McKinsey&Company

MARCH 2017

FINANCIAL SERVICES

A roadmap for a digital transformation

No insurance company has yet completed a digital transformation—one that fully harnesses the power of digital technology to rethink every aspect of the organization. But a number of carriers are making remarkable progress, indicating the direction others should take.

The future of insurance will be digital. That much is certain. The industry might have been slow to feel digital technology's impact, protected by regulation, the size of companies' in-force portfolios, and customers' tendency to stay put with their insurers. But the pressure is mounting. In auto insurance, a handful of direct carriers already enjoy the lion's share of profits. Disruption of other lines of business will surely follow. Distribution channels, products, underwriting technology, competitors, and even business models will shift as technology attacks market inefficiencies and customer expectations evolve.

Most insurers are responding to some degree, albeit often cautiously. Some see how digital technology will transform pieces of the business, but find it harder to envisage how the entire value chain and business model might change. They therefore content themselves with investing in a new sales channel, launching a service app, or automating a few processes. At other carriers, executives believe a transformation will not be completed on their watch, because the magnitude of change required will leave no part of the organization untouched and could take up to a decade. So why bet on an uncertain future and risk cannibalizing existing profits or alienating distributors when they face more pressing issues, such as regulatory compliance?

A growing number of executives, though, are facing up to digital reality. They know that digital technology can significantly improve the performance of their current business. They know that first-movers have an advantage. And they are keenly aware that digital can give birth to entirely new business models that shake up sectors, leaving companies that fail to adapt struggling to survive (newspapers are a case in point). They have therefore taken steps toward transforming their businesses.

> The CEO cannot simply sanction a digital transformation; he or she must communicate a vision of what needs to be achieved, and why.

They are far enough advanced to know that each stage of the transformation will present challenges. The first will occur at the outset, when the CEO must set the company on the right course for success. More will present themselves during the first six to 18 months—the launch and acceleration phase—when initial changes have to start taking root, and yet others will arise during the long haul of subsequent years, when digital initiatives need to be scaled across the enterprise and digital capabilities and new ways of working become the lifeblood of the company. Already, the industry's digital pioneers are meeting these challenges and demonstrating to fellow CEOs ways in which they can be overcome. And from these early efforts and successes a set of ten guiding principles is starting to emerge (Exhibit 1).

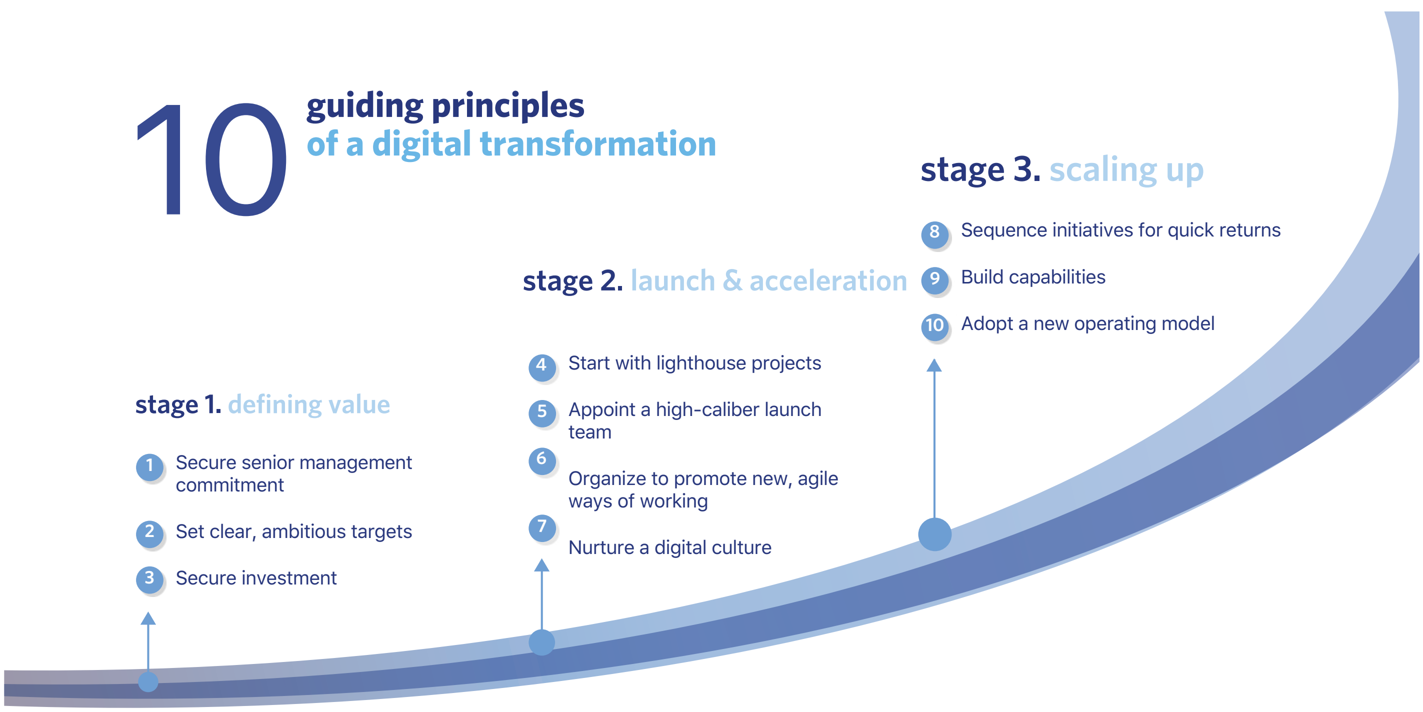
Defining value

To set a digital transformation on the right course a company must place it at the core of its agenda, and understand the magnitude of that undertaking. It is not for the fainthearted, but CEOs are heading in the right direction if they grasp the fundamental importance of heavyweight management commitment, are willing to make significant investments, and set clear, ambitious targets.

1. Secure senior management commitment

Any transformation will be dead in the water if it does not have the commitment of the CEO and the leadership team. That statement seems almost glib, given how often CEO commitment is positioned as the solution to any major challenge. But the CEO cannot simply sanction a digital transformation; he or she must communicate a vision of what needs to be achieved, and why, in order to demonstrate that digital is an unquestionable priority, make other leaders accountable, and make it harder to back-track. Hence, in 2015, Allianz announced that a key strategic growth

Exhibit 1



initiative was to become “digital by default”—indicating the extent of the changes ahead. Similarly, ING branded its transformation “Fast Forward.”

> “It’s not enough just to have CEO sponsorship. It needs to be provocative, disruptive, ambitious, and often uncomfortable sponsorship to be successful.”
>
> – Andrew Brem, chief digital officer, Aviva

With the vision set, results are then achieved through relentless daily engagement. Andrew Brem, chief digital officer of Aviva, says CEOs need to be “single-minded and aggressive” about driving the transformation. “There’s no way you can do digital transformation by halves,” he comments. “Our CEO is chirping in my ear the whole time. He is very activist. He bases himself in our garage frequently. He drops into meetings. He just starts talking to people. It’s not enough just to have CEO sponsorship. It needs to be provocative, disruptive, ambitious, and often uncomfortable sponsorship to be successful.”

2. Set clear, ambitious targets

To set the organization’s sights at the right level, investments need to be linked to clear, ambitious targets. This helps on three fronts. First, it signals the magnitude of what digital technology can deliver. Without targets, people who find it hard to accept that the old ways of doing things were massively inefficient might be content to sign up for a 10 percent improvement in cycle time, for example, when 100 percent is possible. External benchmarking can help in this respect by reinforcing the conviction that cutting the time it takes to, say, process a claims submission from 90 minutes to 20 is not good enough if someone else has reduced it to four. A company can be certain that if it does not match that benchmark soon, others will.

Second, setting clear targets at the outset prevents back-sliding when the going gets tough. And third, it imposes discipline on the process of deciding which initiatives to pursue for maximum impact.

Targets are needed for each source of value creation—cost savings, revenues, improved performance of agents, and satisfaction of employees and customers—and for new ways of working and the new capabilities required. They can be set, for example, for the frequency of releases, the percentage of processes that will be automated, the percentage of transactions that will be migrated from one channel to another, the fraction of new code that will be tested automatically, the level of personalization that will be achieved, and the number of campaigns that will be run each month.

An insurer with premiums worth more than $5 billion should expect to hire between 20 and 100 new specialists during the first 18 months of a transformation.

3. Secure investment

Digital transformation is likely to require significant investment. European insurer Axa, for example, invested €950 million over just two years. Our experience suggests that in IT alone, companies with outdated systems might need to double their current spending over a five-year period. That investment is likely to result in lower profits for a while—but without it there is a serious risk to profits in the longer term. Importantly, companies will need to allocate investment both to improve the current business and to build new businesses as the insurance model evolves. To acquire expertise in new fields and keep abreast of innovation, for instance, insurers will need to invest in partnerships or a venture capital arm, perhaps both, as well as in their own innovation labs.

Launch and acceleration

It is easy to launch change initiatives. It is hard to keep them afloat and spawn more. Often companies decide to fund several, assign people, even set up separate units. But then the initiatives fail to take off and the old ways of doing business continue much the same—at which point executives wrongly conclude there is no urgency as the market is not ready for change.

To ensure early efforts thrive and build momentum, companies should consider carefully which projects to start with and support them with the necessary resources. Prerequisites include a high-caliber launch team often led by a chief digital officer (CDO), consideration of organizational structure, and the nurturing of a digital culture.

4. Start with lighthouse projects

To win early support, companies should start with projects that offer potential for significant rewards with manageable risk. Such projects include customer services activities and the redesign of the claims process, from the moment a customer needs to file a claim to the moment of reimbursement. Customers will be delighted, cost savings can be as high as

40 percent, and effectiveness, measured in return on investment, can rise by as much as five percentage points.

5. Appoint a high-caliber launch team

The importance of securing a high-caliber launch team, often under a CDO, cannot be overstated. A CDO can prove invaluable in co-ordinating a transformation—avoiding duplication by devising a methodology for the redesign of customer journeys that can be replicated across the organization as digitization efforts are extended, for example. He or she can also ensure the appropriate technology and skills are in place, decide the sequence of the transformation, monitor progress against targets, and ensure that tactical day-to-day priorities get the attention they need. But the role of CDO is a temporary one. At the end of the nineteenth century, many companies employed a chief electricity officer to ensure supplies of what was a new industrial commodity. A few years later, none did. Key recruits to the launch team include designers to contemplate customers' unmet needs and inform the creation of experiences, products, and services; data scientists; scrum masters to facilitate agile development; and developers who can work in the modern IT environment. Roughly, an insurer with premiums worth more than $5 billion should expect to hire between 20 and 100 new specialists during the first 18 months of a transformation.

That is not a huge number, but the competition for digital talent and the advantage technology companies have in attracting it makes finding people of the highest caliber a considerable challenge. The scarcity of elite data scientists, for example, has been a factor in some insurers' acquisitions of cutting-edge artificial intelligence start-ups; $5 million to $10 million per employee can be commanded in these so-called "acqui-hire" deals.

> "We have an advantage when it comes to culture. We are a tech company in the insurance space, not an insurance company that plays with technology."
>
> – Adam Lyons, founder and CEO, TheZebra.com

One way to meet the challenge is to start by hiring a renowned expert to serve as an anchor hire, who will help to attract others, on the basis that they will be drawn to him or her more than they would be to an insurer *per se*. Some companies go further than hiring individuals and acquire agencies that specialize in design thinking. To help satisfy the expectations of their ambitious recruits, companies might have to adapt their traditional value proposition, based on span of control, with a different kind that promises empowerment in their work on high-impact digital initiatives. “The talent piece is essential,” says Andrew Brem. “I’ve hired an entirely new digital team. I’ve brought in people from the world of gaming, from travel, from retail, from pure digital. And they’ve brought in a lot of people too. There are some particular skills I’d call out. One would be digital product and design. Another would be digital marketing on the social side. And another would be data analytics, particularly on the customer side rather than risk.”

People leadership skills are essential too. Transformation is not just about tipping everything upside down, reinventing products, and disrupting value chains. It is partly about balancing old and new and integrating fresh talent with old, valued hands. As Clara Shih, founder and CEO of advisor marketing cloud company Hearsay has observed, digital-savvy hires from outside the industry might ace building a digital-direct, e-commerce business, but are often ill-equipped to modernize insurers’ existing channels, where huge, value-creating opportunities await. “The reason traditional agency distribution hasn’t innovated is because it’s very hard to find someone steeped in digital who also understands field sales, and vice-versa,” she says.

6. Organize to promote new, agile ways of working

The way a company organizes itself is key to a successful launch. Setting up a digital unit independently of the organization will promote new ways of working essential for digital success, such as agile product development, test-and-learn methods that speed progress while keeping the focus on customers, and cross-functional teams that pool specific types of expertise.

> “The reason there hasn’t been more innovation within traditional distribution ... has been that it’s very hard to find someone with a digital skill set who also understands field sales and vice versa.”
>
> – Clara Shih, cofounder and CEO of Hearsay

A digital unit can also help attract and retain those specialists, while offering them freedom from incumbents’ organizational constraints and the support of like-minded colleagues. If such people are simply parachuted into the existing structures of incumbents they can become bored and frustrated at the pace of change. They need to be empowered to make a swift impact, which often means giving them authority to make their own decisions.

Separating a digital component from the rest of the organization is not entirely the answer, however. To begin with, newcomers can (unintentionally) run roughshod over what is valuable in an incumbent: the reason many insurance companies have been around for more than a century is that they excel at what they do. They can also start to create channel conflict, particularly if innovations threaten to cannibalize revenue streams. The digital unit therefore needs to be reintegrated at some stage, and that becomes more difficult as time passes. Whatever the choice, the ultimate goal has to be to enmesh the old and the new.

> McKinsey research has shown that 46 percent of financial services executives feel cultural or behavioral change is the biggest challenge they face in pursuing their digital strategies.

7. Nurture a digital culture

We have touched upon how digital ways of working and thinking—fast, collaborative, empowered—will be the default mode of new recruits with digital skills. These methods also need to take hold across the organization, and now is the time to start nurturing them.

So much needs to change. A focus on customer needs rather than process and procedure, continuous customer feedback, comfort with testing and learning and hence with occasional failure, and collaboration—all are vital. But insurers can be made to feel they are being asked to jettison the things that have made them successful and adopt an untested culture. No wonder McKinsey research has shown that 46 percent of financial services executives feel cultural or behavioral change is the biggest challenge they face in pursuing their digital strategies.

They are not, of course, being asked to abandon the traits that have made them successful, but to renew their heritage with innovative ways of thinking and working (see “Building momentum for cultural change”). Brad Auerbach, US industry manager at Facebook, describes it as recalling what initially made them successful. And there are relatively easy ways to kick-start change and gain support. For example, rather than making decisions by considering the business case or what competitors are doing, insist that the starting point is “How does this create value for the customer?” Moreover, change can begin in areas where there are fewer risks—in marketing, for example, by testing messages and channels to find out what is most effective.

“Agile principles are now standard operating procedure for software design, but they’re also applicable any time you need to orchestrate a large number of people to get something complex and multi-faceted done over an extended time frame.”

– Marcus Ryu, cofounder and CEO at Guidewire Software

Scaling up

At the 18-month point, companies should be making good progress. They should have a handful of initiatives up and running and be starting to capture value. But just when everything seems under control is also the time to supercharge the transformation and do everything on a grander scale. The thoughtful sequencing of subsequent initiatives is key to this. In addition, close attention will need to be paid to building more capabilities. And to reap the full rewards of a transformation, eventually an entirely new operating model will be required.

8. Sequence initiatives for quick returns

Sequencing with a view to quick returns is key to building scale fast. The more value a transformation captures as it progresses, the more it becomes self-funding and the greater the support it garners. Often a company’s approach is to let a thousand flowers bloom. But this spreads scarce resources thinly. Moreover, transformation incurs costs at a time when competition is probably putting pressure on margins. Hence the imperative to thoughtfully pursue a manageable number of digital initiatives to tend the performance of the core business while cultivating future sources of growth (see “Capturing value from the core”).

Initiatives that are strategically important, pay back quickly, and reduce complexity are the ones to prioritize. This almost always means looking for ways to cut costs—a counterintuitive notion for many executives who tend to focus on digital technology’s growth potential. But context matters. A company’s financial pressures will shape the sequencing to some degree. So will its IT, if legacy systems restrict initial choices. And companies need to be flexible. It could prove hard to recruit the particular people needed, while technology and customer behavior will continue to evolve.

Tracking returns is essential to ensure all available value is captured. Often, targets can be raised during the course of the transformation as prototypes reveal greater productivity improvements than have been assessed on paper. And when initiatives are successful and deliver the intended financial benefits, the board and top team should be emboldened to push to achieve more. But while concentrating effort and attention on what works well matters, so does letting go of what does not.

9. Build capabilities

By now it will be apparent that insurers will have to invest in more than just digital technologies themselves to scale up digital initiatives. Marcus Ryu, cofounder and CEO at Guidewire Software, contends that it is only by modernizing core operating platforms—most importantly policy administration, billing, and claims systems—that insurers can externalize the data and business logic necessary to deliver a satisfying digital experience for the policyholder or distribution partner.

Skills as well as systems will need to be boosted. But if a company struggles to hire 20 to 100 new people for the launch team, how should it go about hiring several hundred? Searches are likely to extend to developer communities and to technology conferences and similar events. The quest for talent might even lead companies to establish partnerships with software providers.

A huge internal training job will be needed too. Business leaders will need to understand IT's strategic value—the reason one large European insurance group has set up an IT literacy program to educate and update business line managers, while all newly appointed top business managers must take a three-day training module to help them understand and capture IT's strategic value (see "Modernizing IT for a strategic role").

Ultimately, however, it will be important to help all employees rethink the way they work, as the end result of a digital transformation is the establishment of a company-wide agile operating model.

10. Adopt a new operating model

Whatever structures a company chooses initially, it will reach the stage when only a fundamental organizational redesign will do. Silos drawn along functional lines have always been a drag on collaboration and performance in large organizations. In the digital age, when companies need to reinvent the way they work on the fly, an inability to connect all parts of the organization to share data, expertise, and talent can be crippling.

> The only way forward for a company is to learn as it goes and figure out how to apply lessons as scale is built.

That is why companies will have to lean away from a traditional matrix structure with rigid functional boundaries if the transformation is to succeed. They will need a network structure, organizing around sources of value, with product managers empowered to make decisions with implications that cut across functions. Teams will not be permanent. They will be dissolved when they capture the value at stake, then regroup around new sources of revenue growth or cost reductions. Some companies call them scrum teams, others tiger teams, portfolios, or tribes. Whatever the label, the ossified matrix is giving way to a more agile one. In other words, the entire organization, not just IT, will adopt an agile approach to working. “Agile principles are now standard operating procedure for software design,” says Marcus Ryu, “but they’re also applicable any time you need to orchestrate a large number of people to get something complex and multi-faceted done over an extended time frame.”

▼ ▼ ▼

Insurers that pursue digital transformation will meet challenges. IT projects fall behind schedule, channel conflicts arise, and unexpected regulatory concerns emerge. Typically, companies also struggle with cultural issues and challenges in recruiting new types of talent.

No rule book will solve all of this. A transformation is not a science. The only way forward for a company is to learn as it goes and figure out how to apply lessons as scale is built. Along the way there will be important markers of success. IT strategy will become clearer as early prototypes afford insight into decisions relating to technology architecture, data architecture, and platforms. Customer satisfaction is likely to jump. Cycle times will be shorter and costs will fall. New ways to accelerate revenue growth will reveal themselves. This is the time to double down on efforts.

A closing thought, and perhaps one that reframes the challenge: the term digital transformation puts the emphasis on technological change. But it becomes clear to anyone who understands digital technology’s potential that what is afoot is less of a digital transformation and more of a fundamental rethink of the corporate model, for which digital technology is the catalyst. Sources of revenue, efficiency, and the organization’s structure are all up for scrutiny, as are talent models, which need to offer more flexible, more empowering, and more rewarding career paths. Some executives might feel the reframing makes the challenges more daunting still, others that it makes the opportunities more exciting. We are in the second camp. ▢

Tanguy Catlin is a senior partner in McKinsey’s Boston office, **Johannes-Tobias Lorenz** is a senior partner in the Düsseldorf office, **Bob Sternfels** is a senior partner in the San Francisco office, and **Paul Willmott** is a senior partner in the London office.

Copyright © 2017 McKinsey & Company. All rights reserved.