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A strategy for a digital age

Few insurers have defined a comprehensive digital strategy fit to withstand attackers at the gate. The starting point is to understand the sources of disruption.

The verdict is clear: those insurance companies with the most advanced management practices related to digital strategy, capabilities, culture, and organization outperform their peers.[1] Yet relatively few incumbents have so far defined a comprehensive digital strategy—the foundation from which all else logically follows if they are to compete in a digital world. Instead, they package together tactical or incremental initiatives that individually drive modest performance improvement—some digital marketing, a new sales channel, or some degree of automation, perhaps—while leaving significant value potential untapped and their futures in doubt.

Why? Part of the answer lies in the extent to which carriers have been protected by regulation and the strength of their in-force books. In addition, CEOs with limited tenures might be wary of upsetting what has served them relatively well—and are likely to be more circumspect when the future is so uncertain. With competitive landscapes changing fast, it can be hard to know just how digital technology will play out, and hence where to place big bets. Yet hesitation is not an option. In insurance, as in other industries that have felt the force of digital disruption, those that move fastest to adapt are likely to take a disproportionate share of the profits.

Hence, a means of discerning clearly the sources of opportunity and disruption in digital technology lies at the core of a digital strategy, and is critical to building a leadership position.

Building a digital strategy

The definition of a digital strategy is no different from that of any other strategy. It is a set of integrated, hard-to-reverse choices, made for the future, in the face of uncertainty, with the purpose of creating and capturing economic surplus.[2]

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The building blocks of a digital strategy likewise resemble those of any other strategy: a diagnosis of where and why a company makes money in the present, a forecast of how that might alter in the future, an understanding of the potential pathways to success, a portfolio of initiatives, and then a commitment to driving change.

1 Tanguy Catlin, Ido Segev, and Holger Wilms, "The Hallmarks of Digital Leadership in P&C Insurance," McKinsey & Company, August 2016.

2 Frederick W. Gluck, Stephen P. Kaufman, A. Steven Walleck, Ken McLeod, and John Stuckey, "Thinking strategically," *McKinsey Quarterly*, June 2000.

What is different in a digital age is the speed and potential magnitude of that change, upending old business models and rapidly building entirely new ones. Circumventing the need to build traditional fixed assets, the likes of Amazon, Netflix, Uber, Airbnb, and a host of fintechs have disrupted incumbents in the space of a few years by using digital technologies, data, and analytics to create value without owning, respectively, physical shops, cable connections to viewers' homes, car fleets, hotels, or bank branches.

The prerequisite of a digital strategy is an understanding of the threats and opportunities that digital technology poses.

All these considerations will transform certain aspects of how companies manage their strategies, even though the foundations remain the same. In the first instance, companies need to be bolder. A McKinsey survey of more than 2,000 executives in industries affected by digital technology shows that the companies with the highest revenue and earnings growth looked for digital opportunities across all elements of their business model, not just one or two, and either led the disruption or were fast followers. These leaders made bets on digital processes across the value chain, on innovative products, and on new business models.

Companies that procrastinate over such bets risk disappearing. In insurance, as in other industries, it takes a while for customers and companies to embrace digital technology, but as the pace of change accelerates incumbents' scope to adapt diminishes. There comes a tipping point where those that have not adapted their strategies fade away—as in traditional print media, for example. The insurance industry might have been relatively slow to feel the digital effect, but personal lines in P&C cover look set on a steep trajectory toward the tipping point, with small commercial lines just behind. Life insurance and large commercial insurance, with longer-term, often more complex contracts, have further to go (see Exhibit 1).

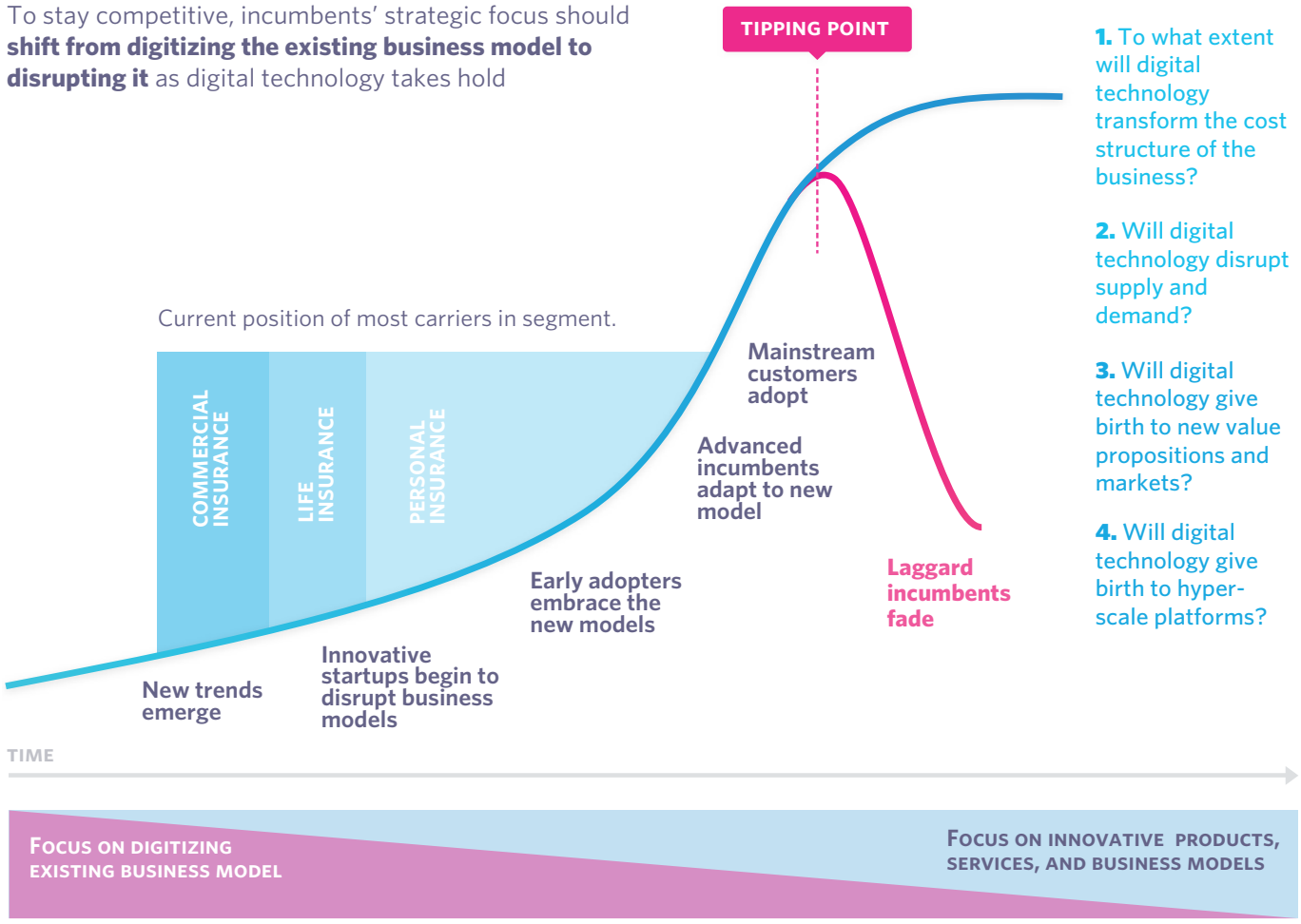
Second, companies need to review their strategies frequently as technology, consumer behavior, and competitors evolve ever more rapidly. The five year strategic review—once a staple of board-level strategies—is increasingly outdated. Recall that five years ago, the iPad, now ubiquitous, had been on the market for only 18 months, Netflix stock was taking a beating after the company suggested it would spin off its DVD delivery business, and Spotify had just launched in the United States.

Third, companies need to build a wider range of strategic options because conditions can change so quickly.

Exhibit 1

The digital tipping point

To stay competitive, incumbents' strategic focus should **shift from digitizing the existing business model to disrupting it** as digital technology takes hold



And fourth, when conditions do change, they will need the discipline and agility to reallocate management time and resources swiftly. As Klaus Schwab, chairman of the World Economic Forum, memorably said, "In the new world, it is not the big fish which eats the small fish, it's the fast fish which eats the slow fish."

The catalysts of disruption

The prerequisite of a digital strategy is an understanding of the threats and opportunities that digital technology poses. A review of what peers and newcomers are up to can help in this regard and presage what the future might

hold. The problem here, however, is that there are hundreds of insurtechs to track, with more appearing as venture capital pours into the industry (to the tune of $1.7 billion). They cannot all be monitored, and it is a sure bet that although some will succeed, most will vanish. It is therefore important to focus on the nature of the disruption rather than on the would-be disruptors, with a view to getting ahead of it—in other words companies must understand both what is happening, and why. Only in this way, according to Tom King, senior director at US software company Pegasystems, will insurers be able to respond promptly to changes in the market.

Our research suggests that digital technology can disrupt in four, non-mutually exclusive, ways. It can transform the cost structure of a business system. It can disrupt supply and demand. It can create new value propositions and markets. And it can create hyperscale digital platforms. There are thus four questions companies should ask in order to start building a strategy.

1. To what extent will digital technology transform the cost structure of the business system?

Netflix took movie rentals and rethought the business around them, then went from DVD delivery to owning one of the world's largest video streaming services. In a digital world, all businesses are likely to be disrupted if they rely on a physical distribution network and involve manual processes that can be automated. It is easy to see how traditional insurance models, often reliant on agents with commissions, could be attacked by companies that are able to automate advisory processes and apply advanced analytics to improve pricing and underwriting. McKinsey estimates that up to 40 percent of P&C and life insurers' expenses are locked up in their top 20 to 30 core end-to-end processes—costs that digitization can reduce, and in some cases, eliminate.

> "It doesn't matter how much business you sell today, it's whether or not you can identify where [future] profits and losses lie, and what you need to jettison."
>
> – Tom King, senior director at US software company Pegasystems

2. To what extent will digital technology disrupt supply and demand?

In the analog world, economics can make it hard to cater precisely to individual demand. Think of the hefty package of supplements bundled together in Sunday newspapers. Most consumers do not read everything, but the economics of distribution mean they get it anyway.

Digital technology can cater to demand more precisely so that customers are no longer obliged to buy elements of a package they do not want. iTunes makes it unnecessary to buy a whole album, for example. This unbundling makes businesses vulnerable to disruption, particularly if they cross-subsidize parts of their offering, as insurers do, with direct sales channels covering the cost of more expensive agency channels.

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Aware of what is afoot, some carriers, such as Progressive, enable customers to "name their price" and choose elements of a policy that fit their budget—the level of deductibles, for example. Some offer pay-as-you-go auto insurance whereby drivers are charged by the mile. And some use data on, for example, driving habits, to price products in a way that more precisely reflects an individual's risk. These developments amount to an "unbundling" of coverage, better matching the protection provided to the protection required.

Digital technology also has the power to unleash supply. YouTube has made it easy and inexpensive for millions of individuals to become published video producers, unlocking a supply of content that previously would have been too costly to distribute. In insurance, complex regulation and capital requirements have restricted supply in primary markets as start-ups seldom want to take insurance risk on to their balance sheets. But start-ups are targeting accessible slivers of the industry, primarily marketing and distribution. And institutional investors are hovering. They have already poured money into insurance-linked instruments on the capital markets in search of non-correlated returns and higher yields, disintermediating reinsurers in the process. Some are now investing in primary markets, a move that digital technology could accelerate. It is conceivable, for example, that a manufacturer of sensors that gather data about weather conditions in order to optimize fertilization could turn to investors to back an insurance product for crops, using the same sensors to indicate whether weather conditions were harsh enough to damage them.

3. To what extent will digital technology give birth to new value propositions and markets?

There are myriad ways of using digital technology to improve value and offer new propositions, such as making purchases simpler and faster, adding fresh elements to a product or service, using data and analytics to make products more relevant, or removing costs incurred by intermediaries. Examples are emerging of carriers using it to reward consumers

with benefits for behaving in a way that aligns with their own interests—such as US insurer John Hancock offering customers discounts on products and services, as well as lower premiums, in return for leading healthy lifestyles. Some digital attackers are making it possible to buy complex products such as life insurance online, while others are using internet crowd sourcing to negotiate better deals with insurers for "long-tail" insurance products. Policies for pug dogs and diabetic travelers fall into this category.

New value propositions can lead to the establishment of new markets, by matching supply and demand in pioneering ways.

And there are new products for new risks—protection against cyber risk, for example, or cover for "sharing economy" risks such as those to which car owners are exposed when they decide to become cab drivers for Uber.

Some value propositions are emerging that threaten to undermine the existing insurance model. The more real-time data becomes available, from sensors in cars or on drones, devices installed in homes, or monitors worn on our bodies, the more companies can learn from the analysis of that data and the more it will be possible to mitigate risk, reducing the need to insure against it. That hits the volume of demand, but risk mitigation becomes a new value proposition in the process.

New value propositions can also lead to the establishment of new markets, by matching supply and demand in pioneering ways. The likes of Uber, Lyft, and the Chinese ride-sharing company Didi Chuxing use digital platforms with location-based mapping technology to match would-be passengers with the drivers in closest proximity, along with analytics to make dynamic pricing adjustments and encourage drivers to meet demand in peak periods. It is a far cry from passengers trying to hail a taxi in the street. In insurance, online price aggregators have established markets to help consumers compare prices and bypass the traditional agent distribution model.

4. Will digital technology give birth to hyperscale platforms?

Digital technology can give rise to companies that build platforms on a massive scale. Their size, the huge amounts of data they amass, and the depth of analytical talent they deploy—along with the network effects they generate—are hard for others to match and thus create barriers to entry.

Moreover, these companies' skills and capabilities enable them to blur traditional industry definitions by spanning product categories and customer segments and

inventing new value chains. For example, Uber has signed a deal with Volvo to invest in the development of self-driving taxis in the United States; testing began in Pittsburgh in September 2016.[3] Apple has used its unique data, infrastructure, and product platform to push into the world of finance with Apple Pay. And Chinese e-commerce giants Alibaba, Tencent, and JD.com have leveraged their volumes of data to offer microloans to the merchants that operate on their platforms. By using real-time data on merchants' transactions to build its own credit scoring system, Alibaba's finance arm has been able to achieve better non-performing loan ratios than traditional banks.[4]

Insurers will need to consider what their role might be in the ecosystems developing around these data platforms, and where value lies in owning and analyzing data.[5] Will, say, a large car manufacturer that fits sensors as standard in vehicles amass enough data to dominate an ecosystem that brings together insurers and other service providers such as telecom companies, repair shops, road side assistance, telematics providers, and legal services?

A heat map for capturing value

The process of understanding these forces and analyzing the value at stake will reveal the need for a portfolio of initiatives that grapple simultaneously with two strategic imperatives.

The first is the need to capture short-term value. In the early stages of disruption, digital technology invariably starts to transform the cost structure of the business system and disrupt supply and demand, posing opportunities and threats to incumbents. To respond, they will need to digitize their businesses in order to cut costs, grow revenues, and improve the customer experience. Essentially, however, the business model will remain the same.

> By understanding the catalysts for disruption and regularly reviewing their businesses, companies will be able to lead the wave of disruption as it gathers strength, not drown in it.

Drawing up a heat map that examines the value at stake throughout every business line will indicate the extent of the opportunity—the cost savings an auto carrier could make by digitizing and

3 "Uber and Volvo to develop self-driving cars," Financial Times, August 18, 2016.

4 *China's digital transformation: The internet's impact on productivity and growth*, McKinsey Global Institute, July 2014.

5 Nicolaus Henke, Jacques Bughin, Michael Chui, James Manyika, Tamim Saleh, Bill Wiseman, and Guru Sethupathy, "The age of analytics: Competing in a data-driven world," McKinsey.com, December 2016.

automating the claims process, say—as well as the threat if it fails to respond—the fall in profits that would ensue if customers were to gravitate toward price-driven aggregators and comparison sites, for example. The "hot spots" will help a company decide where to prioritize initiatives, although this will depend also upon whether it has the capabilities to pursue them, and upon regulatory issues.

The second strategic imperative will be to look beyond today's business for fresh sources of value. Pondering the potential for new value propositions and markets, and for hyperscale platforms will suggest how digital technology might disrupt not just elements of the value chain but the entire business model. The higher up the digital curve a business line rises, the more imminent such disruption is likely to be, and the greater the need for innovation. The exhibit shows how the strategic focus shifts as digital's influence on an industry grows. In P&C lines it is already apparent that the traditional model is being reshaped by data and analytics that make it easier to mitigate the risks we insure against today. By understanding the catalysts for disruption and regularly reviewing their businesses, companies will be able to lead the wave of disruption as it gathers strength, not drown in it.

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Delivering on these imperatives will prove a hard balancing act for CEOs, faced with the constant pressure of the next earnings report. Although digitizing the existing business will reap rewards, it can require significant investment that pays off after several years. At the same time, innovating for the future risks cannibalizing profits in the here and now, along with organizational upheaval.

The answer lies not in reverting to a strategy of incremental improvement. Competition in a digital age rules this out. Rather, it entails fully grasping where value lies, in order to shape and sequence initiatives in ways that meet strategic imperatives while maximizing quick pay-backs to protect the performance of the business. Understanding the catalysts of change has to be the starting point, helping to reveal where value-creating opportunities lie and where value is at risk, and ensuring companies disrupt before they are disrupted. ▢

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