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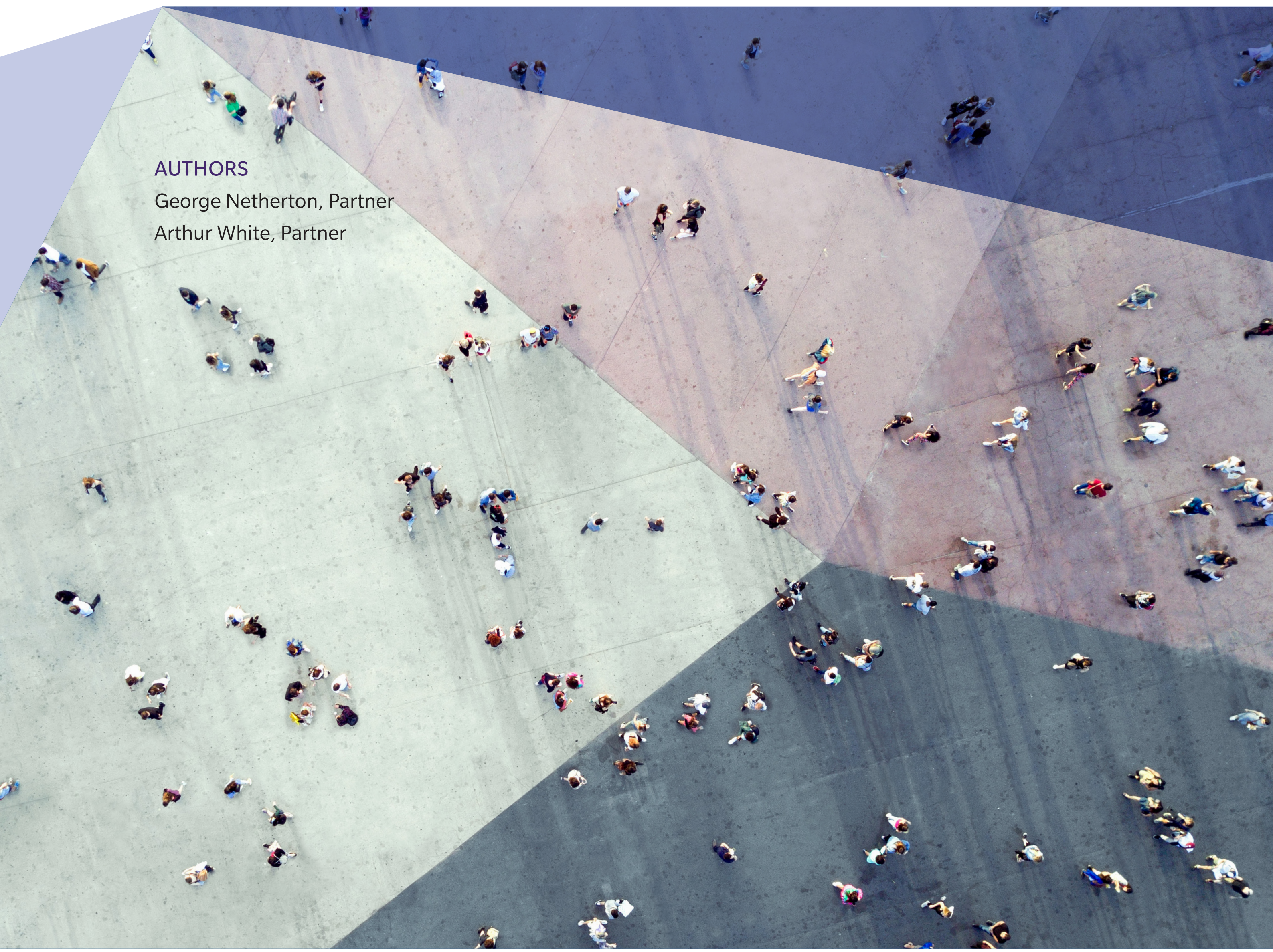
THE FUTURE OF PERSONAL INSURANCE IN THE UK – EXCELLENCE OR IRRELEVANCE



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UK PERSONAL GENERAL INSURANCE IS A PARADOXICAL MARKET

On the one hand: Some leading competitors are generating stronger profitability and return on equity (ROE) than for many years. Insurers are learning how to survive in the fast-moving, price-transparent world of distribution via price-comparison websites (PCW). Forward valuations for leaders are comfortable and not indicative of an industry which investors believe to be in imminent danger.

Yet at the same time, personal insurance CEOs thinking about the medium-term horizon tell us of very legitimate worries over a 5-10 year horizon: will there be demand for today's insurance product? Will they retain any control of the customer relationship? Will they be outmaneuvered by faster or more agile competitors?

So what is really going on and what are the choices for executives?

UNDERLYING TRENDS

A lot of ink has been spilled on the trends in insurance, but it has not always been easy to sort signal from noise. In our view there are five key trends that really matter:

"Motor, Jim, but not as we know it": Motor insurance remains the "anchor" product of the industry today (in premiums if not in profitability). Fears that autonomous cars will destroy motor insurance as a category any time soon are overblown given the slow-moving mathematics of fleet replacement. But the impact of collision-reduction technology is already clearly showing up in reducing accident frequency in the UK. Although for now this is being offset by high claims inflation, over time we expect the frequency effect to start shrinking the total claims pool – and in a highly competitive market the benefit will be passed back to the consumer in lower pricing.

In other words, over the medium term (starting as soon as the mid 2020s) the motor market will get materially smaller and less profitable. And of the remaining pool, less motor insurance will be bought individually by end consumers, as protection gets packaged with autonomous services and the liability for collisions moves over to technology and car firms rather than individuals. Taken together this suggests that the motor market of the future will be dominated by a small number of large business to business to consumer (B2B2C) providers, and the heavily competed retail market of today will be a distant memory.

Battle for the consumer relationship: "you ain't seen nothing yet": UK personal insurers have perennially struggled with building real long-term consumer relationships. The underlying product is useful but unloved by the consumer; the buying journey is generally fiddly and complex; insurers have tended to think in product categories rather than build from customer needs; much time and money has been spent by the PCW industry to educate the customer to compare and switch instead of sticking with one provider over time; and a proliferation of prominent non-insurance brands with strong customer pull and behavioural insight have taken advantage of the low cost of entry in distribution to become established insurance brands.

Yet this may merely be the warm-up act for the main distribution battle. The economics of customer acquisition are changing as customers move from desktop to mobile web- and app-based interactions. Price comparison websites are looking to increase the depth and duration of their customer relationships (e.g. via loyalty schemes and broader cross-category propositions, etc). A number of fintechs (for example Clearscore and their recent soft launch in insurance) have captured very large populations of engaged customers for which insurance could be a natural extension. And – perhaps most disruptive of all – it seems highly likely that at least one of the global digital giants will shortly enter insurance with (in effect) a "super price comparison" offer that could potentially capture a disruptive share of the market, especially if they wield their full pricing power and integrate with their wider customer proposition and retention mechanisms.

In short, the economics for insurers around customer acquisition and brand / marketing spend will become ever more challenging as non-insurance players, with stronger brands, better-quality customer access and richer customer datasets continue to muscle in. This means reliance on direct-to-consumer models and propositions will become much harder (and more expensive) to sustain. Insurers will have to make some hard choices around how and where to focus their business model.

Unsustainable pricing: Paradoxically, although the UK market is in some ways one of the most transparent and competitive in the world for customers who are willing to switch their business, there are persistent skews in where profit is earned. In particular, the industry today is locked into a competitive equilibrium that focuses acquisition spend and discounts on a relatively small number of switching customers that can only be recovered from longer-tenure customers or sales of higher-margin ancillary products.

This equilibrium is unsatisfactory for a number of reasons, not least because a system that relies on making significant profits from customer loyalty, inertia or ignorance is hard to reconcile with principles of customer centricity. It also brings strong financial risk to retention and can open loopholes for behavior verging on predatory.

The equilibrium has been stable over time as it has been competitively hard for individual insurers to move away from industry pricing practices – and for obvious reasons insurers are restricted on acting in concert. Historically the regulator has been reluctant to prescribe pricing directly (though recent pronouncements may indicate more activism in future).

However, collectively the industry and the regulator will have to work out how to move to a more sustainable model, and how to do so in an orderly manner. In this scenario, insurers with large, profitable books of long-standing relationships (or tied into partnerships of this sort) may have to pass some of that profit back to their customers – affecting profitability, the long-term value of their in-force portfolios, and their ability to fund new business price wars. A market where first year pricing is less aggressive may also become more attractive to new entrants and InsurTechs.

More and more modular: It used to be easy to classify insurance competitors as either distributor or manufacturer. However, in a "modular" world where there are viable at-scale outsourced providers of almost every capability / functionality in the insurance value chain, it is possible to compete in a far wider range of roles – Managing General Agent (MGA), specialist claims outsourcer, white labeler, etc. We also foresee the invention of new propositions & operating models – for example in claims – that require radically less infrastructure.

It is also becoming much easier to be modular – digital technology and the advent of API thinking means the cost of connectivity has gone down. This implies is a much lower "minimum viable scale" for insurance competitors building new models, and could open the door for any consumer business with data assets and good customer relationships (banks, digital retailers, travel companies etc) to create insurance businesses.

At the same time it may also provide opportunities for incumbents to build "greenfield challengers" business models alongside their existing businesses – just like in banking, where we have seen increasing numbers of existing banks decide to rebuild their core platform from new rather than trying to rewire the previous core.

Size still matters (but it's not always easy to take advantage): Conventional wisdom suggests large incumbent manufacturing insurers should have enormous scale advantages in personal insurance, given the fixed costs of operating in a regulated sector, the advantages of historic datasets, capital diversification benefits and so on. However, incumbents have not always managed to take advantage: for example, due to the very significant challenges of migrating from inflexible legacy technology (and the financial and management bandwidth that can get absorbed in change programmes), and the difficulties of making large complex organisations act flexibly and entrepreneurially enough to win in the new trading environment. This has opened up space for a number of successful new agile entrants to enter with new platforms and agile, trading-oriented operating models.

Looking forward, it seems obvious that "minimum efficient scale" will continue to increase. In particular in insurance "pure manufacturing", there will only be more pressure on small incumbent producers given the complexity / cost of admin, minimum regulatory hurdles, the cost of operating the balance sheet, and the difficulty of making small scale investments in digital. Further consolidation or exit is likely.

In addition, shifts in the capability and flexibility of newer modular core systems, and the ability to deploy new more powerful algorithms on their existing large datasets, may mean it will be possible for large incumbent insurers to truly make a step change in the efficiency of their cost base and the effectiveness of their trading performance – as long as they can also build sufficiently entrepreneurial trading and innovation processes to take advantage.

However at the same time, the benefits of speed and flexibility in pricing & underwriting and the fact that it is increasingly possible to outsource capital provision and administrative functions will continue to allow space for "small and smart" plays such as reinsurer-backed MGAs – in principle cutting out the traditional primary insurer altogether from the value chain.

IMPLICATIONS AND CHOICES FOR THE GI COMPETITORS OF TODAY

Incumbent insurers are being pulled in different directions, and the right strategic response is not at all clear. In core manufacturing, scale still seems to matter (but age and over-complexity are painful). In pricing and underwriting, speed of movement and differentiated insight are key, but access to customers and their data retains its importance. In distribution, the game is about customer relevance – and the rules of the game are changing significantly. Worse, these are not independent trends; there are plausible end state scenarios where multiple trends combine in very unfavourable ways for today's competitors.

Hence It is far from clear how to optimize the business for these apparently conflicting demands. We believe there are four core choices:

1. Consolidate or be consolidated in manufacturing?

"Pure manufacturing", by which we mean operation of a core balance sheet, administration and license, will continue to consolidate. Ultimately there may be as few as five truly "at scale" providers of capacity – some of which may be non-traditional manufacturers such as reinsurers operating quasi-direct behind MGA plays.

Larger manufacturers may be able to benefit from the opportunity to act as consolidator, and/or to benefit from organic market share at the expense of weaker players. Smaller manufacturers will have to make hard choices about whether to stay in the market in the face of increasingly adverse economics, to exit altogether, or to partner with larger scale providers to maintain a presence – potentially thinning out their participation to act only as a broker, white-labeller or balance sheet free MGA.

2. How to go to market?

Those choosing to remain in manufacturing – and those distributing for others – need to choose their channel strategy and what their relative channel mix should be. The cost and complexity of maintaining a direct brand presence is ever higher – but so is succeeding in indirect or intermediated models.

- A few will be willing to spend enough to maintain a full "front to back" model, including a branded customer presence and a fully owned direct-to-consumer journey. But very few (more likely none) will be able to keep this as their only channel to market.
- Others will embrace a pure "component supplier" model where they are willing to sit behind someone else's customer / distribution model. This could include variants
  - The "PCW specialist" specializing in fast, responsive, analytics-led proposition underpinned by a low cost, flexible model and delivered through multiple niche brands
  - The "B2B2C specialist" requiring a modern "API-enabled" flexible partnership model[1]

1 See our paper on how to succeed in the B2B2C insurance market https://www.oliverwyman.com/our-expertise/insights/2016/nov/inside-insurance.html

- A few of the largest providers will dare to be radically multichannel – willing to operate direct, PCW and B2B2C partnership models alongside each other while managing the very different capabilities required to succeed.
  - They will have to be as adept managing their own brands as those of third parties, and at allowing the very different business models to operate alongside each other.
  - At the same time they will need to take a rigorous approach to simplification and cost reduction

Larger insurers will have to make a specific choice about whether and how to compete when the digital giants – who have already won the battle for customer mindshare in many other sectors – turn their minds to compete more actively in insurance. In particular, full-service insurers will have to choose whether to co-operate or compete with the giants. They will have to work out how to make their partnership model flexible and low-cost enough to allow them to make sustainable economic profits – and ideally find a way to lock themselves into the relationship rather than being continuously "rebid". For those with a significant existing presence there will be the risk of cannibalization of existing business. Yet given the size and scale of these new distribution businesses if they succeed, it would be a brave move to avoid participating at all.

3. Where to play?

Fragmentation of the value chain and the wide availability of outsourcing means that competitors in all parts of personal insurance market need to ask very clearly where they have real competitive advantage, or where they must maintain strategic control of the customer moments that matter. For everything else they should consider seriously whether to cede operating control to a provider who can deliver a better and/or cheaper outcome.

Only those with a provable (and sustainable) advantage should expect to be able to continue to make ongoing profits in excess of the cost of capital. However there remain multiple areas where such an advantage might exist:

- Customer relationship ownership has been the most reliable way in the past to capture insurance margins, as proven by the economics of old-world bancassurance deals. This will continue to be true in the new world – but with the caveat that the competition for customer mindshare is increasingly intense (and not one that traditional insurers are well placed for)
- Insight and data advantage: it has clearly been possible to build models without a strong end customer brand that rely on better / smarter analytical understanding, strong access to data, and rapid responsiveness and trading agility. In many respects Insurers remain well behind other industries in their use of advanced analytics and real-time price delivery. However success relies on being able to keep up with (or stay ahead of) a very competitive arms race
- Scale: as previously noted, this is a double-edged sword, with traditional advantages of scale (e.g. fixed cost and investment leverage) being offset by clear risks of over-complexity and aging infrastructure

There will remain space for a broader set of small but profitable niche plays that have privileged data, insight or access to a specific customer segment. However in the era of modularity there is no reason these businesses will need to play either a traditional broker or insurer role. There is a clear opportunity for innovative models that cherry-pick the parts of the value chain they compete in and partner for the rest – for example smart, data-enabled underwriting engines acting via an MGA license with committed backup capital from a reinsurer directly – with no role for the traditional primary insurer. In other cases we see major digital-first retail or leisure brands where an insurance proposition could be complementary to the core offer – for example in the home sharing space – building their own modular global insurance operating models to bring a standardized proposition to multiple markets without the complexity of partnering with an existing multinational insurer.

4. Build your own – greener on the other side?

The retail banking sector is experiencing a proliferation of "greenfield" challenger banks – not only via new fintechs, but where major existing incumbents have been willing to launch internal digital-only challengers to their existing operations. These greenfield banks are designed and built to deliver customer-focused propositions by assembling a series of API-enabled microservices into an integrated operating model, at a fraction of the cost and build time that would have been required to reconfigure existing legacy systems.

However, to date most insurers trying this have failed to deliver on the promise of greenfield (even fewer at major scale). Many have instead been diverted into complex, expensive multi-year re-platforming programmes. At the same time the insurance sector is only now starting to see the new technology backbones that would support a full greenfield build of the same type as has been seen in the banking sector.

We believe that incumbents will have to have a "greenfield mentality" to reducing cost / complexity of legacy operations – either radically simplifying or building from new alongside the existing setup. In the best case incumbents could build new compelling customer propositions backed by slicker, lower-cost processes and taking full advantage of all the relevant data inside and outside the organization- without the need for painful, multi-year replatforming. This could then act as a catalyst for change throughout the core business.

IN SUMMARY

Personal lines CEOs are right to be concerned about how they will compete in the personal insurance market of the future. What customers buy (and how they buy it) will be very different; the competitive landscape in manufacturing and distribution will have shifted significantly; and the choices for how and where to compete will look very different to today.

Winners will have a clear, realistic strategy, execute it decisively and focus their efforts on where they have true competitive advantage. They will take hard choices to stop unrewarded activity, and to invest in filling strategic gaps. Those who focus only on in-year trading and maintenance of the status quo risk consolidation or even extinction.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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