

Policy for insuring profits

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European insurers face intense competition. What was once a steady market, with double-digit profit potential, is now a battleground with declining profitability. Insurance companies in Europe, like their successful counterparts in the manufacturing sector, need to be distinctive. They must provide high quality services to their customers whilst investing prudently in technology capable of both making them more efficient and mitigating the impact of agent and customer churn. Find out how European insurers can create a new service-based operating model that exploits technology for agility and flexibility whilst increasing the cost effectiveness of their operations.

The insurance industry is going through a challenging period, with growing regulation, weakening premium rates, uncertainty in the financial markets and intense pressure to cut costs.

Increasing regulation by organisations such as the Financial Services Authority (FSA) and the European Union (EU) is piling on costs (see [Conforming to Corporate Governance in a complex technology world](#) by Pal and Hammond). For example, Aviva reported in January 2005 that complying with the new International Financial Reporting Standards (IFRS) cost the company £90 million during 2004. Mis-selling scandals continue to raise questions as to whether life insurers have full control over sales processes and whether, despite heavy investment, they are meeting regulatory and compliance requirements.

Meanwhile, premium rates are softening as insurers undercut each other's prices in order to win business – yet the cost of claims is rising. Margins are being squeezed and there is concern about profitability in the industry, especially in long-term insurance. The headaches for European life insurers have been compounded by bear stock markets between 2000 to 2003, which repeatedly forced insurers to cut bonuses for millions of policyholders. Nor have shareholders benefited from the performance of European insurers over the last four years (see Figure 1).

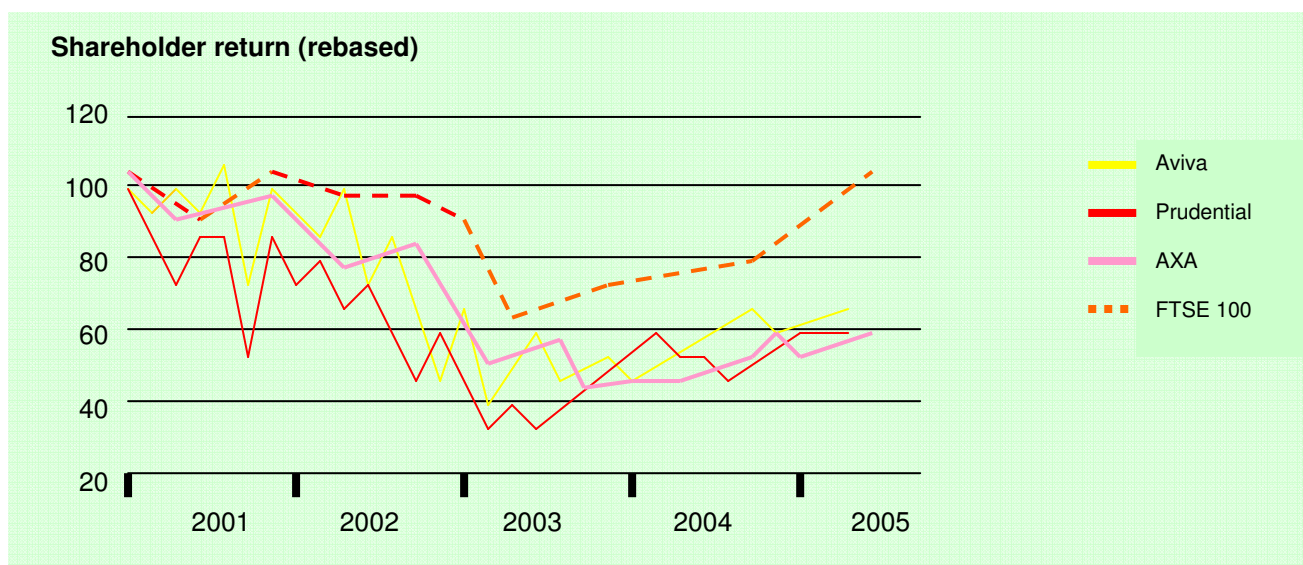


Figure 1: Shareholder return from European Life Assurers (Source: Thomson Datastream)

The UK insurance market was worth £126.51 billion in 2004. This represents a 2.9% increase on 2003 but is still lower than the market's value in 2002. Long-term insurance accounted for an estimated 73.2% of the market in 2004, but the sector's value has fallen by 1.8% since 2001, whereas sales of general insurance have grown by 20.1%.

Market continues to get tougher

European insurers are facing further pressures from the expansion of the European single market, international trade, deregulation and growing customer sophistication. All of these are forcing insurers to operate in a global market.

At the same time, the industry is in the middle of a fundamental transformation as services become *industrialised*, in a similar fashion to the manufacturing industry. Technological innovations such as call centres and the web, coupled with changes in the rules governing the sale of insurance laid down by the FSA, are challenging traditional distribution models and channels. They are also increasing customers' price sensitivity and lowering the barriers to switching insurance providers.

However, the major headache for the UK long-term insurance industry is that people are not saving enough for retirement. The Pensions Commission will deliver recommendations in October 2005 on how to address this pensions gap, perhaps by advising that there should be some element of compulsion in personal pensions. Unless consumer behaviour changes dramatically or the Government makes personal pensions compulsory, sales of general insurance are likely to continue to grow faster than sales of long-term insurance.

Moreover, the frontiers between banks and insurance companies are dissolving as bancassurance expands in scope. Banks and asset management companies are now scrambling to grow revenues in businesses traditionally dominated by insurers. The distribution of life products through bank branches is already commonplace, the sale of property and accident insurance through the same channel has gathered pace, and asset management is emerging as a business in its own right. Emerging markets, changing employment patterns, greater disposable income and longer and earlier retirement means there are now significant opportunities for European insurers to target new customer segments and develop new products using bancassurance. Meanwhile, traditional insurers have responded by pursuing efficiency improvement and looking for growth and economies of scale through consolidation.

Yet, despite suggestions that the UK insurance market will grow by between 3% and 4% a year between 2005 and 2009, a number of British life assurers, including Prudential, Standard Life, and Aviva, have cast doubt on the prospects for growth in the UK life assurance sector. Standard Life, which plans to demutualise in 2006, is actively targeting expansion in China, India and France as a countermeasure to these gloomy forecasts. In November 2004, the company announced it expected to move over the course of the next twenty years from its current position of having 75% of its business in the UK and 25% outside to a state where its business will be split equally between the UK and international operations. With the UK no longer the easiest place to make a good return on capital, it's no surprise insurance companies are looking at where capital can be better deployed to give a more sensible rate of return.

Aviva is a little more optimistic about the UK life assurance market over a three-year period, but does not expect rapid growth in the next 12 months. Prudential, meanwhile, is looking to the forthcoming increase in the cap on charges for new stakeholder savings products – from 1% to 1.5%.

New service based operating model: a necessity, not a luxury

To address this decline in profitability, many life insurance companies are overhauling their IT systems – seeking to improve operational efficiency – or offshoring business processes such as call centres to low-cost destinations like India or Sri Lanka, in a bid to reduce costs (see *Offshoring practices in European financial services companies* by Pal and Hammond). But these moves will not be enough to keep insurance companies viable. They need to develop a new service-based operating model (see Figure 2) that:

- provides high quality service to their customers and agents;
- uses technology to streamline processes, speed up decision making, and restructure front- and back-office functions to minimise costs; and
- directs resources to areas where they can have the biggest impact.

In this new operating model, the critical imperatives are underpinned by superior service to both agents and customers. Many insurers depend on agents to sell policies and deliver customers. Given that policies, pricing and agent commission structure within the industry are fairly standardised, agents have little incentive to choose one insurer over another and agent churn can be high. Insurers must offer personalised service and flexible commission schemes to keep agents, just as much as customers, satisfied. The new model not only increases agent and customer satisfaction but also improves revenues and increases market share at lower cost per customer.

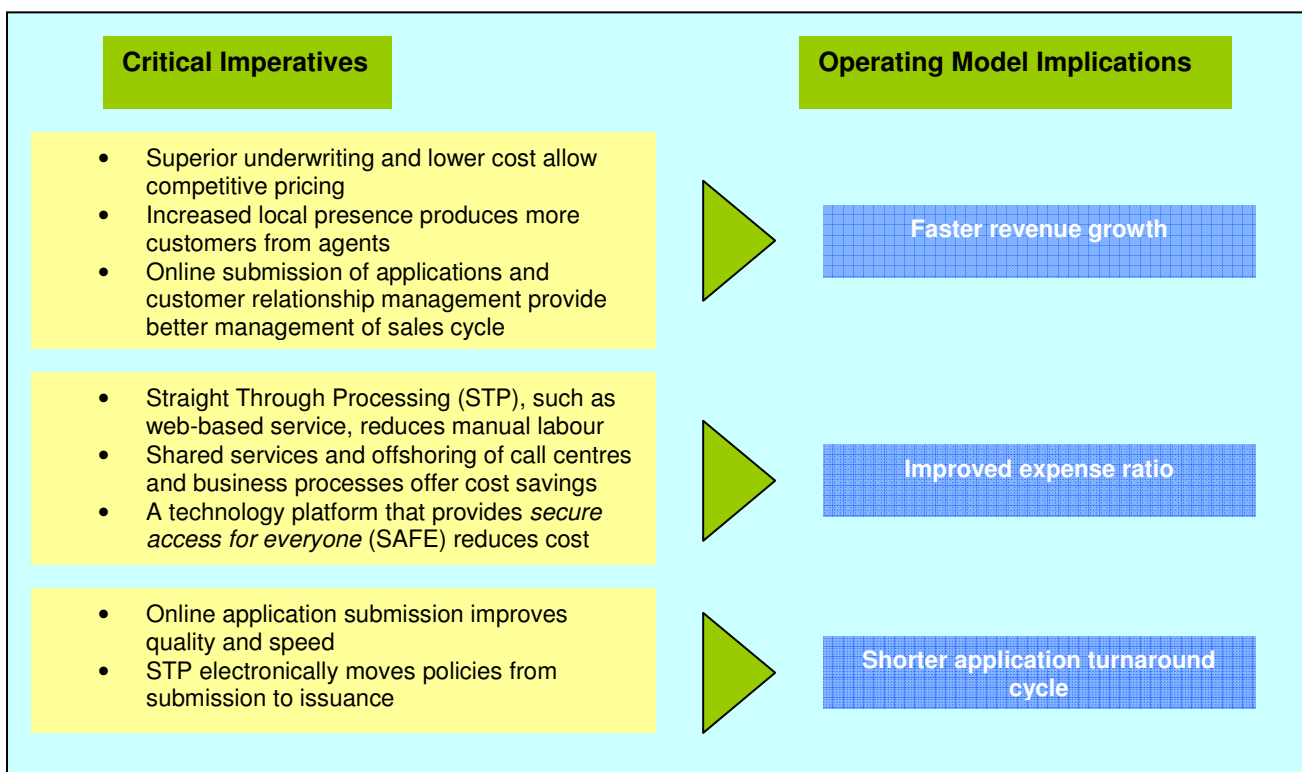


Figure 2: Potential impact of new service based operating model

This operating model takes account of the division between “manufacturing” and “distribution” within insurance: a division that is already strongly evidence in non-life business and increasingly being defined in life business. Insurance “manufacturers” who create products have to be able to cost-effectively connect to a variety of distribution channels, whilst minimising the costs associated with serving each additional channel. The challenge is to define customer segments and structure the organisation with the right mix of remote and high-touch distribution, coupled with appropriate products and superior levels of after-sales service. Addressing the issue of distribution is a driving force behind the kind of back-office

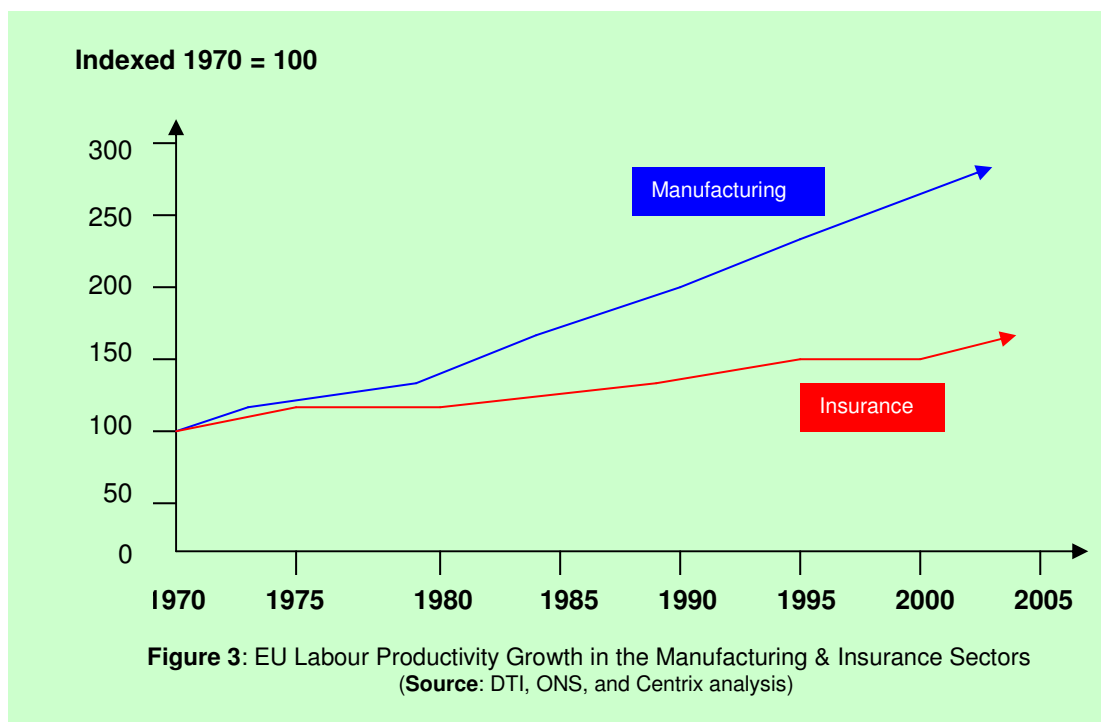
transformation, through definition and development of strategic technology platforms, that most European insurers now accept is inevitable.

Learning from other industries

Finding the breathing space to move to a new operating model will not be easy against the background of daily demands from the business, Customers and agents call for better services and more personalised offerings. Sales managers push for incremental revenue, improved customer retention and superior service levels. And senior executives expect the almost impossible: meaningful cost reduction at the same time as new product launches, integration of acquisitions and entry into new markets.

Yet companies in other sectors have faced and overcome similar challenges. The manufacturing sector's 30-year struggle to keep pace with increasingly demanding consumers and new and more efficient competitors generated an array of methods for improving cost and performance (see *Manufacturing: It's survival of the best* by Pal and Hammond). Each drove a fresh wave of efficiency improvements that have seen the manufacturing industry outstrip the services sector when it comes to productivity (see Figure 3).

Early efficiency pioneers, such as Honda and Toyota, rode these waves of improvements to global leadership positions in their industry. Today's European insurers can apply the insights of the manufacturing sector to achieve the same kind of efficiency gains in less time, by using the sequential discovery process that manufacturing has already endured as a pathfinder.



The eight key lessons for European insurers are:

1. Use Six Sigma techniques, cost-benefit modeling such as Centrix's Economic Value Assessment (CEVA), and benchmarking against other business units and industry best practice. Do not invest time and effort to improve business processes without understanding what the outcome should be and what value will be achieved for that investment.
2. Standardise business processes to maximise economies of scale, while preserving valued flexibility in service delivery.
3. Re-engineer business processes for improved speed and quality; use this focus to drive costs down and service levels up.
4. Architect product lines to maximise commonality, while recognising that customers value variety and personalisation (see Figure 4).

5. Establish a governance framework and push authority and accountability down the organisation's chain of command.
6. Work with small, innovative and independent service providers to craft a service-based architecture and supporting technology platform that will reduce cost and increase agility.
7. Avoid falling prey to large outsourcers or service providers, who have a vested interest in locking insurers into their business model, so that they can increase their fees – and insurers costs – as insurers business needs change.
8. Help employees understand the efficiency improvement drive from a process perspective and give them the necessary support to ensure they execute these initiatives.

Culture change needed if technology is to increase efficiency

Technology can help insurers become more successful at their primary goals – which include helping customers and agents interact more easily with them, simplifying the claims experience and enabling increased product innovation – as well as rationalising operations and removing unnecessary costs. Yet IT organisations in most European insurance companies need a change in culture. There are three interdependent and interrelated initiatives for getting most from IT. And, it is the board's responsibility to understand and help apply them. The three initiatives are:

1. A long-term technology renewal plan that is aligned to the company's strategy;
2. A streamlined and unifying companywide technology architecture replacing numerous vertical IT architectures;
3. A highly capable and performance orientated IT organisation that works as a team and operates according to corporate performance standards.

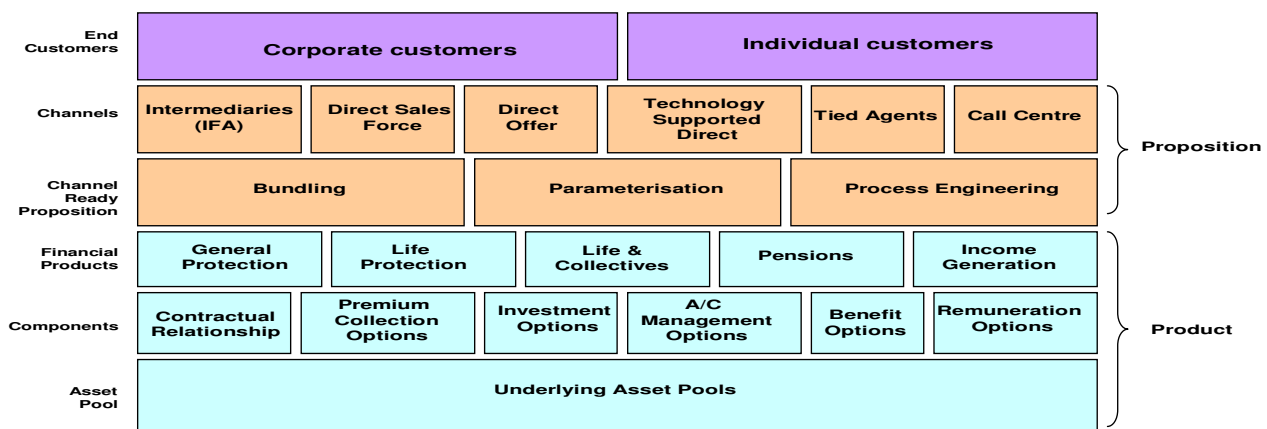


Figure 4: Elements of a modularised core insurance product architecture

In addition, European insurers should be more skeptical of hardware vendors – many having “reinvented” themselves as outsourced service providers – software vendors and systems integrators (who often have close relationships with hardware and software vendors, selling their products on commission). All of them promise huge returns from implementing expensive new technologies or taking business processes and information network problems away at a seemingly lower cost. However, European insurers should instead focus on getting their basic infrastructure technologies right, and implement a governance framework to manage the demand and delivery of services (see *Taming the beast: containing spiraling IT infrastructure costs* by Pal and Fuller). This will allow IT organisations to deliver better services to the business, more rapidly and at a reduced cost. Basic infrastructure technologies include: the service delivery platforms for both offshore and onshore activities; channel platforms for automated voice systems and call routing to agents; agent desktops; and a platform underpinning *secure access for everyone* (SAFE) in distributed and partnered organisations.

Big vendors are no longer safe

Insurance companies – whose business is about managing risk – also need to take a more sophisticated approach to managing risks in their IT operations. Traditionally, most large insurance companies have procured their technology and related services from large vendors, believing them the safest bet – but in today’s business environment, that isn’t necessarily true: just look at what happened to once mighty Enron, WorldCom, MCI, Digital Equipment, Compaq, and Parmalat. Moreover, many large vendors – especially in the hardware sector – have become outsourcers, whose primary aim is to carve out technology and back-office functions from insurers, lock them into long-term contracts, and subsequently make them pay over the odds when their business changes (see *Offshoring: Saviour or Value Destroyer?* by Pal and Hammond). Many insurance companies have failed to recognise this new risk. Prudent CEOs need to steer their CIOs and supply chain organisations toward small and independent technology service providers, who are more likely to act in the true interests of their clients by helping them to deliver efficiency and operational excellence.

Right technology infrastructures matter for secure access for everyone

Moreover, a strategy based on the service-based operating model described earlier will only be as good as the technology infrastructure that delivers it. Decisions about what is the right technology infrastructure should not be left to hardware vendors, outsourcers, or software vendors. Winning insurance companies, for instance, put in place an optimal network of call centres, in the right geographical locations, outsourcing when appropriate, to be able to offer consistent service with high security, and minimum disruption from labour, political, and economic factors. Successful insurers also segment inbound calls – recognising that a sales call from a new customer will generate more value for the company than a standard claim inquiry – and direct each call to an appropriate agent (see Figure 5).

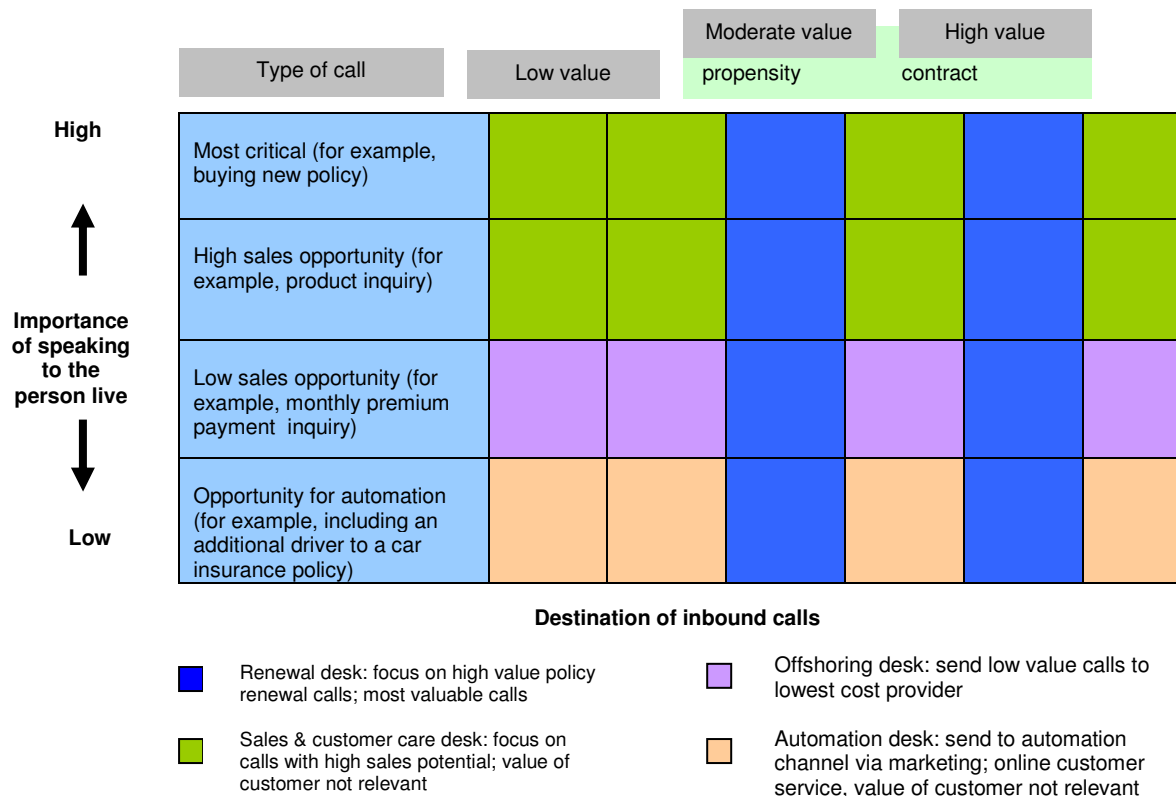


Figure 5: Customer segmentation strategy for inbound calls

Designing technology as a service reduces cost and increases flexibility

To complement the introduction of the new operating model, business and technology people must work together to reinvent the organisation's IT architecture. IT architecture is important to business executives because it can either help or hinder the launch of new products, or moves to exploit new distribution channels. Many insurers, for example, find that their IT organisations cannot efficiently support multi-channel offers, because products and channels are served by separate IT systems that communicate only to a limited extent.

Problems with the IT architecture are often the root of the frustration experienced by business executives when the IT organisation takes too long to make changes, the cost is too high, or the changes fail to deliver the expected benefits. Moreover, business executives who believe that IT people neither understand their requirements nor deliver real value do not like to commit good staff members to work on IT projects. With limited input from business, IT organisations deliver the best systems they can, but from a technology rather than a business perspective – exacerbating the tendency for new developments to fail deliver the expected business benefits.

The key step is to organise IT systems into *service bundles*: sets of applications, processes, and supporting data that are managed as units for business reasons. This is a change from the traditional approach of managing them at the applications level or organising by types of hardware or operating system. An insurer might, for example, bring together the applications that contain policy holder information and rethink the links among them. In this way, the company can streamline the tangle of interconnected systems, root out duplication, and eliminate redundant applications (see [Why integrate, when you can aggregate?](#) by Pal and Hammond). The objective is to turn an environment that resembles a plate of spaghetti into a system of modular blocks with relatively few interconnections. As a result, the business will reduce its maintenance and development costs, while IT experts find it easier to change or scale such systems, and can support business changes more rapidly and less expensively. It is necessary for most insurers to overhaul their IT architecture to reduce cost and increase flexibility. It is equally important to bridge the divide between the cultures of business and IT. And insurers can do both in parallel (see Figure 6).

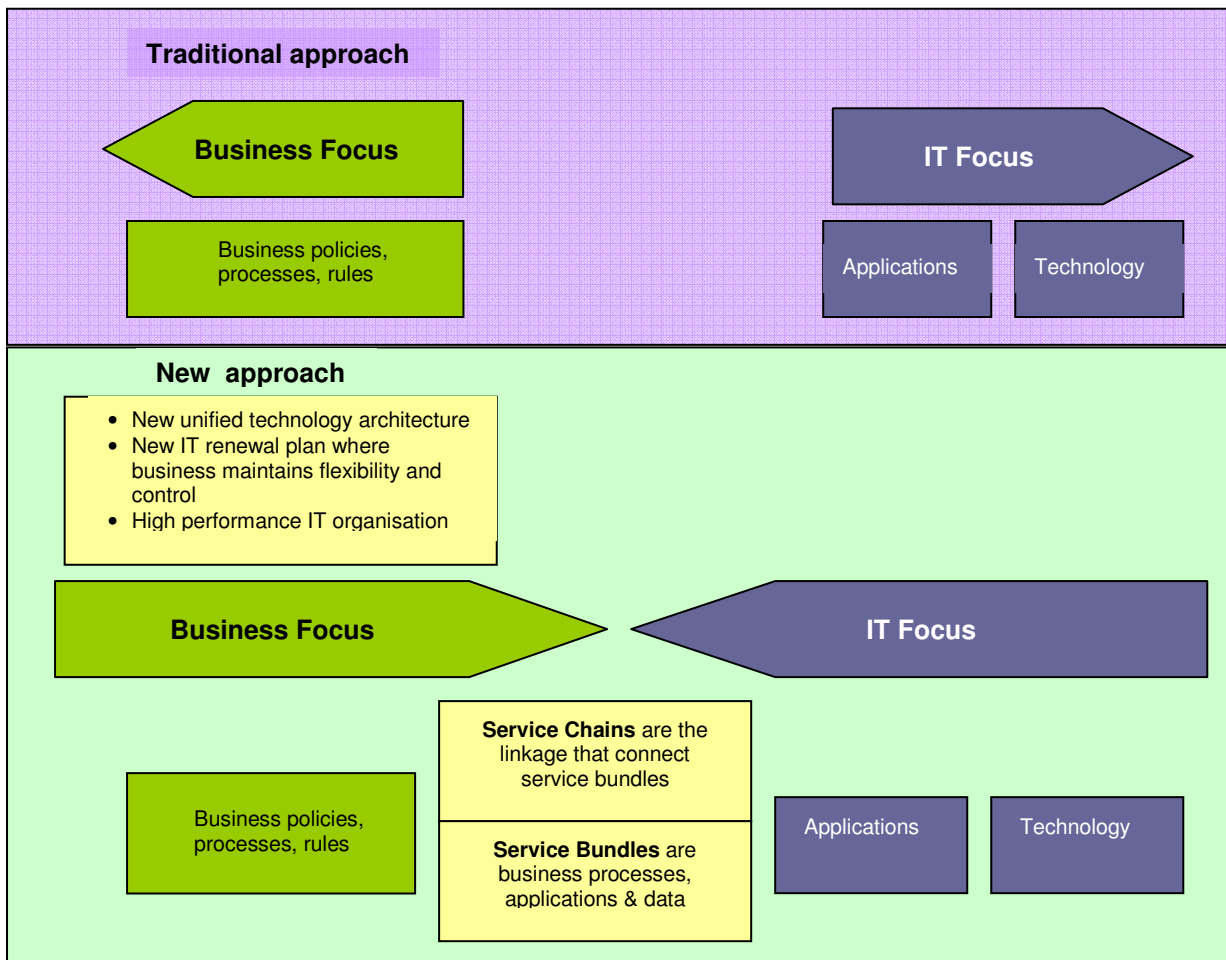


Figure 6: Framework for designing technology for servicing business

Once the three initiatives outlined earlier are aligned, IT organisations and systems tend to deliver results rapidly. However, despite the obvious benefits of these initiatives, some CEOs may ask themselves:-

- Do we really need to do all this ourselves?
- Can't we outsource or offshore to companies that already claimed to know this work?
- Wouldn't outsourcing or offshoring be a cheaper solution in the long run?

The answer to all of the above questions is yes and no. In coming years, fewer and fewer CIOs will run their networks and data centres, and mundane applications development may be carried out by capable offshore partner organisations. But these initiatives become even more critical when outsourcing and offshoring come into the picture. This is because, both outsourcing and offshoring increase management complexity. And, CEOs and CIOs cannot abdicate the leadership and vision of these critical initiatives. For example, if an insurer has a number of long term contracts with various outsourcers and/or offshore service providers, the long-term technology renewal plan (initiative one) must be well articulated. When an insurer works with a number of outsourcers that have their own tools and methodologies, it is vital to orchestrate an overarching common technology architecture with which everyone can work productively (initiative two). It is also much easier to build a high performance culture when insurers own the human resources (initiative three).

What does all this mean for the insurance industry?

So far, 2005 has proved more positive for the European insurance industry. Interim results from top insurers have beaten expectations, some by a generous margin, and this strength is broadly based. General insurance is benefiting from premium rate increases, underwriting discipline, and the absence of natural disasters, which cost a record £26.95 billion (\$49 billion) in 2004. For instance, Allianz recently

produced an impressive combined operating (COR) ratio (calculated as premium minus costs and claims) of 89.8% in the second quarter of 2005; in 2002, this figure was over 100%. Meanwhile, savers are regaining their trust in equity markets as a store of wealth, helping sales of life insurance policies as well as increasing the value of assets under management. Since equities hit a low in March 2003, the life and general insurance sectors in Europe have outperformed the market by up to 25% and some companies have resumed dividend payments.

Yet the industry may be at the top of the cycle again, with premium rates coming under pressure in certain markets. Moreover, to earn attractive returns in the insurance industry, companies have to be distinctive players. What was once a stable and clearly defined industry is changing its boundaries and become de-parameterised: new types of provider are moving into the market, new value propositions are being offered to customers, and alliances, partnerships and the outsourcing of processes throughout the value chain are in a state of flux, as some companies become highly specialised providers of particular elements while others are extending the scope of their activities. The speed of change varies from country to country, according to the regulatory environment and cost of labour, but the sophistication of the market is rapidly on the up in every country. For insurers who would like to stay in the traditional world of product lines and conventional sales channels, the market will be an ever more difficult one.

Most CEOs of large insurance companies are still relying on a set of formula that served them well in past. But, in today's intensely competitive insurance industry, these formulae (see below) need to be revisited to return decent value to shareholders.

- **Scale:** It is better to be deep and geographically focused than big and shallow. Bigger is no longer better in the insurance sector, and it is difficult to grow, and harder to manage. After a certain size, there are few economies of scale in general insurance.
- **Skills:** Instead of traditional economies of scale, it is the economies of skill that would make the difference. If, for example, one of the geographic regions can find a way to increase sales by 10% more than anybody else, then the insurer can use that formula globally.
- **Revenue growth:** The key to the bottom line is the top line. Don't just focus on cost and efficiency, focus on revenue growth and agility. If an insurer is generating sufficient new revenue, then they must be doing something right with the customers.
- **Revenue enhancing merger and acquisitions:** Don't do traditional merger and acquisitions unless the revenue growth of the combined company will be faster than the sum of the two companies.
- **On cost-cutting merger and acquisitions:** What does a one-time saving of £100 million do for a global insurer? At best the share price may go up by 10 pence – but what's next? What about sustainability?

The operational challenges of emerging technology, globalisation, service industrialisation, and new sales channels will increase pressure on cost and operational efficiencies. In response, CEOs of insurance companies need to steer technology in four primary directions:

1. core insurance capabilities, such as policy administration and underwriting, which are the bedrock of regulatory functions;
2. distribution channels;
3. products; and
4. a technology architecture that underpins the other three areas and provides *secure access for everyone* (SAFE).

Today, the world is shrinking and insurance CEOs must know what is happening in the de-parameterised company from Norwich to New Delhi in a few seconds. While many insurers have tried to leverage technology to lower costs, their investments in offshore call centers, business process offshoring, and web-enabled access have so far actually increased their total service costs. Successful CEOs will need to avoid falling prey to large scale outsourcers and service providers, who promise the earth but deliver little,

and opt for a service-based operating model that exploits proven technology whilst growing new revenue, increasing the efficiency and cost effectiveness of their operations.

About the authors

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