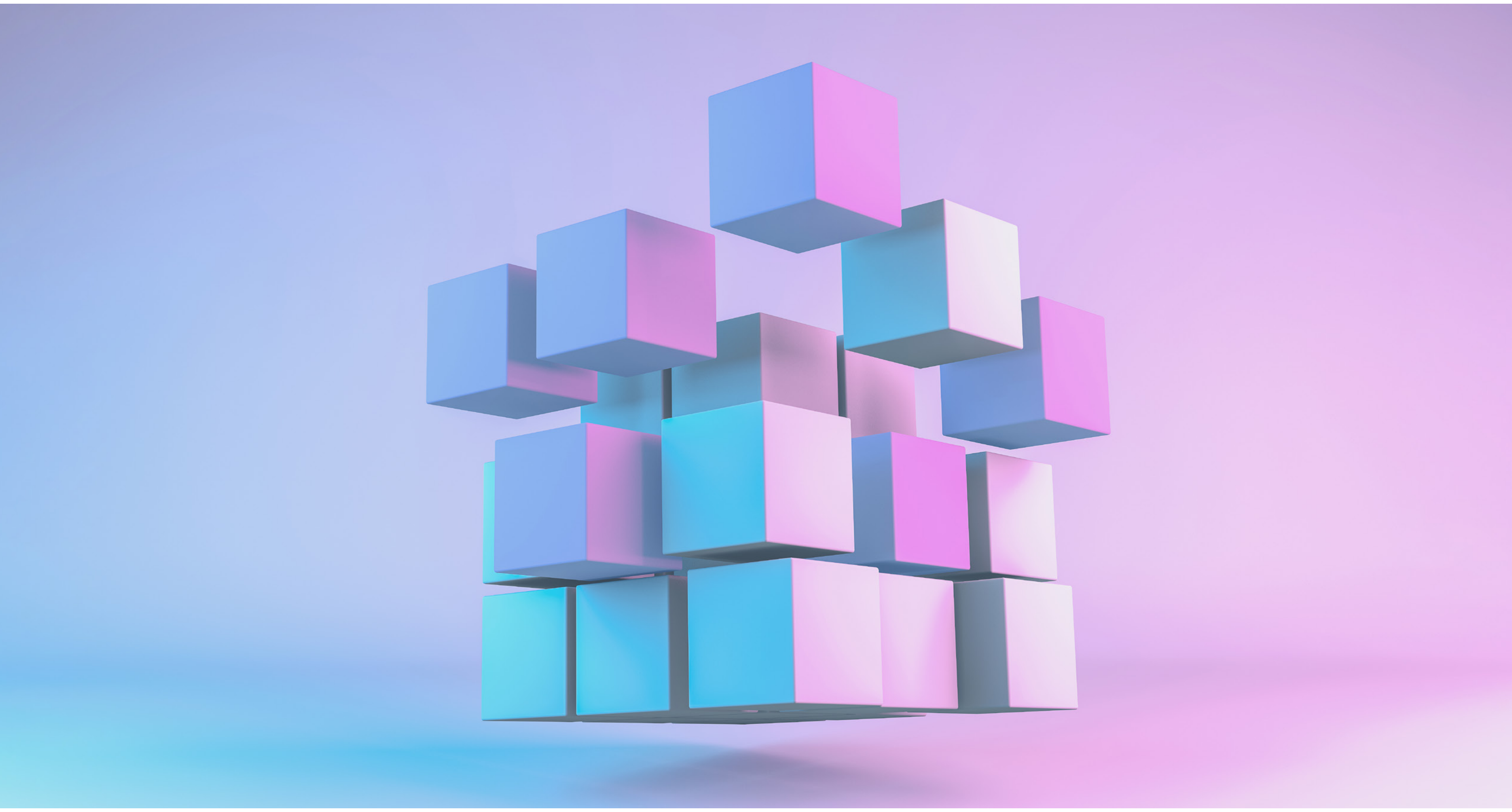
Insurance Practice

How insurers can improve combined ratios by five percentage points

Midsize North American property-and-casualty insurers have been slow to make improvements to their cost structures and operating models. Eight building blocks can help them make significant progress.

This article was a collaborative effort by Shahed Al-Haque, Kia Javanmardian, Rohit Sood, Binu Sudhakaran, and Angelina Tan representing views from McKinsey's Insurance Practice.



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Collectively, the property-and-casualty (P&C) industry has not substantially improved its cost structure in the past 15 years. In large part, this is because traditional P&C insurers are slow to make substantial changes to how they operate. The industry can no longer afford to continue in this manner, however, as the impact of the pandemic has created, or in some cases exacerbated, balance sheet and operational issues—particularly for midsize P&C carriers.

Insurers are experiencing challenges such as increased pressure on expense and loss ratios in the face of premium pressure, claim losses, and declining coverage demand in core areas such as small commercial and liability. The result: weak combined ratios (CRs).[1] To mitigate the effects of these issues, improve their CRs, and maintain—or move closer to achieving—profitability, P&C carriers must undergo a transformation.

Many midsize insurers have been hesitant to pursue a large-scale effort because securing a favorable outcome is costly but not guaranteed. However, based on our experience, we estimate insurers can trigger a significant percentage-point improvement in their CR over one year by pursuing a transformation with eight building blocks that focuses on areas including procurement, claims recoveries, underwriting, and the creation of a new normal operating model. By focusing on these eight blocks and strategically sequencing them, insurers have a much greater chance of significantly improving their CR.

Why the P&C industry is under pressure

As the COVID-19 crisis evolves, there is continued uncertainty about how it will play out for insurers. One certainty, however, is that the pandemic has highlighted (and in many cases heightened) financial and operational challenges across the P&C insurance industry,[2] and not just for midsize players. We have observed four challenges in the P&C industry:

Permanent structural and operational shifts. While organizations were slow to address digitization before COVID-19, a decrease in face-to-face interactions has accelerated the need for digital processes within the P&C operating model, as well as increased demand for remote-working capabilities.

Indeed, a recent McKinsey survey[3] found approximately 60 percent of service operations leaders[4] think more than 50 percent of customer demand will be met online in the next two to three years. And close to 80 percent of those survey respondents believe more than 30 percent of their operations will be conducted remotely. But in that same survey, 40 to 60 percent of the respondents said process disruptions in digitization and remote working are their biggest operational challenges.

Stagnant or increasing expense and loss ratios. As previously mentioned, cost structures in the P&C industry have not substantially improved in more than a decade. In the United States, for instance, administrative costs per policy have increased by 34 percent during this time.[5] While P&C carriers have attempted to make changes and limit rising costs, they have not been successful. Indeed, P&C has been outpaced by other industry sectors, such as automotive and telecommunications, which have eagerly adopted new operating models and technologies.

Declining investment returns. More frequent equity portfolio drawdowns mean insurers will lose money invested in the market; furthermore, a secular downturn in interest rates could result in a

[1] A combined ratio (CR) is the measure of underwriting profitability in insurance, calculated using the sum of incurred losses and expenses divided by earned premiums. Insurers can have an underwriting loss (a CR of more than 100 percent) but still be profitable because of investment income levels. Anshuman Acharya, David Hamilton, Pradip Patiath, Zachary Surak, Grier Tumas Dienstag, and Jasper van Ouwerkerk, "Insurance resilience in a rapidly changing coronavirus world," April 29, 2020, McKinsey.com; and Ari Chester, Sylvain Johansson, Steven Kauderer, Erwann Michel-Kerjan, and Andy Pinkes, "Coronavirus response: Short- and long-term actions for P&C insurers," April 14, 2020, McKinsey.com.

[2] Acharya, Hamilton, Patiath, Surak, Dienstag, and van Ouwerkerk, "Insurance resilience in a rapidly changing coronavirus world," April 2020, McKinsey.com.

[3] A live online poll was conducted on April 23, 2020, with approximately 45 operations, automation, and digital transformation senior executives (including CEOs, CFOs, and COOs) of service organizations mostly based in North America (less than 10 percent of respondents were from Europe, the Middle East, Africa, and Latin America).

[4] "Service operations leaders" are executives who lead operations for functions such as claims, underwriting, and procurement.

[5] Sylvain Johansson, Andy Luo, Erwann Michel-Kerjan, and Leda Zaharieva, *State of property & casualty insurance 2020: The reinvention imperative*, April 22, 2020, McKinsey.com.

decrease in normalized earnings for most companies. Indeed, the lower-interest-rate environment will disproportionately affect the economics of longer-tail lines of business (potentially lengthy settlement periods for liability and injury claims) and will require adjustments to pricing and capital allocation.

Disproportionate availability of resources. As the insurance industry continues to implement digital capabilities and remote-working concepts, large P&C players will have structural advantages over midsize insurers due to existing infrastructure, capital sourcing for large-scale future investments, and large-scale remote-work capabilities.

Eight building blocks for a CR transformation

To address their financial positions, insurers should focus their efforts on a structured transformation to improve their CR. Based on our experience, eight building blocks are critical to a successful CR transformation (exhibit). These blocks affect insurers' loss and expense ratios, albeit to different degrees, and some may only affect one ratio or the other.

For midsize P&C insurers to make significant improvement to their CR, many will need to pursue all eight blocks; for others, their transformation may only include a few. These variances depend on an insurer's starting point and the maturity of its capabilities, such as standardization of workflows and processes, performance management, and effective and efficient use of technology. Insurers can assess their maturity level and readiness needs against current performance and industry benchmarks. Doing so will help them see the value at stake and determine which blocks they should focus on. (For more on how one midsize insurer improved its CR in less than a year, see sidebar "A P&C combined-ratio transformation.")

A P&C combined-ratio transformation

After several years operating at a combined ratio of more than 100 percent, a midmarket North American P&C insurer sought to improve its performance and profitability. To begin, the new leadership team initiated a comprehensive performance diagnostic across divisions, identifying several high-impact opportunities that could quickly be captured with minimal investment. Examples include improving its underwriting and claims operational efficiency and reconstructing its business portfolio by focusing on strategic segments, exiting select markets, and taking rate actions on a certain portion of its book.

The insurer's functional and regional managers helped start the transformation by identifying areas for improvement and design initiatives within underwriting, claims, procurement, and IT. Given the low maturity of existing processes in the organization, the transformation team tackled foundational actions such as redesigning processes, setting up performance management systems, and conducting vendor renegotiations.

Over eight weeks, the insurer piloted initiatives for each building block to confirm the anticipated value before applying the initiatives across the organization. For example, the working team developed and tested an analytics-driven tool for early identification of recovery opportunities such as subrogation and salvage, and then trained the entire adjuster team on how to use the new tool only a few weeks later.

The insurer reinvested savings realized from the first block of this transformation into subsequent ones such as digitizing the end-to-end claims operating model and deploying analytics at scale. For example, the team created advanced analytics models to segment and streamline claims processes across business lines. Thus, the carrier could tailor its claims-handling approach based on the complexity of the claims and customer needs.

As a result of these efforts, the organization successfully built momentum around its ambitious goal, created a bias to action from the top to the front line, and triggered a five-percentage-point improvement in CR in fewer than 12 months.

Exhibit

Eight building blocks can help insurers improve their combined ratios.

Size of impact: ● No impact ● Moderate ● High

Building blocks	Examples	ER[1]	LR[2]
1. Procurement excellence (claims and nonclaims)	• Optimize preferred vendor networks by identifying vendors offering the best quality services • Eliminate or reduce redundant hardware/software • Negotiate improved rates for key service areas, especially where contracts are close to expiration	High	High
2. Claims recoveries	• Identify subrogation and salvage opportunities early; prioritize fraud and subrogation opportunities based on expected value at stake • Use analytics-driven fraud identification and prevention processes (eg, building a model that can flag potentially fraudulent activities)	No impact	High
3. End-to-end claims operating model	• Find opportunities to capture the most important data during first notice of loss • Standardize intake procedures to reduce rework • Optimize claims processing through standard work and job aides • Reduce inbound demand	Moderate	Moderate
4. Underwriting excellence*	• Support underwriting discipline • Improve underwriting effectiveness (improve quality of risk selection and bind rate[3]) • Improve straight-through processing • Enhance underwriting and pricing capabilities through advanced analytics to improve loss accuracy	Moderate	Moderate
5. Retention management*	• Review existing analytics/key performance indicators used for performance management • Use analytics to identify important churn and retention factors, root causes of customer attrition during customer life cycle, and opportunities to increase reach within certain client bases • Make data-backed performance improvements and support capability building for call-center agents	Moderate	No impact
6. Targeted and rapid IT optimization	• Create transparency around costs and flexibility of the IT operating model to support the business (eg, product- or service-based operating model, technology modernization, automation of IT processes) • Provide clarity around where legacy functionality might require replacement vs ring fencing (financially separating a portion of a company's assets)	Moderate	No impact
7. Brokers commission management*	• Increase profitability tracking and reporting at broker level • Conduct comprehensive carrier-broker conversations around the breadth of services broker can offer (eg, health/benefits/retirement) and the value carrier provides to broker • Better tie commissions to performance and profitability	Moderate	No impact
8. New normal operating model	• Aim to meet 50 percent of demand through digital channels (eg, digital submissions and virtual assessments) • Target moving 30 percent of workforce to a remote-working model while reducing associated operating costs (eg, consolidating real-estate footprint)	Moderate	No impact

*Also a driver for top-line impact.

[1] Expense ratio is the measure of an insurer's profitability.
[2] Loss ratio looks at the ratio of losses to premiums earned. It is calculated by taking insurance claims paid plus adjustment expenses divided by total earned premiums. The strategies and tactics identified here are not intended to achieve some arbitrary percentage reduction in indemnity payments on claims actually made. The primary impact on loss costs is through better underwriting and risk selection; improvements in loss adjustment expense, both allocated and unallocated, can be achieved through procurement excellence, claims recoveries, and optimization of the end-to-end operating process.
[3] The rate at which insurance coverage is bound either through written or verbal agreement.

Note: The example actions are listed in order from basic to more advanced.

Regardless of how many blocks in a carrier's transformation, to reach its full potential an insurer must sequence the blocks appropriately based on its unique context. Procurement improvement and claims recovery often make sense as starting points because they can improve loss ratio (in the case of claims activities) and enhance the customer experience; conversely, nonclaims activities such as IT procurement can free up capital to invest in other areas such as along the end-to-end claims operating model and in underwriting. These quicker-value wins can create momentum early in the transformation.

Within each of these building blocks are foundational elements that insurers can start with before moving on to more advanced endeavors. For instance, insurers might start with claims recovery and focus on a process redesign before moving on to using analytics at scale to improve fraud identification.

As insurers move through the transformation, they should keep several principles in mind to focus their efforts; doing so can increase their probability of success (see sidebar "Key combined-ratio transformation principles").

To help midsize P&C insurers see how they measure against top-performing players, we've chosen four building blocks that typically have high potential value to illustrate what success looks like.

Achieve procurement excellence

Best-in-class companies take a comprehensive approach to managing both claims and nonclaims procured spending.[6]

To get the best rates from their vendors, leading organizations take a systematic and data-backed approach to conducting requests for proposal.

[6] Claims procurement spending includes areas such as repair costs (for auto and property), auto rental costs, medical management, and litigation management. Nonclaims procured spending includes areas such as IT.

Key combined-ratio transformation principles

As insurers pursue their transformation effort they can lean on six principles to increase their likelihood of success.

1. **Take a comprehensive approach.** Address both core and support functions across the P&C value chain, using all possible actions within the building blocks. Under procurement excellence, for instance, insurers should focus on not only reducing rates but improving demand management.

2. **Aim for pragmatic and fast solutions with very limited tech investments.** Insurers should design initiatives that release cash quickly and require minimal tech investment. Solutions and value-unlock should not be dependent on significant IT changes or upgrades.

3. **Adapt to a digital-led reality.** Embrace a digital way of working to engage agents and customers and design initiatives with business continuity and resilience in mind.

4. **Focus on capability building.** Develop new capabilities within the organization and train the workforce to implement them; focus on mindset and behavioral shifts to make sure the change is sustainable.

5. **Create a bias for action.** Commit to achieving a five-percentage-point CR improvement within 12 months and take actions to execute swiftly on that objective.

6. **Structure to self-fund.** The transformation should be self-funding over a 12-month period through savings from certain blocks that can be used to fund others.

They also work to constantly optimize their networks of preferred vendors to help customers receive the best quality work. In addition, these insurers use advanced analytics models to better understand underlying demand patterns to improve demand management. Examples of analytics in action include conducting appraisals for repair work, analyzing the quickest turnaround for auto repairs based on which day of the week the vehicle is taken to the repair shop, and identifying total losses as early as possible. Based on our experience, focusing comprehensively on these areas can trigger a 7 to 11 percent reduction in base spending while improving quality and customer service.

One midsize North American P&C carrier, for example, analyzed its preferred auto-repair network and found a large degree of variability in quality and cost, even among the preferred repair vendors. The company also discovered that drivable vehicles dropped off at the repair shop were returned to their owners up to five days faster depending on the day of the week the vehicles arrived.

With these insights in mind, the company curated a list of tier-one versus tier-two preferred repair vendors by region. The insurer published that list on its website and trained its adjusters to provide recommendations to customers based on where they live. Adjusters were also trained to help customers book appointments with repair shops through an online system that recommends the best days to drop off vehicles according to repair turnaround times.

Build a robust and resilient end-to-end claims operating model

To build a strong and flexible end-to-end claims operating model[7] and make the claims journey more efficient, leading carriers invest in digitization, automation, and analytics. Best-in-class companies can meet 50 percent of demand through digital channels.

Midsize P&C insurers can start by identifying key areas in their claims journey where it makes sense to include digital and automation. For example, implementing natural language processing to identify customer sentiment and understand the nuance in customer or claimant emails could make it possible to automate medical record ingestion and medical bill review. Improving system abilities to correctly detect sentiment and nuance can also help carriers expand their use of straight-through processing for simple claims.

Insurers can also invest in data and predictive analytics. Leading insurance companies, for instance, use their claims data to create predictive models enabling better claims outcomes. These insurers might also build specialized teams with expertise in prevention; by integrating data provided by telematics, sensors, and wearables, these teams could create a predictive analytics model that generates actionable insights to help in early claims intervention.

One US P&C insurer uses chatbots to guide customers through a full claims-filing process via a smartphone app. The workflow from start to payment only takes a few minutes, and the chatbot handles the conversation with the customer, orchestrating data and events to facilitate customer interaction. In this case, the carrier uses back-office analytics to validate claims and issue payments.

Pursue underwriting excellence

Establishing analytic-driven feedback loops across underwriting, pricing, and claims can help leading insurers assess the profitability of their products and adjust underwriting and pricing practices accordingly, potentially improving pricing accuracy by two to three percentage points. These insurers also have strong relationships with their broker networks to attract business in line with their underwriting capabilities and growth strategy. Moreover, they use advanced analytics models to help them prioritize and triage underwriting submissions based on criteria such as premium size, profitability, and likelihood for renewal. Highly automated underwriting processes for personal lines, such as auto insurance, are also effective.

[7] Deniz Cultu, Kristen Ganjani, and Elixabete Larrea, “How North American claims organizations can respond to the coronavirus,” May 1 2020, McKinsey.com.

These companies also use their analytics capabilities to enable a high degree of automation and straight-through processing submissions (more than 85 percent for personal lines) for quotes. In the case of condo or home insurance, insurers can use third-party sources, such as databases with information on building construction (for example, building materials and heating systems), which can help companies underwrite risk. Having access to this kind of information streamlines underwriting and can enhance the customer experience.

As an example, one midsize North American P&C carrier knew it needed to improve its underwriting capability and use a more consistent methodology. To start, the insurer conducted a diagnostic of its underwriting function and discovered a lack of clarity on its strategy at the desk level, high variability in underwriting capabilities (such as exposure recognition and pricing), and little formalized training for underwriters. The company realized that addressing these challenges could improve its pricing accuracy across its commercial book.

In response, the insurer developed a series of tools and support programs to improve the capabilities of its underwriters. The company adopted approaches including risk-selection decision trees (with a detailed list of considerations to ensure decisions align with the organization's strategy), broker review tools (to understand past profitability), and broker interaction guides. In addition, the company also implemented a rigorous performance management system consisting of key performance indicator (KPI) measurement and tracking, huddles, and problem-solving sessions to reduce performance variability.

Build an operating model for the next normal

As carriers move into the next phase of the pandemic, they will need the right operating model and digital capabilities in place to support changing customer and market demands. Indeed, remote working is critical, as insurance and agent workforces continue to operate from home.

Large insurers have already built some remote-working models and will continue to use them as they navigate the crisis, aiming to move 30 percent of their workforce to this model for the long term. These same companies are also developing methods to support effective remote—workforce performance management, such as dashboards, virtual team rooms, and remote team huddles. Insurers are also identifying the roles and skills needed in the future-state organization, including an outsourcing model of the future. In doing so, they are working to determine how to fill skill gaps through reskilling or strategic external hiring, and reimagining the talent management journey—for instance, how to recruit, onboard, train, and develop the adjusters of the future.

The lasting effects of the COVID-19 pandemic are unknown. Even before the crisis, however, midsize P&C carriers were under pressure to change their business and operating models to address years of stagnant expense and loss ratios and underwhelming cost structures. Now, insurers have an opportunity to reimagine how they do business and make comprehensive changes across the value chain. In doing so, they can improve their profitability and resiliency for the next normal.

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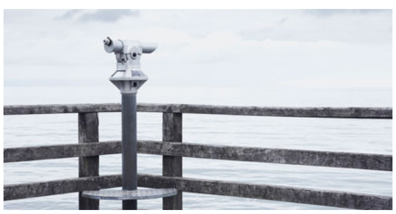

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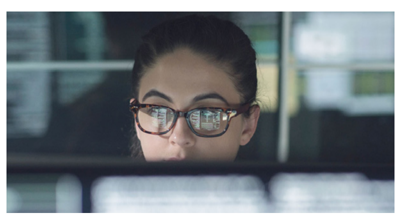

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