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# State of property & casualty insurance 2020

The reinvention imperative

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# Foreword

The insurance industry is often perceived as complicated and slow moving. Yet insurance is one of the largest global industries, generating more than \$5 trillion in annual revenue. It plays a critical role in today's economies, offering financial protection and risk mitigation to individuals, small businesses, large corporations, nonprofit organizations, and even governments. As a whole, property and casualty (P&C) insurance represents \$1.6 trillion in premiums (about one-third of the insurance industry) and remains one of the few industries that has yet to be disrupted.

## **The three Rs: Resilience, relevance, and reinvention**

As a notable achievement in the financial-services world, the insurance industry has grown economically stronger in the past two decades after sustaining \$45 billion (2020 prices) in insured losses from the terrorist attacks of September 11, 2001—then the costliest event in the history of insurance globally. And in the past few years, natural disasters have led insurers and reinsurers to pay hundreds of billions of dollars in claims, an unprecedented amount of losses. Despite these claims payments, the most recent natural disasters have been earning events for insurers, not solvency ones—perhaps a testament to the industry's resilience. But this resilience will be tested in the years to come through the changing severity and frequency of disasters coupled with limited flexibility to balance market-driven price responses in the changing risk level, continued low interest rates, and changes to the traditional business model.

In fact, as innovation and technology significantly transform entire industries, P&C overall has largely been running in place. Industry growth relative to GDP is flat or even negative in several developed markets, valuations in the sector are often lower compared with adjacent financial-services sectors such as banking and asset management, and new talent acquisition isn't prioritized, despite more than one-quarter of its most experienced professionals soon retiring in key geographies. Furthermore, despite improvements in labor productivity, overall cost performance has not improved in the past 15 years. The P&C industry is being outpaced on total productivity by sectors from automotive to telecommunications to banking. In the face of current and emerging advances in fintech and digital distribution, the P&C industry's existing operating model faces challenges and risks losing economic relevance.

Moreover, the fast-changing risk landscape is creating many new and evolving risks—cyber, climate change, pandemic, intangible assets—that remain underinsured, while others have slowly been transferred to governments to handle. This shift creates significant insurance gaps. However, it also presents substantial opportunities for P&C insurers that can innovate,

serve clients more comprehensively, and capture value across an increasingly sophisticated traditional value chain that is being reshaped by factors such as B2B2C, alternative capital, and direct sales. Insurers must also be proactive in setting (perhaps even shaping) a clear agenda on environmental, social, and governance (ESG) issues.

As this report goes to press, the entire world is facing the deadly spread of COVID-19. The unfolding human tragedy will have massive short and long-term social, economic, and geopolitical implications. While it is too early to assess the full spectrum of its impact on the insurance industry, we will be monitoring the situation as it evolves. For more, see the P&C memo by the same authors, “Coronavirus response: Short- and long-term actions for P&C insurers.”

Given the fragmented nature of the industry, new models of collaboration—including with governments and regulators—will need to be tested to help carriers transition to this future state, as no single insurer can efficiently and repeatedly absorb first-mover costs as change accelerates. The industry must reinvent itself.

### **A call to action**

This report paints a nuanced picture and provides a call to action. On the one hand, some geographies are winning over others, and leading CEOs are inspiring their organization to be true market shapers (those in the top quintile by measure of economic profit) by making the necessary bold moves and executing them relentlessly. Those carriers are success stories. On the other hand, a number of insurers have created limited economic value, if any at all. In this report, we provide a global view of the P&C industry using proprietary McKinsey data sources, including our Global Insurance Pools database, power curve analysis, and Insurance 360 cost benchmarks. We examine key market structure elements, including growth and profitability, M&A, and distribution. We analyze what market shapers have done differently as a source of inspiration for CEOs. We also explore six key forces that are shaping—and will continue to influence—the evolution of P&C insurance. And finally, our analysis shows how P&C carriers can find a path to higher profitability and sustainable growth once again.

Our research and experience reinforce that succeeding requires bold moves of considerable scale and investment. Now is an exciting moment for the industry, but leaders must act with speed and conviction. We anticipate that the gap between carriers that act swiftly and deftly and those that do not will increase: the former has proportionally more to invest in deploying new capabilities, as they capture most of the industry profits. This dynamic will further increase the gap between winners and laggards in subsequent years.

CEOs, working with the board, have a unique role to play in this context: they must decide what kind of organization they will steward and lead in the next five years, which clients they will serve and focus on, and how they will do so with distinction and relevance.



# Executive summary

**This report** provides a close study of a complex industry. Some developing markets are poised to surpass developed markets by measure of growth, the M&A space is active, and distribution is under attack. And while insurance as an industry may be slow to change, its risk environment is not. The increased occurrence of extreme threats (whether relating to climate or terror), the proliferation of technology and innovation, and the growth of ecosystems, for example, all provide ample opportunity—and risk—for insurers.

Some carriers are flourishing in this landscape. Market shapers have achieved growth, yes—but they have also figured out how to do things differently, achieving sustainability and setting themselves apart from their peers.

So what are insurers to make of the state of the industry? And how can they adapt? This report provides an overview of the P&C industry, what market shapers are doing differently to capture value, and how CEOs can make their organization the next success story.

## Variations across markets

The global P&C industry contributes significantly to the global economy: it generated \$1.6 trillion in premiums in 2018. For a mature industry, it now faces a rapidly changing risk landscape caused by factors such as intangible assets, man-made emerging risks, changing climate patterns combined with growing exposure in high-risk areas, pandemics, the growth of the cyber world, changing customer expectations, and the use of advanced analytics tools, among others.

Given P&C's focus on risk management and financial protection, one might expect the industry to reinvent itself more profoundly to meet the shifting demand and to move the insurability frontier forward.

But the industry as a whole accounted for 2.1 percent of global GDP in 2018, the same share as in 2008.<sup>1</sup> These top-line numbers obscure significant variations in performance and growth across geographies, product lines, and stakeholders along the value chain. Developed countries still dominate by total gross premiums written (80 percent). However, Western European markets, and to some extent the US market, grew slower than GDP, while developing markets in Latin America, the Middle East, and Africa not only grew much faster (at annual growth rates of 11 to 16 percent from 2012 to 2018) but also achieved higher profitability. We expect the fast growth in the developing Asia–Pacific market to possibly surpass Western Europe this decade as the world’s second-largest P&C market.

By comparing market dynamics, we found that P&C overwhelmingly remains a local game in many countries. Domestic carriers regularly dominate their markets, maintaining a higher market share and better profitability compared with multinational players. Executives should carefully review the trade-offs between international expansion and a focus on core markets and reflect on the importance of mastering local distribution and market access.

In addition, the global P&C industry has seen robust levels of M&A activity. The largest deals in the past few years were completed by European and North American carriers aiming to increase scale, smaller companies accessing new digital and advanced analytics capabilities, Asian firms investing more capital into Europe and North America to establish a presence beyond their home markets, and active private-equity and hybrid investors diversifying their portfolio.

Despite this M&A activity, which we expect to continue for the next five years, the industry remains fragmented. This is true even with the personal lines market undergoing consolidation: a few auto insurers in large markets have led the charge as digital attackers and have captured a growing portion of a customer base with changing expectations.

Last, in distribution, intermediaries have significantly increased their clout, especially given the consolidation of global alpha brokers in commercial lines that generated significant value to their shareholders in the past decade. Furthermore, new models such as ecosystems threaten to further divide the industry. We estimate that more than 30 percent of personal lines P&C premiums will be distributed through ecosystem models by 2030. Thus, P&C industry market shapers will have to win on that front. In the future, increasing the value transfer of cheaper distribution to the customers will be key. Our market analysis reveals that today, insurers can spend a multiple in distribution costs as their products generate in profit; in the United Kingdom, for instance, P&C insurers spend three times more in distribution (as percentage of their total revenues) than what they generate in profits; by comparison, the mortgage industry spends half in distribution what it generates in profit.

## What market shapers do differently

To gain a detailed view of the reasons for success beyond decisions on where to operate, we assessed more than 200 insurers around the world. [Our power curve analysis](#) found that from 2013 to 2017, the industry generated an average of \$37 million in economic profit per company (generally accepted accounting principles view).<sup>2</sup> This figure falls short of the \$500 million to \$2 billion generated by industries in the top quintile of our global distribution, such as beverages, automobiles, pharmaceuticals, technology, and biotech.

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<sup>1</sup> Overall, P&C growth written premiums (GWP) over GDP decreased globally by 2 percent from 2008 to 2018.

<sup>2</sup> For a more complete discussion of the power curve see Alex D’Amico, Mei Dong, Kurt Strovink, and Zane Williams, “How to win in insurance: Climbing the power curve,” July 2019, McKinsey.com.

That said, insurance market shapers (those in the top quintile) have already made bold moves in recent years that helped them create significantly more economic value than their peers: on average, these insurers have created more than \$750 million in economic profit—nearly twentyfold the industry average. Market shapers can then reinvest this revenue into new capabilities needed to win in today’s environment, further widening the gap with competitors.

Interestingly, carriers that have made the most progress in creating economic profit have pursued five bold moves:

- *Dynamically shift resources between businesses.* Reallocate at least 60 percent of surplus generated over a decade.
- *Reinvest a substantial share of capital in organic growth opportunities.* Be 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.
- *Pursue thematic and programmatic M&A.* No individual deal is larger than 30 percent of the market cap, but the total value of deals over a ten-year period is greater than 30 percent of the market cap.
- *Make game-changing improvements in productivity.* Reduce costs in line with the top 30 percent of the insurance industry.
- *Positively increase underwriting margins.* Improve underwriting capabilities to be in the top 30 percent of the industry by gross underwriting margin.

## **Navigating an evolving risk landscape: Six shaping forces**

We also analyzed six forces that will shape the industry in the years ahead, each with significant implications for insurers (exhibit). Taken altogether, they indicate that if P&C is to significantly increase its relevance over the next decade, carriers must be prepared to reinvent themselves across the value chain.

1. *A rapidly evolving insurable mass calls for product innovation and a reallocation of portfolio priorities.* In response, P&C insurers will need to adapt their go-to market strategies, embrace modularity in their product offerings, reallocate capital between personal and commercial lines, and compete to insure new types of risks. On commercial lines, for instance, data and cybersecurity (perhaps the new directors and officers insurance), intangibles, and machine-learning liability are examples of new types of risks that need new product offerings. Terrorism risk also remains a real threat to the industry, with many countries having developed their own protection programs.
2. *Uninsured natural catastrophes are creating new market opportunities.* While the insurance industry has become more resilient financially, it has also let a significant portion of risk go uninsured. The evolution of natural disasters and changing climate calls for increasingly sophisticated catastrophe models and pricing approaches. Increasing climate risk will quickly intensify and challenge the insurability of entire regions: the P&C insurance industry can address this issue by forming an industry-wide coalition and collaborating more closely with governments and regulators. And CEOs should be prepared to address how climate change may affect their organization and how they plan on reducing the downside and capturing the upside.

Our culture of preparedness must change significantly to make financial protection and the adoption of risk-reduction measures at scale a priority. Carriers will need to overcome deep behavioral biases in risk selection and pricing that currently constrain adequate protection. In high-risk areas, insurance may

## Six forces will shape the industry in the years ahead.



need to become mandatory, as it is in several countries, to significantly increase financial protection. At the very least, an opt-out option rather than the current opt-in would significantly increase insurance penetration, as behavioral science has shown. Rather than artificially suppressing risk-based rates, governments and insurers will need stronger public–private partnerships (PPPs), including government insurance voucher programs to address affordability issues.

3. ***Evolving data and analytics capabilities are changing the game in acquisition, risk selection, and underwriting and pricing.*** The rise of Internet of Things (IoT) sensors and telematics are providing insurers with more information to improve underwriting. Making thoughtful investments in data and analytics at scale will also be a differentiator in P&C. However, to capture value from their data carriers will need to crack the code on how to efficiently harness their data and shift their talent mix—from a large workforce that prioritizes transactional policy and claims activities toward one focused on higher-value activities enabled by technology.
4. ***A shift to solutions and service as well as the growth of ecosystems is reshaping distribution.*** As insurance purchases become less à la carte and more integrated into customer buying and experience journeys, business as usual may no longer suffice. Carriers will need to take a close look at their relationship with end customers in the context of purchasing journeys (for instance, buying a car, going on vacation, buying a home) and decide how to embed solutions and services alongside insurance coverages. Insurers must sharpen their value propositions and reconsider their cost structure and capital allocation.

Sometimes being a low-cost provider will be the winning model, while in other situations providing the best customer experience will be the differentiator. In ecosystem-oriented models, successful carriers will also need to become better at getting value from the enormous pool of data they have (or can get) access to in order to stay relevant. Insurers could also add more value to services. Similarly, embedding services into the offering will become more important for carriers to provide value to clients beyond the core underwriting function.

5. ***Unchanging cost improvements have made productivity an industry imperative.*** To keep pace with attackers, address the widening gaps between leaders and laggards, and invest in modernizing legacy technology, the industry needs to reset its operational efficiency. In recent years, while labor productivity has risen, overall industry expense ratios have also increased because of upticks in spending on distribution, marketing, and technology. Small to medium-size carriers must explore more innovative, structural changes, including strategic alliances or partnerships, to stay competitive.
6. ***Solving the talent equation should be a much higher priority than it is today.*** Reshaping the workforce for the emerging era of technology-led business models must be at the top of the agenda for any insurance CEO. Leaders will need to focus on building the talent and expertise needed to integrate technology into operations and support customer engagement. Insurers must enhance their value proposition to replenish their workforce and attract the next generation of employees.

Increasing the relevance of insurance in this new risk landscape will likely require carriers to reimagine new ways to collaborate and cocreate with governments and other stakeholders. Indeed, one carrier alone cannot absorb the first-mover cost as the pace of data, technology, training, and customer expectations continues to evolve rapidly. Public–private collaboration can clarify what is insurable and not, by whom and under which conditions, and who will pay for future losses. As risk experts, insurers and reinsurers can help shape the insurability of known and emerging risks. When price reflects risk, insurance can be a powerful market signal for the level of risk that individuals and organizations face. And creating incentives for good behavior can effectively reduce the cost of risk. But when the market can no longer be that signal, as we've seen in several geographies, then it creates a false sense of safety. More generally, insurers and governments need to work together to improve risk awareness and financial protection.

# The evolving market structure and six shaping forces present a range of opportunities for P&C insurers that are prepared to respond with bold moves, execute them extremely well, and do so consistently.

As this report goes to press, we wanted to share our initial assessment of the likely impact of the COVID-19 crisis on the industry. Insurance is closely linked to the broader economy and this pandemic is likely to affect the industry operating model in several ways, with implications for both growth and profitability. While the impact will differ significantly on a line-by-line basis, we expect some decline in premium revenue as a result of the expected economic downturn. The drop may be especially apparent in commercial insurance, which is more vulnerable to economic conditions compared with personal lines. The cumulative losses that the industry might sustain are not yet clear; to date, losses have been concentrated in travel and event cancellation.

The biggest unknown factor is how the industry resolves coverage for business interruption. This will be a true test of the relevance and resilience of the industry. In addition, the crisis poses challenges to industry operating models and may act as a catalyst for changes in them across the entire value chain. It is also likely to reinforce the need to accelerate product innovation and digital transformation, efforts that were already underway at many companies. Lastly, the COVID-19 crisis highlights the potential for public–private partnerships. Because pandemics affect so many people and businesses at the same time, they are typically considered uninsurable by the market alone. This opens the possibility for insurers and governments to collaborate further on improved pandemic risk assessment, risk communication, and financial protection.

## **What type of organization do you want to lead as CEO?**

The traditional insurance business model and value chain is evolving. This progression will create opportunities and risks for carriers, agents, and brokers to take on new roles, cede some existing ones, and adjust relationships with customers. Today's vertically integrated business model is fracturing as reinsurers connect with distribution, primary carriers build direct distribution models, and brokers move into underwriting. The evolving market structure and six shaping forces present a range of opportunities for P&C insurers that are prepared to respond with bold moves, execute them extremely well, and do so consistently.

To succeed, CEOs have an important role of calibration to play. They will need to objectively assess where they can win and then make targeted investments across technology, finance, and talent. Four archetypes—value player, capacity provider, core reinventor, and ecosystem partner—can guide executives where to play and what capabilities to focus on (for instance, [world-class underwriting](#) or launching new products and services). Pursuing one of these archetypes could profoundly transform the organization. This is an even more pressing CEO agenda in the current COVID-19 crisis environment and will continue to be in its aftermath.



# The current state of P&C insurance, and why it matters

This section looks at the landscape of the insurance market across several dimensions: growth and profitability, M&A, and distribution.

## **Despite financial resilience, P&C is losing economic relevance in important developed markets**

The P&C industry is a significant contributor to the global economy: in 2018, it generated \$1.6 trillion in premiums globally and employed more than one million people in North America and the United Kingdom alone. Over the past decade, gross written premiums (GWP) have grown at a compound annual rate of 4.3 percent. Global P&C premiums as a percent of GDP remained relatively stable at 2.1 percent from 2008 to 2018, with declining P&C penetration in developed markets (Europe especially) offset by the significant penetration growth in developing markets (Exhibit 1).

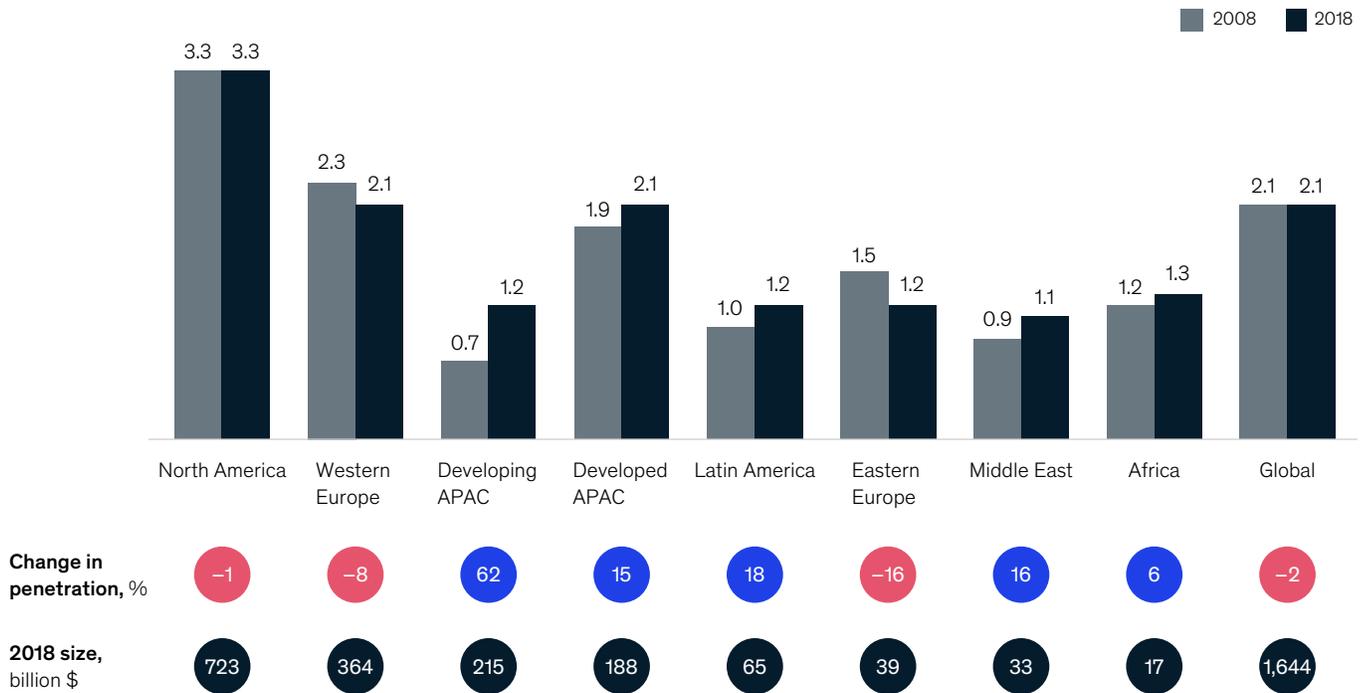
This pattern is not surprising to anyone in the industry. The global economy has experienced transformative growth and innovation over the past decade, led by the increased significance of intangible assets on companies' valuation and emerging man-made risks—for instance, those related to data management and cybersecurity. Yet the insurance market for such risks is still very limited, and this lack of response has produced significant gaps in coverage of property and liability.

The global aggregate numbers mask significant variations in growth and profitability among markets. Developed markets lead in size, accounting for 80 percent of global P&C premiums in 2018.

Exhibit 1

**P&C insurance penetration remained stable from 2008 to 2018 due to the decline in penetration in developed markets, offsetting the growth in developing markets.**

**P&C insurance penetration globally,<sup>1</sup> GWP as a fraction of GDP, %**



Note: Order is based on market size and figures are rounded.

<sup>1</sup> Only countries with Global Insurance Pools premiums considered, representing 95% of 2018 global GDP.

Source: McKinsey Global Insurance Pools; World Bank

However, developing markets achieved average annual growth rates of 11 to 16 percent from 2012 to 2018 (albeit from a low customer base) and also higher profitability (Exhibit 2).<sup>3</sup> In 2008, the developing APAC market was only one-sixth the volume of the Western Europe insurance market; today it is more than half the size of the Western European market. If this trajectory continues, in seven years the developing APAC market will become the world's second-largest P&C market.

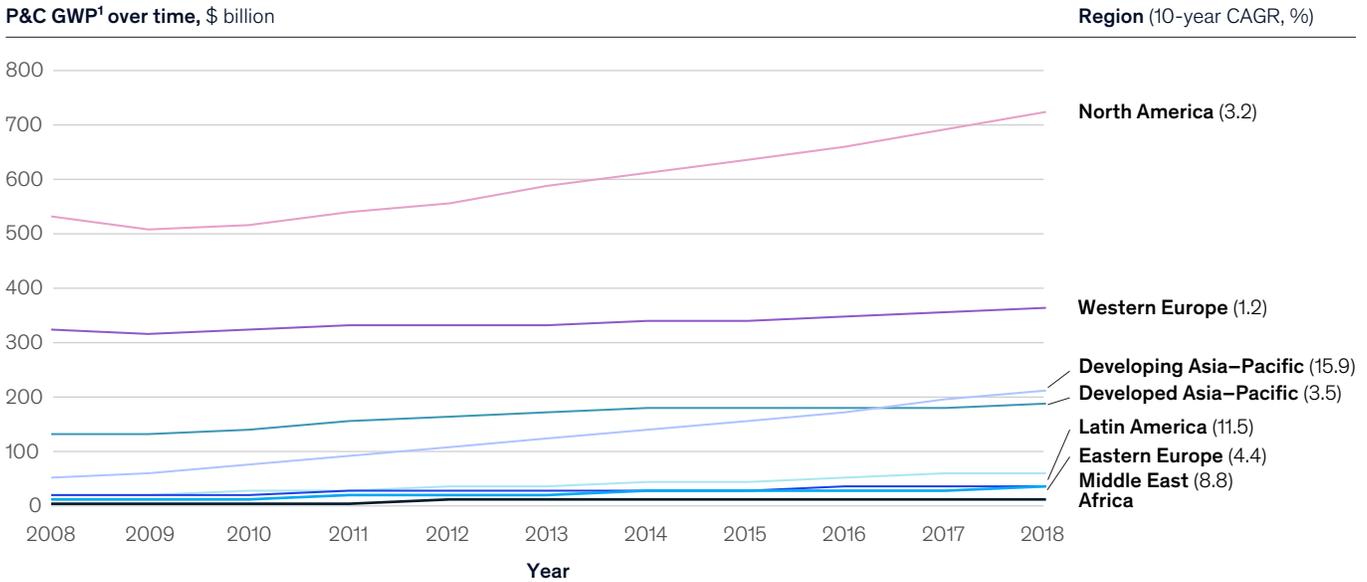
Notably, Latin America, Eastern Europe, the Middle East, and Africa all had average technical margins of 7 to 9 percent from 2012 to 2017—more than double the global average and well ahead of North America. Thus, emerging markets are a growth source of volume and profits (Exhibit 3).

Beneath the top-line numbers, our analysis highlighted several insights that will have a direct bearing on strategic planning for P&C executives.

<sup>3</sup> Globally, Argentina, Chile, China, Colombia, Egypt, India, Indonesia, Kenya, Mexico, Morocco, Nigeria, Peru, Saudi Arabia, South Africa, Philippines, and Vietnam have all demonstrated remarkable growth by more than doubling their market, measured in GWP, over the past ten years.

Exhibit 2

**Western Europe and North America lead in absolute growth, but developing markets Asia–Pacific and Latin America lead in terms of relative growth rates.**



<sup>1</sup> Gross written premiums.

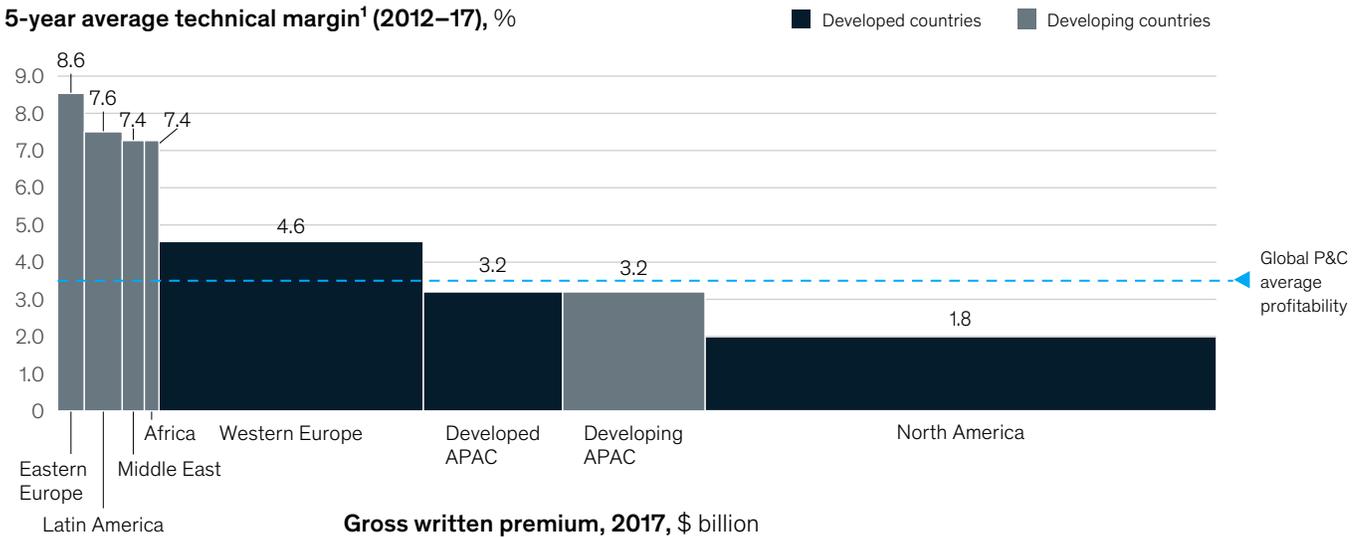
Source: McKinsey Global Insurance Pools

Exhibit 3

**Although P&C profitability is highest in developing markets (including Eastern Europe, Middle East, and Latin America), the developed world still makes up approximately 80 percent of global P&C premiums.**

**Where did profit and premium come from?**

**5-year average technical margin<sup>1</sup> (2012–17), %**



Note: Regions are ranked by profitability.

<sup>1</sup> Technical margin is defined as 100% minus the combined ratio.

Source: McKinsey Global Insurance Pools; team analysis

### P&C is still a local game

Contrary to conventional wisdom on the perceived systematic benefits of geographical expansion, our analysis of five markets (Brazil, France, Germany, the United Kingdom, and the United States) reveals that P&C insurance remains a locally driven business. In these countries, domestic carriers increased market share and largely matched or outperformed the combined ratio of multinational competitors (Exhibit 4).<sup>4</sup>

Outperformance by local P&C carriers can be attributed to privileged access to distributors, knowledge of local risk selection and pricing, and proximity to the domestic regulatory environment.

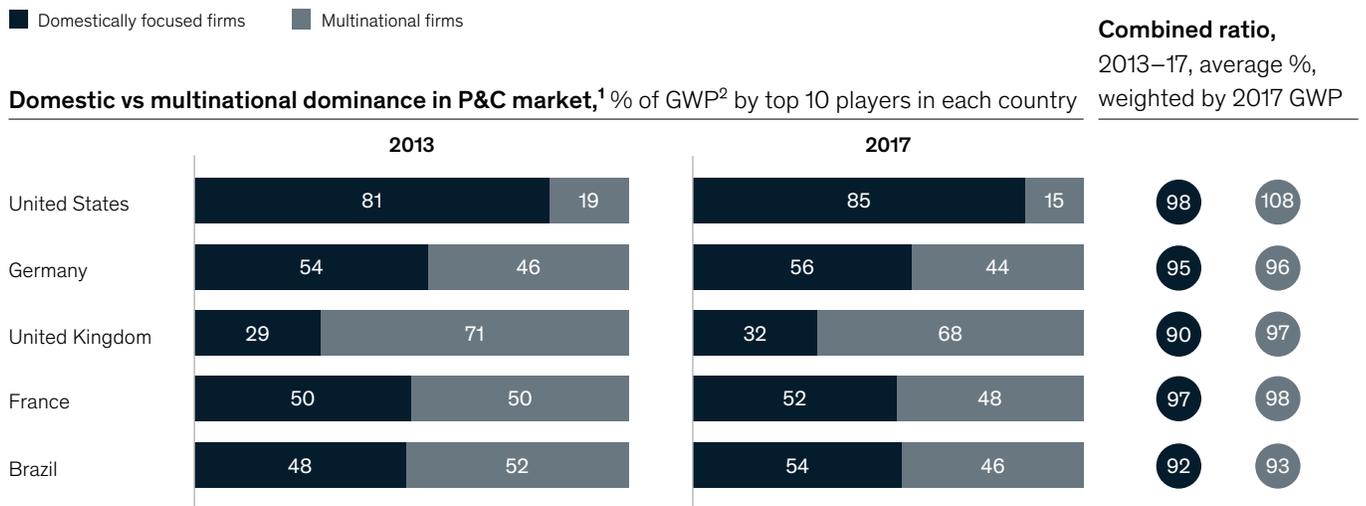
When we replicated a similar analysis at the state level in the United States, we found surprising consistency. Among the top ten states as measured by P&C premiums, local and regional carriers (those focused on one or a few states) have kept their market share relatively stable. They have also often achieved average loss ratios that are three to five percentage points lower than many national carriers, demonstrating that local market knowledge has often yielded better underwriting results for those insurers.

The imperatives of this competitive dynamic are significant. First, carriers should strike a balance between local autonomy and the transfer of initiatives across borders or centralized operations (for example, a large, multicountry center of excellence). Second, multinationals should take a hard look at their global portfolio and determine where they can increase market share and profitability. This exercise can avoid spreading resources too thinly. While some markets might be profitable (or on the path to profitability), they may

<sup>4</sup> Domestic carriers are defined as insurers where more than 70 percent of their revenues come from the country in which they are headquartered. Those carriers where more than 30 percent of their revenues are outside of their country. The same analysis done for Brazil, France, Germany, the United Kingdom, and the United States was also conducted in Japan. Research found that three of the largest Japanese carriers (Tokio Marine, MS&AD, and Sompo) are also considered multinational corporations (more than 30 percent of their revenues come from outside of Japan), and they collectively control more than 85 percent of total top ten player premiums, making the analysis less relevant.

Exhibit 4

## P&C remains a local game, with domestic firms continuing to hold the largest share of premium over multinationals in major global markets over the past five years.



Note: The same analysis of Japan is excluded because the three largest Japanese carriers are multinational corporations and collectively control more than 85% of total top ten player premiums. Countries are listed in order based on market size.

<sup>1</sup> Multinational firms defined as those achieving 30% or greater nonlife GWP from other markets.

<sup>2</sup> Gross written premiums.

Source: Individual country regulatory bodies, SNL Financial; McKinsey analysis

be relatively less so than if a company had used its resources to push hard on the markets it knows well (including through local acquisitions) and where the franchise is recognized.

### The M&A space is active, but the industry remains fragmented

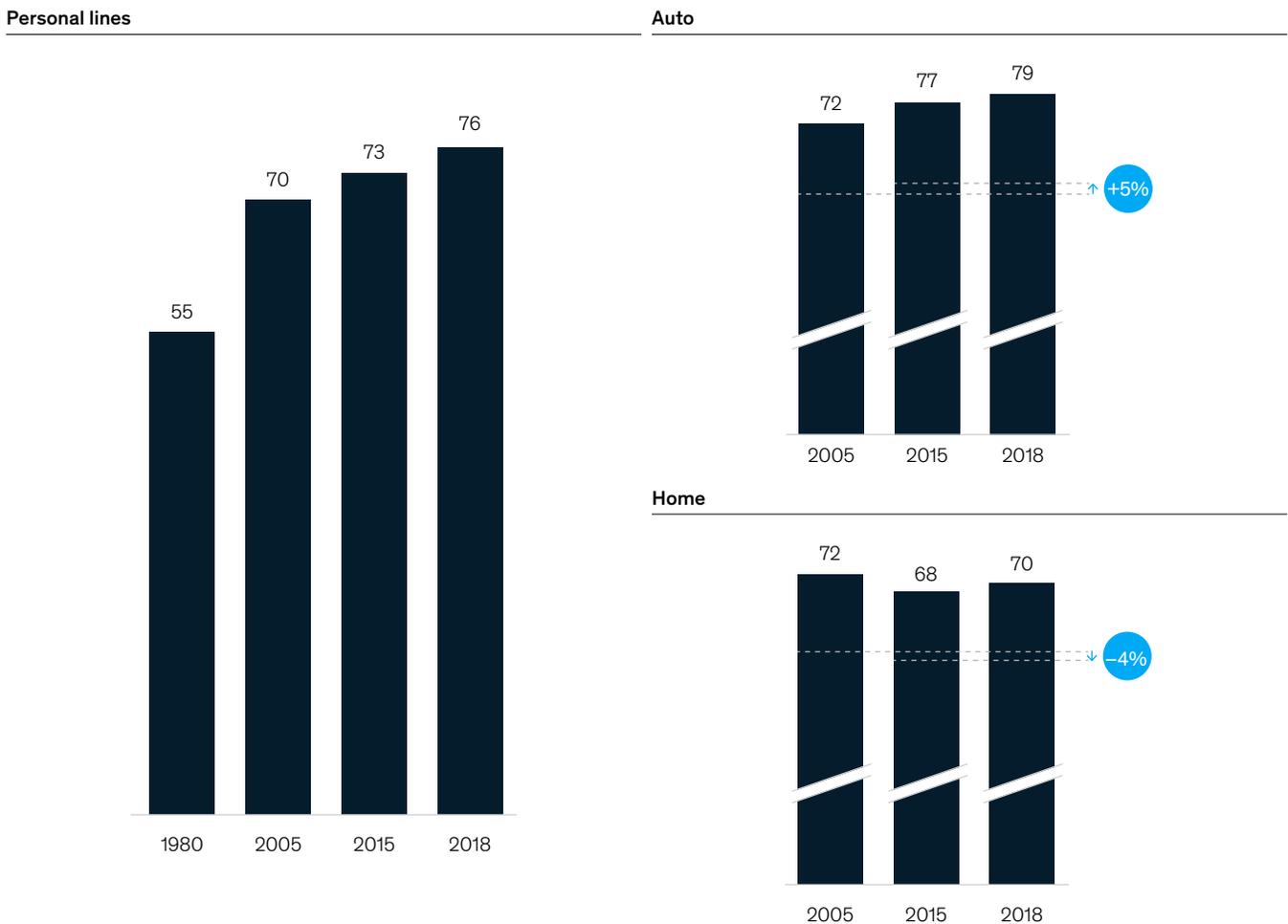
The P&C industry has experienced consolidation across personal and commercial lines. Globally, high levels of M&A activity from 2013 to 2018 had a total disclosed transaction value exceeding \$180 billion, including broker deals.

Auto insurance is leading consolidation in the personal lines market—a trajectory that will likely continue—where top carriers have significantly increased their share in the largest, most mature markets. For instance, the top ten personal-auto carriers in the United Kingdom accounted for about 82 percent of the market in 2018, a gain of four percentage points over the previous nine years. In the United States, the top 15 carriers now account for approximately 80 percent of personal auto premiums, up seven percentage points from 2005 to 2018 (Exhibit 5); GEICO, Progressive, and USAA are largely responsible for these market gains.

Exhibit 5

### The US market is consolidating in auto insurance but not in home insurance.

US market share of top 15 carriers, %



Source: SNL Financial

Other personal lines markets—such as homeowner’s insurance, which has been fragmented in the past decade—could become the next frontier for consolidation as carriers’ capabilities mature.

Despite recent large M&A deals, commercial lines insurers remain fragmented, with the top ten carriers commanding about 43 percent of the US market share in 2018. Specialty lines carriers, due to their niche nature and strong reliance on underwriting talent, have always been more fluid than rest of the market, with (re)insurers entering and exiting more frequently based on market conditions.

In looking closely at the deal rationale behind the largest acquisitions with a deal value of more than \$100 million, we identified four types of M&A transactions for P&C insurance (Exhibit 6):

- European and North American carriers acquiring to increase scale and reap diversification benefits (for instance, AXA’s acquisition of XL Catlin and Hartford’s acquisition of Navigators)
- Carriers acquiring smaller companies to gain access to new capabilities or digital platforms and expertise, such as advanced analytics, to reinvent the core business or make targeted bets (for instance, Travelers’ purchase of Simply Business)
- Asian carriers investing capital into Europe and North America, often at a premium, to seek growth beyond their home markets (for instance, Tokio Marine’s purchase of HCC and China RE’s acquisition of Chaucer)<sup>5</sup>
- Private-equity investors building an attractive return profile in the industry, typically in reinsurance and commercial specialty lines (for instance, Apollo’s acquisition of Aspen)

Of the approximately 130 deals with a value exceeding \$100 million from 2013 to 2018, roughly two-thirds belong to the first category. In 2018 alone, the industry saw a total of \$37 billion in acquisitions. Only a handful of deals were motivated solely by the need for new capabilities. This pattern may change in the next five to ten years as carriers seek competencies in digital marketing, advanced analytics, and customer experience (see sidebar “How P&C market shapers create value”).

<sup>5</sup> This trend continued in 2020 with Tokio Marine’s acquisition of Privilege Underwriters/PURE Group the United States for more than \$3 billion.

## Exhibit 6

### Four main types of large M&A deals occupy the P&C insurance space.

P&C carrier deal activity, Europe and North America, 2013–18, deal value >\$100 million

	Number of deals	Cumulative deal value, \$ billion	Average deal value, \$ billion
European and North American carriers with desire for increased scale and diversification	~80	~100	~1
Access to new capabilities or expertise	~5	~1–2	<1
Asian carriers seeking growth in Europe and North America	~5	~20	~4
Private-equity transactions	~40	~40	~1

## How P&C market shapers create value

In a market that appears ready for disruption, P&C carriers have, on average, created small but positive economic profit over time. We assessed more than 200 insurers globally and found that from 2013 to 2017 the industry generated an average of \$37 million in economic profit per company. This overall average industry performance falls far short of the \$500 million to \$2 billion generated by industries in the top quintile of our global distribution (such as beverage, automobiles, pharmaceuticals, tech, and biotech).<sup>1</sup>

Moreover, there is an uneven distribution of economic profit in the P&C industry, what we call the power curve. Insurers in the top quintile have created \$764 million of economic profit, on average, while those in the second, third, and fourth quintiles generated only \$26 million. Those in the bottom quintile have destroyed significant value—an average of nearly \$1 billion per company (Exhibit 1). Overall, 66 percent of P&C insurers created some value from 2013 to 2017, compared with 56 percent of all companies in our database. However, the distribution for P&C is flatter: winners

created relatively less economic profit compared with other industries, but losers destroyed relatively less value too, with a large number of insurers in the middle quintiles creating or destroying low levels of value.

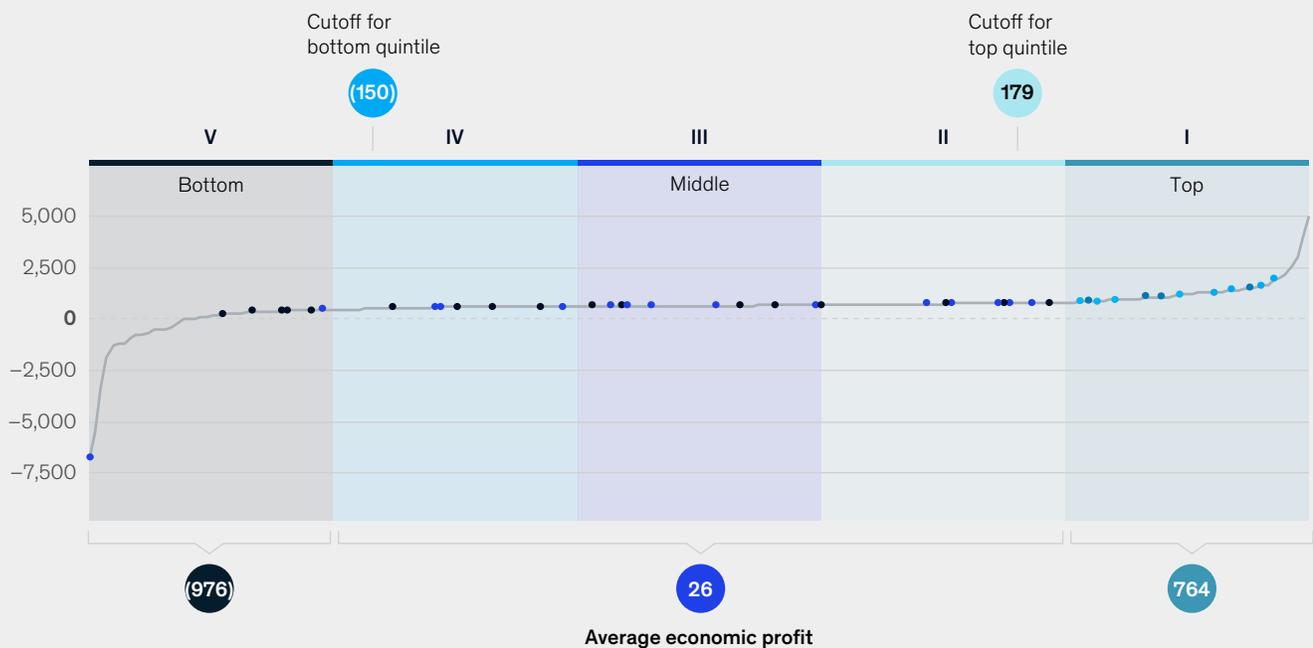
The analysis pointed to five types of bold moves and related intensity levels commonly observed across the top-performing insurers (Exhibit 2). Three moves in particular—dynamically shifting capital, programmatic M&A, and underwriting—can make the greatest

<sup>1</sup> Alex D'Amico, Mei Dong, Kurt Strovink, and Zane Williams, "How to win insurance: Climbing the power curve," June 2019, McKinsey.com.

Exhibit 1

### The bottom quintile has destroyed a significant amount of value.

Average economic profit, 2013–17, \$ million



Source: McKinsey Strategy Practice and Corporate Performance Analytics

## How P&C market shapers create value (continued)

Exhibit 2

### Crossing certain thresholds can maximize an insurance carrier's chances of moving up the power curve.

Threshold	Bold move
Dynamically shift resources between businesses	Reallocate at least 60% of surplus generated over a decade
Reinvest a substantial share of capital in organic growth opportunities	Be in the top 20% of the industry by strategic reinvestment relative to new business premiums; typically, that means spending 1.7 times the industry median
Pursue thematic and programmatic M&A	No individual deal is larger than 30% of market cap, and total value of deals over ten years is greater than 30% of market cap
Enhance underwriting margins	Be in top 30% by gross underwriting margin
Make game-changing function improvements in productivity	Cost improvement that is in the top 30% of the insurance industry

Source: Alex D'Amico, Mei Dong, Kurt Strovink, and Zane Williams, "How to win in insurance: Climbing the power curve," June 2019, McKinsey.com.

impact on value creation and competition for P&C carriers.

P&C carriers have historically not been the nimblest in reallocating capital. Many winning companies have started to accelerate their pace of reinvestment and innovation by divesting portfolio businesses that are not mission critical and investing in new organic growth opportunities.

Although most carriers have remained cautious of acquisitions, others have

pursued rapid, profitable growth via programmatic M&A and focused talent acquisition. Our analysis found that six of the top 20 carriers had a total deal value greater than 30 percent of their market cap, and 11 closed three or more deals. The remaining carriers have made targeted acquisitions to strengthen capabilities, such as digital technologies and advanced analytics, that will be critical to stay competitive.

Given the industry headwinds over the past five years, underwriting excellence

combined with operational efficiency have become critical markers for outperforming. In our analysis, nine of the top 20 carriers have improved their loss ratio by more than three percentage points in the past five years. Top-quartile efficiency also distinguishes the winners: eight of the 20 also have an expense ratio in the top 30 percent of the industry.

Dominant carriers have already set the new standard for core competencies in personal auto, including omnichannel experience, digital marketing, and data and analytics to support microsegmentation and pricing. As these capabilities, ongoing investment, and the war for talent become table stakes, the gap between the top and bottom companies will likely widen.

With all this M&A activity, the remaining and realistic universe of larger viable acquisitions has become somewhat limited. In US commercial lines, for example, only about 50 of the 405 carriers with net written premiums of \$250 million to \$15 billion could be plausible acquisition targets. The rest are mutuals, balance sheet-bearing entities, or subsidiaries of large groups.

Still, appetite for deals by both strategic and private-equity buyers is high. Future deals are likely to also include divesting of business units, as large carriers tailor their business to areas of competitive advantage, or include small rollups (as seen in UK commercial and London Market broking).

As a result, we anticipate this investment profile to significantly shift in the next five years as winning carriers take the following actions:

- Reevaluate their footprint and appetite for geographic expansion and divestiture versus playing a local game in a few markets of choice
- Look for ways to diversify or optimize their portfolio more efficiently, such as asset swaps instead of acquisitions
- Acquire new capabilities outside traditional insurance to jump-start innovation and increase the monetization of services outside of underwriting

## **Distribution is under attack on two fronts—potentially benefitting the customer**

P&C insurers are grappling with two different challenges around distribution: intermediaries have increased their clout, and ecosystem growth further segments the industry.

### **Rise of intermediaries and brokers**

In personal lines, the traditional agent model faces strong competition. From 2009 to 2017, direct distribution significantly increased its share in US personal auto and moderately grew its penetration in homeowner's lines. At the same time, the independent agent channel has maintained its share in personal auto and significantly grown in homeowner's insurance. In contrast, the captive channel lost seven to nine points of market share in both segments (Exhibit 7). In Europe and developing APAC, price comparison websites are growing rapidly and have even become the main distribution channel in several countries (such as Italy and the United Kingdom).

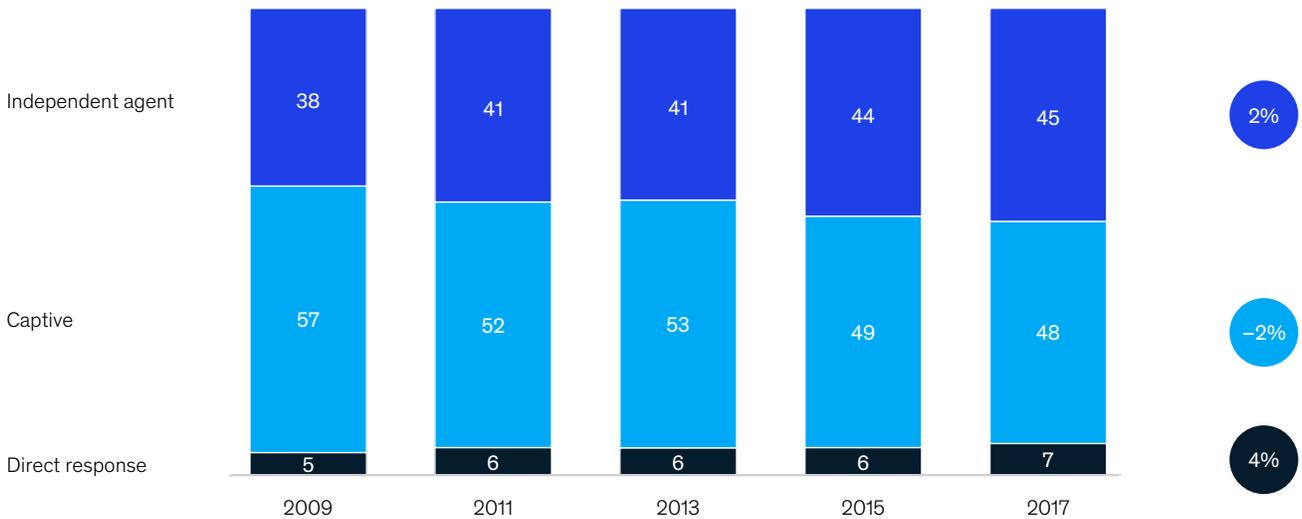
In commercial lines, brokers continue to increase their robust presence. They are increasingly aggregating risks (by promoting portfolio underwriting approaches) and pushing new services. The much-anticipated growth of direct distribution in small commercial lines has not materialized yet, except for a few markets such as Australia and the United Kingdom. We also observe continued broker consolidation particularly in large corporate and specialty segments, such as the acquisition of insurance broker JLT in 2019.

Exhibit 7

**Direct response in homeowner's insurance and auto saw a slight increase in US market share at the expense of the captive agent channel.**

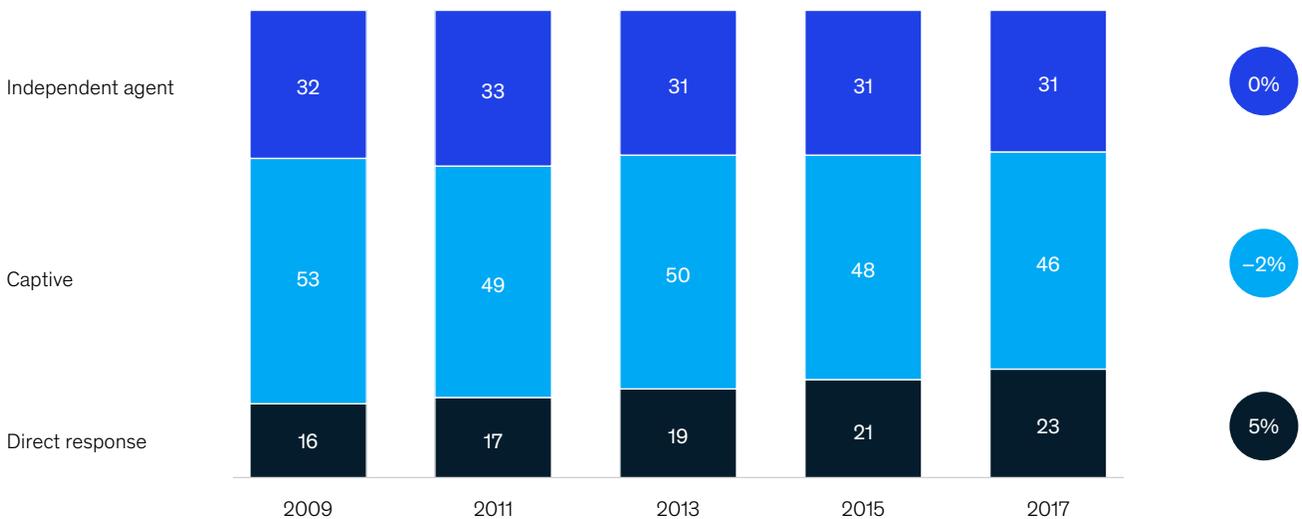
2009–17 US homeowner's direct premiums written by channel, %

2009–17 CAGR



2009–17 US personal auto direct premiums written by channel, %

2009–17 CAGR



**Direct response personal auto premiums are predicted to reach \$90 billion by 2022 and account for more than 30% of private auto insurance sales**

Source: Conning Research; IIABA market share reports; JD Power Homeowners Study 2019; S&P Global Market Intelligence

The three global alpha brokers (soon to be two)—Aon plc, Marsh, and Willis Towers Watson—now control at least 20 percent of the commercial lines' broker channel in every global region (Exhibit 8). In early March 2020, Aon plc and Willis Towers Watson announced their intention to merge in an all-stock deal expected to be completed in the first half of 2021, subject to regulatory approvals.<sup>6</sup>

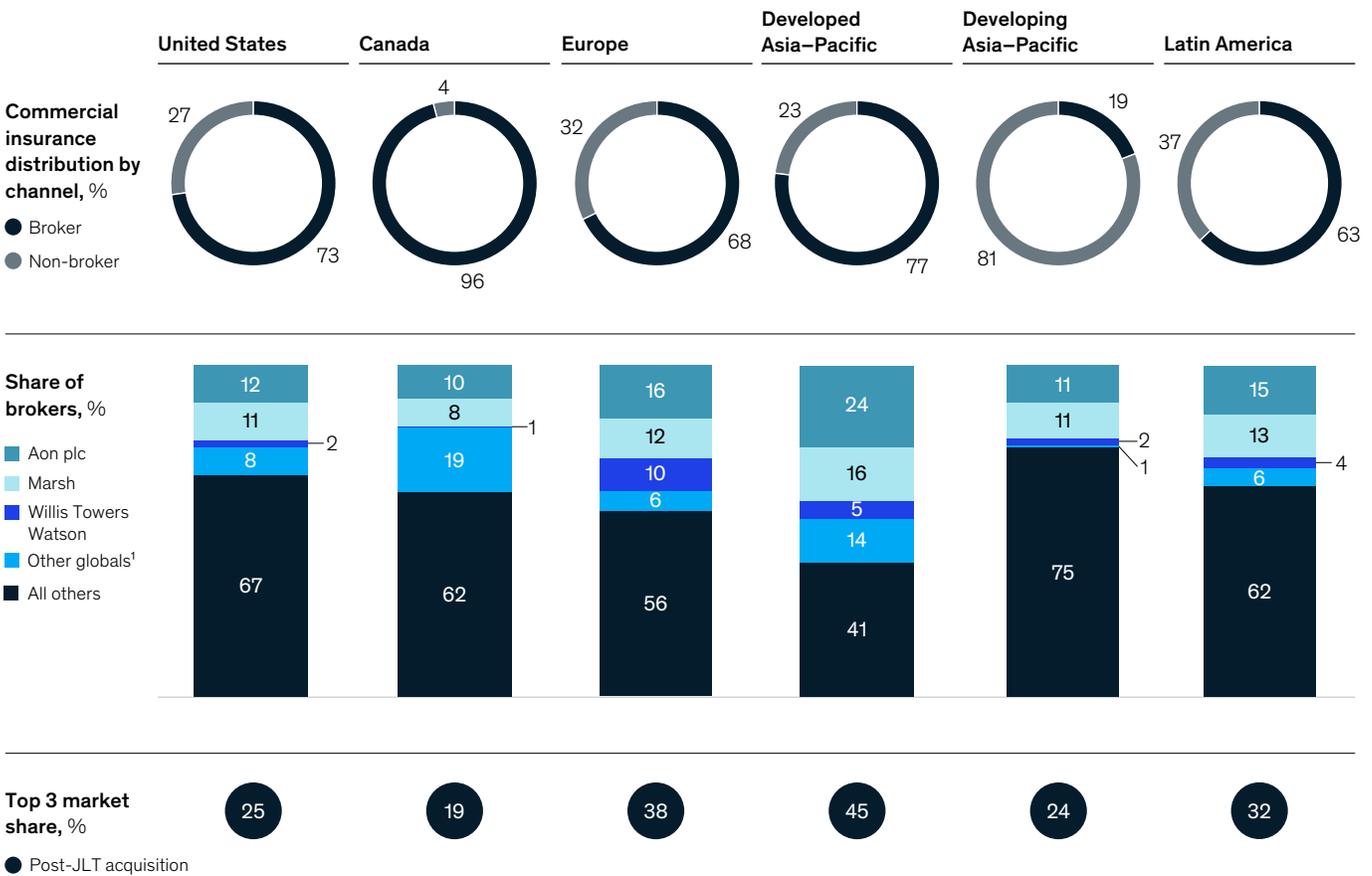
In addition to consolidating, brokers have also developed a business model that has generated significant value for their shareholders over the past decade. Total shareholder returns (TSR) for brokers from 2008 to the end of 2019 exceeded 350 percent, significantly outperforming that of P&C carriers and the S&P 500 (Exhibit 9).

Whether consolidation has translated into efficiency gains for customers is also beneficial to study. The P&C industry spends a large amount of capital on risk transfer and distribution, with many intermediaries involved across retail, wholesale, and reinsurance brokerage.

<sup>6</sup> Ben Dummett, "Insurance broker Aon strikes year's biggest M&A deal on tumultuous markets day," *Wall Street Journal*, March 9, 2020, wsj.com.

Exhibit 8

### The share of alpha brokers is significant in all markets.



Note: Countries and regions are listed in order of distribution penetration by channel. Figures may not sum to 100 due to rounding.

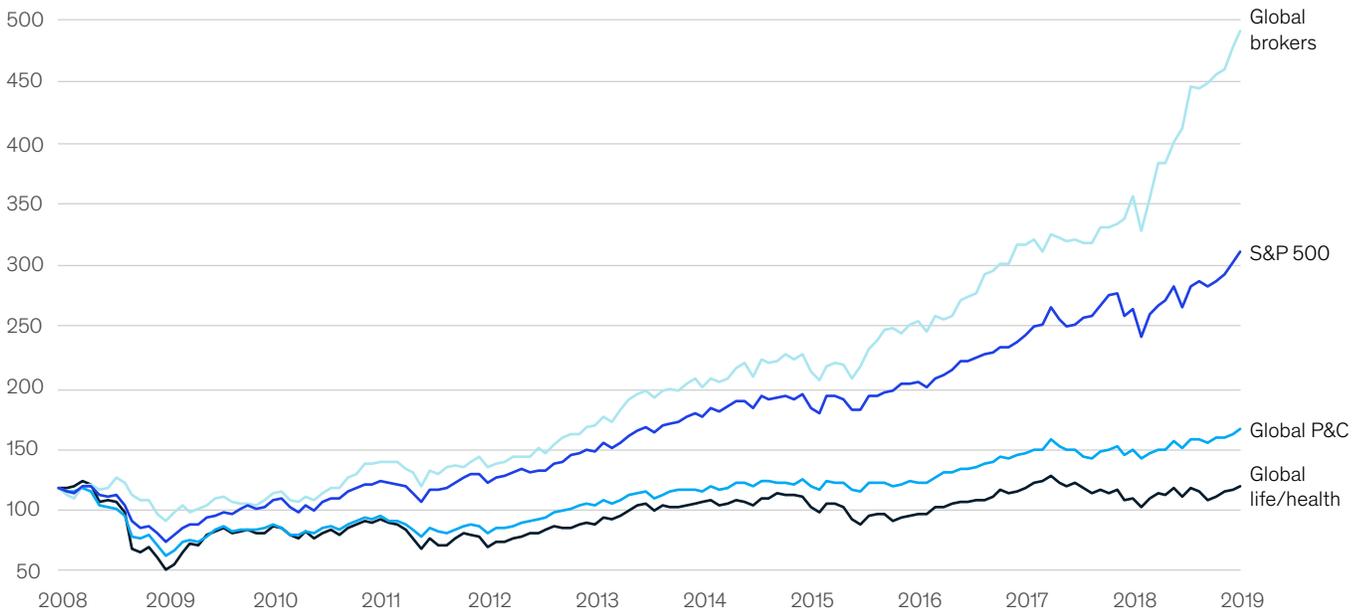
<sup>1</sup> Including Funk Gruppe GmbH, Arthur J. Gallagher & Co, JLT, and Lockton Companies.

Source: Broker interviews; Finaccord

Exhibit 9

**Over the past decade, P&C insurers have had higher total shareholder returns than life insurers but lower returns than brokers.**

Monthly total shareholder returns, indexed to January 1, 2008



To determine whether the industry spends too much or too little on distribution, we compared the proportion of revenues spent by P&C and mortgage industries on distribution relative to profit generated. In the UK, for instance, both spend a large portion (about one-quarter) of their revenues on distribution, but the mortgage industry’s profitability is much higher than P&C’s; as a result, mortgage spends the equivalent of half of its profits on distribution, while P&C spends the equivalent of about triple its profit on distribution. P&C insurance will need to address distribution costs to retain relevance—disrupting the current situation and lowering distribution costs could bring significant value to the end customer.

**Growth of ecosystems**

We estimate that more than 30 percent of global personal lines’ P&C premiums will be distributed via ecosystems by 2030, particularly via products and markets where ecosystem orchestrators and distributors own the last mile and the brand. This shift is like a slow electroshock for traditional P&C carriers. They will need to completely rethink their cost structure and the ownership of client data for a significant portion of their personal-lines books, for which demonstrating value added beyond underwriting expertise and balance-sheet and regulatory management will be difficult.



## Six market-shaping forces and their implications for P&C

Six forces will shape the P&C industry, spanning shifting risk pools and the catastrophe insurance gap to the continued integration of digital technologies and the need for new digitally savvy talent. The industry's previously lukewarm adoption of digital technologies, for instance, means insurers must play catch up, learning how to apply data and advanced analytics tools to underwriting and price matching. To do so effectively, carriers must attract talent with the know-how to incorporate digital tools into insurance activities.

No facet of the insurance industry will be left unchanged. Therefore, carriers must reinvent themselves by adapting their strategy and business model to meet the evolving market. In what follows, we not only discuss the trends but also highlight their implications for insurers.

### **A rapidly evolving insurable mass calls for product innovation and the reallocation of portfolio priorities**

Two developments will significantly change the P&C insurable mass: technologically upgraded physical assets and changed usage trends. The first shift involves equipping relatively stable, nonconnected *physical assets* with smart technology, or even replacing them altogether with smart devices. This movement has created new types of risk exposure (such as through cyberattacks) as well as product innovation opportunities. The second shift, in *consumer usage and ownership patterns*, alters the nature and true ownership of insured risks—as evidenced by the evolution of mobility and home-sharing (such as Airbnb).

We explore these two concepts further in the context of personal auto, homeowner's, and commercial insurance lines.

### **Personal auto insurance**

The auto industry's evolving technologies and business models will likely change the frequency and severity of auto risk and the typical ownership structure of vehicle fleets.

As personal-vehicle models modernize, advanced driver-assistance systems and telematics are becoming standard, leading to a decreased risk of driver errors and overall accidents. Nearly 1.35 million people die in road crashes globally each year—an average of nearly 3,700 deaths a day—and up to 50 million are injured or disabled.<sup>7</sup>

Advances in safety technology are transforming road safety. Blind-spot detection, forward-collision warning with auto-emergency braking, lane-departure warning, and driver-drowsiness detection are all examples of new safety features that can reduce accidents. According to the Insurance Institute for Highway Safety, lane-departing warnings have decreased injuries by 20 percent, while blind-spot technology has reduced lane-change crashes resulting in injuries by even more.<sup>8</sup>

Unfortunately, this significant progress is counterbalanced by the rise of distracted driving caused by greater smartphone use. Distracted driving has increased the number of car accidents—in vehicles with or without safety features—especially among younger or less-experienced drivers, who are the highest risk segment.

The hope is for higher levels of awareness and tech features to curb distracted driving and help enforce regulations—for example, phones that disable texting or web-surfing capabilities while driving. And as new car safety features become standard, better data will be available to help carriers validate the benefits of this technology. On the downside, when accidents do occur, more sophisticated machinery in the car is costlier to repair; this dynamic is already affecting the severity of the damage and, thus, insurance premiums.

The more significant change for the industry, however, is likely to be a move from personal lines to commercial lines.

Shared mobility, such as ride-sharing services and fleet-usage subscriptions, will likely also change the definition of vehicle ownership, calling for insurance policies with greater flexibility such as usage-based insurance. Auto insurers are already witnessing material changes in the insurable mass and go-to-market requirements; as such, some auto risks are likely to gradually move to commercial lines.

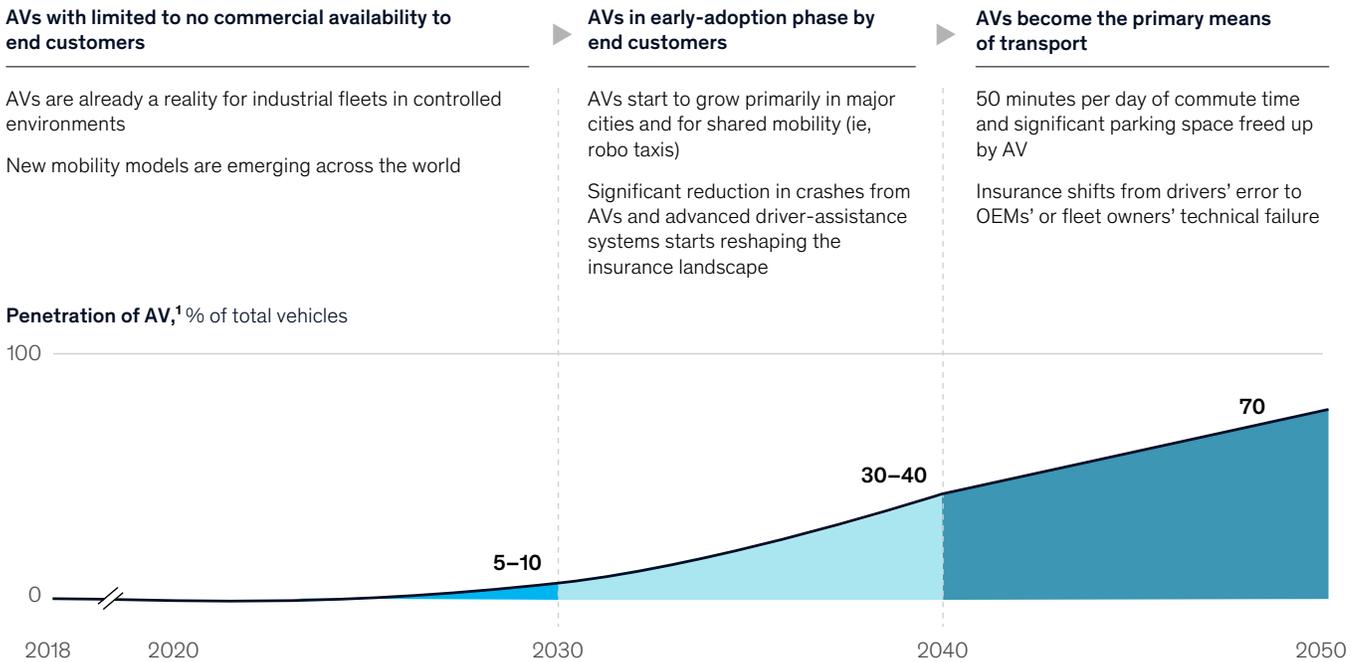
In the long term, partially or fully autonomous vehicles will become more prevalent, with an expected penetration rate of more than 70 percent by 2050 (Exhibit 10). This change will likely adversely affect the personal auto premium pool through a dramatic drop in the frequency of driver-related accidents. In addition, the number of vehicles in markets with high adoption rates could potentially drop—a reduction of 20 times the current vehicle adoption rate based on the average rate of car usage, which is 5 percent.

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<sup>7</sup> *Global status report on road safety 2018*, World Health Organization, 2018, who.int.

<sup>8</sup> "Lane departure warning, blind spot detection help drivers avoid trouble," Insurance Institute for Highway Safety and Highway Loss Data Institute, August 23, 2017, iihs.org.

## Auto risk expects a significant shift due to the prevalence of autonomous vehicles (AVs).



<sup>1</sup> Autonomous vehicles.

More connectivity within cars also presents an opportunity for P&C insurers. As the risk of algorithm errors and cyberattacks (for instance, hackers taking control of vehicles) creates new exposure for auto manufacturers, original-equipment manufacturers (OEMs), and tech companies, some will want to purchase insurance protection—if the right product exists.

As these trends play out, we anticipate that a significant portion of personal auto premiums will shift to new commercial coverages (such as fleet damage, algorithm failure, and other third-party liability).

### Homeowner's insurance

Similar to the auto industry, changes in connectivity, technology, and consumer behavior (including how people define “home”) are shaping the homeowner's segment.

Smart home penetration is on the rise. Centralized-system devices such as Google's Nest and Amazon's Alexa have lowered the cost of connecting a home compared with traditional security systems. Furthermore, these technologies are becoming more integrated, presenting an opportunity for insurers to collect more data to better customize policies for homeowners. Carriers can also use these devices and data to further improve loss prevention and mitigation through nudging and active behavioral recommendations, especially for those devices or systems that achieve sufficient scale. Increased prevention can also mean a reduction in damages.

The growth of shorter-term accommodation options such as Airbnb is also changing home ownership and usage. This shift requires new types of coverages both for those renting their home and for those seeking short-term accommodation. We anticipate an increased need for modular and temporary coverage.

### **Commercial insurance**

Commercial lines insurance is experiencing an equally important change in the insurable mass because of the increasing importance of intangibles and regulatory compliance. For instance, businesses purchasing cyber-liability insurance have increased their limits by 15 to 30 percent in the past two to three years. Today, cyber premiums remain a niche market and the risk is largely underinsured—though global volume is likely to continue steadily growing. For cyber insurance volume to reach \$15 billion to \$20 billion by 2025, insurers will have to innovate and bring new products to market.

While physical assets for firms have not declined, the relative importance of the property premium pool is being challenged by the increase in intangible assets such as intellectual property and data. Risk exposure has grown for nonphysical assets as business is increasingly conducted online or through the cloud and more data is collected and stored centrally. Indeed, cyberthreats are evolving, with the increased sophistication of attacks making every company vulnerable. (For a discussion of how government and industry are seeking to protect physical and intangible assets in the event of terror attacks, see sidebar “Terrorism risk remains a threat to the world and the P&C industry.”)

The tightening regulatory environment has increased the need for commercial liability insurance. And as developing markets continue to mature, the regulatory and litigation landscape will provide more recourse for plaintiffs. Yet conditions have also improved for complainants in developed markets. In the European Union, the General Data Protection Regulation and other privacy-related measures have increased exposure for companies. And in the United States, laws now make class action lawsuits easier to file. No board or management team can operate without proper cyber coverage—indeed, cyber might become the directors-and-officers-liability insurance of this decade.

And given the current global trade landscape and political uncertainties on many formerly stable fronts, renewed demand for hedging coverages (such as noncompliant transaction insurance, political risk, and credit risk) will increase as counterparty risks and political and regulatory environments remain uncertain, especially among corporations doing business across borders.

### **Implications for insurers**

The shifts in personal auto, homeowner’s, and commercial lines present P&C carriers with several opportunities to change their current business models and explore new offerings.

*Change the go-to market approach.* P&C carriers that depend on local intermediaries (agents and brokers) for traditional personal lines, auto, and business must drastically shift their value proposition and strategic approach toward a B2B premium pool. For insurers to succeed in serving new corporate and B2B clients (such as self-driving ride-hailing companies and mobility providers), they must acquire new capabilities, such as data collection.

*Offer competitive products.* While traditional home insurance is less likely to be disrupted, P&C carriers can make their product offerings more modular, thus appealing to evolving customer preferences, such as short-term renting options. Carriers will increasingly face competition—at least by measure of distribution—from multiple industries that have voice- or remote-control devices used in homes (such as telecom boxes, smart-utility meters, and voice assistants). The contextual data from these devices can reveal market opportunities.

*Be ready to address new risks.* On the commercial insurance front, P&C carriers must reinvent themselves if they are to address some of the risks of their corporate customers. Sufficient risk-transfer offerings regarding data security, intangibles, and machine-learning liability are not currently offered. The insurance

## Terrorism remains a threat to the world and the P&C industry

**The evolving nature** of terrorism risk remains a significant threat. The September 11th attacks, which killed more than 3,000 people and injured many more, were then the costliest disaster in the history of insurance at about \$45 billion (in 2020 prices), which was largely paid by reinsurers. In the aftermath, insurance and reinsurance markets reconsidered the insurability of this type of risk. Today, more than two-thirds of the 36 OECD member countries rely on the insurance market to manage terrorism risk, as do nearly all nonmember countries.

Over the past two decades, in about one-third of OECD countries, insurers and national governments have renewed, modified, or established public-private partnerships to provide financial protection against government-certified terrorist attacks. Some examples include Israel's Compensation Fund (established in 1941), the Consorcio de Compensación de Seguros in Spain (1954), Pool Re in the United Kingdom (1993), GAREAT in France (2001), Extremus in Germany (2002), the Indian Market Terrorism Risk Insurance Pool in India, or IMTRIP (2002), TRIP in the United States (2002), and ARPC in Australia (2003).

These national terrorism insurance programs differ by what is insured or excluded. For instance, Pool Re in the UK and GAREAT in France both cover chemical, biological, radiological, or

nuclear attacks such as dirty bombs (a type of radiological dispersal device). In contrast, this type of coverages is excluded from Extremus in Germany and from the IMTRIP in India. Only a few programs explicitly cover cyberattacks, including Pool Re and GAREAT. Pricing levels also vary across countries, based on coverage, risk-sharing arrangement, and national market dynamics. Insurance penetration also varies significantly. France, Israel, and Spain have nearly 100 percent penetration, as terrorism is included in most policies. In the United States, penetration is in the 60 to 80 percent range across industry sectors, but much lower in United Kingdom despite the country historically having significant exposure to terrorism risk. These programs do have one thing in common: they rely significantly on the national government for handling the insured economic cost of truly catastrophic attacks.

In the United States, TRIP began as a temporary solution, providing businesses with up to \$100 billion of insurance protection for certified terrorist events. The law requires insurers to offer terrorism coverage to all their corporate clients, which has boosted penetration. TRIP also provides benefits from free, up-front federal reinsurance for truly catastrophic losses, keeping prices relatively low compared with other international markets. Similar to many of the global

terrorism insurance programs, TRIP was renewed several times since its inception. Each time, more risk was transferred to the private insurance market. Nuclear, biological, chemical, or radiological weapons insurance coverage is not readily available in the private insurance market, so CBRN risk covered by the program is limited. According to the US Treasury Department's published guidance, insurance lines regulated by the program that include cyber risks components are covered. In the December 2019 renewal of the program, the updated law requests that the comptroller general conduct a study on of the potential vulnerabilities and costs associated with cyberattacks, the current adequacy of coverage in the private market and under the program, and how Congress could amend the program to meet the next generation of cyber threats. The findings should be submitted in a report to the US Congress.

Last December, TRIP was extended until the end of 2027. While the program has never been triggered, the federal backstop and the fact that all insurers participate in it and that costs have been relatively small (around 2.5 percent of premiums paid by commercial entities) provide an important stabilizing force to the P&C market and the US economy overall, similar to the existing programs in other countries.

gap also consists of terror threats, environmental issues, business interruption, and reputational risks. Continuous PPPs will be critical to insuring these extreme risks—and will help the industry build resilience.

These emerging-risk insurance gaps cause tension between a loss of relevance vis-à-vis business owners and CFOs—where insurance does not always offer attractive risk-transfer propositions for new risks—and those insurers that are not yet equipped to consider the new risks as fully insurable. P&C carriers can take four possible stances:

***Wait it out.*** Carriers can apply underwriting prudence and wait until there is clear evidence of the insurability of the new risks before committing capital, which might take a long time.

***Substitute with services.*** Invest in prevention and mitigation services linked to new risks without engaging in risk transfer propositions.

***Occupy the space.*** Where feasible, take a broad approach and underwrite the new risks for key clients and customer groups and pass on the risks to the market (reinsurance and alternative transfer). This strategy is not necessarily about making an underwriting profit but rather about satisfying the new needs of primary customers and remaining relevant.

***Build consortiums.*** Orchestrate an industry-wide solution to the transfer of new and not-yet fully understood risks. This approach can take the form of PPPs or government-supported risk pools, similar to solutions that address terrorism or nuclear risks.

## **Uninsured natural catastrophes are creating new market opportunities**

Since the 1990s, the increasing frequency and severity of natural-catastrophe losses significantly affected personal- and commercial-insurance carriers.

Globally, average annual economic losses due to natural catastrophes in the past decade were more than twice as large as those in each of the previous two decades. The industry has grown more resilient—through better underwriting practices, a higher level of available policyholder surplus to handle those losses, and reliance on reinsurance and third-party capital—but the property-catastrophe market still has significant coverage gaps. Although the gap fluctuates depending on the nature of the disaster, we estimate that 50 to 80 percent of economic losses caused by natural and man-made catastrophes globally remain uninsured.

Given the concentration of trillions of dollars of assets in the United States, the degree of risk from numerous perils (including hurricanes, storms, floods, tornadoes, and earthquakes), and the relatively high levels of insurance penetration, the United States remains a prime disaster insurance market.

Given the increased concentration of people and assets in high-hazard areas such as coastal zones and expected changes in climate patterns, the future absence of significant investments in risk reduction measures is likely to bring even more devastating events (see sidebar “Climate risks and opportunities: Insurers as game changers?”). Consider the number of US weather events that have caused at least \$1 billion in damages: from 1980 to 2015, the United States experienced an average of five major weather events a year; since 2016, that number has grown to 15. A year or two of quiet weather will not mute this directional change.

## Climate risks and opportunities: Insurers as game changers?

**Recent research** by the McKinsey Global Institute<sup>1</sup> demonstrates the substantial financial impact associated with climate risk: the value likely at stake from climate hazards could double from about 2 percent of global GDP today to more than 4 percent in 2050, equivalent to about \$8 trillion. Beyond GDP, climate change risk could affect our day-to-day lives, with a pronounced impact in certain regions of the world—for instance, through potential migration from areas that may become uninhabitable without drastic intervention. As greenhouse gases increase beyond long-term historical levels, the planet is entering unknown territory. Natural disasters once considered extreme and associated with very low probability of occurrence are becoming more common.

Almost all industries and sectors are affected by climate change risk, as companies (and investors) with physical assets in different regions are deciding where and how to make further capital investments. Insurers have a unique role to play in this context. As underwriters, they know the risk well and can be translators between the complex science of how climate change affects risk and the simple communication of risk levels through market pricing. When insurance prices are risk-based they can create incentives for those living and working in exposed areas to relocate if the risk becomes too high. People could also adopt cost-effective risk reduction measures (such as improving construction and retrofitting and building large barriers to reduce flood surges) and thus benefit from lower premiums. As the second-largest group of institutional investors in the world after pension funds, insurers can significantly

influence decision making by moving their investment strategy toward risk reduction.

However, insurers would need to do take action at scale to be true game changers. As some large, developed markets lose economic relevance and most of the climate risk remains uninsured globally, insurers have an opportunity to increase their economic relevance by allocating capital in developing markets and incentivizing risk reduction behaviors. Carriers could build an industry-wide coalition and increase collaboration with governments. Several fundamental questions exist on how climate change may affect an individual insurance company—and CEOs should have clear answers.

### Where to focus next

Insurance executives can set priorities by monitoring trends and emerging risks.

### Shifts in profitable growth opportunities.

What macroshifts will we observe over the next five to ten years across markets? What second-order exposures, coverages (business interruption), sectors (oil and gas), and geographies (such as India) will grow? Which exposures could represent profitable growth?

**Decline in segment profitability.** Which specific risks will become uninsurable or too expensive because of excessive risk concentration? Where might the shrinking market be (outmigration)? What prevailing risk-transfer models (if any) will exist in these situations?

**Emerging new risks.** Beyond more common long-tail events such as hurricanes, floods, and fires, what new

risks and insurable losses will arise from sustained climate changes (such as an average increase in temperature of 2 to 3°C)?

### Questions CEOs should answer

Stakeholders should be aligned with a company's current exposure and product portfolio as well as the changing regulatory landscape.

**Insured liabilities.** How susceptible to climate change is your book by measure of exposures and concentrations? How do you embed climate change considerations into the risk selection process? Do your pricing, reserving, and capital models consider the effect of a dynamic state? Do your policies carefully consider, anticipate, and mitigate possible losses related to natural catastrophes and climate change?

**Asset investment exposure.** Are your investments responsible, sustainable, and carbon-free? What are your investment exposures to climate risk? Have you completed a thorough diagnostic? How much of your portfolio do you reallocate annually to investments that will benefit from changing climate—for instance, new companies that develop solutions to protect against weather-related events.

**New products and solutions.** In a heightened climate change risk scenario, are the existing insurance products still adequate to operate and insure clients? What new coverage should be designed to respond? Are the current insurance business systems (actuarial-based pricing and reserving) adequate? What different capabilities should insurers build?

<sup>1</sup> Brodie Boland, Hauke Engel, Mekala Krishnan, Dickon Pinner, Carter Powis, Hamid Samandari, and Jonathan Woetzel, *Climate risk and response: Physical hazards and socioeconomic impacts*, January 2020, McKinsey.com.

## Climate risks and opportunities: Insurers as game changers? (continued)

*Regulatory implications.* How fully does your environmental, social, and corporate governance (ESG) strategy consider climate change risk? What demands from state, national, and international regulators are likely to evolve?

Much like any business, insurance is deeply intertwined with ESG concerns. It makes sense, therefore, that a strong ESG proposition can create value for insurers, and the industry more broadly.<sup>2</sup> While some leading insurers and reinsurers

have been quite vocal and made moves to build an ESG plan, which is broader than just environmental issues, many others have been timid. This approach is not viable given the growing pressure and expectations businesses face from society and investors.

Boards and P&C CEOs must define their ESG plan and ensure it aligns with the company's mission before allocating resources toward it. Not taking this first step is likely hurting insurers already. For

instance, today many young professionals weigh this commitment quite directly in assessing job offers from a company. In addition to supporting local communities where the insurer operates, repositioning the insurer's investment strategy is a good area to focus on. Insurers are already tremendous market shapers. As such, insurers have an opportunity (if not a responsibility) to be at the forefront on those issues.

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<sup>2</sup> Lindsay Delevingne, Anna Gründler, Sean Kane, and Tim Koller, "The ESG premium: New perspectives on value and performance," February 2020, McKinsey.com.

Natural disasters, once considered extreme with a very low probability of occurrence, are becoming more common.

In 2017, Hurricanes Harvey, Irma, and Maria devastated parts of Florida, Texas, Puerto Rico, and several Caribbean islands. Each storm was among the ten most costly insured natural catastrophes in the world, with total economic costs surpassing \$270 billion. And in fall 2018, Hurricanes Florence and Michael swept across Florida and the Carolinas, becoming two of the most destructive storms in recent years. Then, that November, large-scale wildfires erupted throughout California, leading to the costliest and deadliest wildfire season in the state's history.

Insurance payouts in the United States have played an important role in helping insured residents and businesses recover financially. Indeed, despite insured losses of historical proportion in 2017, no insurer went bankrupt as a direct result of these catastrophes. Yet a significant portion of total economic losses from hurricanes and floods are still not insured. The US government is playing a greater role in providing some loss coverage, raising questions about how to fill the remaining insurance gap and help residents and businesses recover from natural catastrophes.

Consider floods: they are typically excluded from homeowner's insurance in the United States, instead covered by the federally run National Flood Insurance Program. Nearly nine out of ten people in the United States lack flood insurance, despite half the population living near water.<sup>9</sup> This personal line financial-protection gap is even more worrisome considering that more than 40 percent of Americans cannot pay for a \$400 emergency expense.<sup>10</sup> Taking 2017 as a test case, our analysis of flood insurance penetration in counties most affected by hurricane-induced floods revealed that as many as 80 percent of Texas

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<sup>9</sup> "Facts + Statistics: Flood insurance," Insurance Information Institute, April 1, 2020, [iii.org](http://iii.org).

<sup>10</sup> *Report on the economic well-being of U.S. households in 2017*, Board of Governors of the Federal Reserve System, 2018, [federalreserve.gov](http://federalreserve.gov).

homeowners, 60 percent of Florida homeowners, and 99 percent of Puerto Rico homeowners did *not* have flood insurance.<sup>11</sup>

And this gap is not just unique to the United States; our research reveals that voluntary purchase of catastrophe insurance for residential lines is typically low around the globe. Many behavioral barriers are well documented: people largely underestimate the likelihood or severity of a natural disaster, deprioritize insurance purchases in favor of other needs perceived as more immediate (such as education and healthcare), and many do not view disaster insurance as affordable. In addition, some people mistakenly believe homeowner's insurance covers catastrophe risks, while others expect the government to help cover them.<sup>12</sup>

In fact, countries with high penetration levels for catastrophe coverage either include it within the overall homeowner policy as bundled coverage or make purchasing that protection a requirement for its residents. Countries as diverse as Israel, New Zealand, Spain, and the United Kingdom all enjoy flood insurance penetration of 70 to 100 percent as a result.

The same holds true for earthquake insurance: France and New Zealand include earthquake insurance in the typical homeowner's policy and as a result, earthquake insurance penetration is higher than 90 percent in both countries. In Chile, banks actively impose mortgage-linked requirements; thus, more than 80 percent of homeowners have earthquake insurance.<sup>13</sup> And in Japan coverage is voluntary, but recent earthquakes have served as vivid reminders of the reality of the risk—about 40 percent of homeowners have earthquake insurance there.

In contrast, nine out of ten homeowners in California, well-known for its seismic risk, do *not* have earthquake insurance—neither the state nor the banks require that kind of coverage. This insurance gap begs the questions: What will happen in the aftermath of a massive earthquake in the state? Who will pay? What will be the economic and social implications?

For those who are not insured, recovering from such events will probably be much harder than expected. Affected individuals will often have to rely on uncertain and limited government relief programs and, when eligible, take on an additional loan or rely on donations. State and federal government agencies in the United States, for instance, have come to play a much more important role in disaster financing than they had previously, substituting market solutions for taxpayer-supported postdisaster relief programs.

An examination of several major disasters in the past 60 years illustrates the growing role of the US federal government in assisting with economic relief after large disasters. When Hurricane Diane hit North Carolina in 1955, US federal relief represented only about 6 percent of the economic cost of the disaster. In 2017, the year of Hurricanes Harvey, Irma, and Maria, federal payouts were in the 70 percent range (Exhibit 11).<sup>14</sup>

Under the right market and regulatory conditions, de facto risk retained by governments could be transferred to market insurers. In 2018 alone, 61 percent of global-insured catastrophe losses occurred

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<sup>11</sup> In the United States, the private insurance market for residential flood risk is relatively small and protection is typically offered through the federally run National Flood Insurance Program. This program has come under scrutiny in recent years given that it now runs a \$20 billion deficit, not having charged enough overtime premiums to compensate for years with large catastrophes.

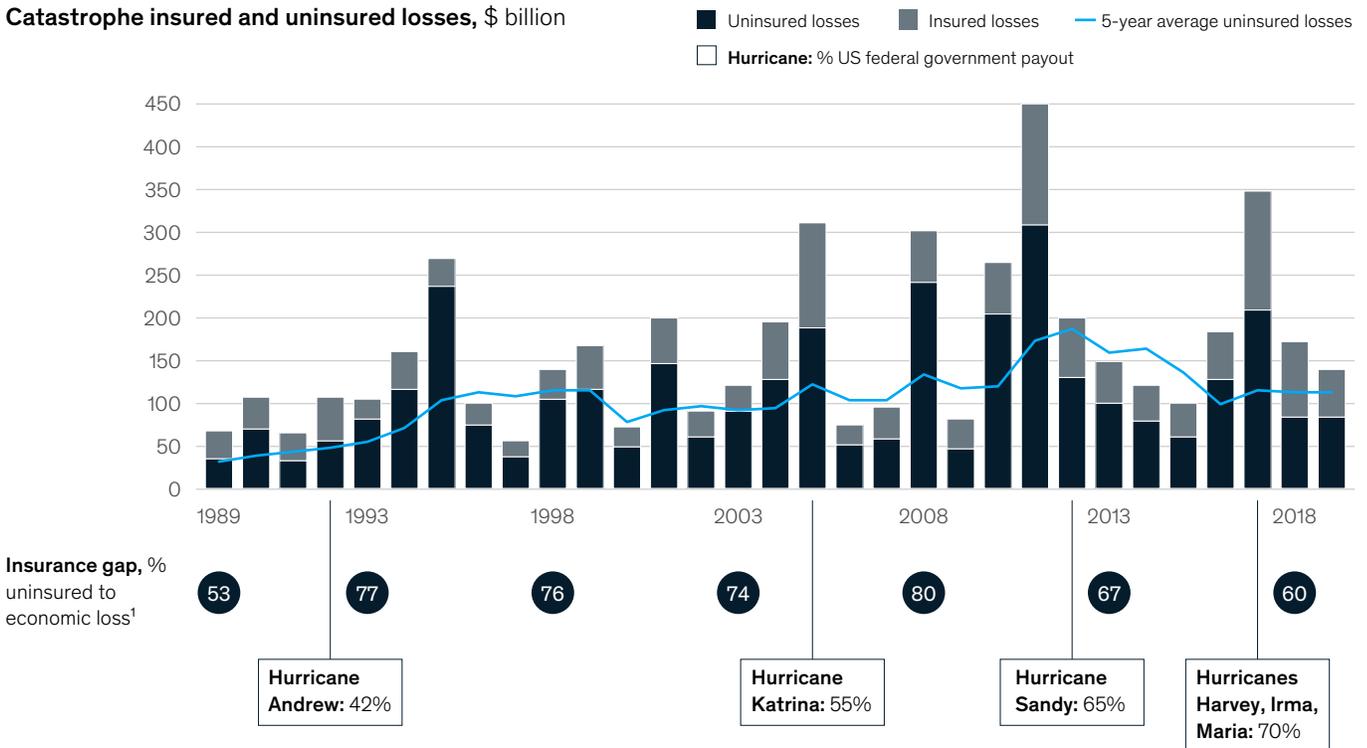
<sup>12</sup> Howard C. Kunreuther and Erwann O. Michel-Kerjan, *At War with the Weather: Managing Large-Scale Risks in a New Era of Catastrophes*, Cambridge, MA: MIT Press, 2009; Howard C. Kunreuther, Mark V. Pauly, and Stacey McMorrow, *Insurance and Behavioral Economics: Improving Decisions in the Most Misunderstood Industry*, Cambridge, UK: Cambridge University Press, 2013.

<sup>13</sup> Michael Useem, Howard, Kunreuther, and Erwann Michel-Kerjan, *Leadership Dispatches: Chile's Extraordinary Comeback from Disaster*, Stanford, CA: Stanford University Press, 2015; *Financial Management of Earthquake Risk*, first edition, Paris: Organisation for Economic Co-operation and Development, 2016.

<sup>14</sup> Erwann Michel-Kerjan and Giambattista Taglioni, "Insuring hurricanes: Perspectives, gaps, and opportunities after 2017," December 2017, McKinsey.com. According to the Congressional Research Service, "three supplemental appropriations bills have been enacted in response to the US Administration requests made in September, October, and November 2017 in the wake of these incidents, providing \$120 billion in budget authority and canceling \$16 billion in debt held by the National Flood Insurance Fund"; for more see, William L. Painter, "2017 Disaster Supplemental Appropriations: Overview," Congressional Research Service, March 20, 2018, fas.org.

## Significant catastrophe-insurance protection gaps remain.

Catastrophe insured and uninsured losses, \$ billion



<sup>1</sup> Economic losses equal insured losses plus uninsured losses of total economic losses covered by federal payout.

within the United States, and the gap in US coverage creates opportunities for international carriers as well, since a significant portion of US property is reinsured via Bermuda or the London Market.

In this context, institutional investors and others have direct access to catastrophe risk in ways that were not available a decade ago. Small changes in the appetite of these investors can have a big impact on the reinsurance market. Currently, close to \$90 billion of assets under management (about \$30 billion for catastrophe bonds) is invested in more than 30 specialist fund managers, making up about 20 percent of the \$450 billion of capital supporting the global reinsurance industry. However, that \$90 billion represents a very small portion of the \$10 trillion invested in alternative assets. Today, the most enthusiastic institutional investors allocate no more than 3 to 4 percent of their assets to reinsurance.

The performance of these specialist reinsurance funds has been more varied since 2017 and 2018 than in preceding years, which produced strong, uncorrelated returns. Indeed, since the historic 2017 hurricane season, some managers have grown or emerged while others have shrunk or shut down. Part of that shrinkage is the direct effect of paying losses, though some investors have decided to pull back from the sector. Investors have been harsh with managers that surprised them with issues such as liquidity, loss estimates, or portfolio composition. Shrinking assets under management puts pressure on funds that have made concessions on management fees and need to overcome high-water marks to start generating performance fees again.

Despite a lower level of catastrophe losses (about \$140 billion globally, 60 percent of which was uninsured), 2019 continued to be a challenge for some funds because of persistent loss creep from 2017 and 2018, and rising catastrophe-bond yields (which caused mark-to-market impairments to fund values), as well as other issues.

Large fund managers have now established track records that extend through both good and bad years. Investors will continue to judge them on their performance and allocate capital accordingly. Insurers will always need to buy reinsurance from someone, but it is likely that the mix of counterparties will continue to evolve.

### **Implications for insurers**

P&C carriers are being challenged by the latest catastrophe events and the prospect of continuously increasing risk aggregation, unless proper risk-reduction measures are adopted by those at risk. To address these challenges, CEOs should consider a few implications to help guide their strategies.

While we focused on developed markets in this context, these considerations are becoming increasingly relevant in developing markets. In fact, the insurable mass is growing quickly there as well, including in highly exposed hazard areas.

*The long-term evolution of natural disasters requires increased sophistication of probabilistic-catastrophe models and pricing approaches.* To some extent, this development is pushing the industry to reinvent itself, improving and adapting in areas where it has historically excelled. Carriers should be ready to quickly handle a significant spike in claims should it occur. Advancements in analytics are helping insurers make this shift by increasing customers' risk awareness (through telematics) and possibly pushing the frontier of insurability for disasters. Insurers should focus on using technological advances to better underwrite risk and decide where to allocate capital so that it can generate the best return. However, this evolution also means that smaller carriers must rely more on external partners and market solutions.

*In the short term, P&C carriers face complicated regulatory and political barriers to free market pricing.* Increased home insurance prices, reflecting the worsening risk profiles of certain geographies because of changing climate patterns and rising sea levels, could be one of the best market signals that it's time to adapt. The continuously growing concentration of assets in high-hazard regions is another. For instance, the population of Florida has increased by 1,000 percent since 1940, and the population of multiple megacities in Asia has increased by even more over the same period; both regions are prone to natural disasters. However, many constraints—such as price caps and conditions on nonrenewals—are being imposed on insurers in the short term, spurred by political will toward local constituencies. Finding acceptable transition strategies that allow pricing to reflect underlying risks will be essential for the industry.

One part of the answer might be increasing the prevalence of PPPs for certain types of risks. The affordability of insurance should not be addressed by artificially suppressing rates, which could create a moral hazard issue. Instead, affordability could be addressed by developing a tailored, means-tested voucher program supported by the government for those who require assistance purchasing insurance.<sup>15</sup> Whether or not certain disaster insurance should be required or optional (including coverage for these types of risks unless the policyholders specifically request that protection be excluded) is worth exploring.

In the end, this is a societal choice too, since insurance cannot be the only answer to growing risks. In areas where the insurance markets deem the risk uninsurable or regulators do not let insurers charge risk-based pricing, the state of the local economy—which traditionally spreads risk nationally and internationally—is uncertain.

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<sup>15</sup> Erwann Michel-Kerjan and Howard Kunreuther, "Paying for future catastrophes," editorial, *the New York Times*, November 24, 2012, [nytimes.com](https://www.nytimes.com).

# To take the lead, carriers will need to prove their resilience by becoming savvy on real-time pricing, contextual marketing, behavioral pricing, and anti-selection avoidance.

## **Evolving data-and-analytics technology is changing the game in acquisition, risk selection, and underwriting and pricing**

Digital marketing is now a must-have competitive skill in auto and home, especially as more insurance purchases are made online.

Aggregators and insurers increasingly compete on pricing, especially as aggregators enhance price transparency and facilitate policy comparison for customers. As insurers become more adept at using external data and simplifying questions and products, the cost–benefit of providing additional expertise through face-to-face contact will be further challenged. To take the lead, carriers will need to prove their resilience by becoming savvy on real-time pricing, contextual marketing, behavioral pricing, and anti-selection avoidance.

The rise of IoT sensors allows for real-time risk measurement and prevention,<sup>16</sup> helping insurers better understand the need and tailor coverage, especially in auto and homeowner's lines. Telematics are already being used to capture information on usage, driving habits, and driver behaviors to help inform auto insurance policies. And IoT sensors used in the home can help prevent losses by identifying leading indicators of risk in equipment and appliances. The data collected from the sensors will reduce adverse selection and moral hazard and mitigate the frequency and severity of losses by using early-warning signs to alert customers. Currently, P&C insurers have few opportunities to be the orchestrator of IoT ecosystems due to limited access to free and easy data. Therefore, carriers must partner with other organizations to gain access to IoT data.

We also expect that a significant part of underwriting will become more streamlined, reducing leakage caused by human error. Technology will lead to faster and more standard decision making, and automated systems will reduce the need for data entry and reporting functions. Carriers are already looking to codify the underwriting process and incorporate technology—for instance, through dynamic decision trees. This trend will affect small commercial insurance first followed by the middle market. Blending external data into the underwriting process will lead to better underwriting in personal lines as well as less incorrect or filler information.

The race for sophistication in data-and-analytics capabilities will also recategorize the P&C industry. Smaller insurers (those that could historically thrive purely on lean operating models, solid local distribution, captive customers, or decent technical expertise) will be increasingly challenged to invest at scale to meet new customer expectations and industry best practices. Gaining access to data and analytics capabilities requires

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<sup>16</sup> Simon Behm, Ulrike Deetjen, Sanjay Kaniyar, Nadine Methner, and Björn Münstermann, "Digital ecosystems for insurers: Opportunities through the Internet of Things," February 2019, McKinsey.com.

skill in choosing the right partnerships and acquiring technology investments. In contrast, insurers with larger investment budgets will be able to develop more of the capabilities internally to differentiate themselves from competitors. In both cases, the predominance of legacy IT systems at many insurance companies will require a programmatic change—an overhaul of systems, processes, and talent. For more, see shaping force five, “Stagnant productivity can be reversed through innovation and new operating models.”

### **Implications for insurers**

P&C insurance will continue to be affected by developing data and advanced analytics. Carriers must adapt, reimagining their strategies to include technology and hiring the right people to implement it. In this context, carriers must consider two implications.

*Consumer data will be critical along the entire P&C value chain.* Carriers can gain privileged access to data on user behavior or from IoT sensors in only a few circumstances. Therefore, to gain access to data and advanced analytics, carriers will need to cultivate the right partnerships and discern which data is valuable enough to pay for.

*Insurers should invest in technology and partnerships.* Traditional P&C carriers should continue shifting their talent mix from a large workforce that’s busy with transactional policy and claims activities toward one with much more data engineering expertise. This talent strategy significantly changes the policy and claims roles as well as the mandate of P&C carriers’ HR function. Attracting the right mix of people requires a reexamination of the employee value proposition and traditional recruitment approaches. Winners historically had to fight to get the best actuaries, but now they must either invest in the data and advanced analytics technologies that might attract data science experts or forge potential partnerships as a selling point.

## **A shift to solutions and services and the growth of ecosystems will reshape distribution**

The shift to ecosystem distribution will vary significantly by product, depending on three factors: the nature of the risk, customer behavior, and competitive landscape. As ecosystems connect services and break down boundaries, the definitions of when and how risks occur will change, as well as how they are managed.

In a best-case scenario, ecosystems act as a frictionless gateway to an array of services. Ecosystem orchestrators and participants, such as car-sharing service vendors, could also collect and integrate massive amounts of data from different services. Participants can use this data to become and stay relevant in the eyes of the customers, offering them an array of services and products tailored to their needs. How willing these players are to enter and compete in ecosystems, as well as their attitude toward risk-management services, will significantly affect the future distribution landscape.

Compared with traditional personal insurance distribution channels such as intermediaries (independent and captive agents) and direct channels, ecosystems account for only a small fraction of the total premiums distributed. We estimate the current share—in the shape of affinity, sponsorship, partnership, or service vendors—to be 10 to 15 percent, with high variance across countries and products.

However, in the next 15 years the emergence of platforms or ecosystems in place of traditional industries will continue.<sup>17</sup> Customer demand for immediacy and convenience will fuel the growth of these ecosystems, which will account for 30 percent of global business revenues by 2025<sup>18</sup> (Exhibit 12). Asia has several

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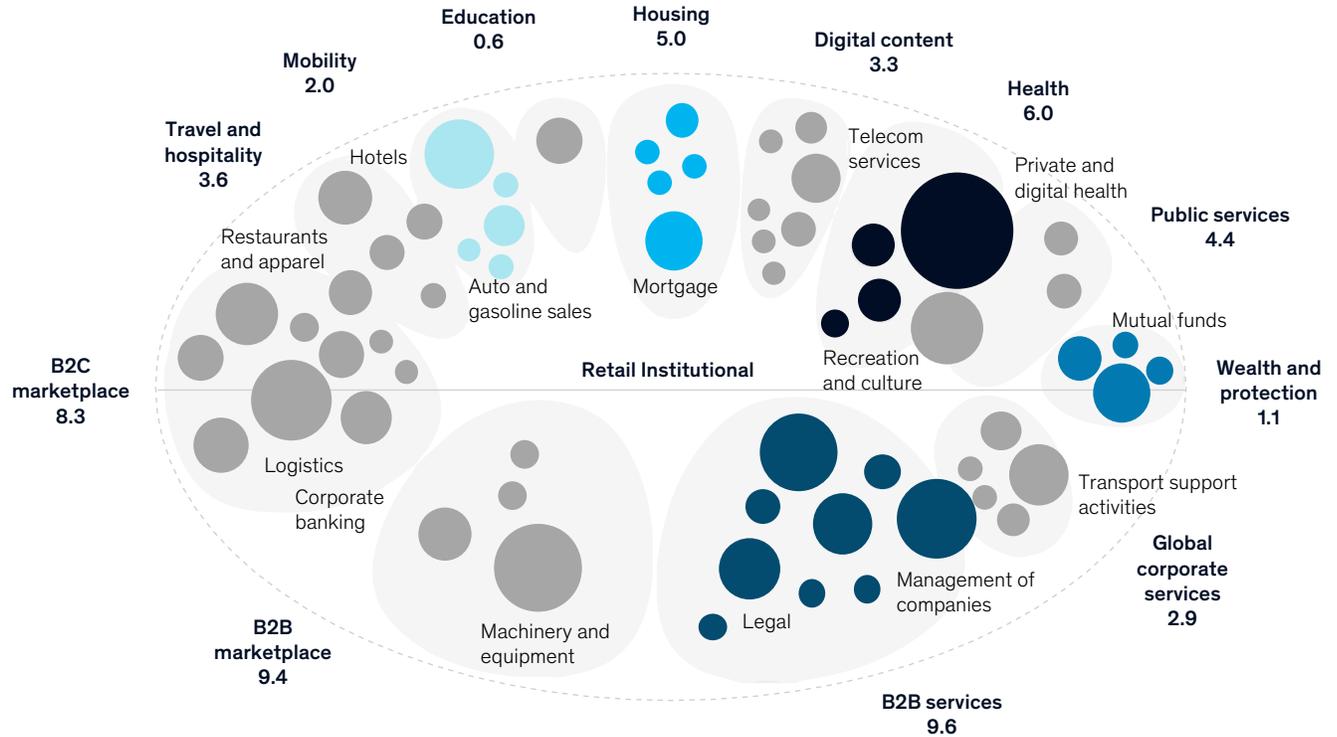
<sup>17</sup> Tanguy Catlin, Johannes-Tobias Lorenz, Jahnvi Nandan, Shirish Sharma, and Andreas Waschto, “Insurance beyond digital: The rise of ecosystems and platforms,” January 2018, McKinsey.com.

<sup>18</sup> Catlin, Lorenz, Nandan, Sharma, and Waschto, “Insurance beyond digital.”

## New ecosystems will likely replace many traditional industries by 2025.

Ecosystem illustration, estimated total sales in 2025,<sup>1</sup> \$ trillion

Circle sizes show approximate revenue pool sizes



<sup>1</sup> Circle sizes show approximate revenue pool sizes. Additional ecosystems are expected to emerge in addition to those depicted; not all industries or subcategories are shown.

Source: IHS World Industry Service; Panorama by McKinsey

examples of platform-embedded insurance sales taking place inside “super apps,”<sup>19</sup> which offer insurance as an add-on to other products.<sup>20</sup>

Taking a longer view, we anticipate that by 2030, close to 25 percent of personal lines premiums could be distributed by some form of ecosystem—be it mobility, housing, healthcare, or others (Exhibit 13).

### Auto insurance

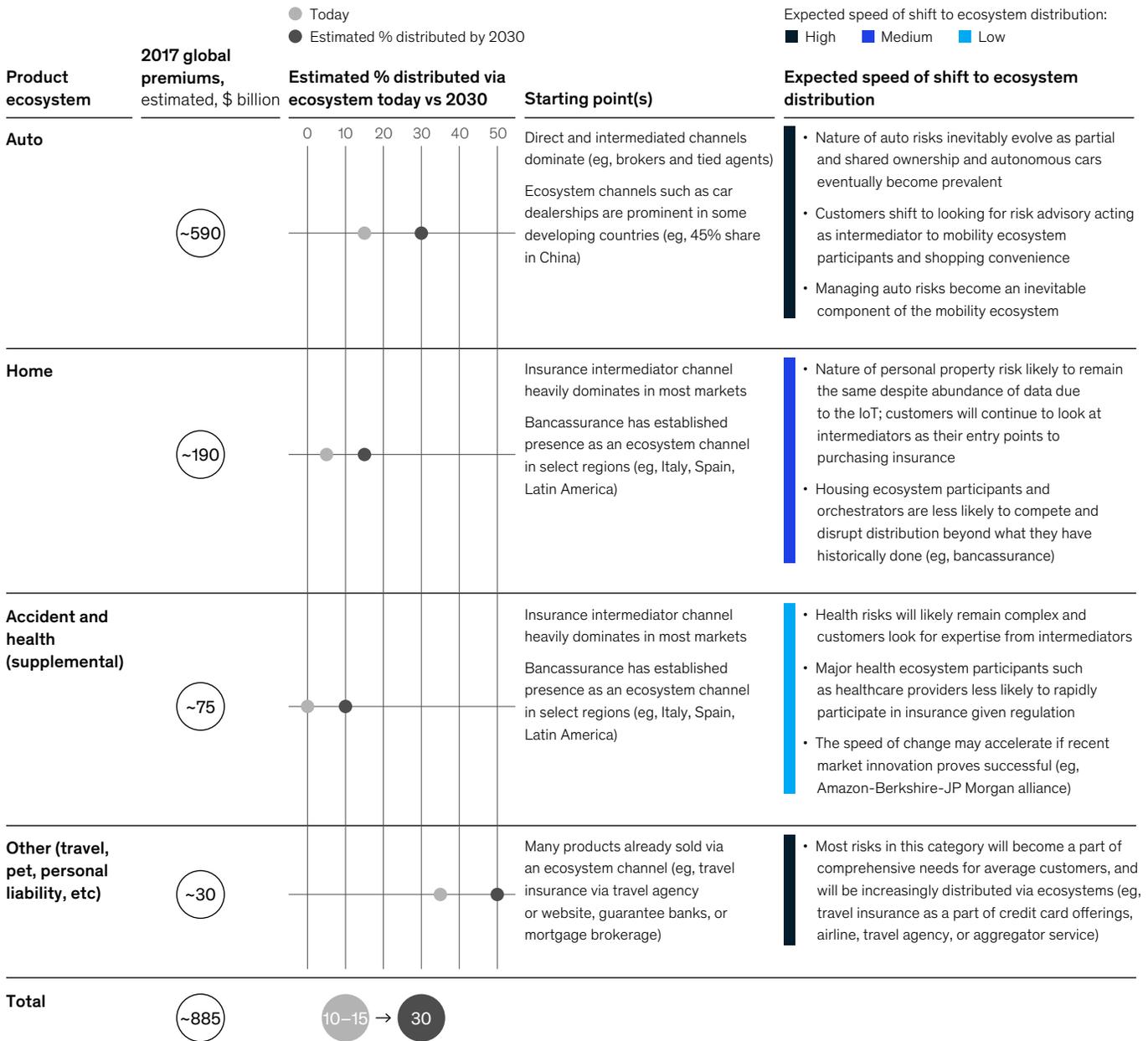
Today, auto insurance is still largely distributed through traditional channels, except in select geographies where service providers in the mobility ecosystem have a significant share. In China, for example, car dealerships account for 45 percent of distribution.

While the mobility ecosystem’s share of distribution is currently estimated to be 10 to 15 percent, in the next 15 to 20 years we expect it to reach at least 30 percent. The nature of auto risk will quickly evolve given

<sup>19</sup> A super app is an ecosystem of apps whereby users can transition from one app to the next under the same platform.

<sup>20</sup> Suchit Leesa-Nguansuk and William Hicks, “Super apps to the rescue,” July 17, 2019, bangkokpost.com.

## Ecosystems will have a significant impact on insurance distribution.



Source: McKinsey Global Insurance Pools

new forms of ownership (such as car sharing) and liabilities (such as software errors from autonomous vehicles). Customers will increasingly turn to ecosystem participants (including OEMs and sharing-economy platforms, such as Uber and Lyft) as a main point of interaction for service, including insurance. With access to different mobility data, it is both attractive and necessary for these service providers to play a larger role in risk management.

### **Personal property or homeowner's insurance**

Today, homeowner's insurance is largely intermediated by brokers and agents, but a small fraction—estimated to be less than 10 percent—is distributed directly by emerging participants of the housing ecosystem such as banks (for instance, bancassurance in Europe and Latin America), mortgage providers, or home security and service providers.

However, the shift from traditional distribution to the ecosystem model will be slower for personal compared with auto, as the nature of personal property risks will largely remain the same. Key ecosystem participants such as banks, smart-home service providers, and sensor technology vendors will likely try to include services such as risk management as part of their future value proposition.

### **Accident and supplemental health (A&H)**

Currently, distribution for the A&H ecosystem channel is estimated to be less than 5 percent. Penetration is greatest in developed markets where customers have high digital maturity, such as the United Kingdom. Developing countries with major ecosystem orchestrators (Alibaba's Ant Financial and Zhong An insurance in China) have played a significant role innovating in the underserved health market.

The complex nature of A&H products means that customers will continue to need a knowledgeable intermediary such as independent or captive agents or an employer-sponsored program to help them navigate the complicated product landscape for purchase. Major supplemental health risks—including critical disease, long-term care, and short- and long-term disability—will also remain complex (if not more so) and less commoditized compared with auto and home.

Historical regulations that separate healthcare providers and insurers will likely continue and limit the health ecosystem's direct competition in the insurance market.<sup>21</sup> As such, the future role of ecosystems in the A&H value chain is uncertain, especially considering major market changes such as the partnership among Amazon, JPMorgan Chase, and Berkshire Hathaway. We estimate a slower shift to A&H ecosystem distribution, with an expected share of about 10 percent by 2030.

### **Other personal products**

Ecosystems already play a prominent role in distribution for most products in personal lines, including travel, pet, and personal liability (such as umbrella and mortgage guarantee). In the United Kingdom, for example, 50 percent of travel insurance is distributed by banks as part of credit card services, and 12 percent by retailers and affinity groups such as travel agencies. Overall, we estimate today's ecosystem distribution already accounts for 30 to 40 percent of the market.

Personal products will likely see the fastest shift to ecosystem distribution, which could handle 50 to 60 percent of premiums. Managing risks such as travel delay or personal liability will increasingly become an integral service that ecosystems such as hospitality, mobility, or finance will need to provide for their customers. For instance, customers that book a trip using a credit card could also get travel insurance to cover delays, lost luggage, and even accidents.

### **Implications for insurers**

This significant shift of the distribution landscape raises several questions for P&C carriers that have a considerable footprint in the personal lines segment.

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<sup>21</sup> One important exception is in the United States, where some healthcare providers are starting to pilot insurance offerings, particularly in Medicare.

*Carriers should study their relationship with customers and sharpen their value propositions.* The traditional wisdom of insurance brand equity and marketing will likely face serious challenges. How will customers make a decision when GEICO, Tesla, and Uber are all trying to sell them auto insurance?

*Insurers must reconsider their cost structure and capital allocation.* How should insurance companies recalibrate their distribution spending to balance the efficiency captured from ecosystems and the capital required to gain the right to play? Cost competitiveness is a must for product providers that do not yet own the last mile or the consumer brand.

*New technology architecture is required to participate in the ecosystem operating model.* The plug-and-play approach in ecosystems is very different from an insurance company's historical infrastructure, which was typically engineered for stability and security. How should carriers invest to catch up?

*Data amassed via ecosystems can provide direction for new offerings.* Ecosystems integrate data collection and allow participants to rapidly innovate on their products and services. To stay relevant in the customer decision and purchasing experience, how will carriers capture value from the enormous pool of data they can access?

*A new operating model requires a reskilled workforce.* An increase in ecosystem distribution would also call for a meaningful change in how carriers manage and reskill their frontline distribution workforce. The skills and knowledge of today are likely a poor fit for a future where distribution relies on the use of data-and-analytics tools.

## **Stagnant productivity can be reversed through innovation and new operating models**

At an aggregate level, the P&C insurance industry has not significantly improved its cost structure in the past 15 years. Administrative cost per policy has remained largely the same from 2004 to 2017 for major markets such as Germany, Japan, and the United Kingdom, while it increased 34 percent in the United States.

Other industries, however, have made headway. In the United States, automotive and telecommunications have reduced their administrative cost per unit by half during the 2004–17 period. Market consolidation has resulted in economies of scale, cost pressure from competition, and the execution of large cost reduction efforts (Exhibit 14).

While cost per unit is not the perfect metric for an efficiency comparison of a balance-sheet business such as insurance, it does highlight the difference in consumer perceptions of value. Automotive and telecommunications services have undeniably become cheaper and have higher-return purchases, while P&C insurance has barely changed over the past decade. To regain economic relevance, carriers must scrutinize their current spending habits and operating models to find efficiencies.

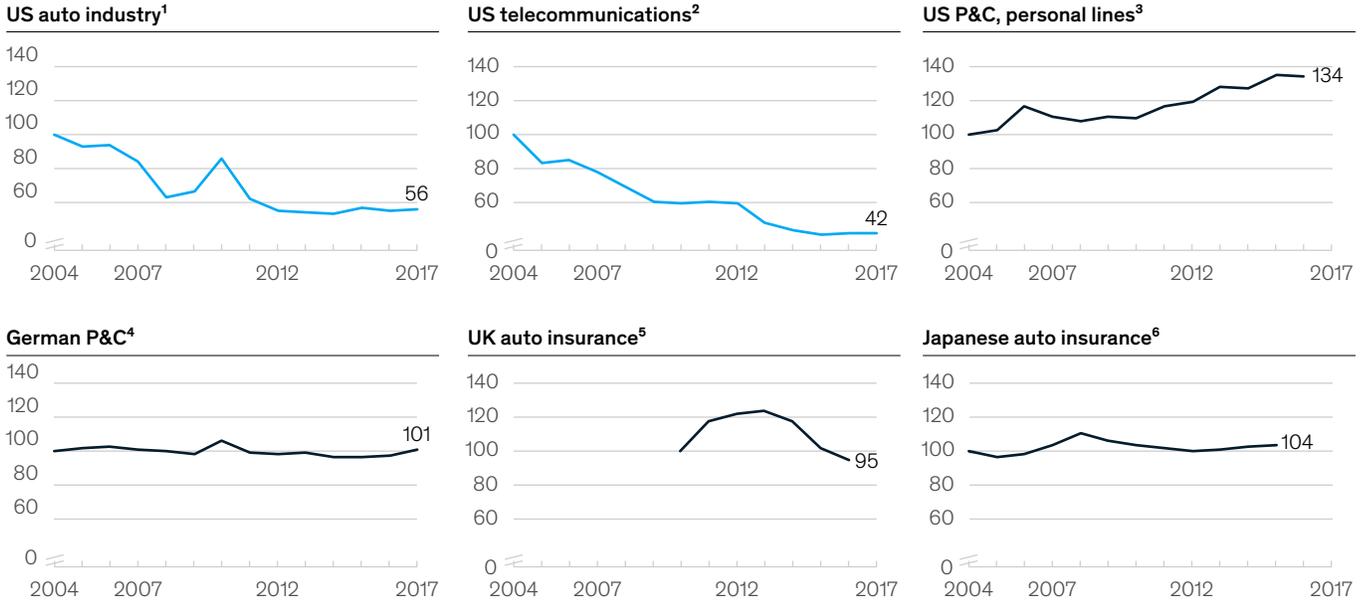
A major cause of persistently high costs for P&C carriers is the relative increase in IT spending. In most cases, this pattern is caused by the push to modernize IT systems to accommodate digital interface requirements, as well as increasing data volumes. According to our analysis, IT-related spending has increased 24 percent since 2012; Western Europe P&C carriers, for instance, saw IT spending rise from 17 percent of total cost in 2012 to 21 percent in 2017. In short, increased IT spending has eaten into some of the demonstrated efficiency gains in pure operational costs.

Exhibit 14

**The insurance industry has not been able to drastically reduce unit costs as much as other industries.**

— Non-insurance industries — Insurance industries

**Examples of administrative cost per unit across industries and geographies, %, normalized to 100% in 2004**



<sup>1</sup> US auto: SG&A costs per vehicle.  
<sup>2</sup> US telecommunications: SG&A costs per line.  
<sup>3</sup> US P&C, personal lines: non-distribution expense per policy.  
<sup>4</sup> German P&C: non-distribution expense per policy.  
<sup>5</sup> UK auto insurance: expense per policy.  
<sup>6</sup> Japanese auto insurance: non-distribution expense per policy.

Source: ABI; GDV; GIP; Memoria estadística DGSFP; NAIC; SNL Financial; Thompson Reuters; Yankee Group

Auto and telecom companies have also heavily invested in new information technology, though they have significantly cut their operating costs.

Our analysis also revealed a gap in cost performance that could continue to widen. From 2012 to 2017, we have seen operating cost per GWP between top- and bottom-quartile carriers in Western Europe increase from 24 percent in 2012 to 45 percent in 2017 (Exhibit 15).

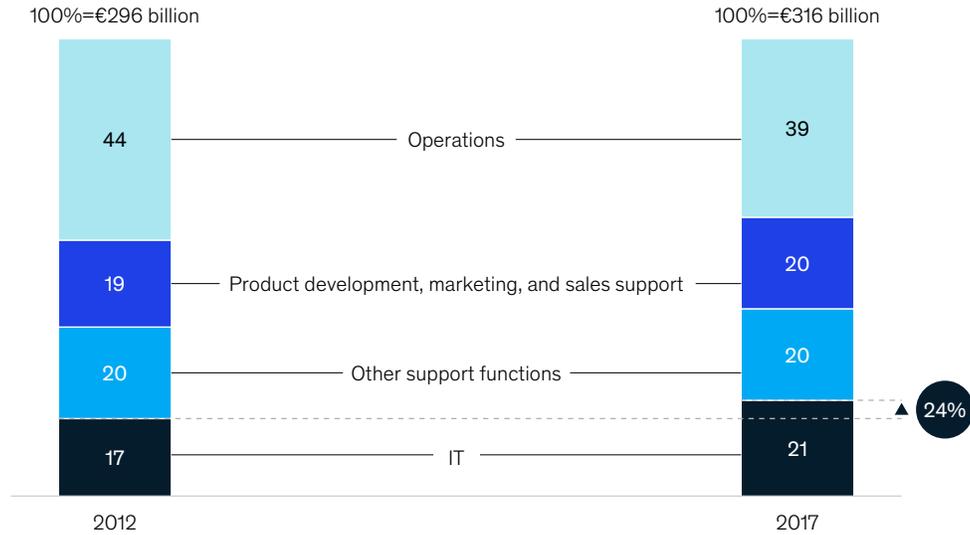
**Implications for insurers**

As the trend toward programmatic cost reduction and increased efficiency becomes more prominent, small to medium-size carriers must respond to remain competitive (and relevant) with their wealthier peers. In practice, this could result in more innovative, structural changes to the industry, including strategic alliances or partnerships. P&C carriers should consider two implications.

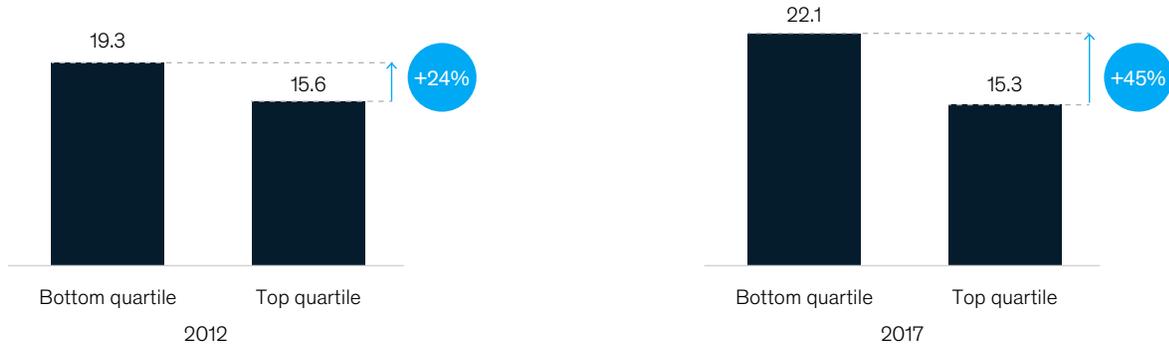
*P&C carriers need to justify the business case for new technology investments.* Carriers' race to invest in the next wave of technology such as automation, robotics, and artificial intelligence could eat into traditional

**The spread in operating costs between top- and bottom-quartile P&C players has substantially increased since 2012, despite increases in IT spend.**

Value chain elements, % of gross written premiums



Operating costs, % of gross written premiums



Source: McKinsey Insurance 360, select Western European carriers

operations costs. Since most quick-win automation efforts have already been addressed, insurers need to justify the business case for new technology investments—for instance, by considering expense reductions, loss ratio improvements, and better customer targeting.

*Efficiency improvement is an imperative.* The industry’s current trajectory is inefficient and unsustainable, creating the conditions for disruption. To achieve breakthroughs, the industry must adopt a different operating model that combines multiple technology approaches rather than using a set of disparate cost-cutting initiatives. This would involve digital technologies, automation, and data and analytics to not only reduce error-prone manual processes but also enable an agile way of working.

## Insurers attract fewer digital workers than other industries, thus solving the talent equation should be a higher priority

Companies across industries are scrambling to build and maintain a workforce capable of deploying and managing analytics, automation, and artificial intelligence solutions. These efforts have a direct impact on competitiveness. McKinsey recently conducted a global digital practice survey of 47 large insurance companies to estimate what proportion of their workforce was in digital roles. The findings show that more digitally advanced carriers have a 15 times higher share of professionals in digital positions than less-advanced carriers (Exhibit 16). The survey also revealed that in the insurance industry, people in digital roles often lean toward project-management skills—but will now need to acquire advanced programming skills.

We also conducted an analysis of more than two million profiles of professionals working in financial services.<sup>22</sup> We found that insurance companies are attracting less digital talent than other financial services companies such as fintechs, payments, and asset management (Exhibit 17). In a recent survey, 80 percent of millennials said they have limited knowledge of the insurance industry, and 44 percent said careers in insurance sound “boring.” Indeed, perception can shape reality, and the current reality is that the insurance industry isn’t viewed as relevant or exciting to up-and-coming digitally savvy workers.

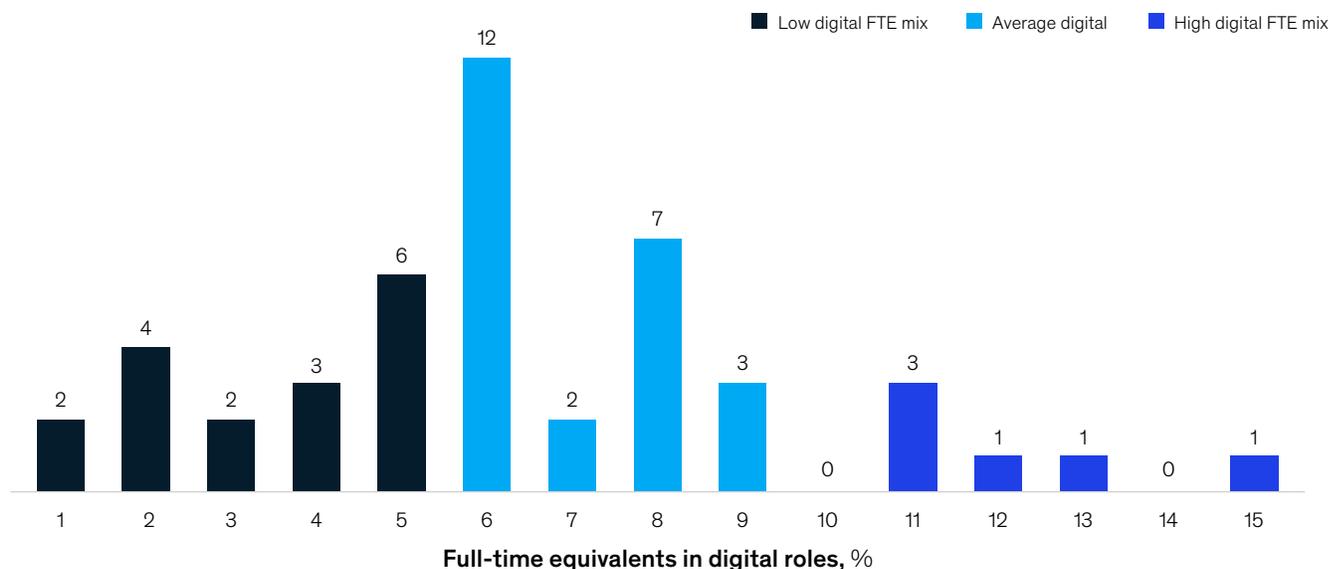
The use of digital technology and automation is expected to increase in insurance, which will have an impact on jobs. For example, automation may affect up to 23 percent of US insurance jobs (Exhibit 18). The impact will be felt particularly in back-office processing (such as claims), which often represents the largest

<sup>22</sup> Based on publicly available profiles on LinkedIn.

Exhibit 16

### Digitally advanced insurers have a 15 times higher share of digital professionals in their workforce compared with less-advanced carriers.

Number of insurance companies by share of digital FTE



Source: McKinsey analysis of 47 insurance carriers globally

Exhibit 17

**Insurance companies are attracting less digital talent than other companies in financial services.**

**Distribution of digital talents across industries, %**

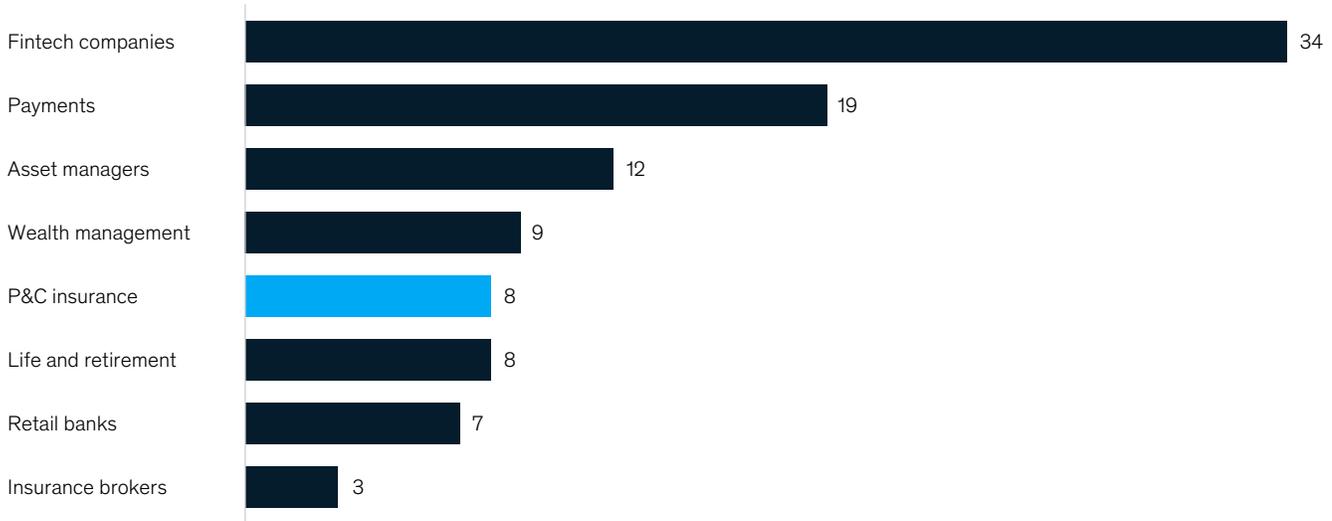
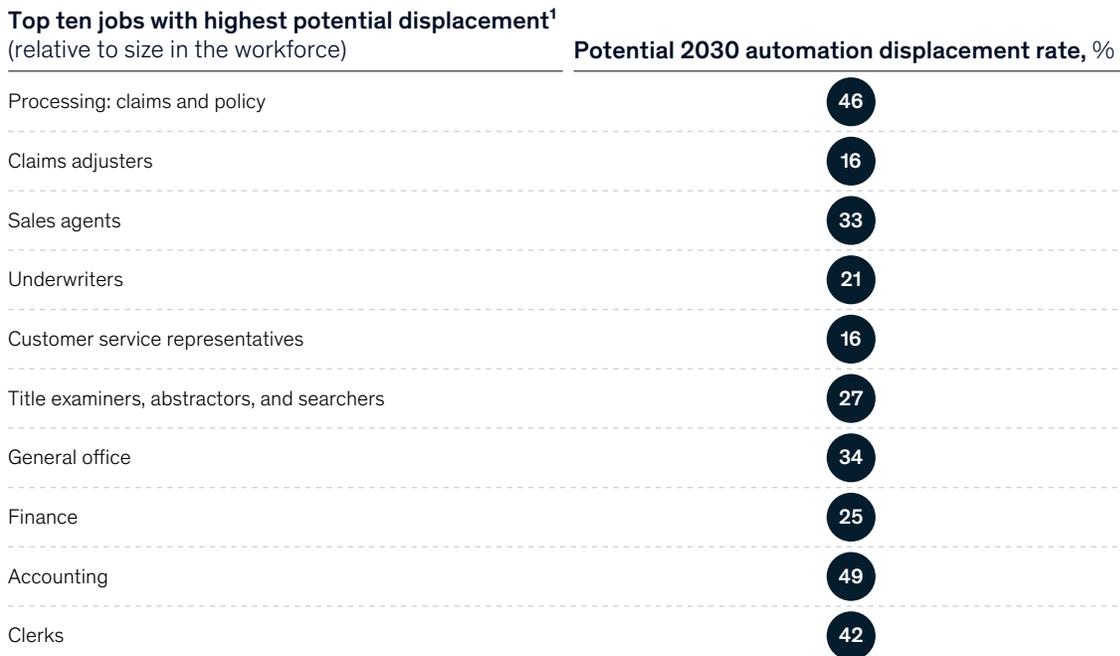


Exhibit 18

**Nearly one-quarter of jobs in the US insurance industry could be affected by automation in 2030.**



Note: Analysis used a 2030 midpoint automation scenario.

<sup>1</sup> Excludes medical, health, and life.

Source: ACS IPUMS microdata; US Bureau of Labor Statistics; McKinsey automation model

portion of the insurance workforce in finance and accounting and sales.<sup>23</sup> In addition, roles that rely on judgment and decision making, such as underwriting and claims, will be aided by systems that significantly boost efficiency, increasing the amount of premiums an underwriter can handle and the number of claims an adjuster can review. Automation's influence will vary across countries and carriers, depending on how manual the work is today and how fast automation is adopted at scale. The implication of automation on the future of work will be profound for the global P&C industry.

For the remaining roles, the skills required will shift drastically. Digital talent will be critical as carriers across all lines expand their reliance on advanced analytics and data to make decisions.

Thus, P&C insurers are rethinking their talent value proposition to attract digital workers from other industries. Some of the touted benefits include offering more flexible work structures and providing more meaningful work. Insurers will need to reach candidates through new channels: millennials and Gen Zers discover job opportunities through friends' social media, digital content that appeals to them, and online research. In addition to attracting candidates from the outside, carriers will need to reskill their existing workers so they can better use data and develop relevant digital channels to reach customers. As billions of people are forced to work from home during the COVID-19 pandemic to limit further spreading of the virus, digital solution adoptions across industries are likely to accelerate.

The actuarial profession, once the career of choice for many people with a quantitative background, is facing significant obstacles. Whereas in the past, many math and statistics majors chose to be actuaries, a number of those college students now favor the shorter educational and career path that data science offers. Our research of the future of work reveals that data scientists now command the same level of compensation as actuaries, if not higher.

More broadly, the ability to attract, train, and retain junior and midlevel workers is becoming a critical competitive advantage for insurers. Some boards procrastinate, claiming they will address the talent issue later. But boards cannot wait: according to the US Bureau of Labor Statistics, the number of insurance professionals aged 55 years and older has increased more than 75 percent in the past ten years. Today more than one-quarter of insurance industry employees are within five to ten years of retirement. CEOs and their boards should already have a clear strategy and execution plan on how their organization will address this looming attrition.

### **Implications for insurers**

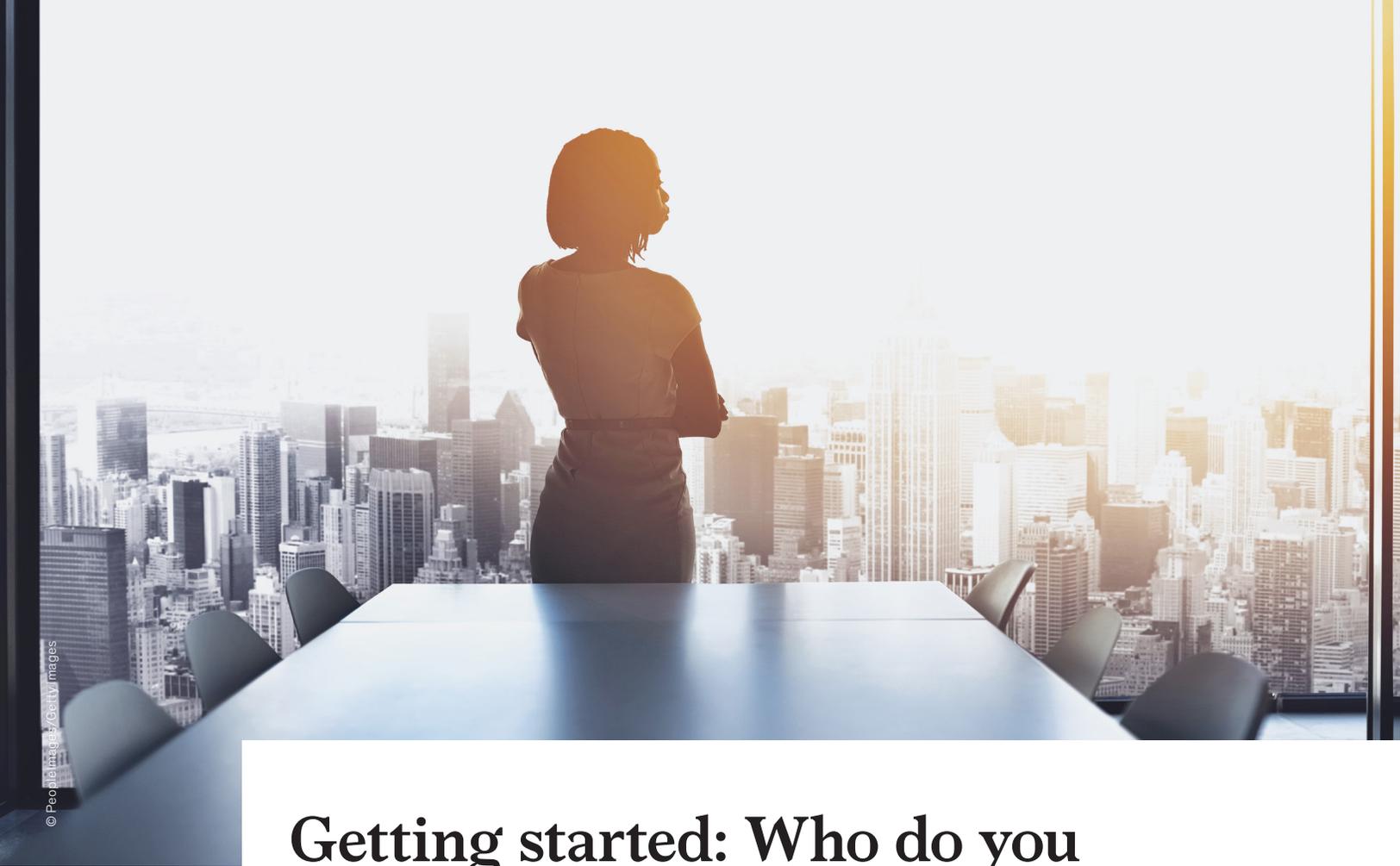
As the need for digital talent increases, P&C carriers need to rethink their current employee acquisition agenda or risk falling behind competitors.

*CEOs and chief human resources officers (CHROs) have a critical role to play in hiring the next generation of talent.* To create value for the organization in the next five to ten years, the CEO and CHRO need to jointly define and execute a clear talent-to-value approach and start hiring at scale. Establishing a clear succession plan is also a must, given the significant number of experienced professionals who will soon retire.

P&C carriers assessing their talent strategy should answer two key questions: How can insurers better attract the right talent and expertise given rapid changes in a service industry where human capital is critical? And how will their value proposition fundamentally differ from what has attracted previous generations of employees to work for an insurer?

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<sup>23</sup> Our analysis consisted of decomposing key tasks across jobs at a granular level and estimating the percentage of those activities that can be automated.



## Getting started: Who do you want to be?

**The pace of change in the P&C industry** will likely accelerate further, possibly reaching a tipping point of major disruption, as other large industries have experienced before. The six forces we identified are reshaping P&C dramatically, with a wide range of implications depending on product line, distribution model, and geography.

In the meantime, the traditional insurance value chain has started to disaggregate. Industry players and outsiders are repositioning themselves to focus on specific elements of the value chain and preparing for the reaggregation of how insurance is sold and consumed in the future. This shifting landscape and dynamic value chain compel CEOs to reevaluate their organization's strategy, prioritization, speed, and operating model.

Our experience shows that many insurers are aware of these forces but have not yet acted decisively. CEOs must decide what kind of organization they want to lead and which business model to adopt. Unfortunately, many carriers have tried to be everything to everyone, with limited success in value creation and economic profit generation. Instead, CEOs must objectively assess where they can win and then make targeted investments to generate growth, attract investor capital, and hire the right talent.

CEOs can choose from four archetypes: value player, capacity provider, core reinventor, and ecosystem partner.

*Value players* will focus on world-class technical underwriting of risk, making significant improvements in owning the customer relationship. These carriers could also position themselves as low-cost alternatives. The value player archetype can fit nicely with traditional personal and small commercial lines (Exhibit 19).

## How can you differentiate yourself as a CEO?

Four archetypes can help insurers understand where to invest

	World-class underwriting	Cover new risks at scale	Own customer relationships	Launch new products and services	Be the low-cost insurer of choice
Value player	●	○	●	○	●
Capacity provider	●	○	○	○	●
Core reinventor	●	●	○	○	○
Ecosystem partner	○	○	●	●	○

*Capacity providers* will excel at underwriting and price-attractive solutions but might not own the customer relationship; instead, they provide capacity to the market.

*Core reinventors* push the frontier of insurability by innovating and bringing new products to market to cover currently underinsured risks. This approach might come at a premium for the customers, but the carrier's underwriting capability has to be top notch given the considerable inherent uncertainty within this new risk space. This archetype embodies a first-mover advantage.

*Ecosystem partners* generate a significant portion of their revenues from non-underwriting activities and build their operating model around this idea. They understand the customers better than most of their competitors, given their sales portfolio of insurance and noninsurance products across the ecosystem. Thanks to new data collection, they can efficiently tailor services to multiple groups of—or even individual—customers.

Each archetype requires focused investment in a different combination of capabilities.

- *Achieve world-class underwriting.* This path involves building additional capabilities, such as analytics and risk selection, to support a truly distinctive underwriting advantage.
- *Cover new risks at scale.* Innovation is altering the risk landscape and presenting new opportunities for the carriers that can adapt and create new products and risk-transfer mechanisms. Cyberrisk and intangibles could be particularly sizable categories.
- *Own customer relationships.* Insurers with direct access to consumers—the last mile—have an opportunity to promote their full suite of products through a variety of channels and models. However, they will have to make investments in branding and intermediaries to maintain their favored position.
- *Launch new products and services.* Generating revenues from services outside of underwriting can be a major source of growth. This approach to differentiation assumes that relevance will come from actively developing and monetizing services related to insurance.

- *Be the low-cost insurer of choice.* Insurers that emphasize operational excellence by focusing on execution and margins could make their products more attractive to new customer segments and become more resilient. This differentiation is a must-have to compete for distribution partnerships with platforms that own the brand and the customer interface.

The road map to reinvention for each insurer will differ depending on its scale, geographic reach, the dynamics of specific markets, and the risk appetite of its executive team, board, and shareholders. The rewards for getting it right are substantial—in the form of market-beating growth and profitability, better services to a larger customer base, brand value, and attractiveness to the new generation of talent.

Each archetype provides carriers with the opportunity to become a true market shaper—but they must avoid trying to do too much. Carriers that have tried to pursue all four archetypes have failed—destroying economic value or generating poor results by spreading limited resources too thin. Without focused investment, insurers cannot achieve transformative reinvention.

Business as usual is no longer an option. P&C insurers must be prepared to pursue bold moves, execute them extremely well, and do so on a consistent basis. The first step is for CEOs to determine what type of organization they want to be by 2025, whom they want to serve, and how they can do it distinctively. It is an exciting agenda.

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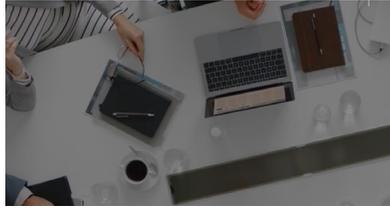
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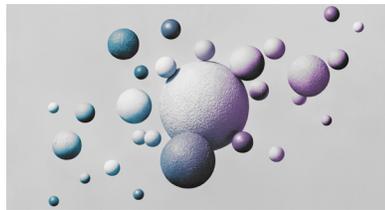
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