McKinsey&Company

European Insurance and Asset Management

Successfully reducing insurance operating costs

Insights from McKinsey's Insurance 360° benchmarking

Foreword

The March 2014 edition of “Successfully reducing insurance operating costs – insights from McKinsey’s Insurance 360° benchmarking” gave a comprehensive picture of cost developments in the insurance industry, and was very well received by insurers across all geographies. As the 2014 benchmarking season drew to a close, we wanted to use the opportunity to give an updated picture of the market based on our most recent benchmarking results.

This year’s edition features updates revealing a number of new insights, including the following:

- A growing group of participants are managing to successfully and consistently reduce costs over time, with the key levers pulled being operational improvements and performance management.
- Some players are achieving impressive operating cost reductions from the digitization of end-to-end processes. While this trend has only just begun, we expect this to have an especially significant impact on core operations such as policy issuance, administration, and claims.
- Cost gaps are narrowing particularly in life insurance.
- The findings and recommendations of last year’s edition still hold true overall.

We very much hope this report will be of assistance to stakeholders, especially insurance CIOs and COOs, and will rouse your interest in learning more about Insurance 360°. We would also be delighted if you would like to participate in our 2015 survey.

Successfully reducing insurance operating costs

Insights from McKinsey's Insurance 360° benchmarking

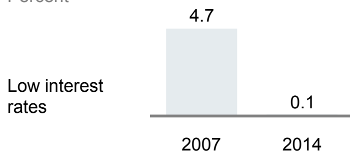
Today's unforgiving economic climate confronts insurers with a multitude of challenges. The low interest environment, greater price transparency and customer cost consciousness, sweeping regulatory changes, and lack of growth perspectives are just a few. As a result, the profitability of Life and P&C players is currently barely above the cost of equity (Exhibit 1): costs are emerging as a key factor for competitive advantage.

Insurers across Europe are finding this hard, as many have failed to sustainably manage their costs. However, a few cases demonstrate that successful, long-term cost management is possible. How have these top performers managed to achieve such stellar performance?

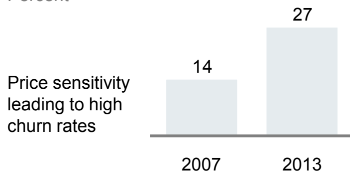
Cost pressure is here to stay

Challenging macroeconomic and competitive environment

Average 3M Euribor
Percent

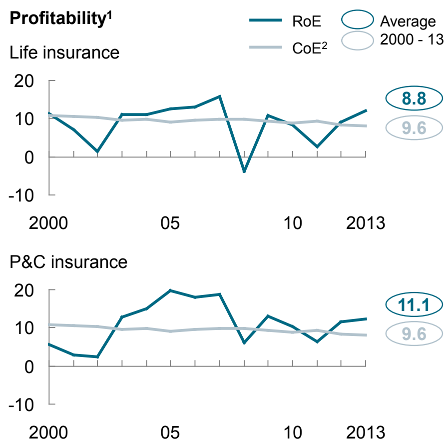


Churn rate motor insurance, UK
Percent



Profitability of Life and P&C players is not much more than their cost of equity

Profitability[1]



1 Data represents Western Europe
2 CoE represents total cost of equity for total Western European insurance industry; split by line of business not available.

SOURCE: Global Insurance Pools; GFK consumer survey; Bloomberg

Exhibit 1

McKinsey & Company's Insurance 360° cost benchmarking survey, now in its 10th year, offers unparalleled insights into the industry (see Box 1 for information on the methodology used). The current survey database consists of 38 Life, 33 P&C, and 9 Health insurers. The data maps the entire value chain, multiple lines of business and products, and sales channels of all kinds. While the benchmarking covers both operational costs and sales and commission costs, this report is concerned exclusively with operational costs.[1]

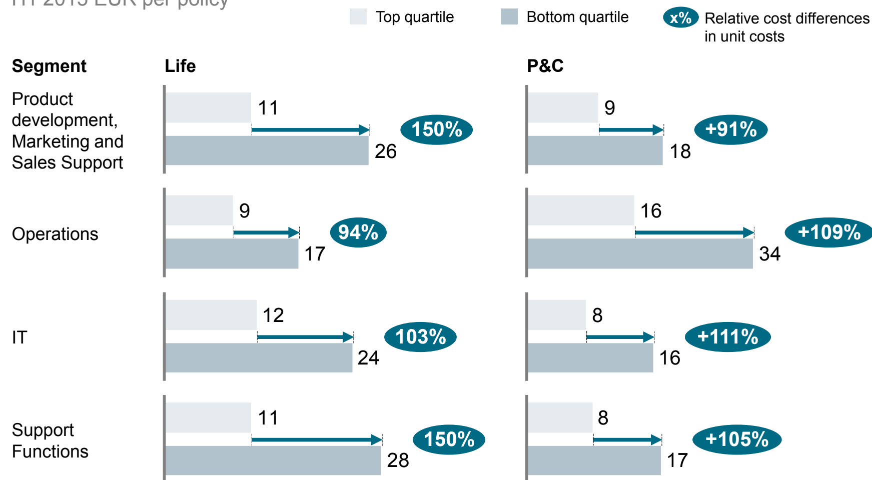
The results reveal significant cost differences within the sector. Astounding is the fact that the differences in operational costs between top-quartile players and those at the bottom of the stack are consistently higher than 60 percent across every business function, and differences of over 100 percent are not uncommon. In some cases, bottom-quartile players' unit costs are almost more than twice those of top-tier players

1 A white paper that specifically focuses on sales and commission costs is currently in preparation.

(Exhibit 2). Compared to last year's peer group, both the spread and the absolute cost levels in P&C have increased substantially. Similar disparities are evident on a per GPW basis. The economic repercussions of the recent financial crisis are continuing throughout the sector. The raft of capital- and risk-management-related changes currently being introduced are an additional burden, as they will inevitably lead to higher costs.

McKinsey's cost benchmark shows that bottom-quartile players' unit costs can be more than twice as high as top-quartile players', particularly in Ops and IT

Total operating costs, excl. sales and commissions; Western European peer group as of H1 2015 EUR per policy



SOURCE: McKinsey's Insurance 360° benchmarking

Exhibit 2

This report gives clear insights into the secrets of success of top performers, and the reasons underlying the weakness of their peers. It does that by both analyzing the industry's key cost drivers as well as examining more inscrutable root causes that actually underlie from 50 to 80 percent of the cost differences between stars and laggards. It also makes actionable recommendations on how players can identify which approach to achieving superior cost performance will best suit their specific corporate profile. Insurers can use these insights to balance cost performance with product and service quality, shaping far-reaching transformation programs to give them an edge on their competitors.

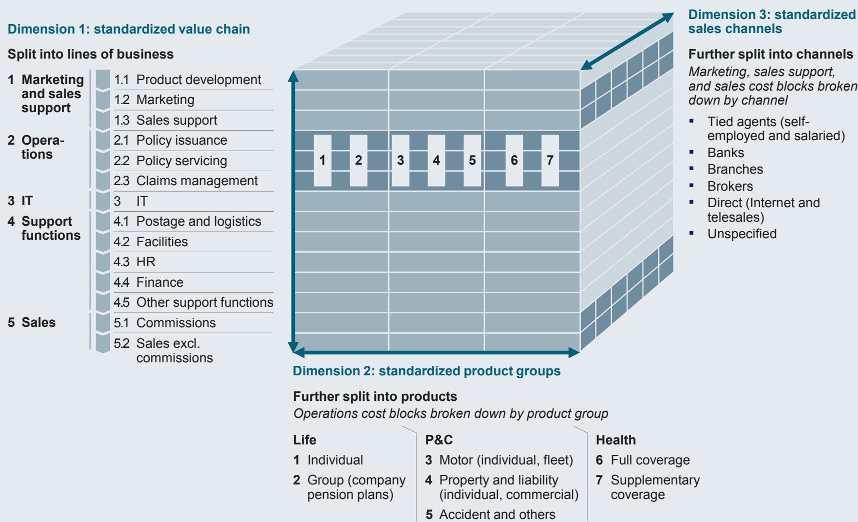
This report takes a four-step approach. First it analyzes the cost drivers that are often considered immutable: size, sales channel, product mix, and geography. The findings reveal that these cost drivers only account for around 46 percent of the cost variance for Life, and an even smaller share of the cost variance in P&C: 19 percent. Second, it examines the root causes that explain why insurers often fail to optimize their cost position. It then takes a granular look at key levers for optimizing the cost base. The report closes with implications for CIOs and COOs that outline how to address the root causes.

Box 1

Insurance 360°: brief overview of the methodology used

McKinsey has been conducting Insurance 360° – an insurance cost benchmarking and root cause assessment – since 2005. The survey uses a valuable and proven methodology for identifying cost gaps and their root causes, as well as highlighting countermeasures. At its core, Insurance 360° is built on holistic disaggregation and mapping of costs to ensure that all costs are assessed, and that they are comparable across insurers.

The cost model is structured along 3 dimensions to ensure comparability, consistency, and transparency



SOURCE: McKinsey's Insurance 360° benchmarking

Exhibit 3

Participants map their costs in three dimensions to ensure they are comparable (see exhibit above). First they chart them along a standardized set of functions – marketing and sales support, operations, IT, support functions, as well as sales and commissions. Second, these costs are matched to three product lines (Life, P&C, and Health), and (optionally) to over ten different products within those lines. Thirdly, they are linked to sales channels. Data on the company's key quantifiable parameters are also gathered, such as size (number of policies), assets under management, gross premiums written, sales channels, product mix, and number of FTEs. Each company's spend is then compared to a peer group tailored to its individual characteristics.

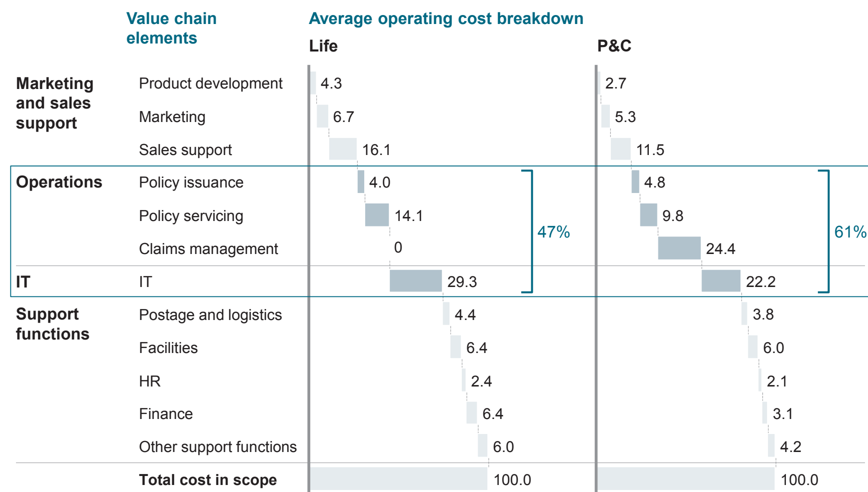
The taxonomy specifies clear definitions of all dimensions, functions, and parameters that have been validated and refined over the last nine years. Each individual assessment is guided by a McKinsey expert to maintain strict adherence to the benchmarking's methodology.

Core elements of operating costs and their underlying drivers

McKinsey's Insurance 360° results provide invaluable insights into the industry's operating cost elements. The biggest for both Life and P&C are operations and IT, accounting for 47 percent of a typical insurer's cost base in Life, and 61 percent in P&C (Exhibit 4). Sales support is also important, at 16.1 percent of the total for Life, and 11.5 percent for P&C.

Operations and IT account for around 50% of a typical insurer's cost base

Percent of total costs,1 Western European peer group as of H1 2015



1 Total costs excl. commissions

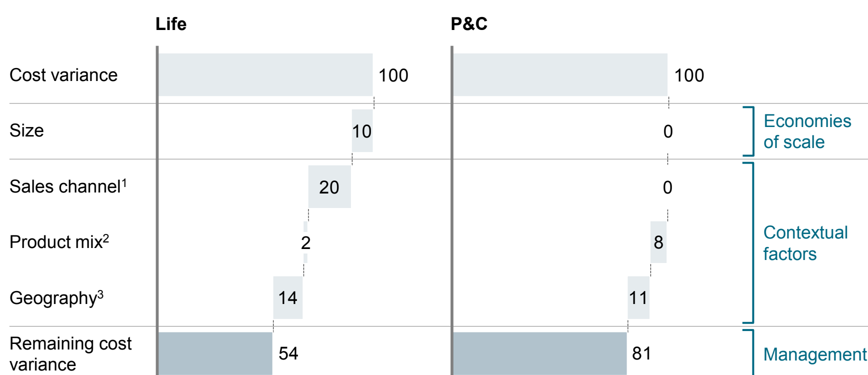
SOURCE: McKinsey's Insurance 360° benchmarking

Exhibit 4

Size, sales channels, product mix or geography of an insurer are often viewed as cost drivers that are carved in stone. In 2014, McKinsey scrutinized these four cost drivers in multivariate analyses: mining the most recent data for insights. Together these were found to explain only around 46 percent of the cost variance for Life, and an even smaller share of the cost variance in P&C: 19 percent (Exhibit 5). While this shows that there is some scope to optimize these four drivers, it revealed that most of the improvement potential must actually lie in other areas. In our experience the true root causes of the cost differences actually mostly relate to management. Before we turn to examining these management-related causes in more depth, it is worth analyzing the four traditional cost drivers to see what – albeit limited – cost leverage they might offer.

Management is an important driver of cost differences, even when monitoring for economies of scale and contextual factors

Percent of variance in cost per policy



1 Life only; sales channel was excluded for P&C because costs do not significantly differ between sales channels.
2 Share of Group Life of Life and share of non-Motor of P&C measured in number of polices.
3 Life: country is Great Britain or Southern Europe (Iberia, Italy, Greece); P&C: country is Germany or Austria. When grouping countries by similar market characteristics, only these differ significantly from other countries in the sample.

SOURCE: McKinsey's Insurance 360° benchmarking

Exhibit 5

- **Size.** Size explains only 10 percent of total cost variance in Life, and has no explanatory power in P&C. The initial impression from the results is that insurers barely manage to capture economies of scale in terms of cost per policy on an aggregate level. This also holds true if we examine costs per GPW, and go a few levels deeper (such as operations by product). Economies of scale are only evident in a few selected areas. In policy issuance, for example, larger life insurers with more than 300,000 newly issued policies have median costs per newly issued policy of EUR 27, while insurers that issue fewer than 150,000 policies have median costs per newly issued policy of EUR 66 (145 percent more). In the vast majority of areas, however, economies of scale remain stubbornly absent, showing significant potential for further improvement.

- **Sales channels.** Surprisingly, the type of sales channel used is only a significant cost driver for Life, but not for P&C. For Life insurers with a high share of bancassurance business, total operating costs per policy are EUR 29 per policy, considerably lower than for insurers who focus on other channels (EUR 73). The median total operating costs per policy of Life insurers with a high share of broker business are much higher (EUR 84). In addition to differences in commissions, these cost differences play a significant role in overall channel profitability and need to be taken into account by any insurer reviewing their channel strategy.

- **Product mix.** Product mix is only a minor driver of overall cost differences between Life insurers, but a relevant driver of cost differences between P&C insurers. In P&C, players with a larger share of non-Motor tend to have lower total operating costs per policy. This effect is largely driven by lower operations costs per policy for non-Motor business: the quartile with the highest share of non-Motor had costs of EUR 46 per policy, while the costs of the quartile with the lowest share were 28 percent higher, at EUR 59.

- **Geography.** Where geography is concerned, players in a few geographies stand out. In Life, for example, Southern European players are less expensive in some categories. Their median total operating costs per policy are EUR 49 for Life, for instance, as against EUR 59 for Germany/Austria. Interestingly, the median total operating costs per policy for P&C are lower in Germany/Austria than in Southern Europe (EUR 43 as against EUR 53).

As intimated above, differences in these four factors are not sufficient to explain the brunt of the cost differences. Exhibit 4 revealed that 54 percent of the cost variance in Life remains unexplained after taking these cost drivers into account, and 81 percent of the variance in P&C – a disparity that clearly deserves very close analysis.

Root causes behind the persistent cost differences

In-depth discussions with executives in the context of McKinsey's Insurance 360° benchmarking survey enabled us to take company specificities into account. This gave us the opportunity to dig deeper into possible underlying causes of the cost differences. Our analyses of the benchmarking data combined with insights from our discussions suggest that four distinct root causes explain both the large remaining cost level disparities as well as why insurers fail to optimize the cost drivers outlined above: business complexity, the company's operating model, management of the IT landscape, and performance management.

- **Business complexity.** Business complexity relating to brands, sales channels, product mix or customer-facing processes is an important driver of operating costs and limits insurers' ability to leverage economies of scale. As a result, we find that insurers with a very large product portfolio, multiple brands and channels are also those with the highest costs on average. One example was an insurer that had introduced numerous individually negotiated discount schemes with a large number of brokers, leading to high complexity and sometimes inadequately priced contracts.

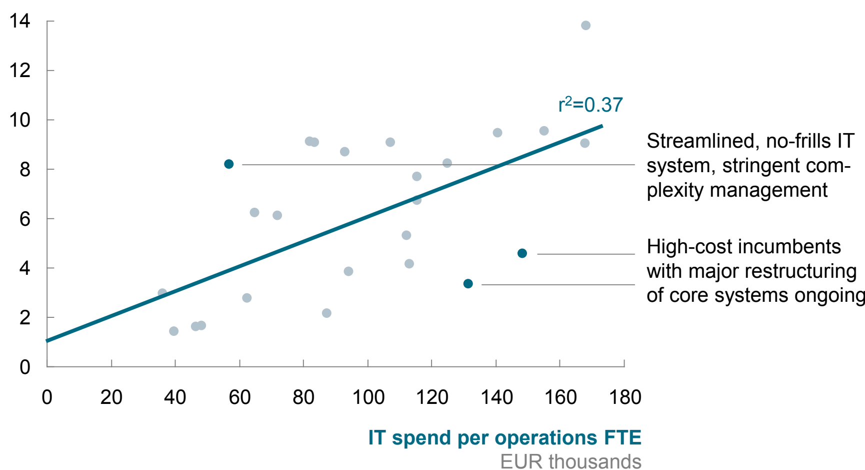
  Similar effects are evident when analyzing differences by channel from a complexity perspective. Life insurance players with a bancassurance focus have median total operating costs per policy of only EUR 29, which is significantly lower than for other channels. This is primarily driven by the reduced product and process complexity in this channel.

- **Operating model.** A nonoptimized operating model is the root cause for failing to leverage economies of scale. High-cost players tend not to have consolidated or optimized the setup of their operating units. One insurer's back-office functions were distributed over numerous locations. Processes and governance structures differed across locations, clear management KPIs were lacking, and individual locations were subscale. The company had difficulties managing workload as a result, experiencing both backlogs as well as underutilization. This led to a drop in customer satisfaction and deteriorating financial performance.

- **IT systems.** A fragmented legacy IT landscape is often a root cause for failing to leverage economies of scale, driving high IT costs as well as mushrooming operational costs. Many participants of our benchmarking expressed concern at the high overall costs of IT and the lack of support it offered to the business. It also facilitates new business opportunities, for example from improved pricing or underwriting. Consolidating and modernizing the IT landscape simplifies operating processes, allows higher levels of automation, and significantly reduces the time to market for new products.

  Our benchmarking data supports executives' statements on IT landscape costs. When comparing the productivity of FTEs in operations (i.e., policies per FTE) for both Life and P&C with IT spend per FTE, we find that insurers with complex legacy systems tend to have both a high IT spend and low productivity, while players with streamlined IT manage to achieve high productivity with limited IT expenditure (Exhibit 6).

Complex legacy systems lead to both high IT costs and low productivity



SOURCE: McKinsey's Insurance 360° benchmarking

Exhibit 6

- **Performance management.** Performance management drives cost outcomes across all areas. From our operational deep dives, one of the most striking findings is the frequent lack of rigorous performance management. The result is that costs rise again after just a few years even after the implementation of cost reduction measures.

Having identified the root causes of cost differences, the question is how to identify focal areas for optimization programs. McKinsey's Insurance 360° benchmarking provides a number of ways for individual insurers to rigorously dig into and assess these four root causes to identify key cost improvement levers. These include in-depth assessments of the benchmarking's three cost dimensions – costs per product, costs

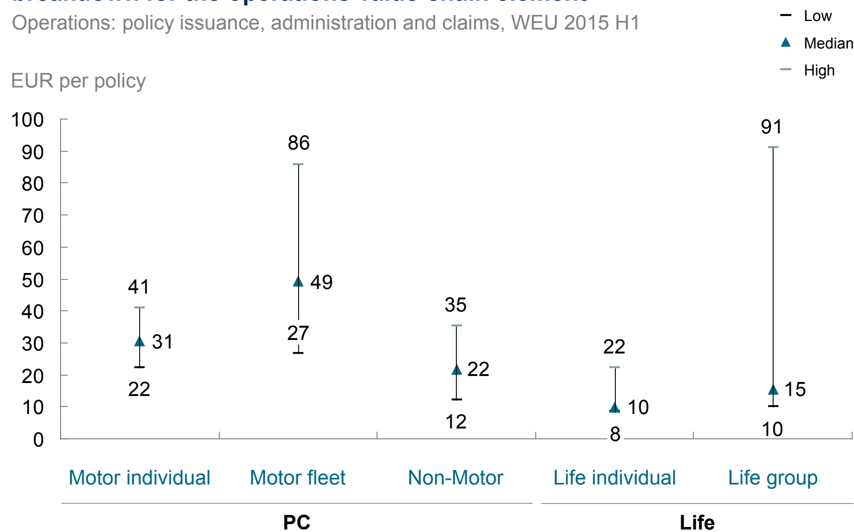
per value chain element, and costs per sales channel – and a set of supplementary assessments based on standardized toolkits. In the following, we focus on one selected in-depth assessment: analysis of costs per product.

Deep-dive assessments to identify key levers: an example

The survey performs detailed analyses of costs for the operations value chain element by product group, such as individual motor within P&C, or company pension plans within Life. Drilling down to a more detailed level reveals large differences in operational costs by product. The operational costs for motor fleet are EUR 27 per policy for the top quartile, for instance, and EUR 86 for the bottom quartile – more than three times as high (Exhibit 7).

Insurance cost benchmark offers a granular cost-per-product breakdown for the operations value chain element

Operations: policy issuance, administration and claims, WEU 2015 H1



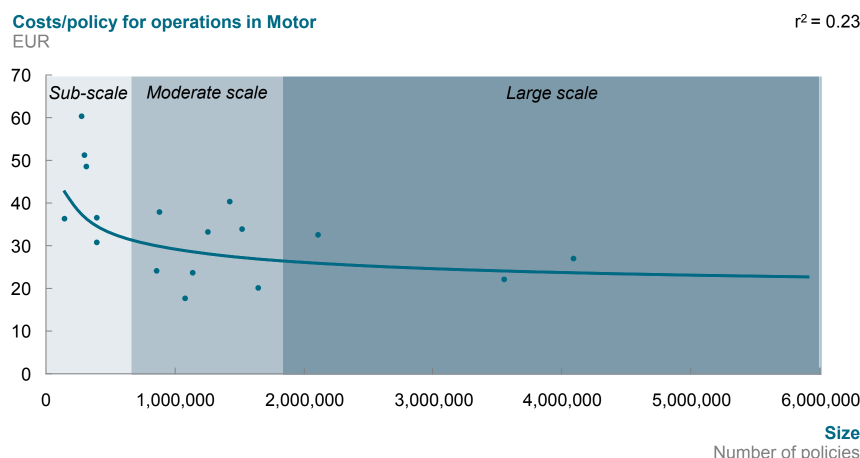
SOURCE: McKinsey's Insurance 360° benchmarking

Exhibit 7

To assist insurers in selecting improvement areas, the benchmarking allows the comparison of operational costs of individual products against an industry scale curve (see Exhibit 8 for an example). This allows larger insurers to assess whether they will be able to reap scale benefits. As intimated above, scale curves exist for a few selected areas (e.g., operations in Motor, as well as overall operations and policy issuance in Life). For smaller insurers, these scale curves give some indication of the size required for a sustainable cost range. For operations in Motor, for example, insurers with more than 1.6 million policies have median costs of EUR 28, while insurers with fewer than 700,000 policies have median costs per policy of EUR 44 (over 50 percent more), indicating that insurers of this size are subscale (Exhibit 8).

The insurance cost benchmark allows the comparison of individual product operations costs against the respective industry-level scale curve

Motor example[1]



1 Analysis is based on a sample of 18 Western European insurers (excl. UK) using data from 2009 to 2014. The most recent data point was used in the analysis in case multiple data points were available for an insurer.

SOURCE: McKinsey's Insurance 360° benchmarking

Exhibit 8

Implications for CIOs and COOs

Having examined the cost challenges facing the industry and the greatest levers, what are the implications for CIOs and COOs? What are the imperatives for a sustainable cost reduction effort?

- **Curb business complexity.** We consistently find that reducing business complexity is a key lever for reducing costs. One insurer stringently limits their product and process complexity, and supports this with a streamlined IT platform (industrialized processes with a high level of automation, high standardization of business logic across channels and lines of business). This strong standardization makes them one of the best life insurers in our sample. Operations costs per policy were half the median, and IT costs just a quarter. Understanding the details behind their cost levels – on a per product, per channel or per location view, for instance – will enable insurers to get to the root causes of business complexity and develop targeted countermeasures.

- **Optimize the operating model and leverage digital.** Another vital key to cracking the cost issue is to optimize the operating model. This requires a holistic examination of the operating model, including processes, location footprint, supporting technology, employee skills, sourcing, and organization and governance structures. There is no "one size fits all" solution – what optimization means will inevitably depend on the context. One insurer consolidated all their existing operating units in one central location to gain economies of scale, while another created six global centralized operating units to have a location – optimized footprint and be close to local business units. By digitizing its insurance processes, another insururer managed to reduce claims regulation costs by 20 to 30 percent, processing costs by 50 to 65 percent, and processing time by 50 to 90 percent - and at the same time to improve customer service The first instance in Box 2 illustrates how one insurer used Insurance 360° to optimize its operating model.

Box 2

How insurers have leveraged their Insurance 360° results

Example 1: optimizing the operating model

A European multiliner insurer was left with high cost rates after a change in company structure. Insurance 360° benchmarked the insurer's cost base by line of business and core value chain elements. The company was compared with six different peer groups that reflected its various lines of business.

The survey identified a cost gap versus the top quartile of 30 percent, driven mainly by IT costs, support functions, and operations. The largest cost gaps were pinpointed in Life, Pensions, and Health. Deep dives on operations and the analysis of IT-specific KPIs identified key levers and initiatives that could achieve the cost reductions planned.

The insurer completely redesigned their operating model as a result. It consolidated the locations of its support functions, further increased outsourcing in both operations and IT, and applied lean IT particularly to its application development. In operations, capacity management was improved, greater emphasis was given to specialization, and management layers were pared down to the minimum. The outcome was a 25 percent reduction in operating costs, a significant reduction in processing times, and an increase in customer satisfaction.

Example 2: cultivating performance management

One European insurance group had low transparency on their cost situation, and no stringent performance management process in place. Insurance 360° conducted detailed mapping of their cost centers and cost types covering all entities and the full value chain. The company achieved full transparency on its cost situation and put techniques in place to track cost development and the impact of initiatives over time. It did this using the tried-and-tested Insurance 360° cost benchmarking methodology for internal controlling and performance management. The effort was so successful that the group decided to update the benchmarking figures annually, and has been doing so for more than five years. The benchmarking enabled the group to have rigorous performance discussions with the various group entities. These discussions created a deep understanding of operating costs and their drivers across the group, and have led to various cost/root cause initiatives both at group and local levels, as well as to successful sharing of best practices between entities.

- **Streamline IT and IT processes.** Our survey revealed successful examples of how IT streamlining is directly correlated to cost reduction. One player completely overhauled their P&C IT landscape, replacing legacy core systems with state-of-the-art standard software. As a result, the insurer dramatically reduced costs

per policy in their P&C business and cut time to market for new products to a few weeks. Costs and time to market remained at bottom-quartile values for the Life business, where renewal of the landscape has not yet been completed.

On top of savings from landscape renewal, Lean IT projects typically reduce costs by 20 to 40 percent, and cut errors by a quarter. Detailed assessments provided by the benchmarking – such as the assessment of how IT spend translates into FTE productivity compared to competitors – empower executives to identify potential levers.

- **Cultivate performance management.** To reduce costs sustainably, insurers need to embed cost consciousness and continuous improvement into their culture – a one-off program will not suffice. A sustainable performance management approach means simultaneously changing mindsets and behaviors, defining new performance metrics and targets, designing new processes, and establishing performance dialogs – all of which need to cascade between hierarchy levels. For one P&C insurer, improving performance management alone using an approach of this kind led to a 20 percent back-office cost reduction. The second example in Box 2 describes how one insurer applied Insurance 360° to cultivate performance management.

Factoring in these imperatives will allow insurers to do more than just improve their expense ratios. It will also give them the freedom to make the investments they need to compete on the global stage.

If you wish to learn more about Insurance 360° or would be interested in participating in our 2015 survey, please contact the authors listed below.

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