

# Taking courageous action on cost in life insurance

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Transparency brought about by regulations such as the Retail Distribution Review and the rise of digital platforms are making customers ever more demanding, and those customers have a growing number of options. There are low-cost players joining the fray – some new, some old. There are digital-only entrants rewriting the game entirely; and there are other investment vehicles that look increasingly attractive at a time of low returns and that operate with a lower cost base.

Indeed, the low interest rate environment may be the biggest threat of all. It is jeopardizing the insurance industry's value proposition. At current rates, most insurers are unable to pay back even the premiums that have been paid in and are simply bleeding money – if not yet hemorrhaging. As a result, insurers have been forced to give up parts of their businesses, in particular those that legally require a gross premium guarantee.

## Costs are falling – but too slowly

Across Europe, players have already announced drastic cost reduction programs. These are frequently focused on lean methods, digitizing value chains, and cutting overhead. Bancassurance as a low-cost channel has grown significantly in importance, especially in Italy and Spain. The result is that gross administrative costs as a percent of reserves have indeed fallen in many markets. In the German life insurance market, for example, administrative costs fell steadily from 0.4 percent in 2000 to 0.25 percent in 2013, and in Italy from 0.4 to 0.2 percent over the same time frame. The Dutch, Spanish, and UK markets, however, have not fallen as much, and there have even been some increases in recent years.

The McKinsey insurance cost benchmarking shows that over the past few years, life insurance cost ratios for our participants have gone down in almost all areas. This decline is driven by a mix of premium rises and lower than proportionate cost increases, or even decreases in some cases. In particular, cost ratios have decreased in marketing and sales support, support functions and sales and, to a somewhat lesser extent, IT and operations (Text box 1). In fact, IT cost ratios actually increased slightly from 2013 to 2014, suggesting that insurers are starting to invest in digitization – although this is much more apparent in P&C. The one notable exception to the reductions in cost ratios is product development, where insurers increased investments in 2012 and 2013 (Exhibit 1).

### **Text box 1** What the McKinsey insurance cost benchmarking is about

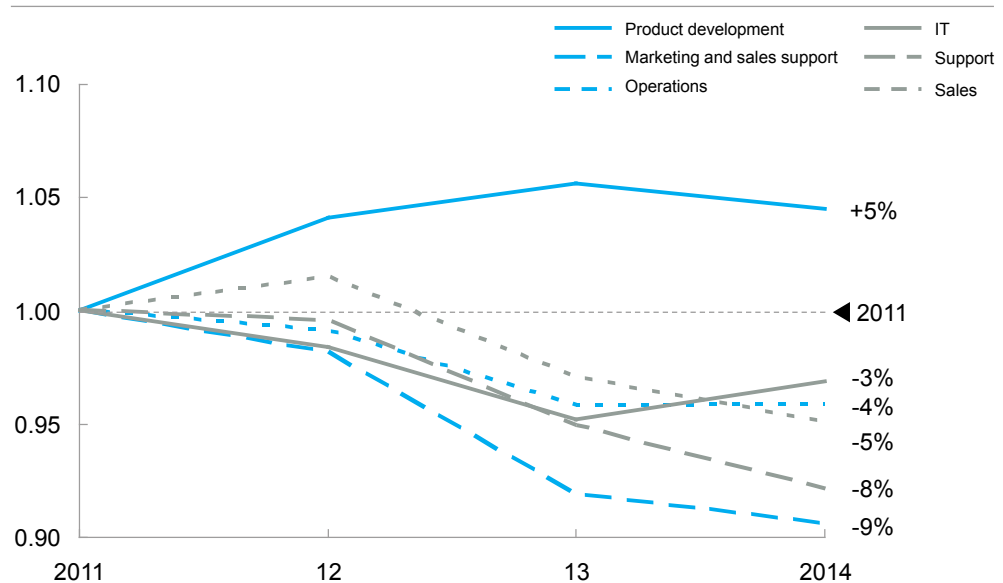
McKinsey has been conducting its insurance cost benchmarking since 2005.<sup>1</sup> The survey uses a valuable and proven methodology for identifying cost gaps and their root causes as well as highlighting countermeasures. At its core, Insurance 360° is built on holistic disaggregation and mapping costs to ensure that all costs are assessed and comparable across insurers.

More than 140 insurers have taken part since its inception, and the benchmark covers the entire value chain from product development and sales to core insurance functions and support. The current peer group comprises 97 insurance businesses in total (43 in life, 39 in P&C, and 15 in health), predominantly from the major Western European markets, together with smaller samples from Central and Eastern Europe and Asia.

<sup>1</sup> <http://www.mckinsey.com/industries/financial-services/how-we-help-clients/insurance/insurance-360>

**Exhibit 1 Since 2011, cost ratios in life insurance have fallen in all areas except product development**

**Costs per premium, European life insurers<sup>1</sup>**



<sup>1</sup> European sample, excl. outliers and corrected for accounting changes  
 SOURCE: McKinsey's insurance cost benchmarking

Although these improvements clearly indicate that many insurers are taking action, this effect to a large extent has been driven by an increase in premiums rather than a decrease in real costs. Many players have been unable to substantially reduce their costs over the last 10 to 15 years. For some, cost reduction initiatives have failed to deliver the expected benefits, while others have struggled with premium declines and have been left with expense ratios two to three times the market average.

Even those that have patched up their wounds could still be at risk of further bleeding, such is the pressure on them. Business and operating models are changing across Europe and beyond, and the cost ratios of new emerging players such as fairr.de, Brand New Day, and Beagle Street can be as low as only half of those of traditional players.<sup>2</sup>

There are several actions and approaches that could help life insurers restore the health of their businesses. For some of them – in particular, those that are the most at risk – success may come only from completely reinventing their business models.

<sup>2</sup> Unless they are presented anonymously, all company-related references in this article are based on company and vendor Web sites, investor reports, and/or press clippings.

### Five actions and two radical approaches for resurrecting life insurers

Although the life insurance industry has been slow to respond to the cost pressure, there are lessons to be learned from those players that have successfully reined in costs and stayed competitive, and two more 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

Distribution costs remain the biggest issue for the life insurance industry. Besides the pure cost effect, adjustments are needed to reflect changed economics for guarantee products. While administration 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. Even in countries that have taken regulatory action, e.g., the Netherlands, the UK, and Scandinavia with their commission bans, the effects on distribution costs have been mixed at best.

In reality, addressing the main driver of these costs – commission payments – is an almost insurmountable challenge. Unless they have a dominating position in the markets, players cutting into the remuneration of their distribution partners are at risk of losing their best-producing agents to the competition. Consequently, successful reforms of commission structures are almost exclusively associated with market leaders. Another option is to increase the new business via dedicated low cost distribution models and partnerships such as Aviva AFER in France, with loadings of 47.5 bp only. Most players will have to rely on external triggers to fundamentally address their commission structures. The aforementioned commission regulations, the Insurance Distribution Directive, and the Lebensversicherungs-Reformgesetz (LVRG) in Germany are examples of events that may be leveraged for achieving fundamental reductions or structural changes in remuneration systems. Life insurers should therefore prepare and develop concepts for new remuneration systems so as to become able to seize such upcoming opportunities.

What players can more easily address are distribution support systems. Many markets have seen a decline in the number of agents, but only a few players have reacted and resized their support structures accordingly. To address the cost challenge, players should develop a perspective on what their distribution structures should look like five years from now and work towards changing their support structures to achieve this target.

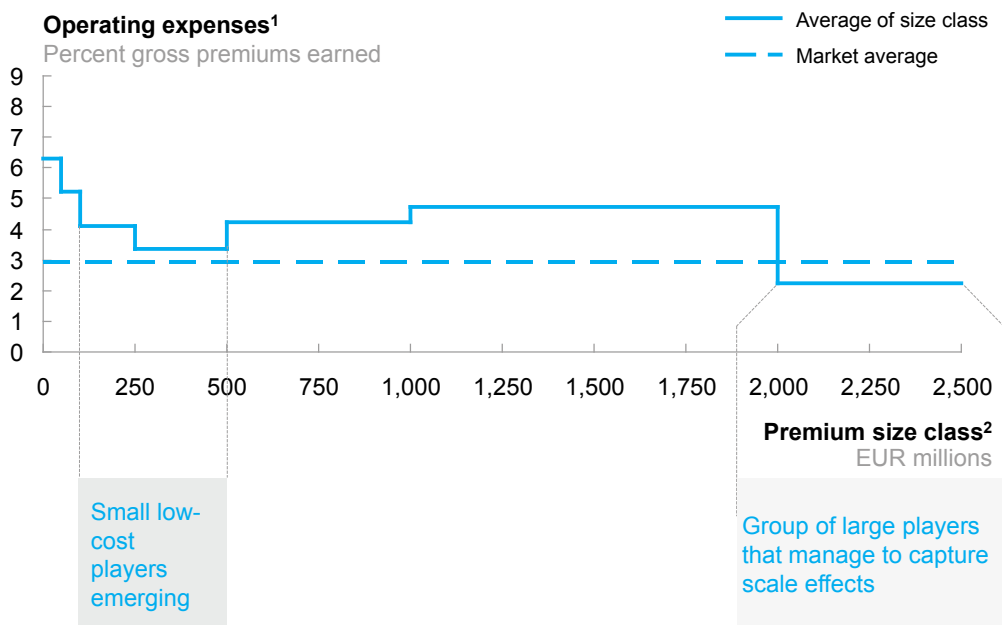
### Maximize operational efficiency through scale or simplicity

Two types of players have successfully driven cost ratios down. Some of the biggest insurers have used their scale to become more efficient. At the other end, a set of smaller players has achieved low cost ratios through rigorous focus (Exhibit 2).

## Exhibit 2 Two routes to low costs: leveraging scale effectively or becoming a focused low-cost player

EXAMPLE GERMANY

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



1 Administrative expenses plus balance (other expenses/other income) plus other taxes; excl. acquisition expenses  
2 Gross premiums earned

SOURCE: McKinsey Life Insurers Database; McKinsey GFIC Research

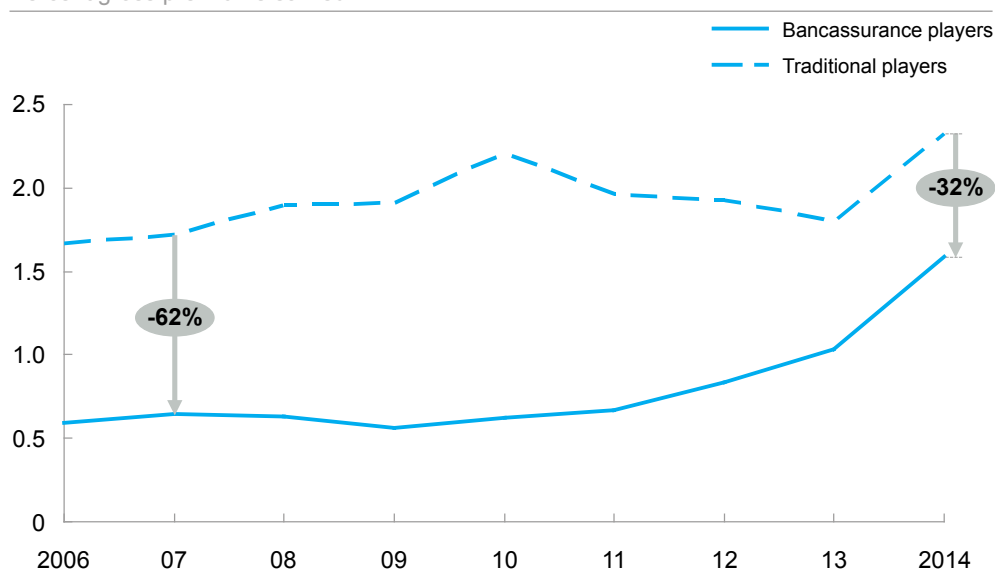
Scale players such as Allianz Leben in Germany or Generali Italy have all consistently worked on their cost base, consolidated subentities, and used shared services to reach new levels of efficiency. Some have grown through acquisition and internal consolidation and reaped substantial synergies. Generali Italy, for example, has successfully restructured its product portfolio and moved from seven brands to just three, leading to large reductions in cost ratios. Their size has also allowed these big players to make large-scale investments in efficiency improvements, which are now paying off.

Bancassurance players are, in principle, also particularly well positioned to exploit their scale. However, in too many cases, the relationship between bank and insurer is far from stream-lined, and costs escalate as a result. When done well, the insurer should be able to reduce marketing costs by using the bank's distribution, as products tend to be simple, and tight operations and IT integration increase straight-through-processing (STP) rates. Spanish bancassurers, for example, have enjoyed gross administrative ratios less than half of those of other life insurers, but the gap is shrinking rapidly as expense ratios in bancassurance rise (Exhibit 3). Other examples for scale players include French bancassurers such as Predica who successfully leverage both scale and the bancassurance model to achieve lower cost ratios. Elsewhere in Europe, there is substantial scope to improve the efficiency of bancassurance.

Even in mature markets such as Italy, new tie-ups are worth exploring. For example, CheBanca!, a new online bank, uses products from Genertellife, a Generali Italy subsidiary, while AXA Italy has extended distribution agreements with Banca Popolare di Puglia e Basilicata and Cassa di Risparmio di Asti.

**Exhibit 3 The cost gap between bancassurers and traditional players in Spain is substantial but narrowing**

**Development of administrative costs<sup>1</sup> of bancassurance and traditional players**  
Percent gross premiums earned



<sup>1</sup> Gross  
SOURCE: DGSFP (Dirección General de Seguros y Fondos de Pensiones); McKinsey analysis

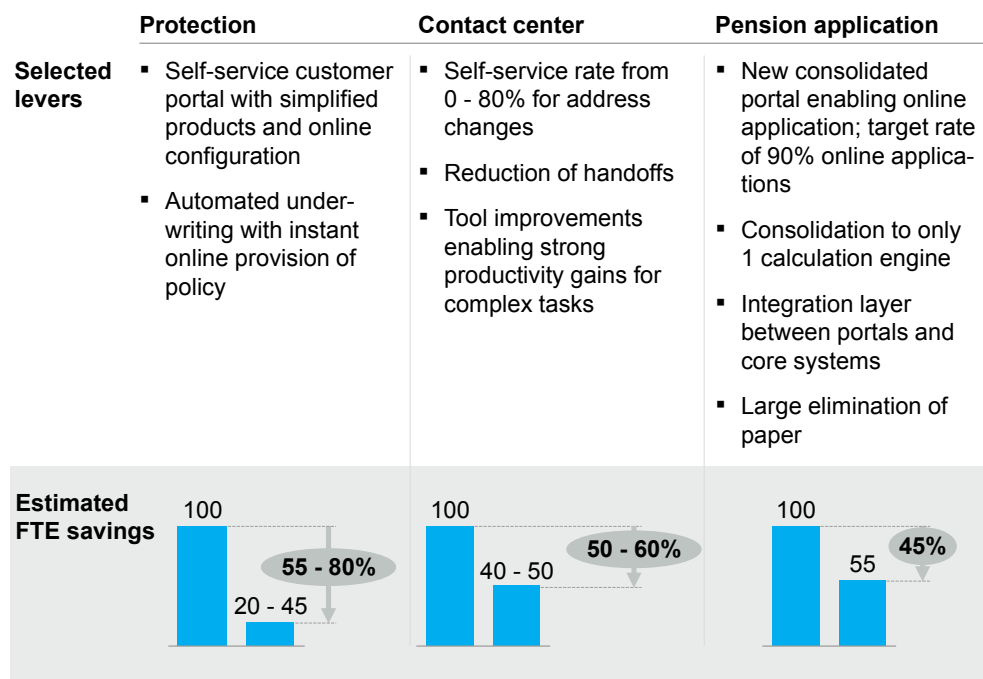
For players that lack scale, focus may be another way to success. There are successful smaller players that have chosen to drive efficiency by reducing complexity. This might mean doubling down on a niche segment, product, or channel and maximizing its potential. For example, players such as Dialog and Deutsche LV in Germany that offer pure protection have their own highly competitive cost structures. Others, such as HanseMerkur in Germany and Mutua Madrileña in Spain, have focused or segment-oriented business models and a strong cost culture.

**Embrace digital technologies**

New entrants are leading the way in developing low-cost models based on digital technology. German online-only broker Community Life, for example, keeps costs down selling white-labeled protection products, while direct player fairr.de has administration and acquisition costs that are as low as 50 bp/AuM. In the Netherlands, the new PPI market is characterized by a low-cost and highly digital offering for the accumulation phase, which enables players to achieve cost ratios unmatched by traditional insurers.

Incumbents should not sit back and watch aghast – digital technologies are not just for new attackers (Exhibit 4). One traditional UK life and protection player, for example, launched an automation initiative, and thus identified FTE savings of more than 40 percent in pension and bonds and 50 to 80 percent in protection that will come from using advanced analytics in underwriting and self-service customer portals. Allianz announced a global cost reduction program of USD 1 billion based on implementing digital processes. A leading US insurer offers a simplified term-insurance product online that can be purchased in just ten minutes. Other players, such as Prudential in Poland and India, have fully digitized the front ends of their distribution partners, enabling straight-through processing at the back end. Also, new types of partnerships may arise in this context. For example, Groupama and Orange have announced their intention to build a mobile bancassurer that will provide French and Spanish customers with cost-effective insurance and banking products.

**Exhibit 4 Digitization can be used to achieve significant productivity gains in life insurance** NONEXHAUSTIVE



SOURCE: Disguised examples; McKinsey analysis

In the UK, a wide range of digitally enabled platform-based business models is emerging with the support of a full ecosystem of IT providers. Assets under management held by these platform businesses have grown from GBP 160 billion in 2010 to GBP 500 billion in 2015 – and as assets grow, cost ratios fall. The transparency of these platforms puts the rest of the market under even more pressure. Therefore, UK life insurers seeking to bring their cost ratios in line with the top quartile players need to consider whether to launch their own platforms or cooperate with existing platforms to stay competitive.

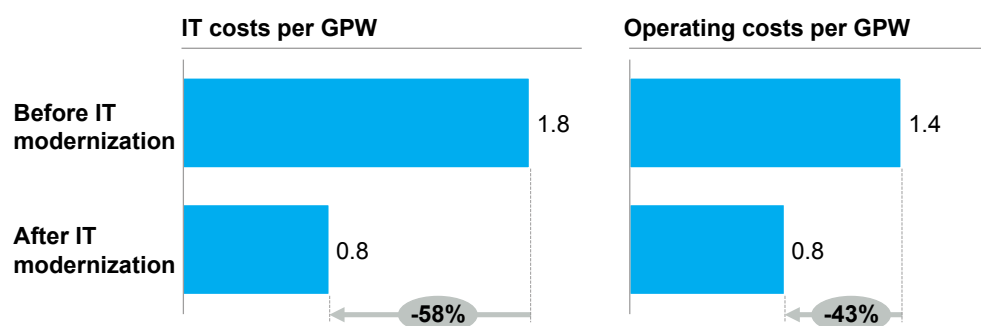


### Modernize IT

Some of the most successful players have used their heft to invest not just in digital offerings but also in their underlying IT platforms. Modernizing IT systems for policy administration and benefits management is undoubtedly expensive, but when done properly it can lower both IT and operating costs (Exhibit 5).<sup>3</sup> McKinsey's insurance cost benchmark shows that life players with modernized IT systems have, on average, roughly 60 percent lower IT cost ratios and 40 percent lower operations cost ratios than their peers with legacy IT systems.

#### Exhibit 5 **Players that have modernized their IT systems benefit from both lower IT and operating costs**

Percent, average of Q1 2016 sample



SOURCE: McKinsey's insurance cost benchmarking; expert interviews

There are many examples of insurers moving to modernize IT. Allianz invested heavily in automation, starting with the first customer interaction and going all the way to consolidated and integrated back ends. Allianz Germany, for example, achieves a straight-through-processing rate of 65 percent in application processing for life insurance. Swiss Life developed a new Web-based IT system for core insurance processes for individual life, helping to bring down IT and other costs substantially. In Asia, Nan Shan Life recently decided to replace its complete IT landscape with an SAP solution to improve the efficiency of its business processes. The solutions selected for IT modernization include both full policy management systems such as LifeFactory or Fadata, and targeted solutions for automated underwriting or specialized rules engines. HUK Coburg, for example, recently implemented the Allfinanz underwriting engine from Munich Re to increase its STP rates for life insurance, while ING Belgium and Aviva use Swiss Re's Magnum engine.

<sup>3</sup> See also "Successfully reducing insurance operating costs," mckinsey.com

The scale of these investments puts them out of reach for smaller players, but similar savings are possible through cloud-based offerings, white-label solutions, and various forms of outsourcing.

While these investments can deliver large-scale cost savings when implemented successfully, delivering on the implementation is a key challenge. Setting up these initiatives in the right way – such as making the individually 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 – to name but a few – is absolutely critical for success.

### Establish a rigorous cost culture

The first four actions all require major decisions on the direction of the business and substantial investment. Yet, while deliberating over which targeted strategy will best fit their situation, it is essential that each player work more generally to ensure that the organizational culture sustains the change. All players, regardless of their relative cost performance today, need to establish or support continuous cost and performance management, and see to it that all levels of the organization are cost conscious. It is also imperative to consider the whole business when simplifying and streamlining – taking into account, for example, the effect of underwriting guidelines and optional coverage on policy administration.

For 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. Some mutual insurers, for example, excel at this, having both cost consciousness and a focus on customer and employee value deeply ingrained in their DNA.

The key levers for achieving such cost excellence are rigorous tracking and reporting, a culture that fosters adherence to budgets and commitments, and regular reviews of the discretionary spend – including those pet projects and sacred cows that have a tendency to soak up money and deliver little in return.

### Two radical approaches

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 to get rid of the burden created by their back books. To do so, insurers may decide to sell off parts of their back books to reduce complexity. ERGO Direkt has followed this path by selling off its Riester contracts to HanseMerkur. Alternatively, groups may opt for putting whole carriers into runoff to enable a stricter management of cost and profitability. Again, ERGO set an example here by burying the Victoria brand in 2010.

Finally, there is an even more radical approach: players may consider completely selling off their closed books to consolidators and make a fresh start with a greenfield business that is designed for efficiency from day 1. The market for such closed book transactions is growing fast (Bâloise (in Germany) and Skandia are recent examples of such deals). However, it still remains unclear whether greenfield models in life will be successful. True success cases are rare, and where they do exist they revolve around direct distribution models.

What is more, it is questionable whether a greenfield model with physical distribution can effectively be built up to a scale that comes anywhere close to the scale incumbent players have achieved with their traditional business models.

### **Doing nothing is not an option**

Despite the many positive examples of insurers that have managed to grapple with costs, the pressures continue to increase. Players already moving in the right direction will need to make even more radical cost reduction efforts in the coming decade.

Transparency and the rise of low-cost attackers operating under a completely different model are jeopardizing incumbents in every market. Customers are already shopping around, and life insurers' offer is rarely the most attractive option. Even the insurers with the deepest pockets are starting to struggle in the low interest rate environment.

Life insurers have not yet been given a fatal diagnosis, but they must honestly assess their business models to determine which lines of business are profitable and which can be made profitable in the near future. Courage will be needed to discontinue lines of business where a return to profitability is unlikely. Investing in IT infrastructure and 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.

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