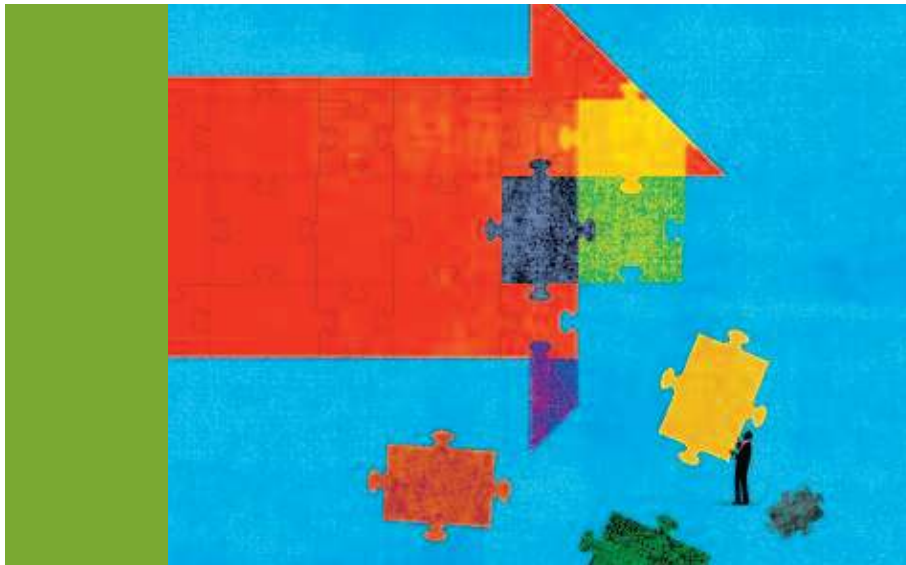


Financial Services Practice



Agents of the Future: The Evolution of Property and Casualty Insurance Distribution

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Introduction

Local agents have long been an integral part of the property and casualty (P&C) insurance landscape, and continue to serve an important role as advisors and intermediaries. However, there has been a gradual shift in the value that carriers and customers (both retail and small business) place on many activities traditionally performed by local agents, which is increasingly calling into question what role they will play in the future.

Where agents once served as the front line in risk selection and pricing, advances in predictive models are making this role obsolete. The agent was once the face of the insurance brand; now, customers increasingly use multiple channels to connect with their carrier. Perhaps most disruptive to the traditional agent value model, auto insurance – which accounts for 70 percent of personal lines premiums – is fast becoming commoditized.

Surprisingly, these trends have not yet led to significant change in the local insurance agent landscape. There are signs now, however, that the economics of the traditional agent model are beginning to unravel. Carriers are interacting more directly with customers, at lower cost and often with more consistent service levels. The once clear division of labor between carrier and agent is diminishing, but agent commission structures remain largely unchanged. Many carriers are now re-considering how they allocate their distribution budgets and asking themselves what role agents should play in the system.

These new economic realities have the potential to alter the distribution landscape in personal lines and small commercial insurance. Within five to ten years:

- Most personal lines *and* small commercial customers will interact with their agents and carriers across the full range of channels: in-person, through mobile devices, and by phone, Internet and video conference.
- Carriers will continue to use technology to increase their direct interaction with the primary customer, delivering more consistent service at a lower cost.
- Agents will be compensated only for the unique value they deliver to the customer and the carrier.
- Carrier agent management models in both the independent (IA) and exclusive (EA) channels will focus resources on those agents that deliver profitable business.
- Winning agents will deliver tailored and relevant expertise and excel at multichannel marketing, while increasing their scale and operational efficiency.

Local agents are not in danger of extinction, but the role they play will continue to evolve. Those that can adapt to a new set of circum-

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stances will thrive. For their part, carriers must think now about what these changes will mean for their business and begin developing robust strategies to respond.



The End of an Era for the Local Insurance Agent

Historically, most insurance carriers distributed their products through local insurance agents. Roughly a decade ago 80 percent of personal auto policies were placed with an agent (the percentage was closer to 100 for homeowners and small commercial policies). These were simpler times for insurance carriers. They competed on the strength of their actuarial pricing models, their ability to return a quote quickly and handle claims, and the quality of their agency force. Management discussions about distribution centered on growing the agency force, making it easier for them to do business, and designing incentives to reward their entrepreneurial zeal.

Over the last decade, market forces and technological advances have complicated this arrangement. The clean division of activities between agent and carrier no longer serves carriers the way it once did. For a number of reasons (e.g., greater consistency, lower transaction costs, better capturing and leveraging of data), P&C insurers are taking on many of the activities that were once the responsibility of agents.

A diminished role in risk selection and pricing

Agents once acted as the first line of risk selection and underwriting, providing the “gut feel” insights that come from living in the market and knowing (often personally) the local customers. Carriers relied on agents’ judgment to improve their profitability.

Today, carriers rely far less on the intuition of their agents. The increasing sophistication and accuracy of predictive models, and the rise in straight-through underwriting, are diminishing the agent's role in risk selection in both personal and small commercial lines. As a sign of how much has changed, many carriers now actively restrict the ability of even their own field staff to deviate from modeled prices, and are questioning whether the agent plays any role at all in managing profitability – especially in personal lines auto.

The rise of multichannel

Where once consumers expected to shop for insurance with their agent, and to submit claims and get answers to their questions in the same way, today they increasingly expect to interact with their insurance provider on their own schedules, at all times and through multiple channels (e.g., phone, online self-service, click-to-chat). Furthermore, customers expect a consistent, satisfying experience at every interaction. As a result, the walls between traditional distribution channels are crumbling. This is most obvious in personal auto, where recent McKinsey efforts to map the customer decision journey reveal the extent to which shoppers jump from one channel to another as they move from information gathering to purchase and beyond (Exhibit 1).

Exhibit 1

Auto insurance customers are using more channels in their shopping journey

Top 5 multichannel shopping journeys¹
Percent of shoppers



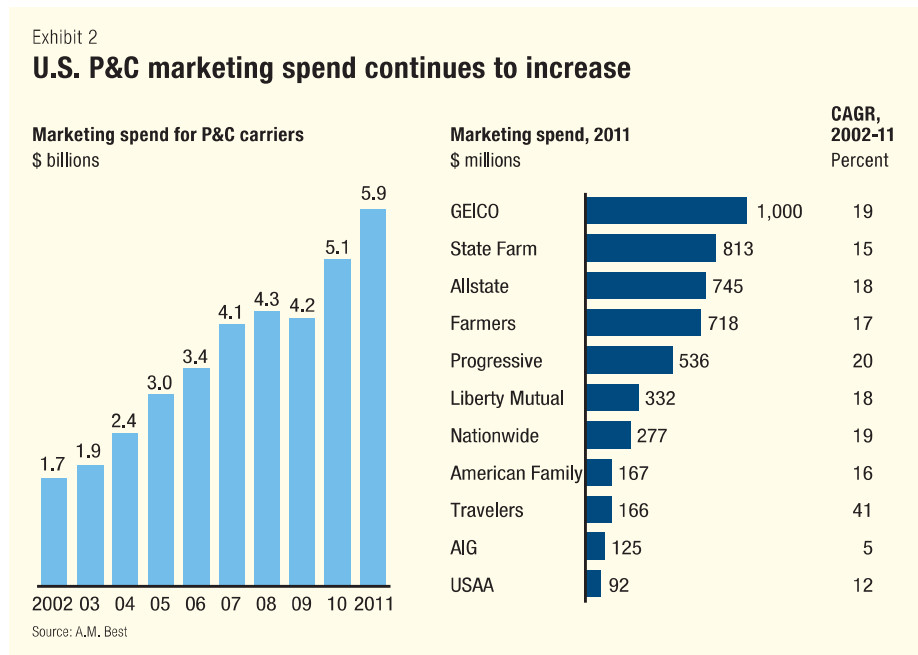
¹ Account for 72% of all shoppers

Source: 2012 McKinsey Auto Insurance Customer Insights Research

In light of this increasing channel “agnosticism,” carriers are making heavy technology investments to reduce friction for customers and data as they move between channels. They are opening central contact centers to handle questions and conduct transactions for policy changes, billing, claims and all other interactions. Soon, carriers will be able to replicate the feel of an agent’s office – with more consistency and with greater ability to test new approaches (e.g., segment-based service-to-sales scripts, “next product to buy” or “likelihood to switch” analytics). As more customer interactions filter through these central contact centers, the opportunities for agents to interact with the customer and add value will decrease.

The ascendance of the carrier brand

Not too long ago, the average insurance consumer would respond to the question, “Who is your insurance policy with?” by naming her local agent. Today, after 10 to 20 years during which carriers have invested billions of advertising dollars building and strengthening their brands (Exhibit 2), customers are far more likely to answer the same question with the name of the carrier instead. It is very hard for agents to compete with this spending, even in their own local markets.

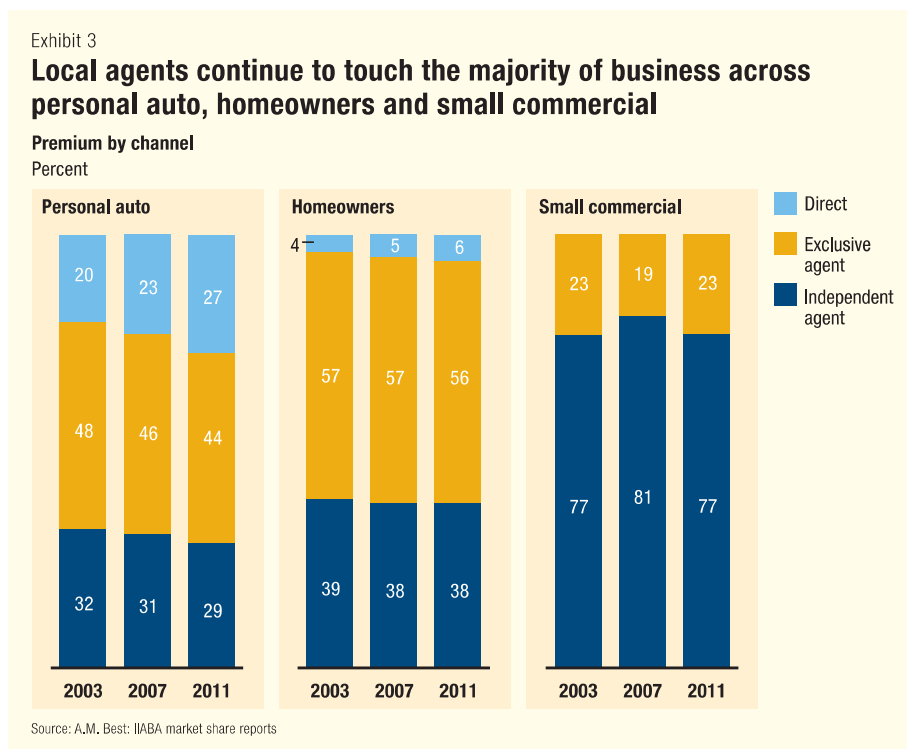


Commoditization in personal auto

Insurance may never be a pure commodity like copper or wheat, but personal auto is edging closer to this territory. Consider the following:

- Consumers have easy multichannel access to auto insurance products from many carriers, and no longer need an agent to navigate carriers or explain terms. Independent agents themselves are using comparative raters to generate enormous numbers of commodity-like price quotes to present to the customer.
- The flood of price-centric marketing for auto insurance has conditioned many consumers to focus on price as their primary buying factor.
- Customer claims satisfaction is at historically high levels, leaving less ground for differentiation between insurers.

The agency channel has lost 7 percentage points of share in auto insurance to direct carriers since 2003 (Exhibit 3). And while more than half of auto insurance purchases still occur through a local agent, in most cases the



agent is simply executing a transaction. (For a perspective on homeowners and small commercial lines, see sidebar.)

Homeowners and small commercial: A bright spot for agents

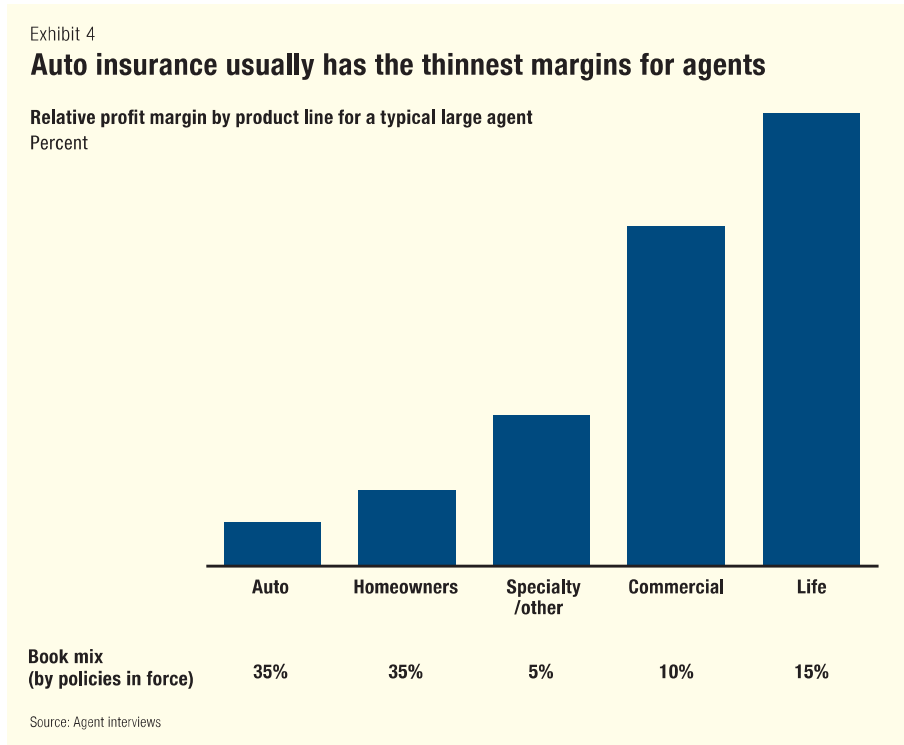
Will homeowners and small commercial lines follow auto down the path to commoditization? Some direct carriers are already quoting these lines on the Internet, and there is an increasing amount of mass-market advertising focused on commercial auto. Small commercial aggregators and comparative-rater technology are making selling on price much easier. These efforts, however, have only seen limited success, and many carriers continue to resist them.

These lines are inherently more complex than auto, and the insured assets are larger; so consumers still find the counsel of a local agent valuable. In addition, there are no widely adopted technologies that supplement underwriting for homeowners and small business insurance (e.g., ability to view homes remotely via satellite imagery), and there is no robust data set (e.g., risk data available by cross street) to enable full automation of the underwriting process, so agents still play a role in risk selection and pricing.

The hard truth is that most agents have neither the scale nor the operational efficiency to profitably sell a commodity (or even a near-commodity). Commission revenues and profit margins have been on a long-term decline as yield rates on new business remain low, average premium per policy has been relatively flat, and costs are rising due to increased operating expenses. Many agents report that auto acquisition has the thinnest margins of any line and can even be unprofitable (Exhibit 4, next page). With auto insurance accounting for 30 to 60 percent of a typical agent's book, the numbers paint a difficult picture for future profitability.

Commission rates under pressure

The traditional agency model provided a straightforward, low fixed-cost distribution system for carriers; they spent little on acquisition until a policy was sold and commissions paid. Growth was often as simple as appointing new agents in new markets. But carriers today operate in a more complex distribution landscape, and their investments must be balanced across a number



of areas (e.g., direct channels, heavy advertising, and the creation of contact centers). This shift is putting pressure on their ability to maintain the level of commissions they pay to agents. Inevitably, carriers will need to consider rewarding agents more directly for those efforts that uniquely add value (such as retention and cross-selling).

* * *

What is the future of the local agent, given the convergence of headwinds? How can they continue to add value and remain relevant? Some lessons can be learned from examining the evolution of travel agents over the last 15 years (see sidebar next page).

Travel agents faced similar dis-intermediating forces. Many disappeared, to be sure; but those that survived did so by reinventing their business models in multiple ways. They shifted towards more complex travel and specialization. They focused on operational efficiency and technology. In the next chapter, we look at how insurance agents can adapt a similar approach in their efforts to remain relevant.

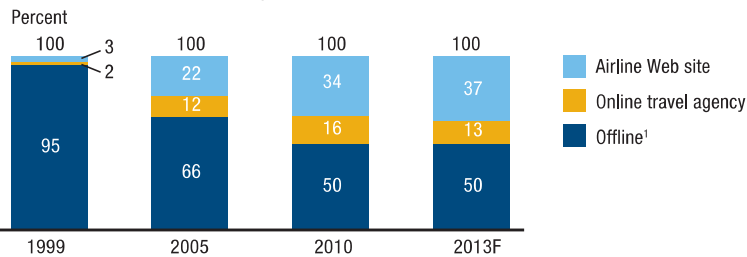
Travel agents: Still afloat

A little more than 10 years ago, the vast majority of airline tickets were booked through traditional travel agencies. With the advent of the Internet as a channel for shopping and price comparison, travel agents' share of sales plummeted (Exhibit 5); by 2010, online travel agents and airline Web sites had cut agents' share in half. The travel agent model seemed dead in the water. Surprisingly, despite a large decline in total numbers, travel agents have not disappeared; in fact, those that remain are on the whole larger and more successful (Exhibit 6).

Exhibit 5

Airline bookings through traditional travel agents declined precipitously with the advent of Internet booking tools

U.S. airline leisure and unmanaged business sales by channel

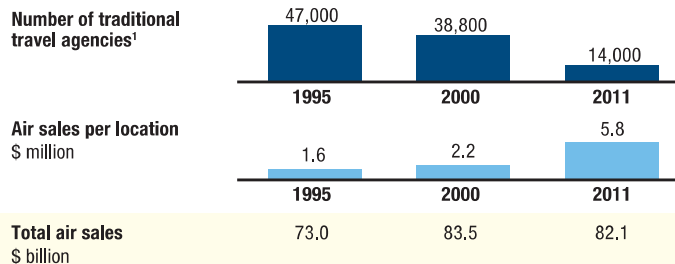


¹ Includes traditional travel agencies (the majority), airline call centers and airport sales.

Source: PhoCusWright; US Online Travel Overview reports

Exhibit 6

The number of traditional travel agents dropped, but those that remain are larger and more successful



¹ Airline Reporting Corporation (ARC) accredited agencies – those that are able to issue air tickets.

Source: PhoCusWright; ARC; ASTA.org



Implications for Agency Principals

To survive in a changing environment, insurance agents will need to develop new strengths and capabilities, and a value proposition that is compelling for both carriers and consumers. There is no single model that will guarantee success in the market, but we expect that several will emerge over time to replace the current operating models. And while the likelihood is that the number of agents will decline, those that remain stand to become stronger.

Three core capabilities

Three core capabilities will serve as the foundation for agents as they seek to thrive in today's increasingly competitive environment:

1. Defining and reaching a target market

A limited and generic view of potential customers can no longer sustain the agent business model. Successful agents will move beyond the local market paradigm, in which their customer base is strictly geographically defined (for example, by the five-mile radius centered on their office). Agents will need to take a broader view of their market and have a clearer articulation of their target customer segments (and associated product offerings). To reach those target segments in the digital era, traditional local marketing tactics will no longer be sufficient. Agents will need to increase their digital presence, become more flexible in how they communicate with their clients (e.g., video chat, Twitter, Facebook), and find new and more effective ways to get in front of potential customers (e.g., through affinity group relationships).

2. Expertise

With easy access to so much free information, customers are increasingly unwilling to pay for generalist advice. The broader retail market has also cre-

ated an appetite and expectation for more tailored, personalized products. This translates into a demand for more tailored and deep expertise from their insurance advisors. They will turn to agents for advice on holistic insurance packages for their personal needs, or for industry-tailored advice on small commercial policies.

3. Operational efficiency and scale

Given the economic realities of rising operating expenses and flat commissions, agents will need to do more with less. Technology will be a source of increased operational efficiency, but increased scale will also be required. Scale can be achieved in two ways – agents can grow bigger themselves (organically or through acquisition), or “virtually,” by banding together with other small agencies or by outsourcing certain functions to carriers or other third-party providers.

Agents may also need to search for new revenue sources, extending beyond P&C products to areas such as life insurance, financial services, group benefits, health insurance, notary services and tax advice.

Many agents are not currently positioned to succeed in a world where scale and operational efficiency, sophisticated marketing tactics and deep product expertise are critical. However, several new agency models are already finding success.

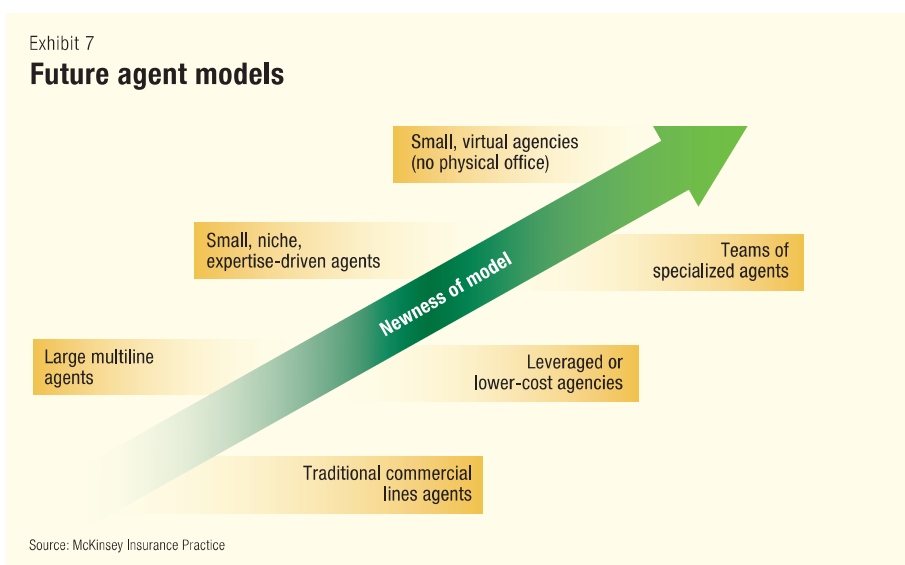
Agent models of the future

Some winning models will look slightly different from today's; others will completely redefine what it means to be an agent (Exhibit 7):

- **Traditional commercial lines agents.** Large and professionally run, these agencies will have industry-focused producers who target larger accounts at the top-end of small commercial (\$20,000 to \$100,000 in annual premiums) or middle market (\$100,000 and up). They will have formalized, at-scale teams for small commercial accounts that leverage automation to drive down costs.
- **Large multiline agents.** These agencies will have a well-balanced product mix that comprises personal lines, commercial lines and life insurance; product-focused producers; a high degree of cross-sell at the point-of-sale as well as into existing books; and a consolidated, at-scale back office.
- **Agents with leveraged or lower-cost models.** In areas where local presence is valued but local market economics cannot support a traditional

agency model (for example, rural areas with low asset density), a lower-cost model could evolve that shares characteristics with existing aggregator, cluster or managing general agent models. Agents adopting this model could take a variety of approaches to drive down operational costs while maximizing access to mass market customers (e.g., hub-and-spoke models, co-locating a small agency storefront in a popular retail outlet).

- **“Teams” of specialized agents.** In this model, agencies formally partner to provide holistic, multiline solutions, each bringing unique product expertise and their own network of clients and prospects. At a minimum, they would provide each other with leads, but could also combine into formal sales teams that share clients, revenue, expenses and support. This model exists informally in P&C, but is more prevalent in other advisory services (e.g., wealth management).
- **Small, niche, expertise-driven agents.** These agents will thrive with well-articulated value propositions targeted at a small number of customer segments across those personal and small commercial lines that require more specific advice, tailored products and a greater degree of service (e.g., wealthy clients or ethnic groups in personal lines; select industry classes in small commercial). The cost structure will be low, with a virtual or limited physical footprint, and they will maintain few carrier relation-



ships, focusing on brands that resonate with their target segments. One such agent today is an online small business insurance specialist focused on select industry classes. The agent has a high degree of specific expertise and provides technology-driven support (e.g., ability to assist small businesses in real time with online applications).

- **Small, virtual agents.** Virtual agents will spend the bulk of their time on sales, as opposed to service. They will have very low overhead, adopt new technologies and focus on remote interactions through phone, e-mail, video-chats and other emerging channels. In one current example, an agency providing personal lines insurance exclusively to high-net-worth individuals has no physical location, and all employees work remotely.

For their part, carriers will need to determine the optimal portfolio of agent models required to serve their target customers and migrate to this portfolio over time.

The shrinking of the agent force

One implication of the changes described in this paper seems clear: only a subset of current agents will transition successfully. Since 1995, the overall number of agents competing to capture a share of the available “commission pools” has declined by about 10 percent (Exhibit 8). If any of these pools shrink without offsetting growth in other lines of business, the decline in number of agents is likely to accelerate.

Several factors make a decline in auto insurance commissions – the largest pool at about \$12 billion annually – likely:

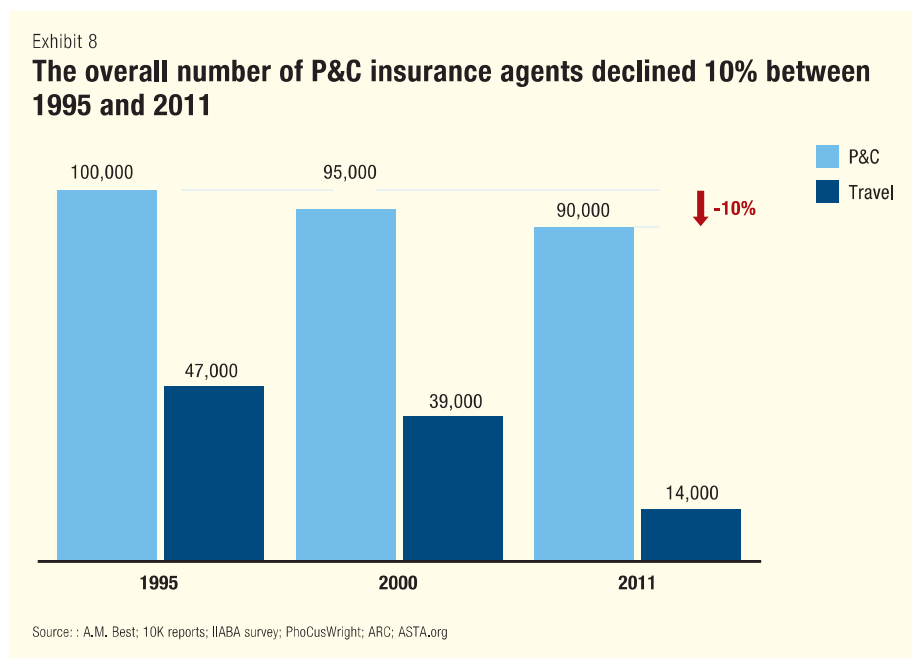
- Total auto gross written premium (GWP) is expected to grow slowly at best or even stagnate or decline with increased adoption of usage-based insurance, continued price competition, the downward trend in accidents and the increasing safety of cars.
- Market share of auto GWP of the direct channel (where few if any commissions are paid) continues to grow at the expense of the agency channel.
- Carrier spending on marketing, technology and physical infrastructure to meet consumer demands for multichannel capabilities will continue to eat away at the amount available to pay agents as commission.

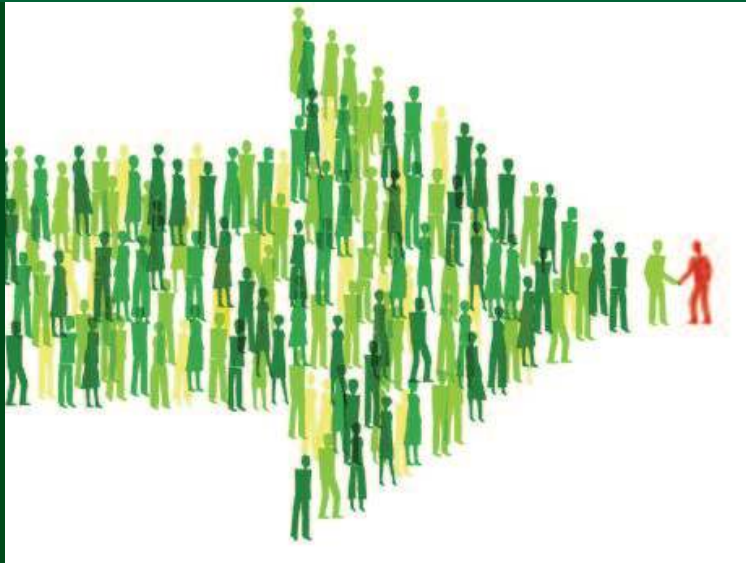
From the agent side as well, auto insurance is becoming less profitable due to rising operating expenses, decreased efficiency of new customer acquisition (driven by increased consumer shopping and resulting low yield rates), and in-

creased investments in technology (e.g., lead management tools, rating/quoting tools with self-populating fields).

It is difficult to make predictions about how the absolute size of the local agent force will change. High trailing commissions and earnings from “sticky” customer segments could allow many agents to survive for years without making any changes (assuming no aggressive actions by carriers). Much will depend on which of the emergent models gains momentum. As a thought experiment, consider that if the average agency size increased by 50 percent, the decline in total number of agencies could reach 20 to 30 percent, fueled by consolidation and the rise of new “agency direct” models. (Compare this to our earlier example of travel agencies, which declined by 70 percent in a decade. Travel agencies, however, did not have the benefit of large renewal books to dampen the decline.)

The local agent channel is undergoing tremendous change, and not all agents will survive the transition. Those that do, however, will likely be well-adapted to thrive in the new distribution environment. For carriers, watching these developments should not be a spectator sport. They should begin positioning themselves now for success.





Implications and Questions for Carrier Leadership

The evolution of the agency channel is both a challenge and an opportunity for property and casualty carriers, who will need to develop new capabilities and new mindsets to thrive in a changing distribution landscape. The following questions for carrier leadership are a starting point for debate as carriers in both exclusive and independent channels consider their distribution and sales strategies for the new era.

1. Which of our current and target policyholder segments value agents?

A more sophisticated and granular approach to customer segmentation will be required for all but the very largest carriers¹ in the new distribution landscape. As part of this approach, both EA- and IA-focused insurers must develop a deeper understanding of which segments still find value in their interactions with agents, what keeps them loyal to the channel, and how their preferences are changing. Insights from this research should inform decisions regarding the carrier's portfolio of agents.

2. How do agencies add value for our target segments today? What unique services can they offer now and in future? Where do they need to excel?

For agents and carriers alike, the burning question is whether agents can carve out a new value proposition that makes sense in the new multi-channel property and casualty market. What can they do more efficiently

¹ See "Beyond Price: The Rise of Customer-Centric Marketing in Insurance," McKinsey & Company, January 2013.

or more effectively than carriers? How will they reach the target customer segments compared to other channels or sales approaches? How will the various channels coordinate in a way that is additive to agents (rather than diminishing their role)?

3. Are our current agents positioned to succeed in this new environment?

Which agent segments should we support and help grow? Does the overall agent network need to change? How do we understand more deeply an agent's business (e.g., succession plans, growth targets) and plans for the future? How do we assess their capabilities to change? Do our current agents give us access to the right customer segments and industries? How do we fill the gaps where existing agents are unable to adapt?

4. How should we work with our agents to support them as they evolve? What tools, systems, capabilities and organizational changes are needed to ensure success?

What change management techniques can we use to help agents make transitions while maintaining a healthy organization? How do we maintain our current flow of new business while our agents migrate to a new business model? If we are building or expanding our agency force, how do we foster a performance culture that drives agents to produce throughout their tenure? Importantly, how can we foster and support distribution innovation? Insurers should not be bystanders in the evolution of the agent channel. They should encourage innovation and be as flexible as possible in giving fledgling ideas room and time to develop.

5. How can we reward agents for the value-added services they provide and remain competitive on price?

Carriers cannot afford to continue paying agents for activities they are performing themselves. They will need to take a hard look at commissions and the many cross-subsidies that exist among products (e.g., home and auto) and activities (e.g., new business and retention).

6. How should we monitor and stay abreast of the challenge (or opportunity) of direct distribution and price-driven sales in homeowners and

How can insurers foster and support distribution innovation? They should not be bystanders in the evolution of the agent channel. They should encourage innovation and be as flexible as possible in giving fledgling ideas room and time to develop.

small commercial? What role can we play in slowing the commoditization of the sales process for homeowners and small commercial insurance? What changes can we make to our marketing messages and our products, underwriting and sales capabilities?

* * *

Fundamental changes in how customers shop for and purchase insurance – and in the very nature of how they view the insurance product – are already altering the distribution landscape in personal and small commercial lines. And the pressure on the current economics of the agent model will soon force carriers to rethink how they distribute their products. To win, insurers must develop a thoughtful perspective on which agent models will emerge from this period of transition, and a clear strategic plan for harnessing these new models.

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