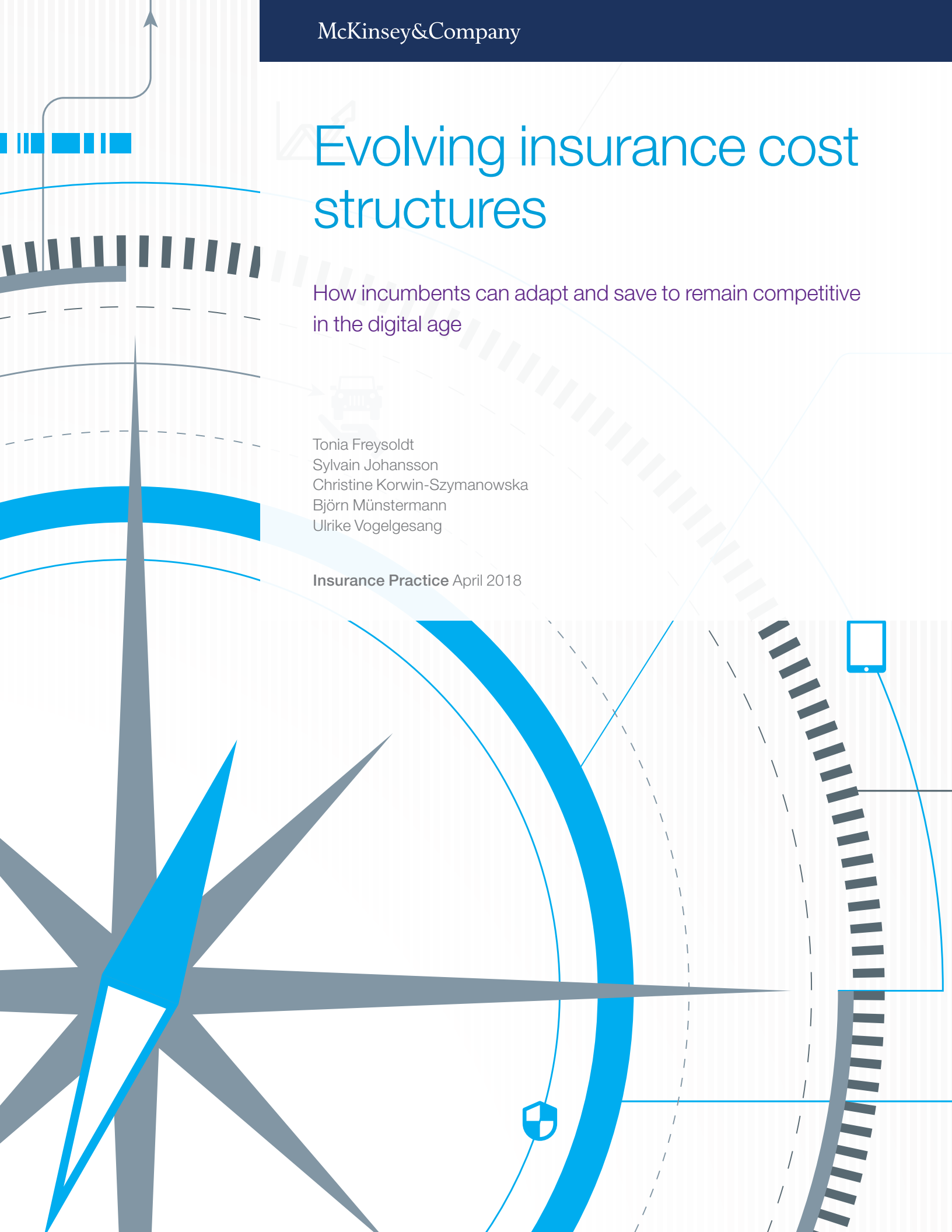


# Evolving insurance cost structures

How incumbents can adapt and save to remain competitive in the digital age

Tonia Freysoldt  
Sylvain Johansson  
Christine Korwin-Szymanowska  
Björn Münstermann  
Ulrike Vogelgesang

Insurance Practice April 2018



**The cost structure of insurers** has shifted—but not enough. Some players, particularly in life insurance, have made impressive strides in reducing their cost position, but most reductions are far from those achieved in other industries. The latest figures from McKinsey’s Insurance 360° benchmarking survey reveal a differentiated but sobering picture: the gap between incumbents and attackers is huge and may soon become insurmountable due to the agility digital technology is enabling. Björn Münstermann, leader of McKinsey’s European Insurance Operations & Technology Practice, confirms: “Incumbents still have huge cost-cutting potential to reap when compared both to insurtech attackers and to other industries.”

The results from McKinsey’s Insurance 360° benchmarking survey, conducted since 2001, clearly demonstrate the structural changes under way in the insurance industry and their expected impact on cost ratios. The pressure on insurers to reduce costs is growing steadily with the continuing low-interest environment, greater price transparency, and the ever more pervasive impact of digitization. New entrants are radically redefining the meaning of high performance, and the gap for incumbents will soon be insuperable. A step change in unit costs is a must for insurers who wish to remain competitive.

Insurers must consider the changes under way, projections of model insurers’ cost structure five years from now, and the transformation required to keep pace. To be lasting and effective, a truly comprehensive approach is needed. This approach must encompass mind-set, operations, and the very heart of a company: its business model.

## **The whirlwind of current industry change**

Digitization is driving an unprecedented shift toward lower cost structures and greater agility in the insurance industry. Market leaders such as Allianz, Axa, Generali, and Zurich have all announced cost savings programs in which digital technologies play a major part. Insurtechs and incumbents alike are launching new greenfield offerings. McKinsey has found that administrative costs for greenfield insurers average half those of incumbents—sometimes even less. Their cost leadership is partially driven by a monoline focus and the absence of legacy but also by digital-by-design products and processes.

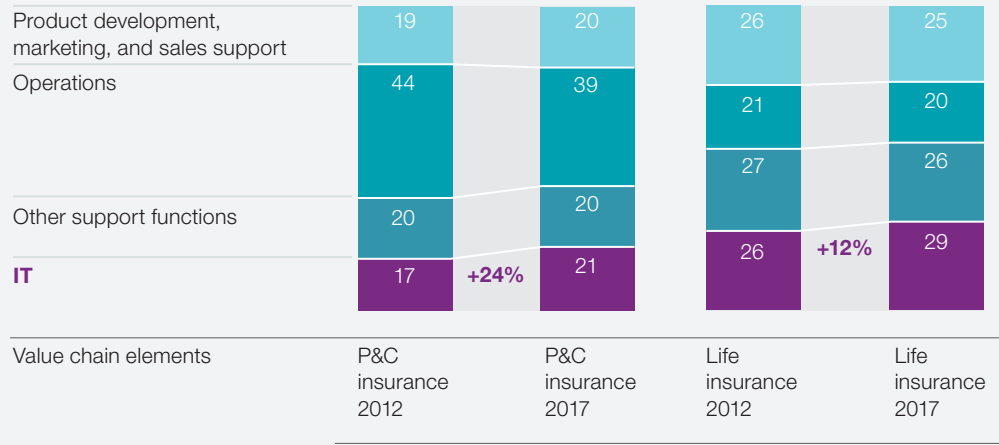
As a consequence, cost ratios in some areas have seen a massive decline. For example, from 2000 to 2016, the acquisition cost ratio in German life insurance fell by 10 percent, and the administration cost ratio fell by 34 percent. Italy has experienced a similar decline in life insurance, while countries such as France, Spain, and the United Kingdom have experienced an increase in cost ratios. In property and casualty (P&C) insurance, cost ratios have barely moved or have even risen in most major European markets.

Data from McKinsey’s Insurance 360° benchmarking survey show that successful cost reductions of incumbents are primarily driven by operations, sales support, and support functions, while costs in areas such as IT have risen. In our Insurance 360° sample, IT costs as a share of total operating costs went up by 24 percent in P&C and 12 percent in life from 2012 to 2017 (Exhibit 1).

**Exhibit 1**

**IT's share of total operating costs has increased by 12 to 24 percent over the past five years**

%



**Average operating-cost breakdown**

Source: McKinsey Insurance 360

Given these shifts in industry structures, it is important for insurers to understand where the market is heading and what the implications might be for their business models. To help insurers define their cost strategies and aspiration levels, McKinsey has conducted proprietary research into cost trends and how they will play out in the future, both for the industry as a whole and for the very best players. We especially examined the impact that digital will have on unit costs. Other trends that greatly impact costs include changes in risk structures, greater use of business process outsourcing (BPO), and growing regulation (see sidebar “Methodology of McKinsey’s proprietary Future Cost Model”).

When aggregating the expected impact of more than 40 individual trends, we find that overall cost ratios for a model insurer will fall substantially in the next five years, with an expected impact of 16 percent in P&C and 8 percent in life insurance in mature western European countries. Effects will vary among countries and will depend on channel and product mix. Business models diverge, too. These figures are likely to underestimate the full impact of new greenfield business models, as the evidence is only just beginning to emerge. Over the past five years, the spread between top- and bottom-quartile players in our Insurance 360° sample has already widened, particularly in life insurance. The spread for operations and support functions increased by 60 percent each and by more than 200 percent for product development, marketing, and sales support.

Increased automation and digitally streamlined products and processes, in particular, will drive significant cost reductions, especially in operations, parts of IT, and support functions. Savings of up to 80 percent for individual processes are not uncommon, and many can be fully automated or phased out completely. Greater BPO levels will play a role in cost reduction for processes that do not lend themselves well to digitization, either because of old platforms and systems or small

## Methodology of McKinsey's proprietary Future Cost Model

To forecast insurance industry developments, McKinsey estimated the cost impact of the following trends (with more than 40 individual subeffects detailed):

- 1 Cost reduction from digitization:** shift toward digital channels, increased automation and innovative working models, new digital-by-design products, advanced analytics for decision support
- 2 Digitization investment requirements:** new digital offerings and capabilities, IT modernization, salary premiums for certain skills
- 3 Structural industry trends:** increase in business process outsourcing and nearshoring and offshoring, changes in risk structures such as cyber or telematics, more extensive regulatory requirements, greater agility in launching new products

Underlying the model is our experience from multiple recent digitization initiatives, proprietary research into telematics and the Internet of Things, McKinsey's annual Insurance 360° benchmarking survey, our Global Insurance Pools database, and a large number of expert interviews in multiple geographies.

The estimates are applied to a model insurer, representative of the respective market and segment, and showcase the art of the possible: the change in cost ratios if insurers decide to act decisively on the cost challenge.

The model uses the Insurance 360° benchmarking structure, which gives us information about current costs by function. Both the cost structure and the estimated effects are specific to each participant's peer group, reflecting channel and product structure as well as the local market.

scale. In operations and technology, savings are typically around 20 percent from a mix of low-cost locations and economies of scale.

### Looking ahead: A model insurer's cost structure in five years

Differences between the individual elements of the value chain will be pronounced in just a few years' time, with a clear transition to digital in the cost structure. Insurers should prepare themselves for a number of shifts in each function within the next five years (Exhibit 2).<sup>1</sup>

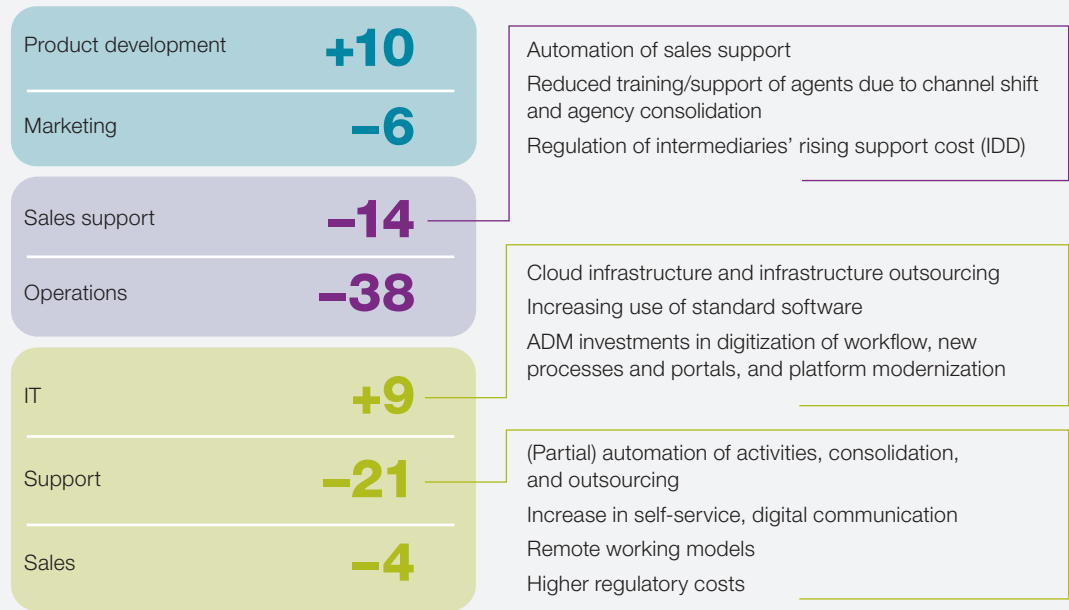
**Product development.** An expected 10 percent cost increase here reflects the greater frequency of new product development but also takes into account the lower costs enabled by huge advances in analytics and product-development tools.

---

<sup>1</sup> As forecast by McKinsey's Insurance 360° benchmarking survey.

**Exhibit 2 Costs will likely evolve in various ways across the industry’s value chain for reasons specific to each category**

Expected 5-year cost change for a median P&C player that acts decisively, %



Note: Estimates vary among markets. The analysis is tailored to every insurer based on local specifics, channel, and product mix.

Source: McKinsey Insurance 360

**Marketing.** The efficiencies gained by a shift to digital channels and more targeted advertising powered by advanced analytics will outweigh the expected increase in marketing salaries and greater importance of brand building. The increased efficiencies will lead to a roughly 6 percent drop in marketing costs overall.

**Sales support.** Costs related to sales support are expected to drop by 14 percent. Automation can be applied to many activities in this category, such as sales reporting. The increasing share of direct business will continue to reduce sales support needs for agent and broker channels.

**Issuance, policy administration, and claims.** Full-service online platforms (offering fully automated policy quotes) as well as consolidation and outsourcing can halve staff in certain categories. Embedding analytics and behavioral economics results in improvements in fraud detection and claims steering. Together, these changes can cut operations costs by a third and yield additional savings on the claims ratio. For example, we expect unit costs to go down from €28 per policy to €16 per policy in P&C.

**IT.** Along with product development, IT is the other area of the value chain where costs are expected to rise. Necessary investments in new digital offerings, digitization of internal and back-

office processes, platform modernization, and IT security will ratchet up IT development costs substantially in the near term. Maintenance and infrastructure costs will plummet, however, due to the continuing move toward standard software and cloud solutions. IT costs are likely to sink again following modernization of the core landscape elements. Considering all these changes, we estimate costs will increase by 9 percent for the model insurer.

**Support.** The automation of key activities, such as transactional HR processes and financial reporting, and the shift toward digital communications will help drive down costs in support areas. Further consolidation and the outsourcing of other support and back-office activities will contribute to an overall cost reduction of 21 percent in this function.

**Sales and commissions.** Lead management powered by advanced analytics will drive up sales effectiveness for direct-sales staff, agents, and brokers, paving the way for reduced commissions. More direct sales will drive down sales costs for some but increase them for those insurers relying on aggregators.

## How to get there: Rethinking strategy along every dimension

In light of the market developments described above, cost becomes a truly strategic topic, and incumbent insurers must review their aspiration levels. While many insurers are currently pursuing cost-reduction programs, these programs typically pale in comparison to the radical shifts the market is already seeing. On their own, these programs are unlikely to deliver sufficient impact (Exhibit 3). Some incumbents have begun to tackle their business models head-on and address their cost bases in ways that will have significant and lasting impact. They are undertaking this change by shifting organizational thinking on cost and then mapping a strategy for fundamental change.

## Changing hearts and minds

Tackling the business model is a fundamental consideration for insurers. The prospect of change on this level is often difficult for traditional organizations. Transformation can only be successful with the complete understanding and backing of those at the very top.

Successful end-to-end transformation requires two cultural shifts that many insurers find difficult to make. The first is developing and encouraging a mind-set that is open to changing the business model—including offerings, channels, and the full operating model. Board members must be both bold and courageous since such ambitious changes are often met with resistance. The second is establishing a deeply embedded cost culture, without which costs will inevitably creep back up despite whatever cuts may have been achieved.

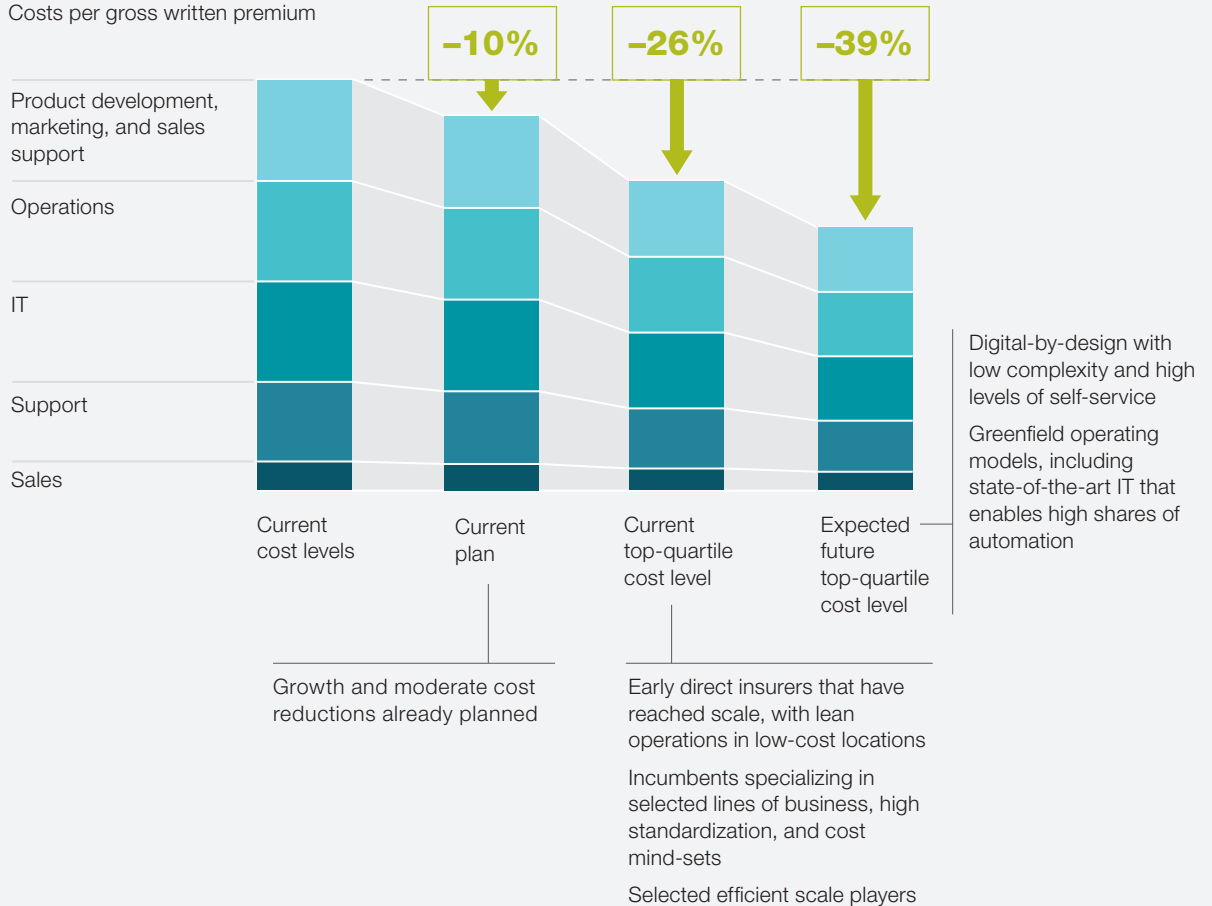
While conversations about beliefs and ambitions can be positive, they often remain intellectual exercises until insurers can see the possible shape of their future business model and cost base. Applying the Future Cost Model to an insurer's cost base and conducting several what-if analyses can break down the resistance to change and motivate management to embark on the digitization journey (see sidebars "Methodology of McKinsey's proprietary Future Cost

**Exhibit 3**

**Many insurers need to make significantly larger improvements to their cost base than are enabled by current models**

**Disguised client example**

Costs per gross written premium



Source: McKinsey Insurance 360

Model” and “Incredulous insurer: How we convinced one carrier to roll back their future”). This analysis becomes all the more powerful with real-life case examples of transformed incumbents, greenfield business units, or new attackers, which can demonstrate to incumbents that the future has already arrived.

**Thinking strategically about change**

Once leadership understands the potential of digitization, they can map out an organizational vision and a strategic direction to implement it. Our work with both leading global insurers and insurtechs that are disrupting traditional models has revealed a number of key actions that fundamentally reshape the way an insurer works. These actions span the insurer’s product and service offerings, operating model, and business model. When effectively combined, they enable a step change in cost performance.

## Incredulous insurer: How we convinced one carrier to roll back its future

We helped a multiliner with a book of more than \$2 billion take a closer look at their business model. The insurer had a cost program aimed at delivering more than 100 individual improvement levers. Benchmarking the company's performance against current best practice, however, revealed a gap of more than 25 percent that its current program would not close.

The insurer had its doubts about the size of the performance gap. We guided the entire management team through a future-oriented simulation, looking at the likely evolution of industry innovations and their probable impact on market cost ratios and cost leaders. This simulation gave them a realistic view of potential future costs and threats.

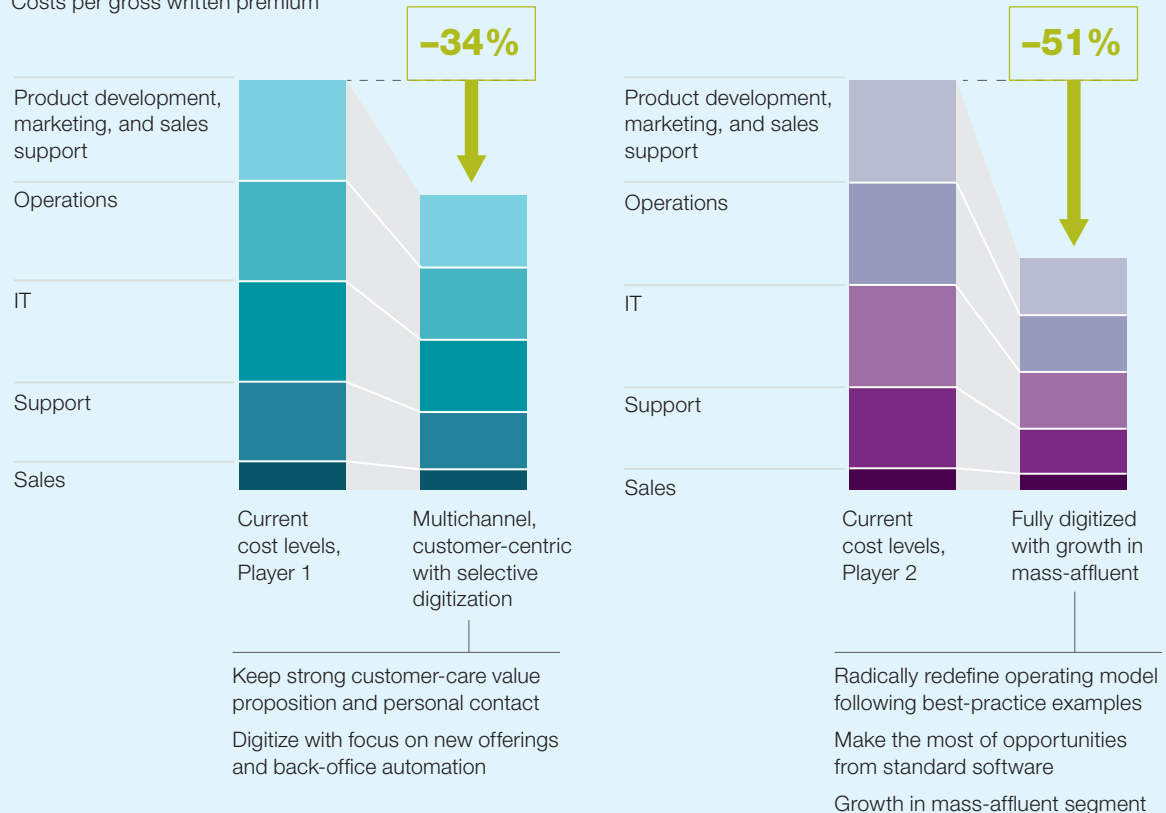
By going through this discovery process and developing an ambitious target, the board was finally able to begin rethinking their business model and conceive of more disruptive measures (Exhibit).

### Exhibit

#### Every insurer needs to determine a tailored cost goal depending on its strategic focus

##### Disguised client examples

Costs per gross written premium



Source: McKinsey Insurance 360



### *Boldly reinvent product and service offerings*

Radically streamlining the product portfolio, both for existing and new products, is the first essential move. This streamlining reduces the costs of product development and sales, taps operational economies of scale, and reins in IT costs.

The next move is to create new digital-by-design offerings enabled by state-of-the-art technologies. Examples include leveraging smart contracts or integrating insurance offerings seamlessly into retailers' websites. Products like these dramatically reduce the number of processes in which human intervention is required. Insurers must make sizable product development and IT investments—which include significant acquisition costs. But these investments can substantially lower operating and support costs over the long term.

### *Overhaul the operating model*

The first stage in reinventing the operating model is to adopt a zero-based design approach. For functions with a high share of manual processes, this approach and full operating models enables a step change in operational and support costs. Another aspect of this process is of course to tactically but forcefully automate existing processes. While completely replacing legacy systems is a long-term commitment, insurers can concurrently automate certain processes in a targeted way and yield some immediate cost savings.

Outsourcing nonstrategic and subscale functions is another operational approach with high potential impact. Smaller entities or areas with a book that is gradually declining will substantially benefit from outsourcing. Insurers are increasingly outsourcing not just operations but a combined operations and IT package, enabling the integrator to capture additional synergies.

### *Rethink the entire business model*

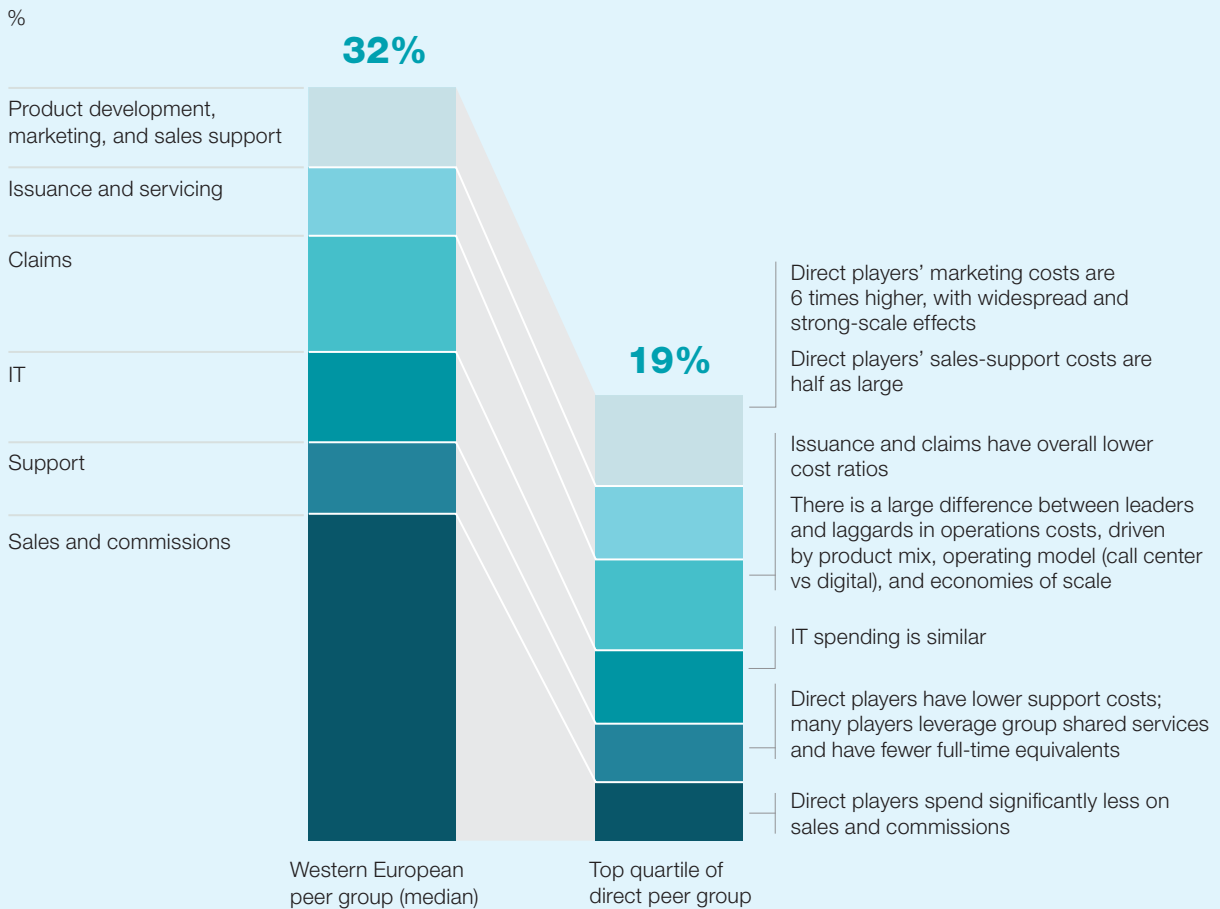
If changing the current operating model is not feasible or would simply take too long, some carriers instead launch a digital attacker that is low cost by design and enables much-needed agility toward the customer. This approach can be a powerful alternative operating model, building low-cost structures that the existing business could potentially use (see sidebar “The cost advantage of direct players”). Insurers must also overhaul their channel strategies. It is important that they review the channel mix with an honest assessment of profitability and future viability of the various channels, existing bancassurance agreements and operating models, and the use of aggregators.

An insurer reinventing its business model will also ideally sell unprofitable lines of business, either by running off specific books or selling complete entities. Particularly in life insurance, taking these actions can unlock substantial value. Legacy costs skyrocket on a declining book—a situation many insurers cannot solve internally. And sometimes the only way forward may be to exit a market completely. Examples include Generali's recent divestments in Latin America and Allianz's decision to sell its life insurance entity in South Korea.

## The cost advantage of direct players

Digital attackers are able to achieve fundamentally lower cost ratios than incumbents. A comparison of the leading P&C direct players in our sample (including digital attackers) with a broad-market peer group reveals a gap of around 40 percent, driven especially by lower costs for sales support and operations, as well as sales and commissions (Exhibit). Being able to reach sufficient scale quickly is key in enabling these players to achieve cost excellence since marketing costs are high and have a large scale-invariant component.

### Exhibit **Leading direct players achieve cost ratios that are about 60 percent of market values**



Source: McKinsey Insurance 360

Another logical move would be for insurers to consider aggressive growth and M&A to become a scale player. Greater scale can be a powerful lever to unlock cost efficiencies. If insurers rigorously manage complexity, greater scale can reduce unit costs, especially in areas such as IT, marketing, and parts of support functions. Scale can also provide insurers with a wider set of benefits by harnessing state-of-the-art capabilities in pricing or customer care. In commercial lines, where the benefits from scale may arguably be even higher than in other areas, there has been particularly strong M&A activity, such as the Chubb and ACE merger.



In light of the sizeable and fundamental structural shifts the insurance market is undergoing, cost has become a key strategic question, especially for industry incumbents. Innovations in technology are giving rise to a growing set of greenfield, digital-native insurers with an unprecedentedly low administrative cost burden.

A host of savings programs are under way, but most are insufficient given the whirlwind of change in the market. In view of this, incumbent insurers should take a three-step approach to analyze and reduce costs.

First, they should benchmark costs and define an aspiration level that factors in current cost developments in the market. Next, they need to map an appropriate cost strategy to achieve their ambitions. They must commit themselves to overcoming the hindrances of traditional models by fundamentally redesigning their business and operating model strategies. This redesign will enable them to drastically reduce spending across several cost categories. The third step in the strategy is to reshape their cost structures and cut costs by following a clear set of actions.

Insurers must undertake these actions urgently. Those who fail to do so soon will struggle to remain competitive in this highly disruptive market. ■

For more information about this report, please contact:

**Tonia Freysoldt**

Expert, Cologne  
tonia\_freysoldt@mckinsey.com

**Björn Münstermann**

Partner, Munich  
bjoern\_muenstermann@mckinsey.com

**Sylvain Johansson**

Partner, Geneva  
sylvain\_johansson@mckinsey.com

**Ulrike Vogelgesang**

Senior expert, Hamburg  
ulrike\_vogelgesang@mckinsey.com

**Christine Korwin-Szymanowska**

Associate partner, London  
christine\_korwin-szymanowska@mckinsey.com

April 2018

Copyright © 2018 McKinsey & Company. All rights reserved.

Printed in the United States of America.