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# From transparency to insights
## McKinsey’s insurance cost benchmarking 2016

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# From transparency to insights

## McKinsey's insurance cost benchmarking 2016

McKinsey recently conducted the 11th edition of Insurance 360°. This annual cost benchmarking study confirmed that cost is a key competitive factor for players in the insurance sector (see pages 5 to 7). Insurers across Europe have already announced drastic cost-reduction programs frequently focused on lean methods, digitizing value chains, and cutting overhead. To help insurers act strategically in their cost-cutting activities, we aim at providing answers to two critical questions looming large in the industry: How has the sector's cost situation developed? What insights can be derived for individual insurers aiming to reduce their cost ratios?

### Insurers are investing in product development and IT, while cost ratios are falling in other functions

Analysis of our benchmarking reveals insurers' cost ratios have fallen since 2011 in most parts of the business – driven by premium increases and less than proportional cost increases or – in some cases – actual cost decreases (Exhibit 1).

Exhibit 1

**Driven by increased premiums, cost ratios for our participants have gone down in most areas except for product development and P&C IT**

Cumulative change 2011 - 14, median of participants, percent

| | | P&C | Life |
|---|---|---|---|
| **Product development, marketing and sales support** | Product development | 3.6 | 4.5 |
| | Marketing and sales support | -7.1 | -9.4 |
| **Operations** | | -8.1 | -4.1 |
| **IT** | | 5.5 | -3.1 |
| **Support functions** | | -10.9 | -7.9 |

SOURCE: McKinsey's insurance cost benchmarking

The notable exception is product development, where insurance companies have made significant investments and costs per premium have risen 3.6 percent in P&C insurance and 4.5 percent in life insurance. Similarly, insurers have increased their spend ratios for PC IT.

In marketing and sales support, costs per premium fell a total of 9.4 percent annually in life and 7.1 percent in P&C between 2011 and 2014. The decline in sales-support costs was the biggest contributor to this drop.

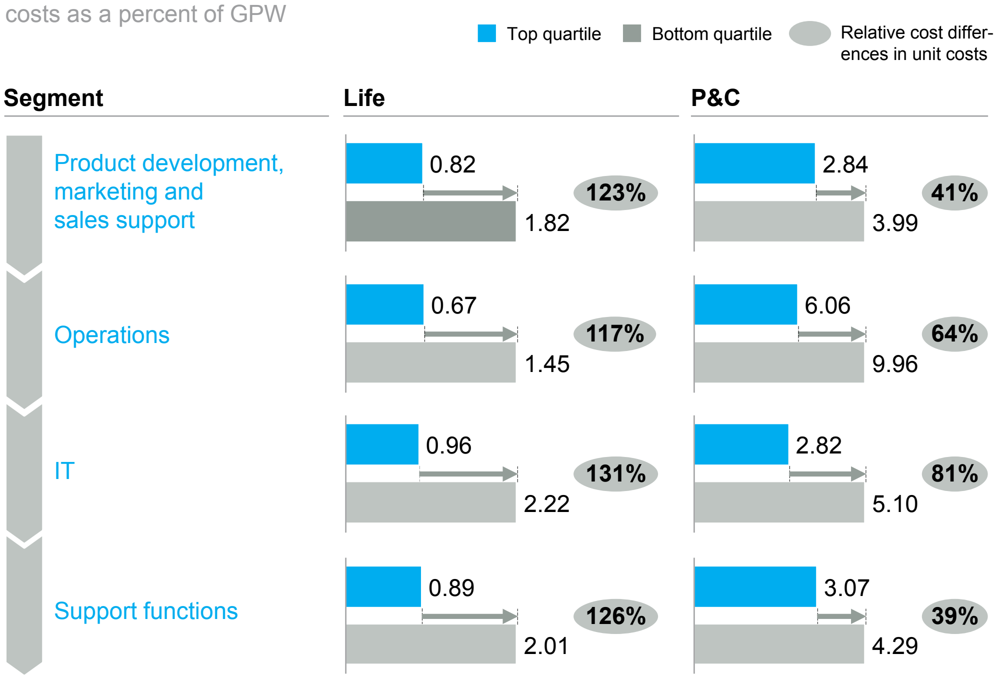
In operations, costs per premium had a moderate fall of 4.1 percent in the life business and 8.1 percent in P&C. This partly reflects an increase in P&C premiums per policy, but P&C businesses have also been able to improve productivity, helping push costs even lower.

IT cost ratios grew 5.5 percent in P&C, but fell 3.1 percent in life. One explanation for this divergence is that many P&C players have made substantial investments in digital technologies, while their counterparts in life insurance appear reluctant to make such commitments given the uncertain market climate. These IT investments could also help explain the greater improvement in P&C operations cost rations, as these insurers benefit from higher levels of straight-through processing in issuance, servicing, and claims. Support function cost ratios have seen a continuous reduction over time in both life and P&C insurance at a total of 7.9 percent and 10.9 percent respectively since 2011.

Behind these developments there are, of course, enormous differences between top- and bottom-quartile players (Exhibit 2). In our current benchmarking sample, we see that bottom-quartile players' costs per gross premiums written (GPW) are more than double that of top-quartile players in life and around 50 percent higher in P&C, with the biggest differences observed in IT.

Exhibit 2 **Bottom-quartile players' costs per GPW are more than double that of top-quartile players' for life and ~ 50% higher for P&C**

Total operating costs, excl. sales and commissions; Western European peer group as of 2016; costs as a percent of GPW




SOURCE: McKinsey's insurance cost benchmarking

## The actionable insights behind the numbers

While the overall trend of decreasing costs is clear, variation across business categories and insurance types creates a more complex picture. Analysis at the granular level reveals three main drivers of insurers' cost performance as well as actionable insights for top managers in the insurance sector:

**I. Size and operating model are strongly related to cost performance.** Averages only ever tell part of the story. Analyzing the characteristics of low-cost players reveals that both niche and scale players are doing well. Insurers stuck in the middle, with neither size nor focus in their favor, face unsustainably high cost rates. In Germany, for example, smaller life insurance players with between EUR 250 million and EUR 500 million in GPW, achieve average cost ratios of 3.3 percent. Large players with GPW of more than EUR 2 billion achieve 2.6 percent, while those in between have substantially higher expense ratios of 4.7 percent.

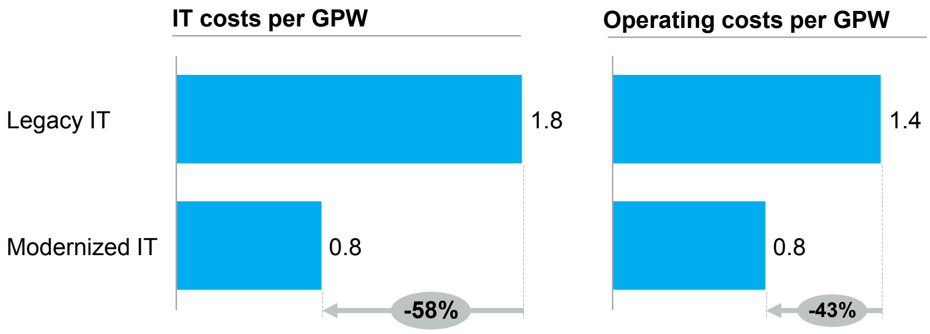
We are also seeing the influence of digital on the cost of doing business with new, low-cost digital entrants such as Fairr.de, Verti, and Quotemehappy.com bringing the average numbers down. Digitization is also starting to have a major impact on costs for those larger players that can leverage their scale. Allianz, for example, announced a global EUR 1 billion cost reduction program based on implementing digital processes. Other insurers are reaping substantial benefits from enhanced back-end automation and interface digitization. One insurer has managed to cut headcount expenses for P&C underwriting by 40 percent, largely through increased automation, image scanning, and automated data capture.

**II. Legacy IT systems have become a major challenge.** For life insurance players with a complex legacy landscape, IT costs per GPW are more than twice as high as those of their peers that have a modern IT system and operating costs are 75 percent higher (Exhibit 3).

Exhibit 3

**Players that have modernized their IT benefit from both lower IT and operating costs**

Percent, average of Q1 2016 sample



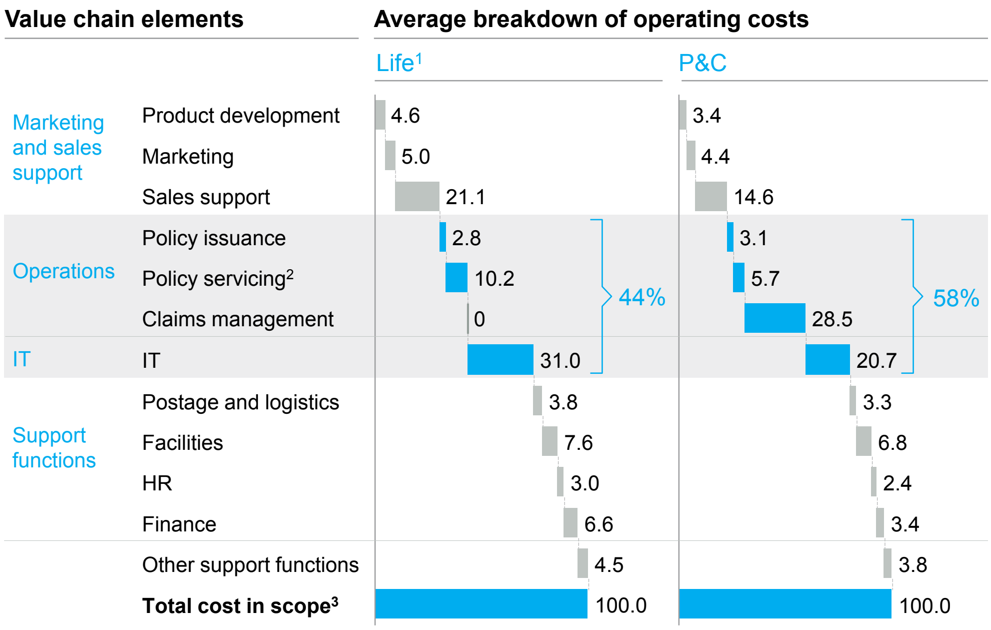

SOURCE: McKinsey's insurance cost benchmarking, expert interviews

Legacy IT systems also significantly limit insurers' ability to embrace digital technologies, putting them at a competitive disadvantage. Many of our benchmarking participants are considering substantial IT projects that would modernize their core platforms, so we expect near-term IT costs to continue to rise in P&C and to start rising in life. This will, however, lead to medium-term reductions in operating costs. For example, a German insurer recently announced it would be replacing its core legacy system to enable greater automation, targeting straight-through processing rates of 80 percent in motor insurance.

In the longer term, we also expect to see the consolidation of multiple platforms, which will help reduce running costs. Therefore, in four to five years' time, we expect overall IT costs to start falling as these large IT investments begin to pay off. This will have a sizeable impact on total cost reduction as IT and operations costs account for 44 percent of operating costs for life insurers and 58 percent for P&C players (Exhibit 4).

Exhibit 4 **Operating costs are concentrated in operations and IT – the areas most affected by digitization efforts**

Percent of total costs




1 Western European peer group as of H1 2016; total costs excl. commissions
2 Includes claims/benefits management in life
3 The sum does not add up to 100 due to rounding

SOURCE: McKinsey's insurance cost benchmarking

**III. Insurers are transforming their underlying business models to bring costs under control.** Many players are abandoning classic life guarantee products, while others are looking to sell their run-off businesses to insurers who can operate them more cost-effectively. Other players are considering greenfield solutions with a high digital component, such as the Groupama Orange cooperation in France for mobile banking and insurance. By design, these and other greenfield models have high rates of straight-through processing and state-of-the-art systems landscapes resulting in substantially lower cost structures.

* * *

Overall, the picture painted by the benchmarking initiative shows that costs are generally headed in the right direction. However, this masks significant differences between players. Insurers in the top quartile have managed to free up capital to invest in areas of profitable growth, but those players that have struggled to address their structural costs remain at risk of slipping into a vicious cycle where they are unable to capture any further potential. And even players that have successfully reduced costs need to double down their efforts given the challenge presented by new entrants with structurally significantly lower cost ratios.

# Why you should participate in the 2016 insurance cost benchmarking initiative

McKinsey's Insurance 360° cost benchmarking offers unparalleled breadth and depth of insight into the industry. 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. Findings from the survey have directly contributed to successful cost reductions for many participants.

**Exhibit 5** **McKinsey's insurance cost benchmarking covers ~ 100 data points, with a focus on Western Europe**


Comprehensive set of European insurers

97 current data points in the database[1]

- 43 life
- 39 P&C
- 15 health

Up-to-date results and context

- Over 60 updates and 15 new participating entities last year
- Cost benchmarking complemented by qualitative assessments reflecting up-to-date industry insights

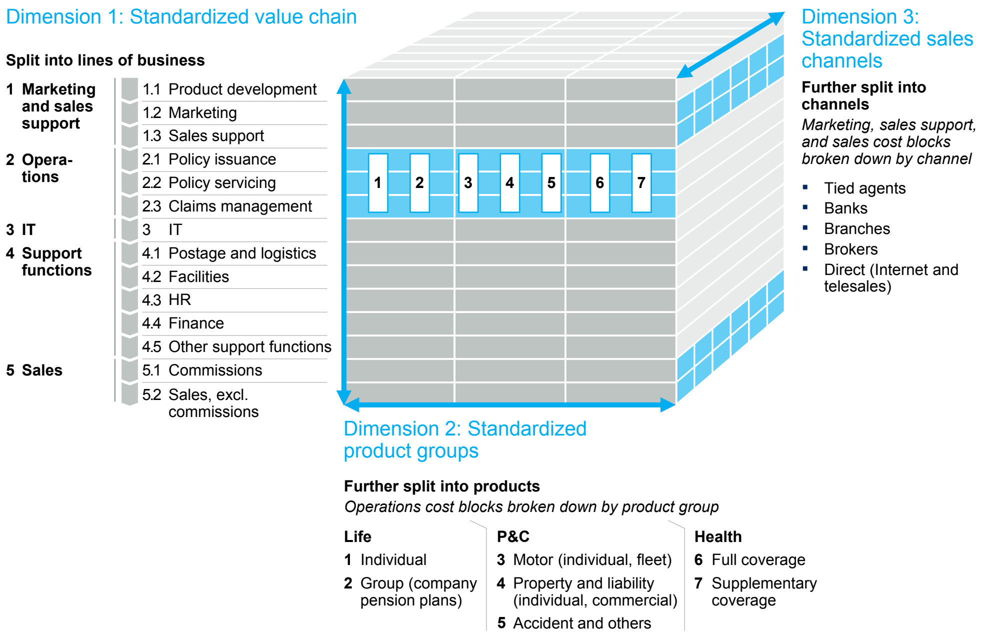
1 Single participant last 3 years only

SOURCE: McKinsey's insurance cost benchmarking

McKinsey is now in the process of rolling out its 2016 insurance cost benchmarking initiative, and you are invited to participate. 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 (Exhibit 5).

**How participants can benefit.** The benchmarking survey compares each participant's cost base against a tailored peer group and identifies cost gaps for each step of the value chain by channel and product (Exhibit 6; also see Text box 1 "What participants from our previous insurance cost benchmarking rounds are saying"). After identifying cost drivers and assessing the root causes of any gaps, McKinsey provides a set of targeted cost reduction levers and assesses their impact on the participant's cost base, building on our extensive experience of cost reduction programs. The benchmarking has additional value for insurance groups with multiple entities as it allows systematic cost comparison between entities and across countries.

**Exhibit 6** **The cost model is structured along 3 dimensions to ensure comparability, consistency, and transparency**




SOURCE: McKinsey's insurance cost benchmarking

**What's new in 2016.** Based on an increase in participation, we now can offer local samples for Germany, Benelux, Spain, and Italy as well as a Central and Eastern Europe sample. We have also deepened our data pool on sales and commissions, added a view of cost scale curves, and developed a number of optional deep dives such as straight-through processing rates and an assessment of the impact of digitization on cost, or an assessment of IT modernization costs.

**Tailored advice.** Insurance 360° sheds light on which segments and drivers will offer the greatest improvement opportunities for individual insurers. If you are interested in learning more, please contact us at insurancecostbenchmarking@mckinsey.com.

**Text box 1**

What participants from our previous insurance benchmarking rounds are saying

Our clients use the performance toolbox to identify one-off cost gaps and for continuous performance management

*"We have been using McKinsey's insurance cost benchmarking for years – it has been invaluable to us for identifying areas with improvement potential and defining required actions."*

– Head of Group Controlling, major European general insurer

*"The results will directly enter our current planning session. They are material in setting targets and identifying savings opportunities for the coming years."*

– CEO, major European life insurer

*"We were deeply impressed by the maturity and level of detail of your methodology, particularly the taxonomy and cost structure."*

– Head of Controlling, major life insurer

*"With its distinct peer groups tailored to geographies and market characteristics, McKinsey's insurance cost benchmarking is a core component of our annual planning process. Personally, I particularly value the joint open discussions about industry insights. They are extremely helpful for us."*

– Head of Group Performance Management, large European insurer

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