

Björn Münstermann,
Sirus Ramezani,
Torben Swart, and
Ulrike Vogelgesang

Taking courageous action on cost in life insurance

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Life insurers under pressure to reduce costs can learn from the success of others — and consider radical change.

Life insurers are under substantial cost pressure. The low interest-rate environment and the increased price competition driven by new digital intermediaries are jeopardizing the industry's value proposition. Indeed, at current interest rates, most insurers are unable to pay back even the premiums that customers have paid in and are simply bleeding money, if not yet hemorrhaging.

As a result of this revenue-squeezing environment, insurers across Europe have launched cost-reduction programs, frequently focused on lean methods, digitizing value chains, and cutting overhead. And gross administrative costs as a percentage of reserves have indeed fallen in many markets. Yet this effect has, to a large extent, been driven by an increase in premiums rather than any significant decrease in real costs. In fact, many players have been unable to substantially reduce their costs over the past 10 to 15 years.

How to resurrect life insurers

Although the life insurance industry has been slow to respond to cost pressures, there are lessons to be learned from those able to rein in costs and stay competitive, and as well as radical approaches for ailing and/or bold insurers that are willing or need to rebuild their businesses more or less from scratch.

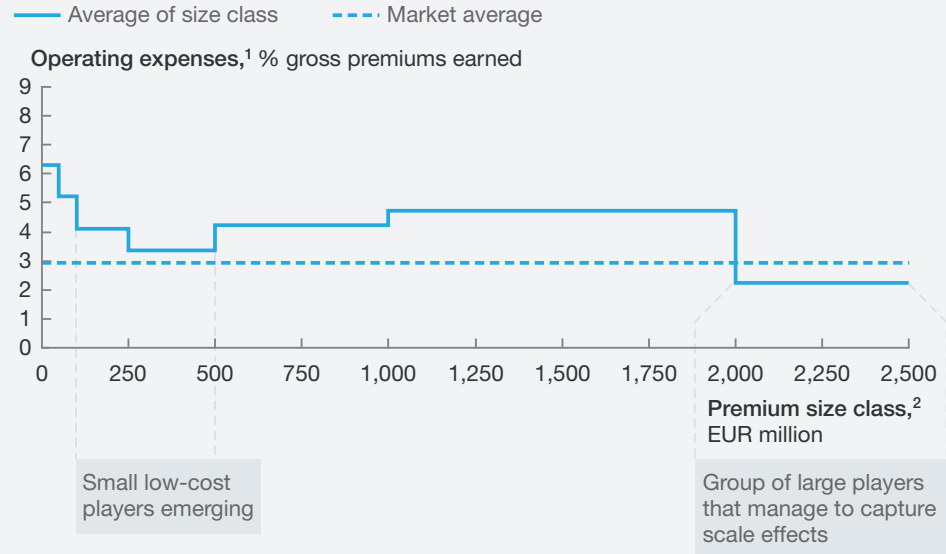
Renegotiate commission agreements and streamline distribution support. While administrative costs have fallen substantially in a number of markets in recent years, only a few players have been able to bring distribution costs down dramatically. Life insurers should develop a perspective on what their distribution structures should look like five years from now, and work toward changing their support structures to achieve a substantial reduction in commission spending.

Maximize operational efficiency through scale or simplicity. Two types of players have successfully driven cost ratios down: some of the biggest insurers have used their scale to become more efficient, while a set of smaller players has achieved low cost ratios through rigorous focus (Exhibit). Scale players have all consistently worked on their cost base,

Exhibit

Germany offers an example of the two routes to low costs: leveraging scale effectively or becoming a focused low-cost player.

Operating expense ratios of German life insurers by size classes, average 2014



¹Administrative expenses plus balance (other expenses/other income) plus other taxes; excl. acquisition expenses.

²Gross premiums earned.

McKinsey&Company | Source: McKinsey GFIC research; McKinsey Life Insurers Database

consolidated sub-entities, and used shared services to reach new levels of efficiency. Some have grown through acquisition and internal consolidation and reaped substantial synergies. Their size has also allowed these big players to make large-scale investments in efficiency improvements, which are now paying off. By contrast, a number of smaller players have been successful through driving efficiency by reducing complexity. This might mean doubling down on a niche segment, product, or channel and maximizing its potential.

Embrace digital technologies. New entrants are leading the way in developing low-cost models based on digital technology, with some of them achieving administration and acquisition cost ratios unmatched by traditional insurers. Yet digital technologies are not just for new attackers. One traditional life and protection player, for example, launched an automation initiative and identified very substantial savings. And in markets like the United Kingdom, a wide range of digitally enabled platform-based business models is emerging with the support of a full ecosystem of IT providers. These models also strongly show the revenue potential of digitization: assets under management held by these platform businesses have more than tripled since 2010—and as assets grow, cost ratios fall.

Modernize IT. Modernizing IT systems for policy administration and benefits management is undoubtedly expensive, but when done properly it can substantially lower both IT and operating costs. Delivering on the implementation is a key challenge. Setting up these initiatives in the right way—such as making the right choice between standard packages and proprietary

solutions (or a hybrid), ensuring business leadership of the transformation, firmly designing the solution to maximize business value, and selecting a team with the right mix of skills—is critical to success.

Establish a rigorous cost culture. The first four actions all require major decisions on the direction of the business and substantial investment. Yet it's also essential that each player, regardless of their relative cost performance today, establishes or supports continuous cost and performance management and sees to it that all levels of the organization are cost conscious. A detailed analysis of the root causes of the cost-ratio gaps between the lowest-cost players and the rest continues to show that excellence in day-to-day cost management—from the CEO down to the teams—is the single most important driver of differences in cost ratios.

Finally, for some players, none of these steps may be appropriate or sufficient. An increasing number of insurers are rethinking their product portfolios and are considering radical options:

Back-book sale. Back books create a high level of costly complexity. Selling off parts of their back books can help insurers reduce complexity and rid the burden they create.

Greenfield model. Even more radical is making a fresh start with a greenfield business that is designed for efficiency from Day 1. However, it still remains unclear whether greenfield models in life will be successful and can effectively be built up to scale.



Even for life insurers that have managed to grapple with costs, pressures continue to increase. Companies must honestly assess their business models to determine which lines of business are profitable or can be made profitable in the near future, and which may need to be discontinued. Investing in digital platforms will bring rewards, even if the initial outlay and transition is painful. Finally, keeping a close eye on the everyday costs will be essential, though easily overlooked given the scale of change elsewhere. This will very likely be the only way that the most ailing insurers can get themselves off the life support machine and back on their feet. ▣

This article is excerpted from *Taking courageous action on cost in life insurance*.

Björn Münstermann is a partner in McKinsey's Munich office, of which **Torben Swart** is an alumnus; **Sirus Ramezani** is a senior partner in the Zurich office; and **Ulrike Vogelgesang** is a senior expert in the Hamburg office.

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