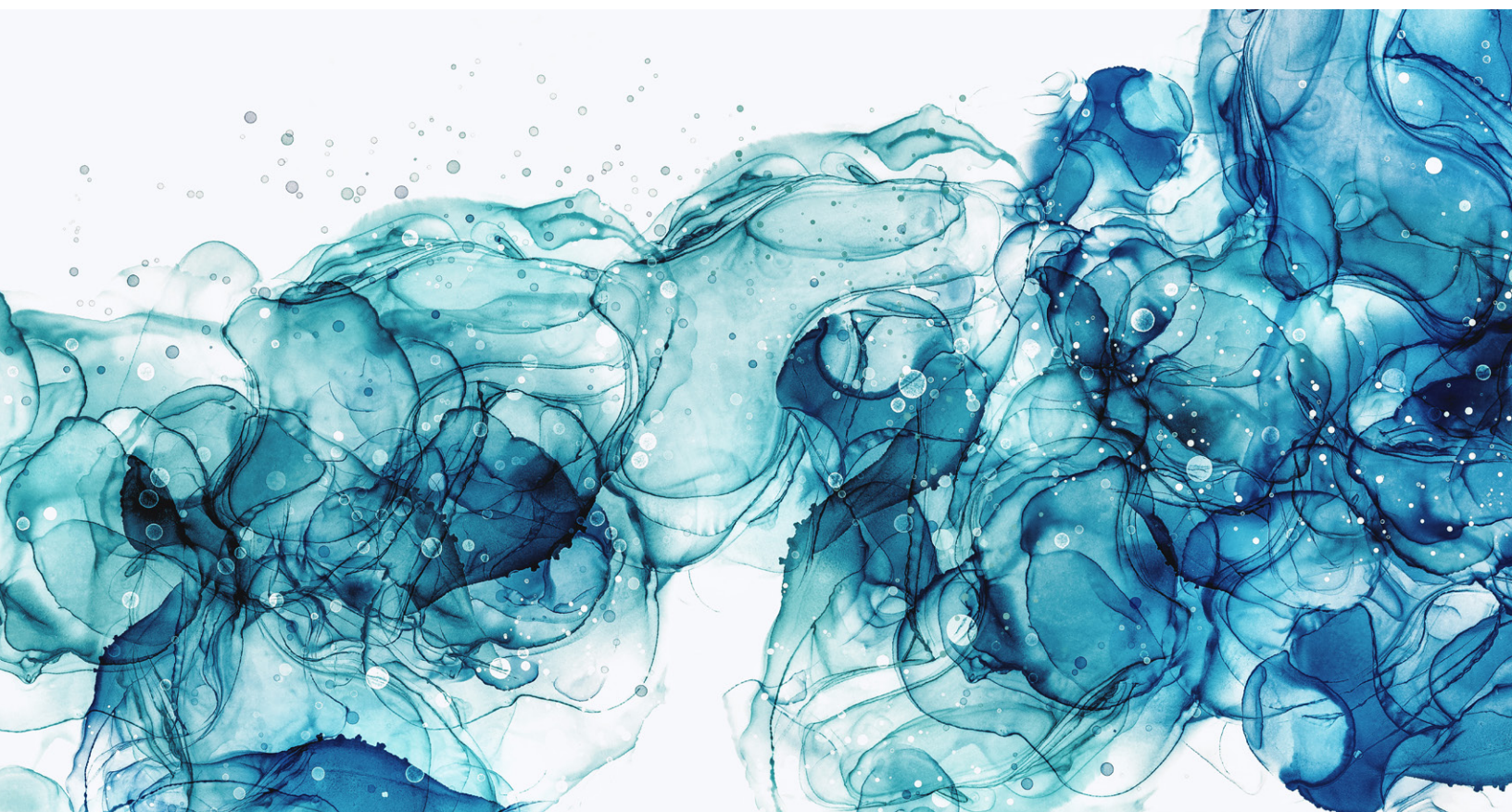


Insurance Practice

The productivity imperative for US life and annuities carriers

Productivity is a vital element of economic value creation. Research reveals what makes top performers different.

by Alex D'Amico, Kweilin Ellingrud, Daniel Garza, and Nancy Szmolyan



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The US life and annuities industry is searching for value after a decades-long struggle to achieve profitable growth. Driven by slow premium growth, lower investment returns, and rising costs, industry returns once again dipped below the cost of equity at the start of 2020, bringing the 35-year average of returns in excess of capital to –0.1 percent. The ongoing economic fallout from the COVID-19 crisis has greatly exacerbated these challenges, with industry analysts projecting that revenue declines of 4 percent and sustained low interest rates could result in a 3 to 4 percent earnings headwind for life insurers for year-end 2020.¹

In these conditions, addressing structural expenses has become an important source of value. In a proprietary McKinsey survey conducted before the onset of the COVID-19 pandemic, senior life-insurance executives estimated the industry needed to reduce its costs by 35 percent in the medium term, far higher than the typical 10 to 15 percent reductions realized in most cost-cutting programs. Our experience and research confirm that an average carrier can shed 30 percent or more of its current costs—but such structural cost improvements can be difficult to achieve and sustain.

Our research shows that productivity—profits as a function of inputs—is positively correlated with both growth and economic value, which is defined as the difference between a carrier's return on equity and its cost of equity. While most carriers struggle to meet their cost of equity, there are huge disparities in performance among the top performers and the rest of the industry.² From 2004 to 2018, average top-quintile carriers returned 2.3 percent of economic value, while bottom-quintile carriers lost 4.1 percent.³ Data from our annual life and annuities insurance benchmarking explain part of the story: top-performing carriers can have cost efficiency ratios that are half that of bottom performers across the value chain (see sidebar, “McKinsey North American life and annuities insurance benchmarks”).

Growth is a crucial part of the productivity equation. Indeed, leading carriers have accelerated their growth by improving distribution effectiveness and emphasizing innovative, capital-light products while making ambitious structural changes to their business models and organizations. In today's low-growth environment, public carriers that fail to achieve lasting improvements to their cost structure will continue to face economic challenges and be at risk from activist investors who want to accelerate progress or push for strategic alternatives.

McKinsey North American life and annuities insurance benchmarks

Our reference data for this article comes from McKinsey's North American Life and Annuities Insurance 360° Performance Benchmarking Survey. The survey was launched in 2018 and has been completed annually since. In 2020, the survey included 39 life, annuities, and accident and health carriers that generate a cumulative \$235 billion in annual premiums (48 percent of total industry gross written premiums).

We use the survey's granular cost benchmarks and operational key performance indicators across the value chain to assess carriers' relative levels of cost and productivity and to identify tangible improvement opportunities. To more deeply understand the sources of variation in expense levels among peer companies, we look at differences in operating models such as the level of digitalization in sales, servicing, and claims, as well as the impact of strategic investments in technology on costs.

¹ “Life insurance: A dollar saved is a dollar earned,” Autonomous Research, autonomous.com.

² For more on productivity in the insurance industry, see Bernhard Kotanko, Björn Münstermann, Pradip Patiath, Jasper van Ouwerkerk, and Ulrike Vogelgesang, “The productivity imperative in insurance,” August 14, 2019, [McKinsey.com](https://www.mckinsey.com).

³ In previous work, we analyzed 209 insurers from around the world and found that in aggregate, the insurance industry was not generating economic profit. In fact, the average insurance company destroyed \$27 million of economic profit each year. However, a small group of winners captured the majority of the industry's economic profit. For more on our work on the insurance power curve, see Alex D'Amico, Mei Dong, Kurt Strovink, and Zane Williams, “How to win in insurance: Climbing the power curve,” June 18, 2019, [McKinsey.com](https://www.mckinsey.com).

High structural costs, with stark differences between over- and underperformers

While life and annuity carriers have focused on cutting costs during the past decade, few have done so in an effective and sustained way. Total expenses relative to total revenues (including investment income), expressed as an index, increased by 20 percent from 2003 to 2019 for the life and annuities industry, even as expense ratios fell in other industries. For example, property-and-casualty (P&C) insurance carriers managed to contain expense ratio growth to 6 percent, while players in

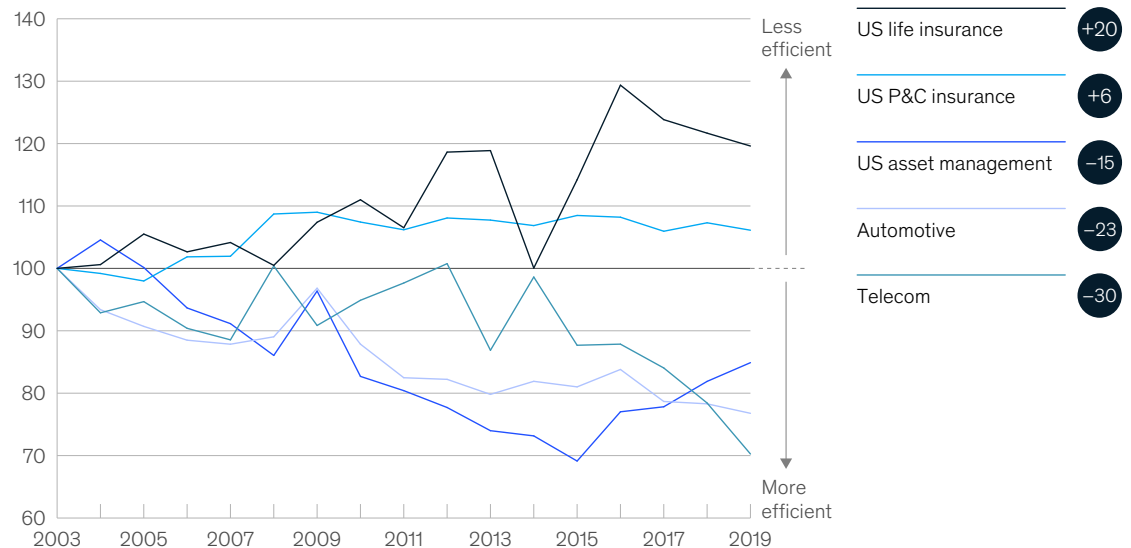
the asset management, automotive, and telecommunications industries successfully *reduced* their total expense ratios by 15 percent or more (Exhibit 1).

The reasons behind US life and annuity carriers' increased costs start to become clear when looking at the evolution of the industry's expense ratio, which measures administrative and operating expenses relative to net written premiums (NWP). From 2014 to 2019, the expense ratio increased to 18.1 percent from 15.8 percent, fueled largely by 2.5 percent annual growth in general expenses

Exhibit 1

The life and annuities–insurance industry has not yet successfully addressed operating costs.

Cost efficiency evolution by industry,¹ 2003–19, % of total SG&A²
expenses/revenues, normalized at 100% in 2003



¹Indexed and expressed as "SG&A expenses as % of revenues"; based on large global players for which continuous reporting is available—28 players in insurance (10 composite focus, 9 life focus, 9 P&C focus), 10 telecom players (including AT&T, China Telecom, Vodafone), 8 road & rail players (including Russian Railways, Japan Railways companies, DSV), 10 automotive players (including Ford, Toyota, Volkswagen) and 10 airlines (including Air France-KLM, American Airlines, Emirates).

²Selling, general, and administrative.

Source: S&P Capital IQ; McKinsey analysis

(60 percent of total expenses). Commissions and brokerage expenses (30 percent of the total) declined relative to NWP, while the remainder—taxes, licenses, and fees (less than 7 percent of the total)—grew in line with general expenses.

The primary areas of increasing general expenses were labor (salaries, wages, and related items) and IT costs. Labor costs accounted for just more than half of total general expenses during that period and grew 2.6 percent annually. IT and equipment costs (about 10 percent of the total) grew by a significant 5.6 percent annually, which may be the result of

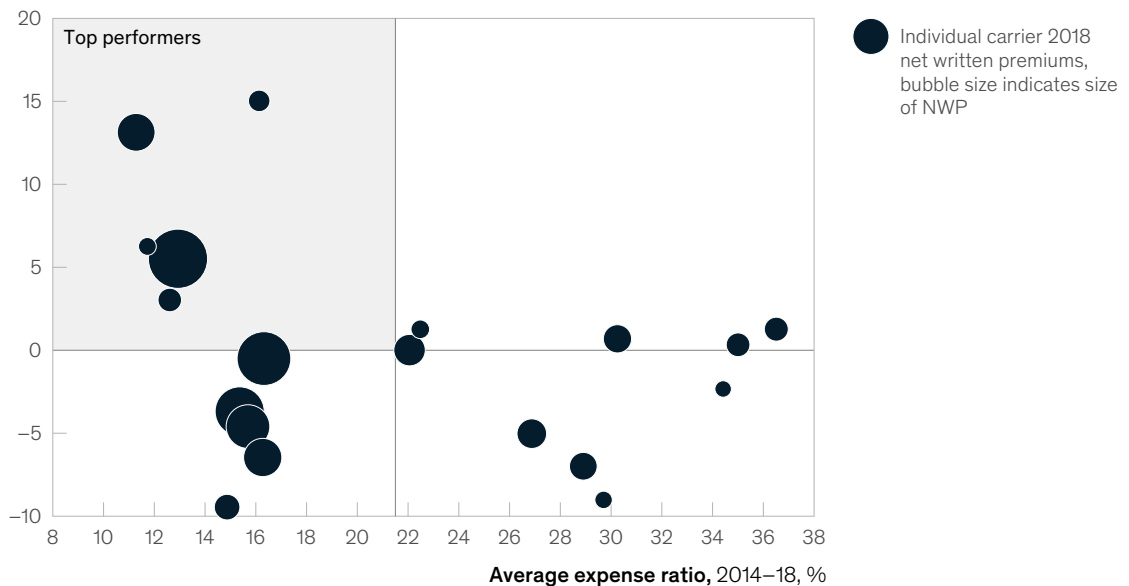
investments in technologies such as digital tools and automation whose efficiency gains are yet to be realized.

Behind the industry-wide escalating costs were stark differences in economic performance among carriers. An analysis of 22 publicly traded US life and annuities companies shows the few carriers that reduced their expense ratios the most from 2014 to 2018 had the fastest growth in NWP and created the greatest economic value over that same period—a virtuous circle fueled by carriers' ability to direct cost savings to fund their growth (Exhibit 2).

Exhibit 2

Carriers with the lowest expense ratios created the most economic value from 2014 to 2018.

Increase in economic value creation,¹ 2014–18, %



¹Economic value creation is measured as the difference between return on equity and cost of equity. The vertical axis measures the change in economic value creation from 2014 to 2018.

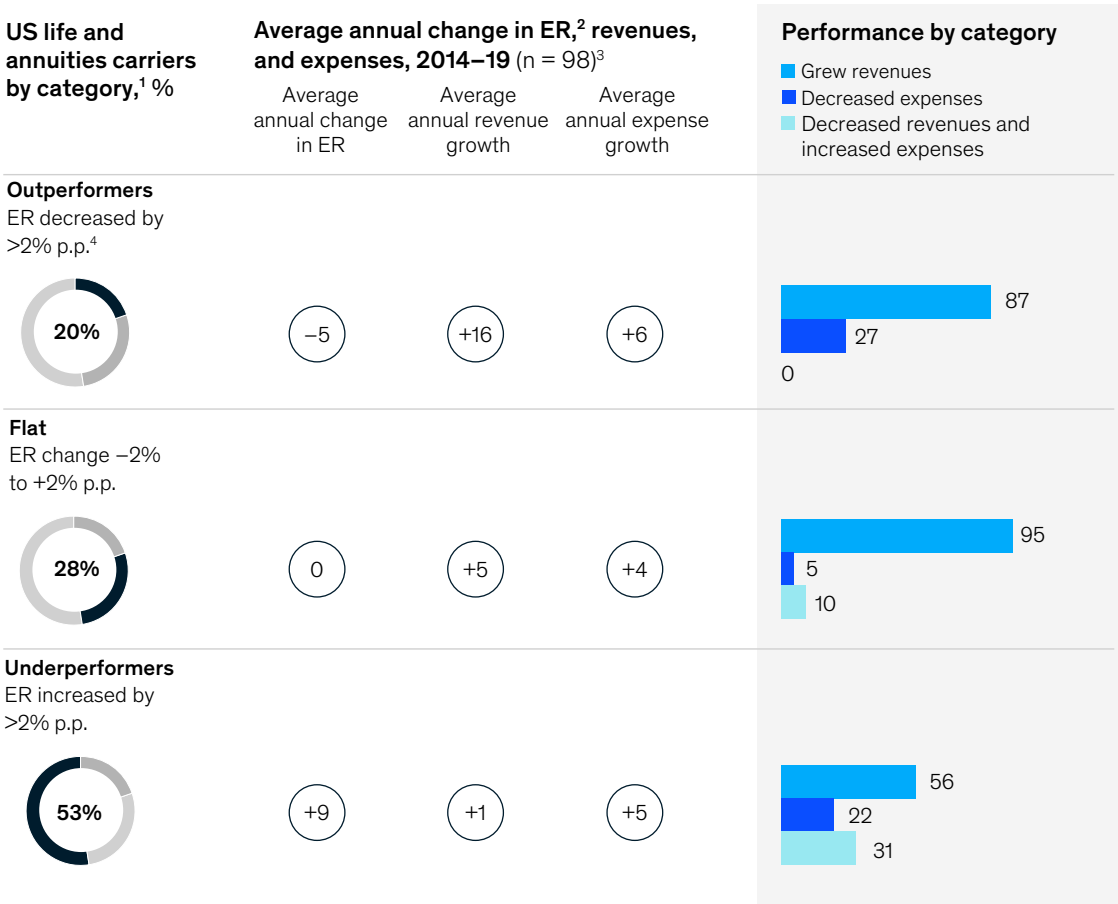
Sources: McKinsey Power Curve database; SNL Financial

A larger analysis of 98 US life and annuities carriers with revenues over \$500 million echoes this finding: a small subset (20 percent) were able to reduce their total expense ratios by more than two percentage points annually from 2014 to 2019 (Exhibit 3). These outperformers succeeded by managing expense growth—almost a third actually cut total expenses—while growing revenues more than three times faster than peers.

Data from the 2020 North American Life and Annuities Insurance 360° Performance Benchmarking Survey show that top-quartile carriers spent about half as much in costs as a share of gross written premiums (GWP) compared with their bottom-quartile peers in 2019 (Exhibit 4). This gap in productivity is not related to scale. A separate analysis of statutory data of nearly 200 US

Exhibit 3

20 percent of carriers reduced their total expense ratios by over two percentage points per year from 2014 to 2019.

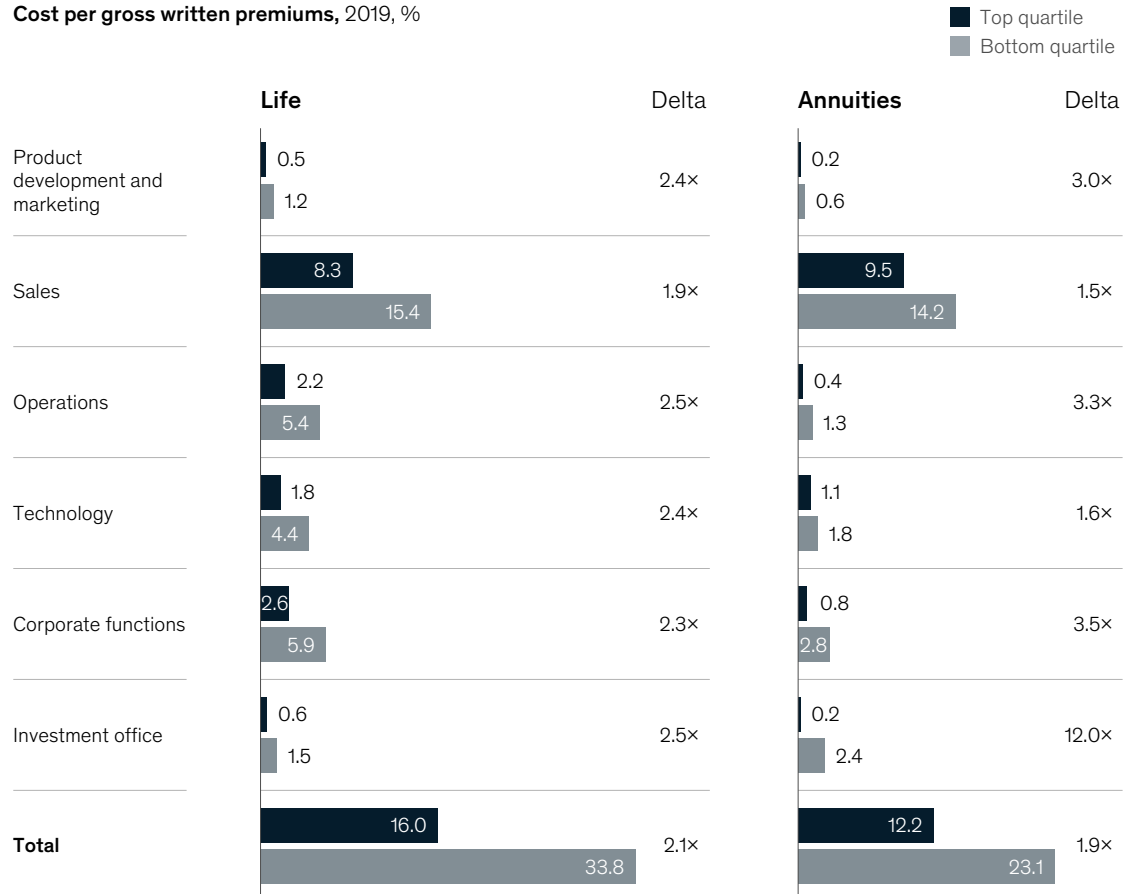


¹Numbers may not add to 100%, due to rounding.
²Ratio of total SG&A expenses to total revenues.
³Includes carriers with at least \$500M in total life and annuities revenues. Excludes outlier data.
⁴Percentage points.
Source: SNL

Exhibit 4

Top-quartile carriers spent about half as much as bottom-quartile carriers, as a share of gross written premiums.

Cost per gross written premiums, 2019, %



Source: McKinsey Life and Annuities 360° Performance Benchmarking Survey

carriers shows that only the smallest life insurers (those with less than \$500 million in direct written premiums) have significantly higher cost ratios than the industry median: 17.1 percent compared with the industry median of 14.2 percent.⁴ Among annuities players, only those with more than \$3 billion in direct premiums written have below-median cost ratios (3.8 percent compared with a median of 4.2 percent).

Strategies for boosting productivity

Each carrier is unique, but industry leaders should begin the process to improve productivity by establishing the trajectory and full performance potential of the business across the value chain—including sales and distribution, product development, operations, technology, and corporate functions.

⁴ Cost ratios are defined as general expenses as a percentage of direct written premiums and miscellaneous income.

Reevaluate and support sales and distribution

The lifeblood of the business is also the most expensive part of the value chain: sales and distribution account for more than half of all expenses for most life and annuities carriers. The difference between the bottom quartile (highest sales and distribution cost) and top quartile (lowest sales and distribution cost) is stark. The carriers with the highest costs spend 15.4 percent of their GWP on sales, while those with the lowest costs spend only 8.3 percent. In annuities, the comparison is 14.2 percent versus 9.5 percent. In fact, as a percentage of GWP, bottom-quartile carriers spend more on sales alone than the top-quartile carriers spend altogether.

This variation in cost for sales and distribution reflects strategic differences in carriers' distribution models, product mixes, sales agent commission rates, and the cost of sales support and distribution management. For example, agent commissions as a percentage of new business premiums for life-insurance products are three times higher for independent agents than for captive agents, but the cost of sales support—driven primarily by field rewards and field support—are greater for carriers with captive distribution.

Nevertheless, there are opportunities to improve effectiveness in all of these areas. In sales, carriers can assess whether their approach to commissions optimizes for long-term value. For example, incentives should account for product economics instead of simply the value of new business, the latter of which is the dominant approach in the industry.

Carriers can also optimize their sales-support costs by segmenting and aligning support based on current or projected sales volume and by managing travel and facility expenses. More engaging digital and self-service capabilities will also help reduce sales-support costs and engage policyholders more

deeply, while fulfilling agents' high expectations of digital support. For instance, some agents are already using prioritized leads for the “next-best conversation,” in which carriers apply analytics to their existing data and knowledge about their customers to suggest ways to engage them. Finally, insurers should use analytics-derived segmentation to improve retention and support effective cross-selling.

Make product development more efficient

An environment of persistently low interest rates makes selling capital-intensive products economically challenging. As a result, many product teams are developing less capital-intensive products to improve carriers' return on equity in current market conditions. Many carriers have also rapidly repriced their existing products or launched new features that bring outsize value.

To meet these priorities and increase speed to market, product teams need to work in new ways, borrowing best practices from innovative and agile companies outside the industry. Instead of taking months to reprice existing products and years to launch new ones, product teams should shorten their timelines to catch up to top-performing carriers, which are generally 20 to 30 percent faster to market than the industry average.⁵

By increasing the efficiency of product development, carriers can shift resources from product maintenance to product innovation. Investing in innovation and customer-centric product design can create differentiated products that are more likely to drive top-line growth. Cross-functional accelerator teams focused on innovation across product lines can further boost this work.

Optimize operations

Operations are core to the insurance business, but our experience suggests that carriers can reduce their operations costs by up to 30 percent

⁵ “Understanding the product development process of individual life insurance and annuity companies,” Society of Actuaries, December 2017, [soa.org](https://www.soa.org).

The operations function has one of the highest gaps in costs between top- and bottom-quartile carriers in both life and annuities.

across new business, underwriting, and in-force servicing and claims. In fact, the operations function has one of the highest gaps in costs between top- and bottom-quartile carriers in both life and annuities: 2.2 percent of GWP for top-quartile life insurance carriers compared with 5.4 percent for the bottom quartile, and 0.3 percent and 1.4 percent, respectively, for top- and bottom-quartile annuities carriers.

To optimize operations, carriers can streamline and redesign end-to-end processes. For instance, accelerating the use of automated tools for repetitive, non-customer-facing work—such as applications-related data entry and analytics in underwriting—can bring significant benefits from reduced errors and faster turnaround times for policy issuance.⁶ Customer-facing work can also be improved; contact centers can use more self-service options, interactive voice-response tools, and training to reduce call volumes and increase first-call resolution rates. Managing the workforce and providing the flexibility that enables call

centers to be fully staffed during peak times can further drive cost efficiencies while improving customer service levels.⁷ Leaders can evaluate the potential value of shifting to more cost-effective locations both within and outside North America and consider strategically outsourcing to vendors.⁸

Simplifying the claims process can also optimize expenses and—importantly—improve beneficiary experience at a critical moment. Updating claims forms to address the most common reasons cases are considered not in good order can speed end-to-end claims-processing time. In our experience, better segmentation and triaging of claims and associated performance management can help increase capacity by at least 25 percent across the claims operation. Increasing the threshold for straight-through processed claims, or claims where a death certificate is not required, can also significantly increase productivity without negatively affecting fraud or error rates.⁹

⁶ For more on how digital tools can revolutionize underwriting, see Ramnath Balasubramanian, Ari Chester, and Nick Milinkovich, "Rewriting the rules: Digital and AI-powered underwriting in life insurance," July 31, 2020, McKinsey.com.

⁷ For more on building the customer-care function of the future, see *The care of one: Hyperpersonalization of customer care*, June 2020, McKinsey.com.

⁸ For more on optimizing in-force operations, see Ramnath Balasubramanian, Alexander D'Amico, Aditi Jain, Nick Milinkovich, and Karthi Purushothaman, "Maximizing the value of in-force insurance amid enduring low returns," April 20, 2020, McKinsey.com.

⁹ For more on the future of claims, see Deniz Cultu, Elixabete Larrea, Michael Müssig, and Swapnil Prabha, "Claims 2030: Dream or reality?," April 2, 2019, McKinsey.com.

Finally, our experience shows that accelerating claims processing and more accurately paying interest across blocks of business can save carriers millions of dollars in interest payments. Improving fraud identification and handling—with more consistent triggers, better segmentation, experienced claims examiners, deep partnership with special investigative units and legal, and collaboration with reinsurers—can lead to further savings.

Transform technology

Technology transformation is vital. Capitalizing on advances in technology, data, and analytics has been made more urgent by the COVID-19 crisis. The demands of the pandemic have accelerated changes in insurers' cost structures, with resources shifting from operations to technology. For life carriers, technology's share of overall expenses rose by 15 percent globally from 2012 to 2019, while the share for operations fell.¹⁰ Our North American Life and Annuities benchmarking confirms widely variant levels of technology spending, with life carriers' 2019 costs ranging from 4.4 percent of GWP for the highest-cost quartile to 1.8 percent for the lowest-cost quartile, and from 1.8 percent to 1.1 percent for annuities carriers. The size of the gap reflects not only variation in the level and timing of investments but also meaningful differences in carriers' focus on technology spending and the value they are getting out of their investments.

Because of the value at stake, size of the investment, and widely divergent costs and outcomes, technology leaders should proceed cautiously and address the common ways in which many insurers miss out on the full benefits of technology transformations. Specifically, decision makers must assess the full scope of the technology changes needed and clearly articulate the business value for the entire organization. They also need to recognize that some capabilities, such as rapid product configurations, will require a full modernization of

core systems rather than a “digital overlay” over existing infrastructure—a shallow change. In a similar vein, decision makers should assume that a platform replacement will not solve all efficiency and data-conversion challenges.

At the core, effective IT transformations require three bold actions by senior technology leaders, under the CEO's leadership, to tie the technological changes to the enterprise's strategic priorities. Carriers should reimagine the role of the technology function relative to other business functions, reinvent the manner in which the technology function delivers products and services to customers and internal users, and future-proof the systems that provide the organization with essential technological capabilities.¹¹

Streamline corporate functions

Top-quartile life carriers spend 2.6 percent of GWP on all corporate functions, while those in the bottom quartile spend 5.9 percent. Annuities carriers spend 0.8 percent and 2.8 percent, respectively. Such large discrepancies suggest a meaningful opportunity to reduce spending on corporate functions without negatively affecting the core business. Typical diagnostics include assessing each corporate function's contribution to the business, how efficiently the functions are organized, and whether organizational resources are allocated in a balanced manner. Our experience suggests there is an opportunity to reduce costs associated with corporate functions by 20 to 30 percent.

The highest return on effort usually comes from strategically renegotiating existing procurement contracts—something that can be done across the value chain. Similarly, insurers can consolidate or reorganize business functions. For in-house functions, particularly corporate finance, strategy, and actuarial, carriers can generate significant

¹⁰ Tonia Freysoldt, Sylvain Johansson, Christine Korwin-Szymanowska, Björn Münstermann, and Ulrike Vogelgesang, “Evolving insurance cost structures,” April 11, 2018, McKinsey.com, data updated to 2019.

¹¹ For more on preparing for the future, see Aaron De Smet, Chris Gagnon, and Elizabeth Mygatt, “Organizing for the future: Nine keys to becoming a future-ready company,” January 11, 2021, McKinsey.com.

savings by optimizing service levels and aligning compensation and benefits with the level of services provided. Standardizing reporting and budgeting processes can further increase efficacy and efficiency, especially for large, multiline carriers. Additional cost savings can come from automating repetitive end-to-end processes and continuing to increase customer and staff usage of self-service tools where possible.

Finally, like many other companies across industries, life and annuities carriers can optimize their geographic footprint. Many carriers are already reimagining the future of work and the workplace, particularly in light of the COVID-19 crisis, and the impact of these changes on real-estate needs. Reexamining the portfolio of owned and leased

property can help insurers support employees in the new way of working and reap cost savings to fund new investments.

In an industry in which top performers amass a disproportionate share of economic value, the importance of productivity for profitable growth in US life and annuities has been magnified by the COVID-19 pandemic and enduring low interest rates. Improving productivity requires going beyond short-term tactical cost cutting to transforming operating costs across the value chain and accelerating growth—all while avoiding pitfalls in capturing and sustaining the impact.

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The authors wish to thank Tanner Abramowski, Charles-Henri Marque, Jonathan Pedde, and Sapna Sharma for their contributions to this article.

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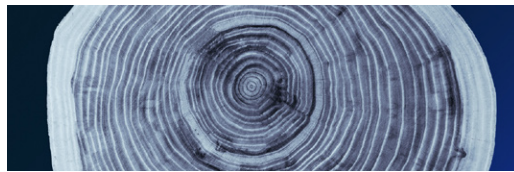
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