What drives insurance operating costs?

Many insurers believe certain costs are integral to their business model and can’t be changed. Yet the biggest driver of cost differences among companies is often management.

Today’s unforgiving economic climate confronts insurers with a multitude of challenges, from the low-interest-rate environment to greater price transparency, customer cost consciousness, and sweeping regulatory changes. As a result, the profitability of life and property-and-casualty (P&C) players is barely above the cost of equity, and costs are emerging as the critical element in achieving competitive advantage. Yet when it comes to explaining persistent cost gaps compared with their peers, insurers often cite factors they regard as fixed—business-model decisions such as size, sales channels, product mix, and geography. Our latest research undermines that excuse: we found that management often matters more, and that’s how a handful of players have been able to demonstrate successful long-term cost management.

To uncover how top performers keep a lid on costs, we turned to our Insurance 360º benchmarking survey and its database of 38 life, 33 P&C, and 9 health insurers. The results revealed significant cost differences within the sector. In fact, the differences in operational costs between top- and bottom-quartile players were consistently more than 60 percent across every business function and, in some cases, bottom-quartile players had unit costs more than twice those of top-tier players (Exhibit 1).

However, this only tells part of the story. We also found that the cost drivers that are often considered carved in stone for insurers—size, sales channel, product mix, and geography—accounted for just 19 percent of the differences in unit costs among P&C insurers and 46 percent among life insurers. In short, differences in these four cost drivers simply do not explain the bulk of the disparity among industry players. So what does?

Management matters

Our analyses of the benchmarking data, combined with insights from our discussions with industry executives, suggest that four distinct root causes explain both the large remaining cost-level disparities and why insurers fail to optimize immutable cost drivers. All come back
to what we regard as issues around management: business complexity, operating model, IT landscape, and performance management (Exhibit 2).

- **Business complexity.** Business complexity related 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, insurers with very large product portfolios and multiple brands and channels are also those with the highest costs on average. One insurer, for example, had introduced numerous individually negotiated discount schemes with a large number of brokers, leading to high complexity and sometimes inadequately priced contracts.

- **Operating model.** High-cost players tend not to have consolidated or optimized the setup of their operating units. They may have back-office functions distributed across numerous locations with different processes and governance structures. Workload backlogs may occur in conjunction with underutilization, leading to a drop in customer satisfaction and deteriorating financial performance.

Addressing these issues requires a comprehensive 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, for example, consolidated its 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 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 simultaneously improve customer service.

- **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. When comparing the number of policies per full-time employee in operations for both life and P&C with IT spending per full-time employee, we found that insurers with complex legacy systems tended to have both high IT spending and low productivity, while those with streamlined IT managed to achieve high productivity with limited IT expenditure.

One company tackled this issue by completely overhauling its P&C IT landscape, replacing legacy core systems with state-of-the-art standard software. As a result, it dramatically reduced costs per policy and cut time to market for new products to just a few weeks. In its life business—which still used the legacy IT system—costs and time to market remained in the bottom quartile. We also found that lean IT efforts can reduce costs by 20 to 40 percent, as well as cut errors.

### Exhibit 2

Management is a major driver of cost differences.

<table>
<thead>
<tr>
<th></th>
<th>Life</th>
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<td>Remaining cost</td>
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</tbody>
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1 For an explanation of the methodology used, see the full report on which this article is based, *Successfully reducing insurance operating costs: Insights from McKinsey’s Insurance 360° benchmarking.*

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Performance management. Performance management drives cost outcomes across all areas. We identified a frequent lack of rigorous performance management, resulting in costs rising again just a few years after the implementation of cost-reduction measures. Reducing costs sustainably requires embedding cost consciousness and continuous improvement into a company’s culture: a one-off program will not suffice. A sustainable performance-management approach means simultaneously changing mind-sets and behaviors, defining new performance metrics and targets, designing new processes, and establishing performance dialogues—all of which need to cascade through the organization. At one P&C insurer, for example, improving performance management in this way led to a 20 percent reduction in back-office costs.

Insurers still have the ability to improve costs in the four areas viewed as immutable: size, sales channel, product mix, and geography. Yet our research found that most of the cost differences among companies actually relate to management. Factoring in these imperatives allows insurers to do much more than just improve their expense ratios: it will give them the freedom to make the investments they need to continue to compete on the global stage.

This article is excerpted from Successfully reducing insurance operating costs: Insights from McKinsey’s Insurance 360° benchmarking.

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