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**A Challenging Time  
for U.S. Insurers**  
*How to Get  
Back to Basics*



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## EXECUTIVE SUMMARY

*General insurers, with the exception of AIG (American International Group Inc.), have made it through the global financial and economic crises unscathed—so far. But no one should be complacent: 2008 was a difficult year for U.S. insurers, with catastrophe losses exceeding those of 2006 and 2007 combined, and inflation lifting claims costs. Starting in September, the credit crunch and bank failures created new worries, and regulators demanded higher levels of capital. The job losses now occurring in most major Western economies have added to insurers' woes, putting pressure on payroll-sensitive products such as workers' compensation. To compound the difficulties, volatile markets mean insurers cannot rely on investment returns to keep their businesses in the black.*

*The insurers that manage to succeed in this increasingly challenging environment will be those that get back to basics, focusing on risk selection and pricing, slashing costs in claims and other functions, improving effectiveness in distribution, and carefully managing capital. They will also make better use of new technologies to leverage the power of information and analytics.*

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## AVOIDING THE MIDDLE GROUND: SCALE VERSUS SPECIALIZATION

Insurers need to make a strategic choice: to pursue scale or to specialize. Those that do neither, instead continuing to occupy the middle ground, will struggle to compete and may become takeover targets as the global insurance market consolidates.

Scale has some distinct advantages. To start with, scale makes it easier to share fixed costs in such areas as IT and delivery platforms. Scale can also help insurers negotiate better commissions. Larger players such as AXA and Aviva PLC have been able to reduce marketing spend and operating costs by consolidating their global brands under one umbrella. With respect to loss ratios, big personal-lines players in markets such as the U.S., the U.K., and Australia can leverage their scale and purchasing power in the auto and home supply chains. More information and greater expertise enable better underwriting and customer targeting as well as better claims decision making. Finally, scale can bring diversification benefits and lower reinsurance costs. Smaller players, by contrast, must contend with higher operating-expense ratios and potentially higher loss ratios because of less-effective underwriting or claims management.

However, achieving scale is by no means straightforward. In mature markets, where customer churn tends to be a relatively low 10 to 15 percent, it's almost impossible to build scale organically. In such markets, mergers and acquisitions are usually a better route to growth, whether the acquisitions are within the headquarters country or across borders. More such opportunities are likely to emerge as cash-constrained companies put their insurance businesses up for sale. And even if a struggling insurer resolves to remain independent, its customer base may be open to overtures from healthier providers. Insurers can also build "virtual scale" through process utilities, outsourcing, and offshoring.

The benefits of scale can also be elusive. Because those servicing claims (e.g., automobile repair shops) are often small local businesses without a national footprint, insurers that have a strong local presence frequently have greater clout than global insurers.

In some cases, it may be preferable to take the specialized approach. The best way to do this, usually, is to target a particular channel, product set, or customer segment (say, those older than 50) with which the insurer can command a price premium, sell more effectively, and better manage risks.

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## ACHIEVING A STEP CHANGE IN COSTS: CLAIMS CAN BE THE MAJOR LEVER

Given the growth challenge in today's environment, insurers should investigate every possible means of cost reduction. The greatest scope for cost cutting in general insurance lies in claims, which account for 60 to 80 percent of costs. However, given that claims are a core part of the company's promise to its customers, any cost cutting needs to be carried out carefully. This is especially true for intermediated businesses (as opposed to direct-to-consumer businesses), in which damage to the relationship from mishandling one claim can have repercussions for the overall relationship. Still, done well, claims can be a major lever for cutting costs and can also form a core element of the customer value proposition.

On the claims operations side, insurers need to streamline and simplify the process. Claims should be segmented and aligned with risk, use of straight-through processing for simple claims should be increased, and the best people should be handling complex claims proactively, supported by the

right information. There is also an argument for quickly resolving certain claims, such as the theft of jewelry, which tends to be an emotionally upsetting experience. To resolve such claims quickly without excessive scrutiny is to enhance customer loyalty in a powerful way.

On the claims management side, the focus should be on active management of the supply chain and the selection of an optimal claims model. For example, in auto insurance, it may be possible to set up preferred supplier networks—a roster of body shops that will do a high-quality job at a low price in return for the knowledge that work will be channeled to them. An alternative model, using auctions in which body shops bid for work, can likewise keep costs down and provide a high level of transparency, but it has the disadvantage of not giving the customer any say in selecting the repairer. (The Progressive Corporation's concierge approach, in which customers simply drop the

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car at a Progressive service center and allow the company to handle the repairs, and other “drop and go” models can overcome the loss-of-choice problem by virtue of a convenient customer experience.) One last model involves setting up relationships with specialized repair shops, such as those skilled in repairing minor dents and scratches. Working with such shops can deliver efficiency savings of up to 30 percent.

In other lines of business, such as personal injury claims, early

intervention by the right provider, ensuring appropriate treatment, can improve customer outcomes and lower costs.

Besides driving efficiencies in claims processing, companies typically have opportunities to improve effectiveness and reduce costs in functions such as products, underwriting, distribution, IT, and support. This can be done by consolidating sites, streamlining processes, introducing automation, redesigning product/IT architecture, and cutting overhead that isn't adding value.

*Early intervention by the right provider, ensuring appropriate treatment, can improve customer outcomes and lower costs.*

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## INNOVATION COMES TO THE FORE: CUSTOMER FOCUS

The acquisition and retention of customers often depends on innovation. This is especially true in the current U.S. insurance market, which has been hurt by the need for double-digit percentage declines in rates, increased catastrophe expenses, and declining underwriting capacity. Moreover, U.S. consumers, at least in certain areas of insurance, are becoming less loyal; for instance, 39 percent of all Americans shopping for auto insurance in 2008 ended up choosing a new provider, compared with 33 percent in 2007. On the other hand, some U.S. rules and regulations work in insurers' favor, including the requirement that automobile owners carry liability insurance and that businesses purchase workers' compensation insurance. Still, the bottom line is that the economic downturn will favor those providers able to offer products that meet a wider range of customer needs. This means that scale players may want to learn from specialist players that have driven innovation in such products as "pay as you drive" programs (in which those who use their cars less pay lower premiums) and such product features as no-claim cash-back payments (in which a fraction of the premium is returned, as a reward, to those who make no claims).

Because switching costs are low in mature markets, insurers need a clear strategy for segmenting customers, aligned with their overarching choice of scale or specialization, coupled with retention initiatives. Customer segments can be defined not just in terms of demographics, but also by customers' needs, attitude toward insurance, and economic value to the insurer. For example, "clarity seekers" are looking for simple, clear

product information and advice, as well as confidence in product features and benefits; insurers should focus on giving them highly personalized services in order to explain the product and answer questions. Insurers have shifted their focus from individual products to consumers, for whom they are bundling products like car and home insurance. That is what Progressive did in 2007, when it combined its agency and direct auto insurance lines with specialty lines under one personal lines organization. The move will cut redundant costs in product design, management, and policy serving, while increasing customer retention, brand development, and price competitiveness.

Retaining customers is a function of understanding what might prompt them to switch and of making sure not to activate any of those triggers. A range of tools can be used to improve retention and to cross-sell, including integrated products, loyalty and multi-policy discounts, and phased re-pricing to keep premiums below the levels at which customers choose to shop around. Nationwide Mutual Insurance Company does some of this; the company is serving targeted customer segments via online payment, through the creation of simpler billing statements, and through an innovative program in which customers can view their car repairs online. Some tools, however, are problematic. For instance, although the use of direct debits tends to increase customer retention, it also tends to attract poorer-quality business. As for product bundles—for instance, the linking of mortgage and home-insurance sales—these seem destined to run into regulatory barriers in some markets.

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## DISTRIBUTION: ONLINE AND BLURRED BOUNDARIES

Major shifts in product distribution are occurring, especially in personal lines. Conventional distribution channels (captive agents, independent agents, and brokers) remain in place, but alternative channels are rising, including direct sales by telephone, mail, and especially the Internet. Auto insurance provides a clear example. A 2008 study by J.D. Power and Associates found that 21 percent of all new auto insurance customers processed their transactions entirely online, with most citing the ease of conducting business as the primary reason for shopping and purchasing in this manner. It is a different story on the commercial side, where independent agents and brokers continue to dominate, writing 70 percent of net premiums.

A second trend, also involving the Internet, is the emergence of online aggregators. Aggregators have increased commoditization and reduced margins for insurers; most insurers have either embraced them wholeheartedly or avoided them. Those insurers that have embraced the aggregators, by and large, have

treated them as an outlet for cheap, no-frills policy offers that cost little to support. Some insurers have even created their own branded aggregation services with more limited market coverage. Then there are the insurers that have made a choice not to work with online aggregators in any way, instead choosing to reinforce their own brands and channels.

In order to make sure they are available through whatever channels their customers prefer, general insurers are looking at how to improve what they do online while balancing their investment in other direct channels and managing potential channel conflict. Distribution represents between 18 and 30 percent of most insurers' costs; there is a significant opportunity to save money through online distribution. What's needed is a complete rethinking of the product and the claims model.

The move online (both business-to-business and business-to-consumer) is also reshaping intermediated commercial and personal lines markets, in particular with the introduction

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## GROWTH: TARGETING EMERGING MARKETS

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of electronic underwriting. New third-party players, including bancasurers, car manufacturers, retailers, and mortgage brokers, are vying for position. Increasingly, boundaries are blurring between manufacturers and distributors, which challenges traditional roles and how players compete. Large brokers like the AON Corporation have extended into risk management; reinsurers are offering a broader range of services. Insurers like Aviva in Europe and Wesfarmers Ltd. in Australia have addressed the changing distribution landscape by acquiring intermediary networks; others have built up their tied-agent networks. Traditionally these insurers have viewed the intermediary, rather than the consumer, as their customer; now they need to offer compelling value propositions to both constituencies. They also need to enhance their sales practices with a “whole of account” approach in which all of the customer’s insurance needs are considered together and the practice of having different product people call on the same customer is abandoned—or at least de-emphasized.

With the erosion of profit margins, especially in established markets such as the U.S., some insurers are starting to eye new geographic regions.

Emerging economies, in particular the BRIC countries (Brazil, Russia, India, and China), are obvious possibilities for expansion. Emerging markets as a whole now account for 12 percent of premiums, after experiencing 10 percent growth in 2007. By contrast, world property and casualty insurance premiums grew a mere 0.7 percent in real terms in 2007, to US\$1.7 trillion. The United States accounted for 39 percent of that, although U.S. premium revenue actually fell 1.3 percent to \$651 billion.

As attractive as emerging markets appear, succeeding in them will require “know-who” as well as “know-how.” This is a key point for insurers to consider as they make their initial international forays. First movers will also find themselves in an enviable position as later entrants scramble to catch up.

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## SUSTAINABLE CHANGE: TRANSFORMING THE OPERATING MODEL

In order to respond effectively in an uncertain and fast-changing market, insurers must choose the most effective business model to support their chosen strategy. Insurers have traditionally organized themselves as “end-to-end” businesses along product or channel lines. Increasingly, scale players are exploring functional models; for example, integrating claims and product development to support different customer segments and channels. The trick is balancing the benefits of scale against clear business unit accountability.

To be sure, trade-offs must be made no matter which model is embraced. Alignment by customer segment, for instance, is good in that it provides clear focus on the needs of that segment, but it can add complexity and cost in product and claims. A functional model can help capture economies of scale and expertise, but can reduce customer focus. Our advice—based on years of research on organizational effectiveness—is to make sure all elements of the model (decision rights, information flows, and motivators) align. It’s vital that

the structure serve the model, but that alone isn’t sufficient to ensure success.

Whereas many firms focus primarily on execution and on standardizing best practices, successful players will need to do more to deliver significant improvements in effectiveness and efficiency. Strategic operating decisions, such as the choice of an IT platform and whether to outsource or even eliminate certain services, and structural decisions such as the creation of a common back office, can deliver much greater benefits. In addition, in cases in which insurers have taken advantage of the current environment to acquire assets or customer bases, it will be important for them to find ways to manage the additional demand while capturing the full value of the additional scale. This transformation will be possible only if insurers recognize they are entering a new time and that streamlining their businesses is now essential. The pressure is real, and those players that want to build sustainable and profitable futures need to act quickly.

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## NEXT STEPS: INERTIA IS NOT AN OPTION

Insurers need to swiftly determine how they will respond and take a critical look at their entire business model. In the current environment, time is a luxury that insurers don't have, and they need to be bold, if methodical, in their approach. Where to start? The best place is with a decision about strategic priorities: Does the insurer want to institute a rapid response that will produce some moderate near-term results and reassure the market at a difficult time, or pursue a long-term strategy of maximizing top- and bottom-line benefits?

Make no mistake: The world is watching. Now that the issues in the banking sector are being addressed, the attention of key

stakeholders—investors, traders, regulators, governments, and customers—will turn toward insurers. There are already signs that insurance groups are coming under pressure; for example, the state bailout of the life insurer AEGON NV in the Netherlands. If the banking example has taught us anything, it is that once market confidence is shattered, even relatively healthy institutions can fall victim to negative sentiment, followed by ratings downgrades and other painful consequences.

The bottom line is that insurers need to move forward quickly and effectively. Those who fail to do so may find themselves making uncomfortable headlines at a time of financial and economic peril.

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