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Insurance Practice

The post-COVID-19 pricing imperative for P&C insurers

Pricing excellence has always been a prerequisite for value generation, but it will be even more critical as insurers recover from the crisis.

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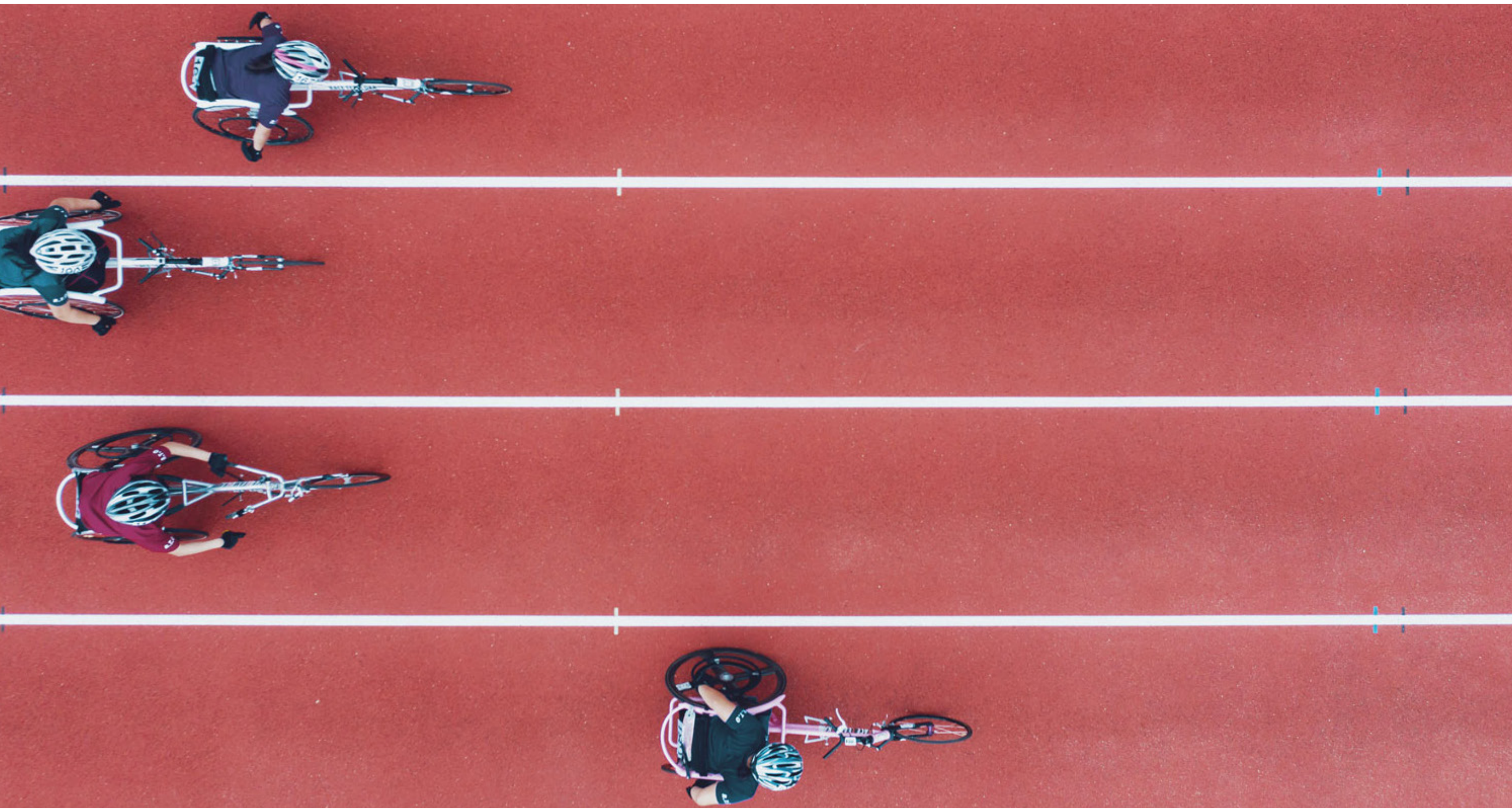

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With the global economy reeling from the COVID-19 pandemic, the pressure on the property and casualty (P&C) insurers' revenues is intensified. The expected dramatic decline in global GDP and the strong correlation of GDP with gross written premiums (GWP) imperil the P&C insurance industry's financials (Exhibit 1).

As a result of the economic crisis, the shrinking economic pie will spur fierce competition. Insurance carriers have already launched aggressive marketing campaigns to reduce customer churn and attract new business. Some are lowering future premiums, others are returning a portion of current premiums to customers, and still others are offering customers free temporary add-ons, such as new policies or extended coverage periods. P&C insurers are likely to roll out further sales strategies in the next normal.

This market is problematic for many insurers: in the face of aggressive competition and price wars, insurers have tended to sacrifice long-term profits for short-term growth. Even before the pandemic, most global insurance carriers failed to generate value.[1] Our power curve analysis shows that the distribution of economic profit within the industry is quite heterogeneous [2] (Exhibit 2). Indeed, about one-fifth of global insurers destroy significant value, while around 60 percent are at least able to earn their cost of capital. Only 20 percent of global insurers actually generate positive returns for their shareholders.

Profitable P&C insurers have few similarities: they differ by region (footprints vary among Asia, Europe, and the United States) and customer or channel segment. However, they all emphasize pricing innovation and underwriting excellence and recently have made significant investments in them. Because pricing will be a primary differentiator for long-term value generation in P&C, it should be an integral part of every insurance carrier's COVID-19 response strategy.

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[1] This applies to most listed insurers. The priority for a subset of insurance carriers (for example, mutuals) may not align with metrics such as return on equity.

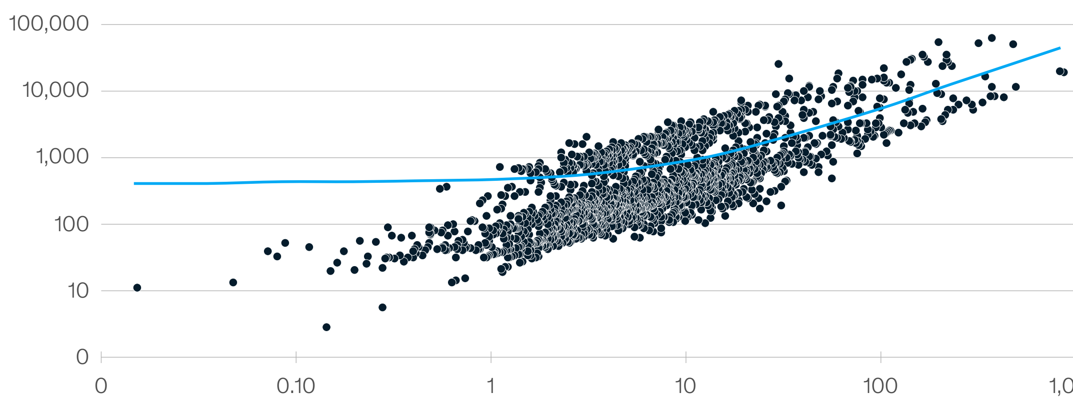
[2] The power curve reflects the economic value added, which equals the value creation above the economic cost of capital—that is, the return on equity less weighted average cost of capital, multiplied by shareholder equity. See Alex D'Amico, Mei Dong, Kurt Strovink, and Zane Williams, "How to win in insurance: Climbing the power curve," June 2019, McKinsey.com.

Exhibit 1

The prospects of P&C insurers are tied to GDP.

US cities, 2010–25 (forecast)

GWP[1] growth, $ million (2010 dollars)



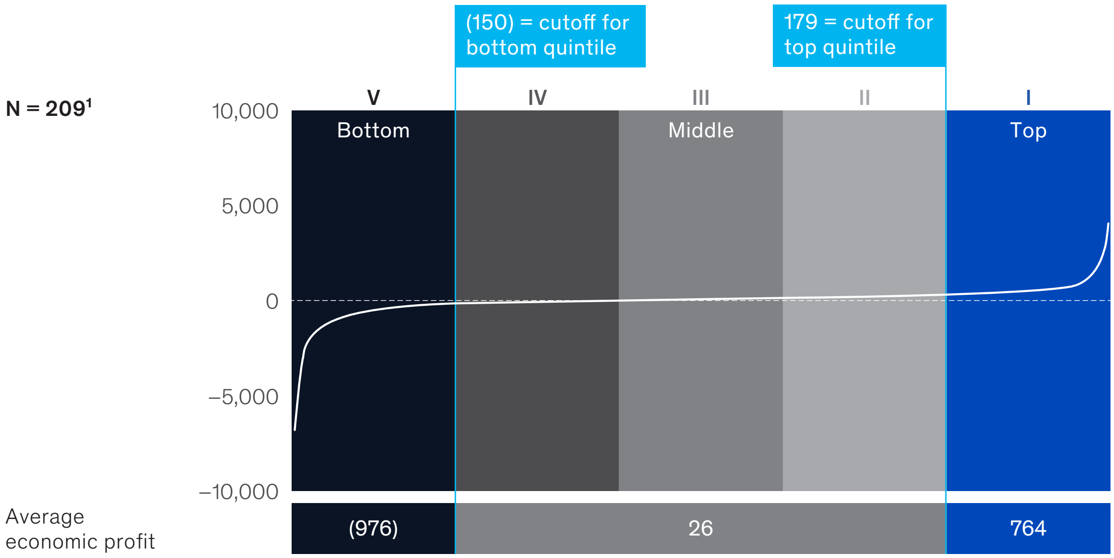
GDP growth, $ billion[2]

[1] Gross written premiums.
[2] At real exchange rate (adjusted for inflation and exchange rate changes).
Source: McKinsey Global Institute Cityscope 2.0; Global Insurance Pools

Exhibit 2

The power curve: Profit is distributed unevenly among global insurers.

Average economic profit, 2013–17, $, million



[1] Sample includes all insurance companies with insurance revenues greater than $1 billion in 2017.
Source: Corporate Performance Analytics by McKinsey

How pricing fuels profitable growth

Before executives can make the right investments in pricing, to yield profitable growth and create significant value, they must first understand how pricing can be the source of a sustained competitive advantage. Typically, the competitive advantage emerges in these four steps:

1. Leaders in pricing innovation invest in data infrastructure to better harness internal data and, perhaps more important, data from external sources. Sophisticated insurance carriers evaluate more than 30 new external data sources and then select two to four sources each year that they use to develop new features to embed in their pricing and rating models.

2. With a superior data infrastructure in place, leaders then invest in pricing technology and self-learning algorithms. These tools have the appropriate granularity and bandwidth to generate price quotes that regularly beat the market while still maintaining profitability and avoiding adverse selection.

3. Next, leading insurers invest in capabilities that generate the traffic required for leads and initial quotes. For example, they use advanced analytics to allocate significant spending on online marketing to the most valuable customer segments and channels.[3]

4. Every quote generates an additional data point, irrespective of a customer's final purchasing decision. The details from each transaction are looped back into the algorithms.

Taking this approach, which is constantly reinforced by new data, enables leaders to outperform competitors with more precise pricing. With every quote, insights get better and better.

Building a competitive advantage in pricing has become a strategic imperative. As the insurance industry matures and existing products in both personal and commercial lines commoditize, P&C insurers must increasingly maintain a clear focus on improving the accuracy of pricing and

[3] Via value-based modeling, for example.

underwriting in order to outsmart and outperform the competition on price.

Five levels of pricing innovation and transformation

McKinsey's underwriting and pricing practice group has reviewed and compared multiple pricing transformations at global insurers. Based on this research, we identified five archetypes of pricing innovation and transformation strategies (Exhibit 3). Each level reflects an insurance carrier's maturity level and the strategic priority of its pricing program.

Consistent application of generalized linear models (GLMs)

We observe that the majority of insurers in different markets have consistently prioritized the application of GLMs for all risk models and product types. This approach serves as the starting point for most pricing innovations and transformations.

Based on our pricing-capability assessment benchmark, a bit more than half of all P&C insurers in Europe and the United States have already attained this stage. This level still marks a step up from the current risk modeling practiced by the lower half of the market.[4] Insurers that master the rollout of GLMs invest heavily in upskilling and hire actuarial personnel with the requisite modeling skills.

A large book of business and the potential pricing effects for renewal contracts pose a significant challenge for many insurers, since even a small pricing mistake can have an outsize effect as it works its way across a multibillion-dollar book.

AI-based and machine-learning pricing tools

A smaller group of global insurance carriers has leapfrogged the first pricing level or has built upon existing GLMs. This group of insurers has started to implement AI-based, automated pricing tools, which offer these advantages:

— AI-based modeling enables the development of risk and pricing models with high quality and validity (measured by the Gini coefficient[5]) through AI-based iterative testing.

[4] Which typically still uses combined frequency and loss-risk modeling as well as static pricing rules. For example, several small regional insurers use the same motor- and home-rate plan they did more than ten years ago.
[5] A measure of the inequality among values of a frequency distribution.

Exhibit 3

Insurance carriers can be classified by level of pricing innovation and transformation.

Level of pricing sophistication →

	Consistent application of GLMs[1]	Use of AI-based or machine-learning pricing tool	Implementation of robo-pricing[2]	Product simplification for the right pricing	Full-scale pricing transformation
Description	Consistently applies "unconstrained" GLMs to all risk models and product types	Implements AI-based, automated pricing models to leapfrog rate-making process using GLMs; alternatively, could build on existing GLMs	In addition to using GLMs and AI, understands real-time market dynamics and uses robotics for ongoing, automatic pricing including sales development	Adjusts product structure and eliminate highly unprofitable tariff cells and product modules; enables end-to-end product value chain optimization and behavioral pricing	Approaches pricing transformation comprehensively, including current capabilities, people culture, organizational design and structure, data and tech strategy

[1] Generalized linear models.
[2] Unavailable in the United States.

— Time to market is significantly reduced for these insurers, since AI-based risk modeling can be completed much faster than the manual test-and-learn approaches of some other models.

— Furthermore, automated processes allow an insurer to leapfrog GLMs if the company lacks the talent required to apply them consistently.

The wider adoption and more efficient use of AI-based tools and approaches are enabled by the exponential increase of data, more processing power (of cloud computing, for example) at reduced costs, and recent advances in the area of explainable artificial intelligence. While these tools can help insurers quickly achieve tangible impact—for example, enhanced pricing and faster times to market—they shouldn't be implemented in a stand-alone fashion. Organizations that do so risk failing to develop the capabilities they need for long-term competitiveness.

Implementation of robo-pricing

Historically, insurance carriers have struggled to incorporate price sensitivities and customer behavior,[6] customer lifetime values,[7] and external market data in their pricing processes. In particular, the ongoing screening of market price movements and the inclusion of this external information in market-based pricing—eventually with continuous updating—have been challenging.

For the past couple of years, insurers around the globe have been integrating robotics into two areas of the pricing process: enhancing market understanding and transparency, and adjusting prices automatically and dynamically. While the former (for example, web-crawling robotics[8]) can be used by insurance carriers in many major markets, the opportunity to harness robotics for dynamic-pricing adjustments varies by market. Robo-pricing does not apply to some markets, such as the United States, where price changes need to be approved by local regulators, making dynamic and real-time price adjustments difficult (or impossible) to implement. Therefore, insurers should assess this capability based on the regulatory environment in which they operate.

Product simplification as a prerequisite for optimized pricing

An increasing number of European insurance carriers pursue a pricing approach characterized by product simplification, which forms a basis for enhanced pricing. By analyzing customer demand for tariff combinations and optional modules, as well as eliminating unused offerings, an organization can reduce complexity and costs for IT, operations, and claims.

Insurers can achieve more competitive pricing by simplifying the product structure and cutting unprofitable product modules that are susceptible to adverse selection. In most cases, removing product variations enhances diversification, which also improves loss ratios. This simplification positively affects risk capacities, premium levels, and pricing competitiveness. In addition, by implementing new product features that customers actually want, insurers using behavioral pricing might be able to charge price premiums.

A pricing strategy that builds on a simplified product portfolio depends in part on a thorough end-to-end optimization of the entire product value chain. This effort includes the systematic integration of external market data from customer insights and competition screenings in addition to the collaboration of operations, claims, and IT to estimate the savings realized from reduced product complexity. Last, insurers must also educate their sales teams on the benefits of simplified products to ensure their adoption.

Full-scale pricing transformation

A full-scale pricing transformation focuses on building the right infrastructure to achieve substantial and sustainable improvements in pricing through the effective management of all functions across the organization.

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[6] Ensuring value maximization for all price quotes for new and renewal business by optimizing commercial pricing based on behavioral information and price sensitivity.

[7] Adjusting pricing based on the predictive assessment of value generated by individual risks across perils—for example, by granting premium reductions to customers with high expected lifetime value.

[8] As an additional means of integrating external data sources, web crawling should also integrate quotes and respective customer behavior from the insurance carrier's own webpage, which is typically a heavily underused source of insight.

Our market observations suggest that pricing excellence can be achieved through improvements in seven areas, ranging from underwriting strategy and risk selection to technical, market-based, and behavioral pricing to execution and governance (Exhibit 4). These foundational building blocks are supported by elements such as organization and talent, as well as advanced analytics and digital capabilities.

A full-scale pricing transformation typically includes establishing an organization's current capabilities as a baseline, setting the vision, and developing and prioritizing a comprehensive set of use cases. Insurers should proceed with creating the initial road map, designing the operating model and governance, and evaluating any potential shifts in the operating model.

In our experience, insurers that have successfully implemented these pricing levels achieved considerable impact (Exhibit 5).

How to position your organization in the pricing race

The path forward depends on insurers' prerequisites and strategic priorities. A three-step self-assessment can help executives identify the type of pricing innovation and transformation that might be the best fit for their company's current position.

1. Start with diagnostics

As an initial step, insurance carriers should evaluate the maturity of their current pricing capabilities, including pricing and underwriting processes, tools (such as AI and advanced analytics), and organizational structures.

2. Get insights on market opportunities

To determine the relative pricing competitiveness, executives should compare their organization's pricing maturity with that of the market environment. Local market interviews with experts and anonymized comparisons can be helpful sources of insight. In addition, insurers should identify potential partners for supplying services such as robo-pricing and AI-based pricing.

3. Select the pricing level that best suits strategy

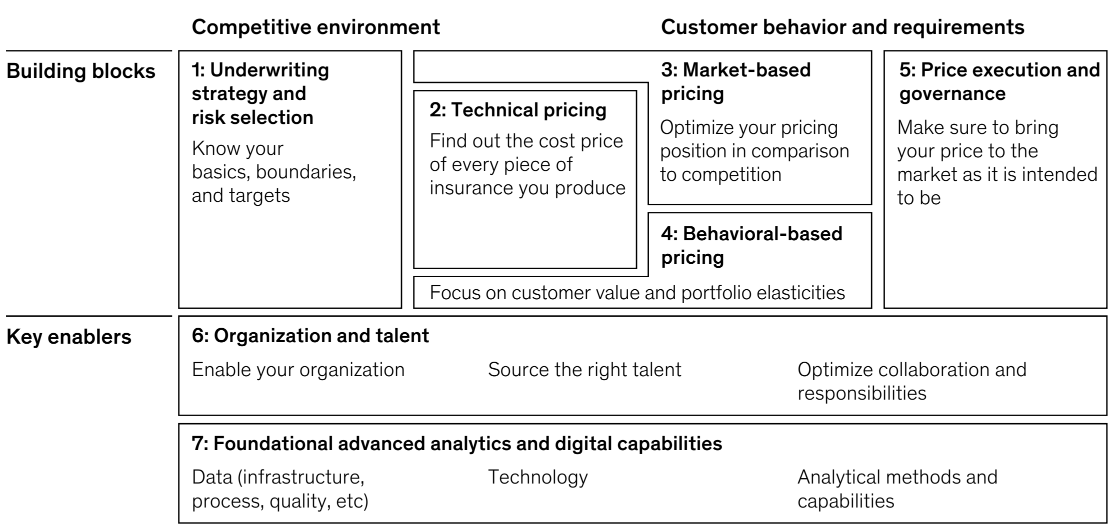
To choose a pricing level, executives should consider the following questions:

— How many and what type of resources (for example, money, talent, and management time) are available for the planned pricing transformation?

Exhibit 4

P&C insurers can attain pricing excellence with improvements in seven areas.

McKinsey Pricing Framework



Source: McKinsey Personal Lines Pricing

Exhibit 5

Good results have been observed for insurers of all five archetypes.

Level of pricing sophistication →

	Consistent application of GLMs[1]	Use of AI-based or machine-learning pricing tool	Implementation of robo-pricing[2]	Product simplification for the right pricing	Full-scale pricing transformation
Impact observed	Improved loss ratio of new business by **0.8–1.5 pp**[3]	Improved loss ratio of new business by **2.1–4.2 pp**	Higher new business profitability by **2–4 pp** of combined ratio	Double-digit growth rates of new business year over year, while loss and cost ratio are improved by **1 pp**	**3–6 pp** of combined ratio improvement
	Improved loss ratio of renewal business by **0.2–0.5 pp**	Improved loss ratio of renewal business by **0.6–1.3 pp**	Higher new business premiums of **10–15%**		**3–4%** Additional GWP[4] growth
			Improved retention by **10–12%**		Reduced severe cross-subsidization of more than **20%** and therefore, anti-selection for **10–15%** of the portfolio

[1] Generalized linear models.
[2] Unavailable in the United States.
[3] Percentage point.
[4] Gross written premiums.

— How competitive is the company's current tariff and risk model?

— Does the business already include external market data in its current pricing processes?

— How urgent is the need for change—is short-term impact or long-term returns the current priority?

— What is the company's differentiation by channel?

— Are there any regulatory restrictions?

The pricing-transformation-journey road map can be developed based on the selected level. The total amount of time required for implementation will vary by pricing level and the products included in the transformation's scope.

COVID-19 has put substantial pressure on the global economy and insurance industry. The majority of P&C insurance carriers have already launched initiatives aimed at boosting top-line revenues. However, the insurers that regularly create the most value make a sustained commitment to pricing and underwriting excellence, which generates a self-perpetuating competitive advantage.

Every insurer has the potential to significantly improve its pricing strategy and capabilities. The key is to select the right pricing transformation approach.

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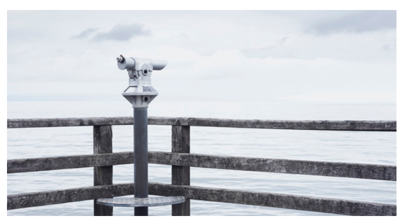

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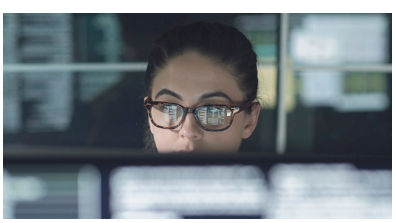

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