seeking to expand the use of analytics to distribution. Brokers can derive value from data on carrier behavior and corporate insureds' risk and buying behaviors.

Exhibit 2

Specialized capabilities will be needed to support a client-centric operating model



Source: McKinsey Broker Survey, 2016

- *Broader footprint:* As premiums consolidate in the mid and large corporate segments and as technological innovations allow for more efficient operations, brokers may expand to adjacent market segments such as small commercial insurance and high-net-worth personal lines.
- *Strategic market relationships with carriers:* Successful brokers are taking a strategic approach to developing their carrier portfolios, in an effort to maximize commissions, ease placement and servicing processes, deploy required carrier expertise and provide a sufficient range of options for clients.

Carriers: Adapting To a Changing Distribution Landscape

Brokers will continue to wield significant power in the U.S. mid and large commercial lines market, but there are steps that carriers can take to adapt and deliver enhanced value to both insureds and broker partners.

- **Prioritize strategic broker relationships.** In addressing a changing landscape, carriers must start with a strategy for segmenting, prioritizing and managing their broker relationships, and clarify to their partners how they will deliver value. Prioritization of market segments or lines of business should be based in part on growth potential. Once they establish broker segments, carriers should determine which tools, incentives and approaches they will use to support relationships with individual firms in that group.

- **Become invaluable partners.** Brokers are seeking carriers that can provide tools, data, insights and concrete expertise. Carriers should focus on developing targeted, differentiated capabilities that can deliver tangible differences to the end customer and streamline placement processes to help brokers be more efficient and profitable.

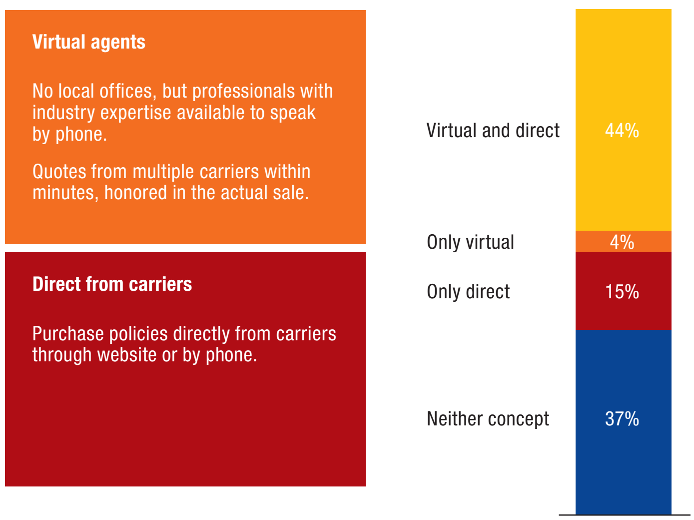
- **Specialize in reducing—not just underwriting—risk.** As the percentage of covered risks decreases, carriers will need to expand their capabilities in managing and reducing risk, and target skills in areas where new peril types are emerging, such as geopolitical risk. The result could be proprietary value-added services (e.g., risk control and mitigation tools) in areas with the highest potential for growth and value. These could include services that serve multiple functions; for example, an industry-specific risk control engineering function that is also used to deliver advice.

- **Build "sales-force effectiveness" capabilities.** Sales-force effectiveness is not an approach typically associated with insurance. But for carriers, sales culture and execution is likely to become an important differentiator in the coming years as brokers refine the list of carriers that they are willing to partner with. To meet this bar, carriers will need new talent to fill roles aligned to the sales culture, and a new focus on optimizing compensation and incentives.

Exhibit 3

About 65% of small commercial customers are interested in direct or virtual agencies today

Question: How interested would you be in the following distribution models?



Source: McKinsey Small Commercial Insurance Buyer Survey, 2015

- **Build alternative distribution in targeted areas.** For some carriers, direct-to-consumer distribution will be a critical capability, particularly in markets, such as small commercial, that are under-served by brokers today.[1] Close to 65 percent of respondents to a McKinsey survey of 1,500 small commercial insurance buyers said they would be open to either virtual or direct distribution in small commercial (Exhibit 3). To begin, carriers can invest in direct or alternative distribution in this market without impacting their broker relationships. However, the movement to direct in small commercial is likely to be a precursor to similar moves in the middle and large market. The effect this will have on carrier-broker relationships is uncertain.

- **Invest in marketing and brand differentiation.** Carriers will need to invest more heavily in marketing to demonstrate their expertise and differentiation. Branding will become one of the most important areas where carriers can communicate their differentiated value and maintain some strategic flexibility in their broker relationships. Branding can create demand from insureds, particularly in specific sectors (e.g., carriers with a focus on the construction sector should ensure that their robust sector-specific data sets and insights are clearly defined and visible). Finally, branding must be tightly aligned to a carrier's unique sources of differentiation and activated in the right channels (e.g., industry events). Branding and marketing in commercial lines insurance will never reach the level of importance it has in personal lines, but it will become more necessary, and must be implemented in a targeted way to be effective.

[1] See "Small Commercial Insurance: A Bright Spot in the U.S. Property-Casualty Market," McKinsey & Company, March 2016.

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A number of trends are changing traditional industry dynamics for U.S. commercial lines insurers. Their distribution partners, brokers, have been gaining influence for some time, and appear likely to continue to do so. The end customers—the insured companies—are retaining more risk and therefore looking for new kinds of risk management support beyond insurance capacity.

To maintain their important position in a changing market, insurers will need to deliver new capabilities and insights, and ensure that the value they add is clear and demonstrable. Decisive action on operating models, value propositions and capabilities will be key to determining which carriers emerge successfully in the new environment.

Questions for management

As they consider their strategy for a changing commercial lines insurance marketplace, senior leaders at P&C insurers should consider the following questions:

- What are the highest-priority customer segments and which brokers will help us reach customers in these segments effectively?
- How do we add value to insureds through their broker partners?
- How can we enhance our market-oriented capabilities to partner with brokers on a more equal footing?
- How can we identify and support brokers who are developing deeper specialization and enhance their value proposition to insureds?

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