CAVENDI MANAGEMENT INSIGHT

Why expense focus is the most valid route to short-term value creation for Swedish non-life insurers

Cavendi
MANAGEMENT CONSULTING

"Beware of little expenses. A small leak will sink a great ship"

Benjamin Franklin

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Setting the scene

The fundamentals of the non-life insurance industry make it significantly more stable compared to the life insurance industry, which is illustrated by relatively stable earnings from year to year. As one would expect from a mature industry, non-life profitability, in terms of return on equity, typically fluctuates around cost of capital, i.e. non-life insurance must be treated as a long-term value case and not a short-term growth case.

Nevertheless, profitability in non-life insurance is very reliant on the capital market environment, as investment income makes up a much larger portion of the pre-tax profit than the technical result in mature insurance markets.

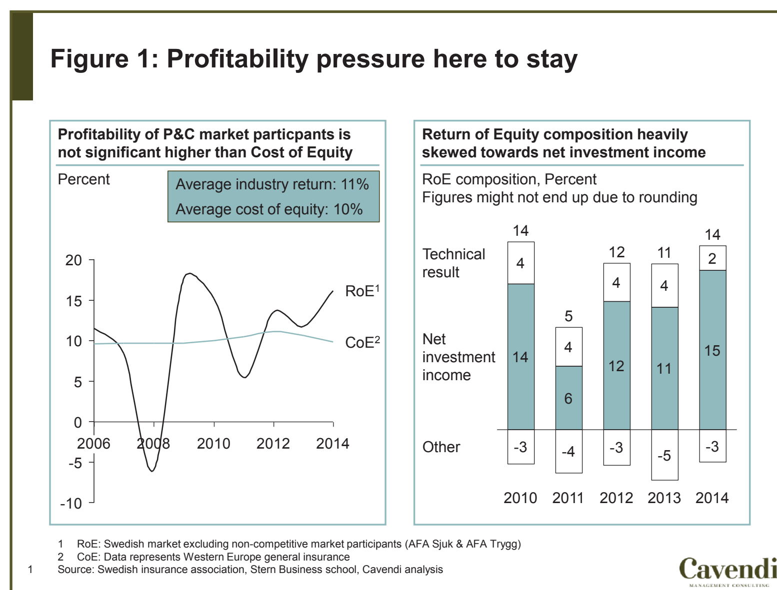

Figure 1: Profitability pressure here to stay

The underwriting operations are, besides being the other fundamental value driver of non-life insurance profitability, the cushion that dampens insurers losses during bust cycles.

The current market fundamentals are characterized by a toxic mix of a low interest rates, higher price consciousness fueled by transparency and increasing complexity driven by regulation, together with a simultaneous need to deal with aging IT infrastructure and a structural lack of growth perspectives – all of which makes keeping the underwriting result high challenging, to say the least.

To conclude, having sound, balanced and profitable underwriting operations is, besides being the fundamental enabler in acquiring investable assets in the first place, paramount in terms of parry poor investment cycles, hence protecting the equity in the balance sheet.

The starting point in Sweden

Even if the Scandinavian non-life markets are often referred to as some of the most cost efficient in the world in terms of operations, the Swedish market participants' performance is relatively polarized due to the high proportion of mutuals in the market, in which the demand for bottom line result and expected return on capital is lower.

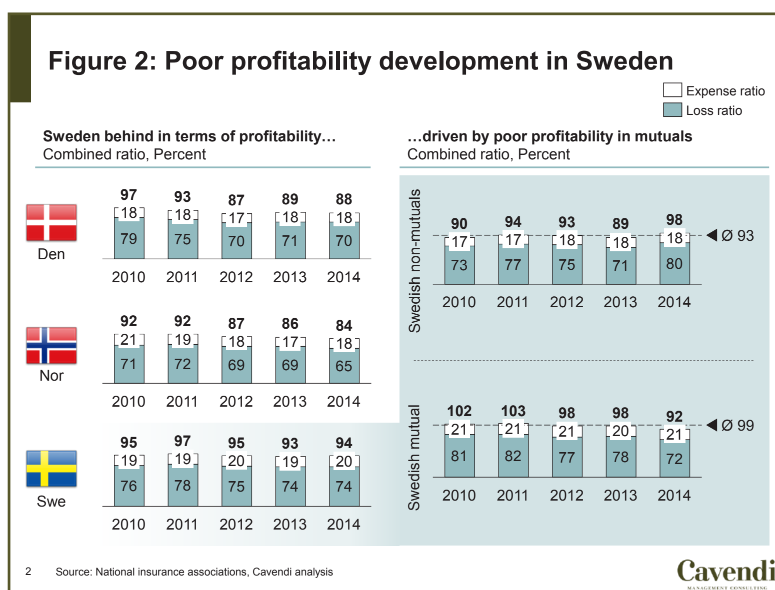

Figure 2: Poor profitability development in Sweden

Historically, value adding insurers in Sweden have generally needed at least 15% RoE to honor their capital obligations to investors. This tends to translate into about 85-95% in combined ratio depending on balance sheet characteristics (investment return expectations) where a higher share of risk-carrying assets would increase the expected return and vice versa.

Since indemnity costs are, by definition, volatile and the fact that loss ratios got stuck at 70-75% levels somewhere in the mid 2000's, structural improvements in this direction have proven to be challenging – expense actions increasingly clearly emerge as the remaining natural source of improvement.

Limited impact so far – IT & other support costs rapidly increasing at the expense of the core business and customer interaction

Swedish non-life insurers, like their international counterparts, are in a transformation mode and are trying to future proof their business and operating models. To fund this, most insurers are therefore actively promoting some kind of efficiency agenda, and have done so for years.

Unfortunately, looking at the Swedish industry's expense ratio as a whole, these savings are not being materialized through an improved bottom line[1], on the contrary, since new expenses seem to be constantly emerging and offsetting old cost savings. Two things in particular are driving this phenomenon:

- IT infrastructure investments not delivering on business case, i.e. process efficiency is much harder to obtain than expected
- Increased level of complexity driven by legislation ramp-up

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[1] Statistics suggest expense ratio levels have not improved materially on the short-term basis since distortions from new initiatives are impossible to clean out from available data. Historically, on a very long-term basis (+10 years) it is possible to identify structural improvements

The fact that many insurers are failing to materialize stated business case efficiency gains on their huge IT investments is worrying in the first place. Furthermore, Cavendi has analyzed detailed expense data for a large number of insurers and outcomes suggest that insurers tend to be ramping up costs as well as staff in support functions at the expense of the core business – a development for the customer value that could be called to question.

This development can be seen when analyzing the relative trend in cost associated to customer facing units, such as sales- or claims-focused call centers, and comparing this to the more administrative OH units.

In the customer facing units, the expense ratios have, over the last five-year period decreased by one to five percentage points, while the OH costs have escalated by over ten percentage points over the same time period.

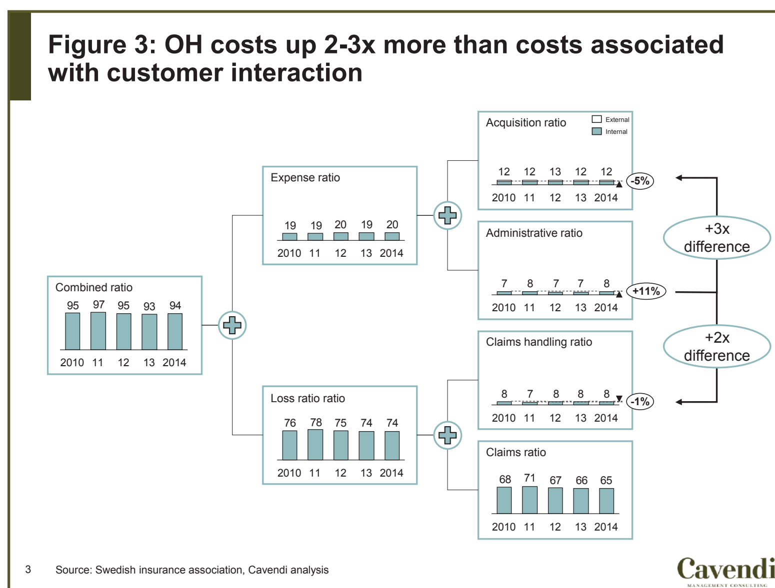

Figure 3: OH cost up 2-3x more than costs associated with customer interaction

Sourcing efficiency gains from the core business units that maintain the primary link to customers is of course not ideal from a customer or management standpoint. An adaptation to online self-service solutions fronting the customer is just part of the solution. Additional reasons as to why this is happening on a broader scale varies of course from company to company, but observations of a wide range of insurers suggest three major drivers:

- The core business units have significantly more efficiency knowledge and experience of how to execute savings than the rest of the organization, hence they finance the growth of general overhead costs
- Cost cutting is easier at 'the organizational base' where managers with budget responsibility and affected staff have limited interactions, i.e. the situation in parts of the organization characterized by multiple layers of staff such as large call centers etc
- IT expenditure outside core investments is being allowed to grow disproportionately, hence offsetting by far any smaller efficiency initiatives that do exist within OH functions[2]

[2] The insurance industry is experiencing a paradigm shift where investments in Digitalization and 'Big Data' are instrumental to continued success. However, these core software investment programs (application development) are normally a relatively small portion of the overall IT operational expenditure budget, where software service and updates (application maintenance and application enhancement) and business as usual running costs (infrastructure etc.) constitute the absolute bulk of the costs.

Similar players operating similar products with huge cost differences

A closer drill down at two isolated classes of business in the market suggests a wide span of costs. For the two largest retail product classes, Motor and House & Content, both serving as the main customer entry product for many insurers the cost situation for the insurers varies considerably.

In Motor, the high mark market participant has more than double the associated operational costs than the best performing market participant.

In House & Content the span is less, however there is still a factor 1.6 between the best- and worst performing market participants.

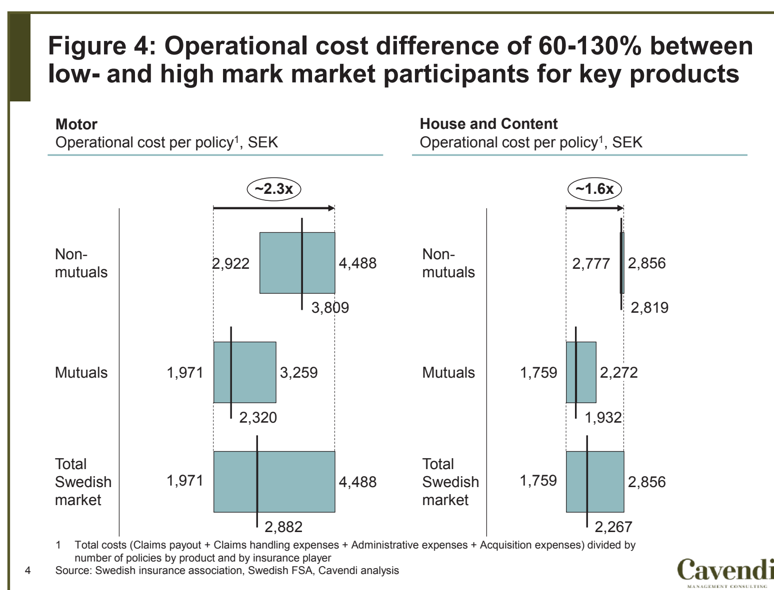

Figure 4: Operational cost difference of 60-130% between low- and high mark market participants for key products

The chosen customer segments and distribution setup is often assumed to make up for the majority or, at least, a large portion of any profitability difference. A drill down in player's profit and loss accounting does however not reveal significant differences in costs between the dominant channels, hence it does not constitute a fully explanatory power for such a wide cost range.[3]

Also, bearing in mind the fact that the underlying risks for these product classes are very diversified and assumed to be evenly spread across the sample, and the relative uniformity of both size[4] and business models[5] of the players in the sample, there is a reason to strongly believe that the absolute cost structure directly controlled by management is much more important than traditional explanatory factors, e.g. distribution models or economies of scale.

This holds true also when benchmarking demutualized and mutual insurers separate.

[3] Share of internal acquisition costs constitutes only about 30% of the overall expense base for an insurer, hence allocation of other costs is more important than channel mix for the overall expense ratio

[4] Top four players each hold more than 1 million policies in Motor and well above 0.5 million policies in House & Content

[5] Most players in the market offer a full product range, a multichannel distribution model and rely on one core entry product, which is the base for cross selling

What does it take to get oneself out of a profitability mismatch?

An insurer has in principle four levers to pull to improve the operational combined ratio over an foreseeable time period:

- *Organic growth:* Growth in exposure with same or very similar business mix[6]
- *Rates:* Price increases on renewed business
- *Net incurred claims costs:* Reduction in net incurred claims across all classes of claims
- *Expense reduction:* Reduction of all expenses impacting the result – directly owned & allocations

Cavendi has scrutinized the effort needed to reach a three (3) percentage point improvement in the combined ratio for three types of hypothetical players in the Swedish non-life industry:

- The average insurer
- The average demutualized insurer
- The average mutual insurer

The takeaway is clear – rate actions and efficiency measures are superior to organic growth for all company types, with a factor five to seven, which implies five to seven (5-7) units (SEK) of growth are needed to offset one (1) unit of efficiency. This holds true for all company types even if it is tougher for public players to reach the target relative mutual ones, which suggests that public players are leaner from the start.

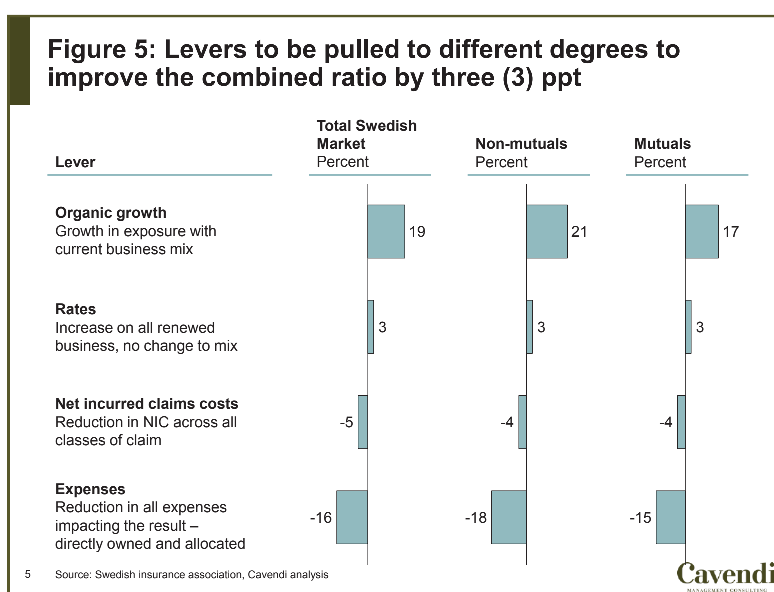

Figure 5: Levers to be pulled to different degrees to improve the combined ratio by three (3) percentage points

The fact that *organic growth*, hence size, is of limited importance for short/mid term profitability for a non-life player also holds true when analyzing other simpler ratios, e.g. costs per GWP through a scale curve[7]. On drilling deeper into this matter, initial findings suggest that classic economics of scale thinking is only valid in a few areas, e.g. policy issuance and asset management etc. but seems to be absent in most areas. The likely explanation lies in the high share of variable costs insurers carry thus making organic growth expensive, aside of the fact that it is hard to obtain.

Rates on the other hand, cost nothing and improve the top line and make a contribution to covering fixed expenses. Obviously, the problematic flipside of rate indexation is the increasing level of transparency fueled by digitalization and the fact that this weapon can only be used once a year.

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[6] Focused growth is almost always only relevant for parts of the company and subsequently has limited overall impact on the overall top line, hence only possible on paper for foreseeable time periods

[7] The fundamental principles of value creation show value is driven by expected cash flows. Cash flow, in turn, is driven by expected returns on capital and growth. Hence, in a long term perspective, growth also needs to be treated as paramount

Reducing *net incurred claims costs* normally means paying claims suppliers less (successfully fighting claims inflation) or customers less (adjusting terms and conditions). Ideally this can be done by being better at technical risk selection, hence better tariffs and underwriting processes. The 'Big Data' evolution will potentially improve this over time, but this lever is unarguably dependent on the historic customer base and significant up front investments in data analytics and IT software.

What remains is the only fully controllable lever – *expenses*. This lever holds all costs linked to both personnel and non-personnel and is the action with the most reliable result.

Where lies the opportunity for expense reduction?

A non-life insurer has an expense base usually consisting of five major buckets

- Wages and other compensation to employees (50-70%)
- IT expenses (incl. depreciation and IT consultancy costs) (10-30%)
- Marketing expenditure (including advertising consultancy) (5-10%)
- Premises & Facility Management (~5%)
- Other items (~10%)

By targeting one or several of the cost buckets above to different extents, there are obviously numerous possibilities to improve profitability. The various approaches all have different means, convey different levels of impact (in both time and money) and cause different levels of distortion to the organization, hence also to the business.

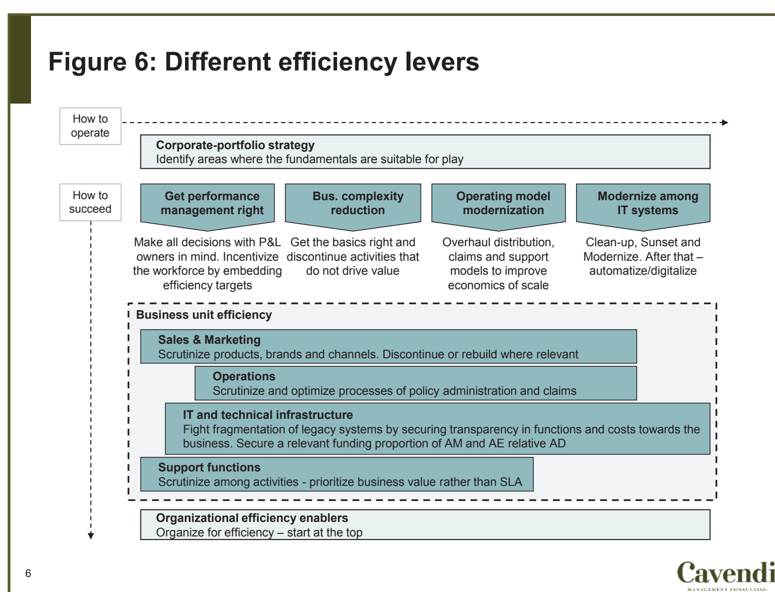

Figure 6: Different efficiency levers

We consistently see that the biggest expense reduction opportunity is to reduce complexity in operations, and that preferably this should be assessed prior to any other expense actions, such as distribution model improvement or performance management etc. Reduction of complexity means getting the basics right and discontinuing activities that do not drive value, all under limited business disruption. For optimal effect, this should principally be executed simultaneously within two dimensions:

1. Organizational effectiveness (personnel costs)
2. Operational effectiveness (non-personnel costs and processes)

For both the organizational and the operational processes and their (in)effectiveness, i.e. their corresponding (often too high) costs, there seldom tends to be one or a few explanatory factors that drive costs out of the budget comfort zone.

Instead, inefficiencies tend to start in a series of minor errors in various unprioritized processes, solved by simple manual overriding. However, when smaller errors bulk up over time, this tends to create an increasingly greater burden for the organization. A common short-term solution for such problems is to extend the organization or construct temporary workaround processes rather than deal with the core issue. The problematic consequence of not addressing the core issue is therefore swelling organizations and inefficient ways of working within units and departments.

Hence, there is almost never a silver bullet to fire to improve effectiveness, i.e. it is almost impossible for management to execute a few smaller targeted changes and simultaneously reach big profitability impact. Instead, and to reach sustainable impact, a substantial amount of smaller improvements is usually needed through a structured program.

This is particularly relevant in support functions (service level agreement adaption) and IT (infrastructure modernization or sunsetting of legacy systems), where an adaption to a lower service level agreement often implies a savings potential that exceeds 15% with limited impact on the business lines.

What is important to consider during execution

Regardless of the desire to drive expense reduction, i.e. price your products or services more competitively, improve financial performance or better serve your customer (stop processes that drive complexity), it is not only important to attack the problem in a structured manner but even more important is to do so with an objective mindset.

What tends to work:

- Critically assess the entire cost mass and **understand which parts that generate value** and focus on the parts that do not (i.e. 'good costs' vs 'bad costs')
- **Concentrate on areas where there is significant potential** – take on the big ticket items first ('quick wins' seldom create material impact)
- **View all departments objectively** – scrutinize top and middle management 'I just need… - requests' and 'business threats' carefully
- **Swift execution all the way through** – plan sufficiently, communicate clearly and execute swiftly
- Ideally, **make cuts when you can, not when you have to!**

What tends to fail:

- Reducing costs **without understanding the big picture** and how cost cutting can impact employee and/or customer satisfaction as well as loyalty (i.e. unable to see the difference between 'good costs' and 'bad costs')
- **Executing non sustainable cost reductions –** if costs are easy to get rid of, they tend to be back sooner rather than later
- **Giving all departments an 'equal' target** of e.g. 10% is a very imprecise way of execution and tends to miss the mark
- Leaving too **large unallocated gaps** in plan – things seldom end up exactly as planned, hence planning for the exact target or slightly below target is often unsuccessful
- Underestimating the need for **honest communication** – not revealing or smoothing over the original intentions often tends to backfire
- **Underestimating the understanding** for tough business decisions at stakeholder level

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Jan has more than 20 years of consulting experience and heads Cavendi Management Consulting since 2016.

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