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General Insurance
Getting Back to Basics



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GENERAL INSURANCE

Getting Back to Basics

General insurers, with the exception of AIG, have made it through the global financial and economic crises unscathed—so far. But no one should be complacent: 2008 got off to a hard enough start, with claims relating to severe weather eating into profits and an intensifying battle for market share. The credit crunch and resulting bank failures have created new worries, with regulators demanding higher levels of capital. And in light of the recessions now affecting Western economies, there is a danger that some consumers will begin to regard insurance policies as discretionary purchases. To compound the difficulties, volatile markets mean insurers cannot rely on investment returns to keep their businesses in the black.

Insurers who manage to succeed in this increasingly challenging environment will be those who 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.

Avoiding the Middle Ground: Scale Versus Specialization

Insurers need to make a strategic choice: to pursue scale or to specialize. Those who do neither, and who continue to occupy the middle ground, will 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 areas like IT and delivery platforms. Scale can also help insurers negotiate better commissions. Larger players such as AXA Group and Aviva plc have been able to reduce marketing spend and lower operating costs by consolidating their global brands under one umbrella. With respect to loss ratios, big personal lines players in markets like the U.S., U.K., and

Australia can leverage their scale and purchasing power in the auto and home supply chains. More information and expertise enable better underwriting, customer targeting, and 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 due to 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 percent, it's almost impossible to organically build scale. In such markets, M&A is usually a better route to growth, whether the acquisitions are within-country or across borders. Similar opportunities are likely to emerge as cash-constrained companies put their insurance businesses up for sale. Even if struggling insurers resolve to remain independent, their customer bases may be open to overtures from healthier providers. Insurers can also build “virtual scale” through process utilities and outsourcing/offshoring.

The benefits of scale can be elusive, however. Because those servicing claims (e.g., auto repair shops) are often small local businesses without a national footprint, insurers with strong local presences often have greater clout than insurers with a global footprint.

In some cases, it may be preferable to take the specialized approach. The best way is generally to target a particular

customer segment (e.g., those aged 50 and older), channel, or product set in which the insurer can command a price premium, sell more effectively, and better manage risks.

Achieving a Step Change in Costs: Claims Is 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 a 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 to the overall relationship. Still, done well, claims can be a major lever to cut costs and also form a core element of the customer value proposition.

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

claims quickly and without excessive scrutiny enhances the customer experience in a powerful way.

On the claims management side, companies should focus on actively managing the supply chain and selecting an optimal claims model. For example, in car insurance, it may be possible to set up preferred supplier networks—a roster of auto body repair shops that do high-quality work at a low prices in return for knowing work will be channeled to them. A second model, using auctions in which repair shops bid for work, can also keep costs down and provide a high level of transparency, but has the disadvantage of not giving the customer any say in selecting the vendor. (Progressive Casualty Insurance Company's concierge approach and other “drop and go” models can compensate for the loss-of-choice problem with a convenient customer experience.) A final model involves creating relationships with specialized repair shops, such as those skilled in small and medium accident repair techniques (SMART) for minor dents and scratches. Working with SMART shops can deliver efficiency savings of up to 30 percent.

In other lines of business, for example personal injury claims, early intervention by the right provider ensuring appropriate treatment can improve customer outcomes and lower costs—in much the same way that sports medicine does.

Besides driving efficiency in claims processing, often there are also opportunities to improve effectiveness and reduce cost in functions such as product and

underwriting, distribution, IT, and support functions. These can be achieved by consolidating sites, streamlining processes, introducing automation, redesigning product/IT architecture, and cutting overhead that doesn't add value.

Innovation Comes to the Fore: Customer Focus

The acquisition and retention of customers often depends on innovation. This is all the more true during an economic slowdown, when some consumers, particularly those in the Gen Y category, may be tempted to write off insurance as a luxury. Scale players would do well to learn from the specialist players who have driven innovation in products like “pay as you drive” (in which those who use their cars less pay lower premiums) and product features such as “no-claim cash backs” (in which a fraction of the premium is returned, as a reward, to those who make no claims).

The low switching rates in mature markets mean insurers need a clear customer strategy aligned with their overarching choice of scale versus specialization, coupled with retention initiatives. Customer segments can be defined not only by demographics, but also by customer needs, attitude towards insurance, and the 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; providers should focus on delivering personalized service to explain the product and answer questions. Insurers have shifted focus from individual products to customers, for whom they are bundling products like car and

home insurance. Some successful insurers have even realigned their operating model around specific segments (young drivers, or those aged 50 and older) in order to improve end-to-end execution. Other insurers meet distinct customer-segment needs with a common back end to capture the benefits of scale.

Retaining customers is a function of understanding what may prompt them to switch companies and making sure not to activate any of those triggers. There is a range of tools that 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. Some tools, however, are problematic. For instance, while direct debits tend to increase retention, they also tend to attract poorer-quality business. As for product bundles—for instance, linking mortgage and home-insurance sales—these seem destined to run into regulatory barriers in some markets.

Distribution: Online and Blurred Boundaries

Major shifts in product distribution are occurring. In the personal lines of insurance sold to consumers, the distribution shifts are driven by two key trends. The first is the move toward online channels. Globally, face-to-face sales remain the primary channel for insurance products; in the U.K. and Australia, however, call centers and Internet channels are becoming more dominant. Worldwide, there is burgeoning demand from customers to purchase products online, and not only to obtain quotes—a

trend that has fueled the growth of GEICO in the U.S. and other companies elsewhere.

The second trend, related to the first and most visible in the U.K., is the emergence of online aggregators. Aggregators have increased commoditization and reduced margins for insurers; most insurers have either wholeheartedly embraced them or avoided them. Those insurers that have welcomed the aggregators, by and large, have treated them as an outlet for cheap, no-frills policy offers that cost little to support. Some insurers, like Tesco Personal Finance Ltd., have even created their own branded aggregation services with more limited market coverage. Some insurers have made a choice not to work with online aggregators in any way, shape or form. Direct Line Insurance plc and Aviva are two examples; both have either refrained, or retreated altogether, from participating, instead choosing to reinforce their own brands and channels.

To make sure they are available through the channels their customers prefer, general insurers are looking at ways to improve what they do online, while balancing their investment in other direct channels and managing potential channel conflict. One challenge is that distribution represents only about 10 percent of most insurers' costs; therefore the opportunity to save money through online distribution is limited. It follows that insurers wishing to become the equivalent of a low-cost airline—doing in the insurance industry what Southwest Airlines has done in the U.S., what Ryanair has done in the U.K., or what Jetstar Airways has done in Australia—are

likely setting themselves up for disappointment. The example of other industries isn't easily transferable. What's needed is a complete redesign of the product offer and claims model.

The move online (both business-to-business and business-to-consumer) is also reshaping intermediated commercial and personal lines markets. New third-party players, including Bancassurers, car manufacturers, retailers, and mortgage brokers, are vying for position. Increasingly, there is a blurring of boundaries between manufacturers and distributors, which challenges traditional roles and how players compete. Large brokers like Aon Corporation have extended into risk management; re-insurers are offering a broader range of services. Insurers like Aviva in Europe and Wesfarmers Limited 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 intermediaries, rather than the consumer, as their customers. 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 planned for together: The practice of having different product people call on the same customer should be abandoned, or at least de-emphasized.

Growth: Targeting Emerging Markets

The online aggregators and Bancassurers are already having an impact on profit margins, especially in established markets,

and this is prompting many insurers to eye new geographic regions. Emerging economies, in particular the BRIC countries (Brazil, Russia, India, and China), are obvious possibilities for expansion.

Success in emerging markets, however, will require "know who" as well as "know how," a key point for insurers to consider as they make their initial international forays.

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 manufacturing to support different customer segments and channels. The trick is balancing the benefits of scale against clear business unit accountability.

Of course, there are pros and cons to any operating model. 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 to product and claims. A functional model can help capture economies of scale and expertise, but can reduce customer focus. In short, there are tradeoffs to any model. Our advice—based on years of years of research on organizational effectiveness—is to make sure all elements of

the model (decision rights, information flow, and incentives) align. It's vital that the structure serve the model, but that alone isn't sufficient to ensure success.

While many firms primarily focus on execution and on standardization of best practices, successful players will need to do more to deliver significant improvements in effectiveness and efficiency. Strategic operating decisions, (e.g., the choice of an IT platform, whether to outsource or even eliminate certain services, structural delivery decisions such as creation of a common back office) can deliver much more substantial benefits. In addition, in cases in which insurers have acquired assets or customer bases, it is important for them to manage the additional demand while also capturing the full value of the additional scale. This transformation will only be possible if insurers recognize they are entering a new era, and that streamlining their businesses is no longer optional. The pressure is real, and players who want to build sustainable and profitable futures will need to react quickly.

Next Steps: Inertia Is Not an Option

Insurers need to consider how they will respond and take a critical look at their entire business models. 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 priority: Does the insurer want to institute a rapid response to produce 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. The press has aimed much negative attention on the world's banks. However, now that 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, such as the state bailout of the life insurer AEGON Group in the Netherlands. The banks' example has taught us that once market confidence is shattered, even relatively healthy institutions can fall

victim to negative sentiment, and experience ratings downgrades and other painful consequences.

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

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