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Financial Services

The Cost House – a tailored toolkit to drive cost performance in insurers



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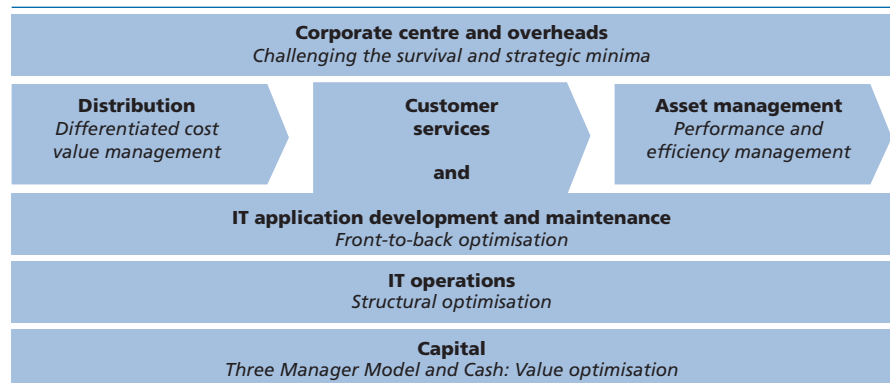
Introduction

Most insurers are now looking hard at their cost base, in the face of a weak economic outlook. In most cases insurers' cost programmes start well, directly and quickly taking cost out and improving the bottom line. However, experience shows that in many cases these programmes eventually disappoint. After early promise they result in too little cost being removed, a disproportionate impact in some areas compared to others, and over the next several years a progressive creeping-back of these costs.

We can see how this happens by considering a typical programme. It begins positively, taking a tool used successfully outside financial services, such as LEAN or Six Sigma, and applying it as a pilot to the area of the business which is best suited to it. The strong results of the pilot encourage a broader roll-out, often delivered by a distinct unit reporting to the COO, but then the same tool fails to deliver across the whole organisation. What worked in the pilot does not seem to work more broadly. The various parts of the business start quoting back benchmarks showing that they are already efficient. The momentum disappears from the programme, the cost management or Business Process Redesign unit stalls, and cost discipline starts to erode once more.

It does not have to be this way. Insurers can deliver sustained and deep reductions in their cost base, even those who are, according to process benchmarks, already efficient. Achieving this is not possible with a single tool: a "one size fits all" programme will not be successful across the whole organisation. For effective and persistent cost management insurers need to apply different approaches to different areas of cost. We distinguish between six areas of cost which acknowledge the different levers along the value chain and the different cost drivers in each area (Exhibit 1). In this article we briefly discuss each area, highlighting the right cost management tool to ensure insurers emerge from the current turbulent times alive, and moreover well placed for the future.

Exhibit 1: The insurance 'cost house'



1. Corporate centre and overheads – Challenge the survival and strategic minima

Under this heading we include all areas which are not a direct part of the operational running of the insurer, for example all management and governance functions, internal staff functions, and functional leads etc. While typically only a small share of total expenses, this is an important area to investigate, for two reasons. First, the way in which corporate centre and overhead costs are managed has a major signalling effect to the rest of the organisation and a strong indirect cost efficiency impact. Second, in our experience this area can be a significant source of duplication and complexity and hence it is possible to remove a significant proportion of the cost in this area with little impact on the organisation, as these areas naturally add activities over time, rarely reconsidering the cost-benefit of existing activities.

Our approach to managing corporate centre and overhead costs is based on the challenge of “survival and strategic minima”. This approach contrasts with traditional activity-value assessments, which often analyse overhead functions in excessive granularity without asking the fundamental question ‘what drives overhead costs in the first place?’ The “survival and strategic minima” framework is developed in three steps:

- First, we divide the overall roles into true corporate centre activities and other functions pursued such as real shared services, or stepping in for business units
- Second, we assess – together with the client – the absolute “survival” minimum organisation required for legal and governance reasons
- Third, having clearly described the initial survival minimum size we go on to identify value-adding investments to pursue and implement the strategy to then reach the “strategic” minimum size

Depending on the client cost efficiency aspiration, the guiding principles for the role of the centre and the overall business portfolio, we expect a 25%-40% reduction in corporate and overhead costs from this approach. Often there are also positive indirect effects, both cost reductions in other parts of the business (for example reduced reporting burden) and improvements from transparency, agility and entrepreneurial spirit.

2. Distribution costs – Focusing on return on investment

Distribution expenses are a major cost driver in insurance. Our focus for cost improvement is less on managing down variable commissions, which we see rather a factor of channel strategy, but much more on distribution overhead and fixed costs – i.e. all expenses to run an agent infrastructure and management, to run a bancassurance platform and/or to serve broker/IFA channels. Major cost components include distribution management staff, regional office and branch infrastructure, training and support investments, recruitment and communication support.

Aggressive cost actions in distribution can be fatal to business momentum. Even indirect distribution cost reductions, such as combining regional sales offices, have a number of knock-on effects such as travel time for agents, local brand presence, need for technology, etc. Despite this, many distribution organisations still largely apply one-dimensional approaches to infrastructure and regional market coverage, to the intensity of management and steering of sales staff or to the spending on training, support and marketing tools. The underlying philosophy is one of pushing sales staff towards a top-down target vision.

Our approach is investment-led: focusing spend on where the returns are largest. The guiding principle is therefore differentiation, because it is undifferentiated spending that is the root cause of high distribution fixed costs. By understanding the individual – and different – requirements and potentials on a granular level, we develop practical action plans that differentiate investments, e.g. by tailoring the coverage model to particular agents or brokers, by altering training programmes to individuals rather than to abstract career tracks, and by focusing investments in the highest potential sales regions.

The impact of our approach goes much beyond lower cost. Sales staff feel better understood and better supported. Regional market opportunities are better exploited and overall momentum is accelerated. These programmes are not easy – they involve significant change and strong management support. But the returns are worthwhile: across Europe, North America and Asia we have seen 20+% improved return on distribution investments through a combination of lower cost and higher productivity. To take one example, a redesign of a German salesforce involved a cut of more than 35% from sales overheads. Part of these savings were then used to fund a new professional advice process resulting in a 184% increase in advice activity.

3. Customer service and IT application development and maintenance – Rigorous front-to-back optimisation

A customer service operation and the IT Application Development and Maintenance (ADM) supporting it need to be treated as one unit in a cost reduction programme. Treating them as separate silos may lead to easy savings, for example cutting the project portfolio. But this is no more than deferred spending, and often deferral at a heavy price. Sustained and deep cost reduction requires structural change in what customer services and ADM together deliver, how they deliver, and to whom.

Delivering this structural change implies rigorous front-to-back optimisation. Instead of blindly applying benchmarks, our approach begins with a close look at each part of the operation in two lenses:

1. The competitive lens: where is value generated and what cost position can we afford versus competitors?
2. The customer lens: which customers are profitable and what drives the value created?

These two lenses result in a thorough view of which resources should be deployed against each business and customer segment and how. We then compare this to current resource deployment such that the changes required to the operating model and the strategically appropriate cost target are clear. Often this leads to large structural changes in the customer service and ADM operating model, which would be beyond the reach of a traditional silo approach. Whilst the outcome is specific to each insurer, some have used quite radical structures for example in the way they separate new and existing business in both customer service and ADM.

With a redesigned operating model and cost targets, our approach then uses different tools to implement in each part of the organisation:

- Process and IT re-engineering: e.g., LEAN Six Sigma initiatives, dematerialisation, etc.
- Organisational change: e.g., de-layering, introduction of shared service units, etc.
- Complexity reduction: e.g., service level unification, product portfolio reduction, etc.
- Strategic sourcing: e.g., outsourcing, offshoring, etc.

Depending on the starting point, our experience indicates that a fully-fledged programme should have an impact of 20 – 35% of the total targeted cost base. The biggest contributors are typically re-engineering and organisational re-design. For example, one of our clients delivered a \$10 BN impact over 3 years – rising to an annual cost reduction of \$4.6 BN through such a programme on a global scale.

4. Asset Management – Performance and efficiency management

Today's market environment is putting even greater pressure on insurer-owned asset managers to determine their *raison d'être* and whether they are in the manufacturing or the distribution business. Revenues from active management have suffered the 'double whammy' of fund outflows on top of falling market values. This is reinforcing a shift to low-cost indexation on the one hand, and a refocusing of active allocations towards real value-added areas on the other.

Typically insurers manage their assets at a cost of around 6-8bps, compared to a fund industry benchmark of 15bps. In most cases, over 60% of total asset management costs are driven by headcount, and 80% are in core functions. Therefore the cost base is quite directly targeted at delivering performance. Cutting costs risks weakening performance, so asset managers need to focus on overall value-added, not just on production cost. This implies a need to differentiate between different asset classes and investor classes in both the cost base and the target performance level.

Cutting costs in asset management is not about shaving X% from your workforce across the board. Rather, insurer-owned asset managers need to make bigger decisions about closing down whole activities. Indeed more and more are questioning whether manufacturing is something they really want to do at all. Even some of those who have decided to continue have switched either to indexation or where this is not possible (for example in unit linked products where insurers are typically offering an active product) to strategies such as an index core overlaid with some aggressive alpha.

To make the big decisions, asset managers need to consider two sources of value. Firstly, the financial value added which refers to the ability to manufacture funds at a lower cost than hiring an external manager to look after them. Secondly, the investment performance value added which measures the value creation through superior investment performance.

The outcome of such value analysis has different implications for different parts of insurers' asset management business. For example, one insurer with \$27 BN assets under management generated \$18 MM of value per annum by managing their fixed income portfolio in-house while they destroyed \$40 MM of value per annum on their global equity portfolio, through relatively weak performance. By outsourcing parts of the global equity proposition and up-skilling other parts, they were able to reduce cost and improve performance value-added.

5. IT operations – Structural optimisation

From a cost-effectiveness perspective, IT operations should be considered separately from the Applications Development and Maintenance part of IT. IT operations are not directly linked to the business and as such the ultimate goal should be to make them a commodity, delivering the appropriate level of service at the lowest possible cost. This is not to under-estimate the importance of this area: despite accounting for 45 – 60% of the overall IT cost base of a typical insurer, IT operations are often the “forgotten half”. Networks, PCs, printers, and data centres are often out of focus of business-led cost programmes, despite the significant cost saving potential.

To achieve a step-change in commoditisation, the programme must have two critical features. First, it has to look well beyond technology, for example into organisation and governance. Whilst technology is the basic enabler of commoditisation, pure technology-driven programmes often fail, as the current organisation and governance structures inhibit the necessary standardisation measures, or the current set-up of internal resources and external services limits the delivery of new services.

Second, the programme needs to be carefully staged to ensure early benefits. Some of the most valuable optimisation measures such as data centre consolidation or technical migrations away from exotic operation systems like GCOS or z/TPF require significant up-front investment – often more than 100% of the annual budget for steady state IT operations. Without a track record of success, IT operations optimisation programmes of this magnitude often fail as the business neither understands nor trusts the delivery. Exhibit 2 shows how a well-staged programme delivers benefits as it runs.

Exhibit 2: Overview of typical measures of a structural IT Operations optimisation programme

	Quick Wins	Rationalisation	Restructuring
Technology and architecture	<ul style="list-style-type: none"> Life-Cycle/Investment cycle optimisation Quantity adjustment 	<ul style="list-style-type: none"> Standardisation Complexity reduction Load optimisation (server, storage, space) 	<ul style="list-style-type: none"> Consolidation Server, Storage, WAN Architecture optimisation Virtualisation
Services, processes, organisation	<ul style="list-style-type: none"> Service Level adjustment Billing optimisation Licence and asset management 	<ul style="list-style-type: none"> Output adjustment Service differentiation Process optimisation 	<ul style="list-style-type: none"> Portfolio optimisation Optimisation demand management/governance Site optimisation and consolidation
Resources	<ul style="list-style-type: none"> Deployment optimisation Reduction of externals 	<ul style="list-style-type: none"> Wage adjustment Co-sourcing 	<ul style="list-style-type: none"> Spin-off Joint ventures Rightshoring
External services	<ul style="list-style-type: none"> Contract re-negotiation 	<ul style="list-style-type: none"> Out-tasking Co-sourcing Sourcing optimisation 	<ul style="list-style-type: none"> Outsourcing Offshoring
Savings potential (in % of annual budget)	5%	10-15%	20-30%
Invest need (in % of annual budget)	0-2%	5-30%	50-150%

In one example in a European insurer, the quick win and rationalisation stages alone delivered a 16% reduction in the IT operations cost base. On a benchmarking basis this insurer was already in the top quintile, with unit costs some 70% less than some peers; it seems unlikely that a conventional top-down approach would have delivered more than a symbolic contribution.

6. Capital – Three Manager Model and Cash: Value optimisation

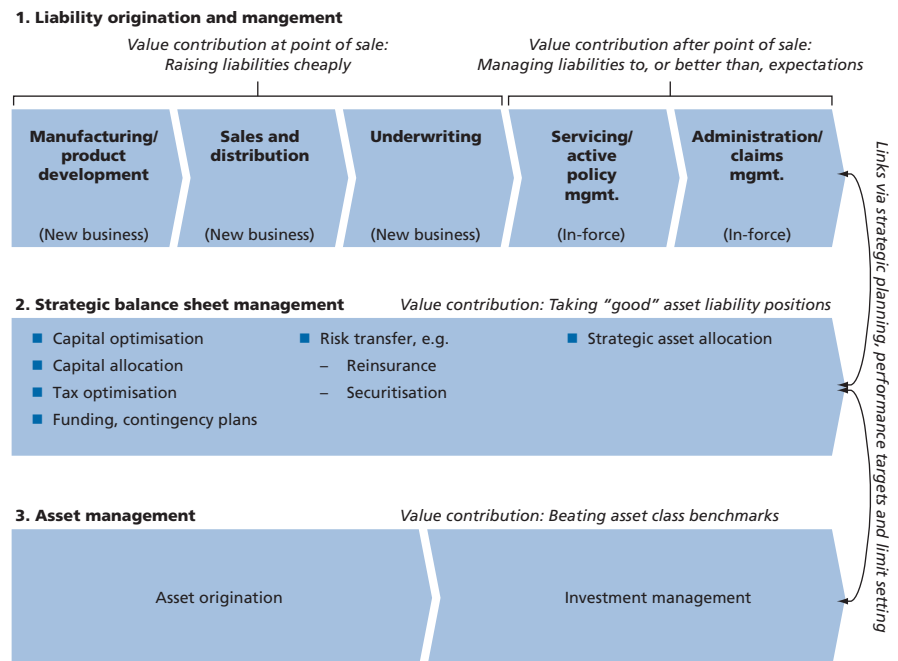
Capital efficiency is not typically part of a cost efficiency programme. We think it should be: Effective management of the capital base can deliver significant benefits to shareholders, and reduce the risk that costs are cut too deeply, to compensate for weak capital management. Our approach is two-fold:

- Re-consider the risk-taking activities of the business: Insurers need to understand how they take risks and the value they earn on the capital backing these risks. Oliver Wyman uses the “three manager model” (Exhibit 3) to recognise that insurers generate value in three distinct ways: liability origination and management,

strategic balance sheet management and asset management. There are different ways to implement such a model; more important than the organisational structure is the transparency of capital generation and usage from each part of the business. Once implemented, the three manager model can be the catalyst for an ongoing programme of capital efficiency, including tighter asset liability management, better use of reinsurance, and reduced capital wastage.

Exhibit 3: Example of the three manager model in life insurance

Life insurer value generation split across three internal companies



- Reduce inefficiency in the types of capital in the business, for example by driving cash to the centre and redeploying it productively. This involves three steps: firstly, determine where the cash is, and why it is there; secondly, understand how to unlock or accelerate that cash; and thirdly, make informed deployment versus payout decisions. For example, one global life insurance group identified their largest pockets of potential cash trapped on their balance sheet in various country units; and then evaluated a shortlist of alternatives to free it up, including an interest rate macro-hedge and internal reinsurance. This created for them a prioritisation of sources of cash based on size and potential speed of mobilisation, which they could execute in the context of their overall capital optimisation programme.

An optimum capital programme will use both approaches in conjunction. The first is structural and strategic, helping the insurer focus capital on value-adding activities. The second is

operational and tactical, helping to deliver real capital reduction from reassigned activities. The impact of such a programme depends on the point of departure, but in our experience reductions of 20-50% in the total cost of capital are possible with life insurers; generally less than that in P&C.

Conclusion

Traditional approaches to cost reduction in the insurance sector are ultimately timid. They treat the organisation like a ship that every few years needs to go into dry dock and have the barnacles shaved off. They accept as inevitable that once the ship is refloated more barnacles will attach over time.

Advanced thinking doesn't accept this. Most insurance companies have been through barnacle-shaving cost reduction programmes and been disappointed with the medium term results. Now they are looking for cost reduction in places and in ways that design the hull so that barnacles don't attach.

Such cost reduction is not easy. There is no single best tool, and sometimes 'headline' programmes are little more than headlines: they fail to deliver significant and sustained cost reduction throughout the business. A headline programme is a good idea – cost reduction needs sponsorship at the top of the organisation. But the programme needs to be supported by a comprehensive toolkit, and the right balance between activity benchmarks and re-structuring. Finally, the programme needs an ambition worthy of the headline: a transformation of the cost base which stands the test of time, and which has no 'dark corners' where the tool-kit doesn't reach.

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