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Shifting cost curves to stay in the commercial insurance race

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Despite ongoing efforts to cut costs, US commercial lines loss adjusted expense and underwriting expense ratios have not improved over the last 20 years. Over two-fifths of every dollar of U.S. commercial lines premium collected is used not to pay claims but to fund loss adjustment, commissions and brokerage, and underwriting expenses (source: S&P Global Market Intelligence data and PwC Analysis). New regulatory burdens and requirements for better service, among other factors, have negated any efficiency gains from technology investments. However, we expect that today's market environment is forcing a shift, and that a more strategic approach to cost management will become an imperative for growth in 2018 and beyond.

It's becoming harder and harder to sustain the same returns as in the past. Insurers are facing pressure on both sides of the balance sheet. Coming off multiple years of soft market pricing and a string of catastrophes in 2017, underwriting margins are being squeezed and reserves depleted. Looking forward, any market hardening is likely to be moderate and short-lived, given advancements in data and analytics and flow of capital toward industry opportunities. At the same time, investment returns are at historic lows. Accordingly, a fresh look at costs is an obvious path to improve returns.

Although a cost advantage has not driven commercial lines performance to date, times have changed.

Technology has now advanced enough that significant productivity gains can result from digitizing and leveraging information assets. Over the past year, enabling technologies such as cloud, artificial intelligence, and robotics have continued to mature. They are no longer "innovative," but tested and proven mechanisms. These technologies help attack the expense problem much more efficiently and at a lower cost than five years ago, and with the help of InsurTech firms that offer point solutions, they no longer depend on core transformation and in-house development to yield results.

With companies already feeling pressure to shift cost curves, **tax reform** further increases the impetus and opportunity to think differently about operating models. In particular, companies will have to make key decisions on existing and new businesses, reinsurance arrangements, investment opportunities, products and services, systems and technology, and employee compensation considering the tax implications. For example, companies will want to evaluate operations in US states and non-domestic jurisdictions to determine strategy for where employees are located, where revenue is accrued, and from where items are sourced. Multinational insurance companies may have significantly more earnings onshore given the US mandatory tax on foreign earnings, and a lower corporate tax rate will make domestic investment more attractive. Additionally, with more cash onshore and the lower tax rate, companies may want to look at how **acquisitions** can advance their strategies. Tax reform also may drive changes to structure, valuation, and timing of acquisitions, dispositions, and alliances. Given the level of change, tax implications can both spur action and uncover cost-saving opportunities.

Challenges vary by segment

At the highest level, the commercial lines market consists of 1) small to mid-sized companies needing standard products (e.g., property, auto, general liability, workers' compensation), 2) large companies with more complex needs and program structures (e.g., self-insured retentions, captives, reinsurance), and 3) companies with high-hazard/specialty risks with customized product needs. Commercial insurers face different challenges to remain profitable and grow in each of these segments, and expense management tactics vary accordingly.

In the personal lines market, an expense ratio advantage typically provides a sustainable competitive advantage (i.e., those with the lowest expense ratios grow the fastest). The small to mid-sized standard market is increasingly going the way of personal lines. A heightened demand for a streamlined agent and customer experience coupled with a larger focus on price means insurers have to focus on efficiency and simplification to remain competitive. Those that do this well will more easily steal share.

On the other end of the spectrum, clients with large or high-hazard/specialized risks continue to demand high touch service and customized underwriting and claims solutions to meet their needs. Insurers in these markets must balance efficiency improvements to reduce cost to serve against the need to deliver the "last mile of service" to a specific location, whether a handshake at New York headquarters or a truckload of generators and plywood to keep operations going after a storm in Oklahoma. Larger clients also may demand higher touch on financial analysis to support their own reserving and reinsurance needs.

Insurers in multiple segments must consider the intricacies of each business segment while leveraging scale and national presence across all of them. This makes cost optimization more complex than it first appears. To add to the complexity, the demand for simplicity and efficiency is increasingly moving up-market while the demand for customized service is moving down-market, blurring the lines between segment needs.

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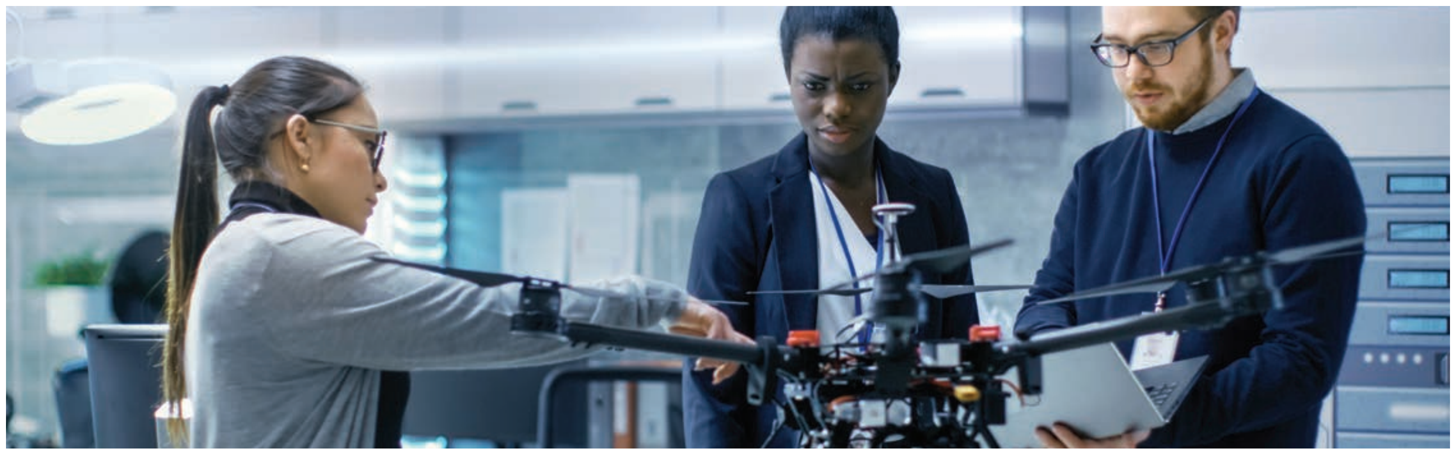
Strategic Cost Management Tactics

Cost management is not a new phenomenon. Our research shows that 75 percent of insurers have undertaken cost cutting programs in the last three years[1] and 61 percent of insurance CEO's plan to launch cost reduction initiatives this year alone[2]. However, while many insurers have cost management on their agendas, few are achieving sustainable cost savings. While most have tackled the basics when it comes to process design and efficiency, business complexity (often driven by a desire to be infinitely flexible and meet a wide range of needs) and fragmented technology environments can get in the way. Furthermore, when cost cutting efforts do not tackle strategic and structural issues or address required cultural changes within the company, costs tend to creep back up as focus fades.

What should commercial lines insurers do?

1. Don't try to shrink your way to greatness.

Driving toward the lowest possible expense ratio is not the key to long-term success. Underwriting is still king and likely always will be; you cannot sacrifice your underwriting prowess in favor of stringent cost reduction tactics or policies. Acquiring and developing strong underwriting talent and having appropriate data, analytics, and governance to guide decision-making are fundamental to strong performance. Investments in these areas may be necessary to keep pace: if they stall for the sake of cost management, there could be bigger profitability challenges down the road. For example, no-touch underwriting and processing in the small to middle market space requires appropriate a) data quality, accessibility, and monitoring mechanisms to govern what is on the books and b) speed-to-market (in terms of decision-making and system change processes) to adjust to market changes. In the large commercial and specialty segments, careful operating model design is essential to align proper expertise to relevant risks at the right time.



That said, costs can be shifted from fixed to variable in order to a) align more closely with the size of the business and b) provide necessary market agility. Partnerships with MGAs can enable quick stand-up of new underwriting operations (with appropriate underwriting expertise) without having to build them from the ground up. This also allows for a quick exit if the new endeavor isn't profitable. In addition, shifting low-value work to lower cost resources (e.g., from underwriting experts to processing centers) makes it easier to hire and train for these activities when scaling up for growth in a given area or repurposing FTEs to other areas when exiting.

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1 https://www.pwc.com/us/en/insurance/publications/assets/pwc-fit-for-growth-insurance-survey.pdf

2 https://www.pwc.com/gx/en/ceo-survey/2017/industries/pwc-ceo-20th-survey-report-2017-insurance.pdf

2. Manage costs for the enterprise, not one function

Insurers should approach cost management at the enterprise level, setting targets for the organization and challenging the business units and functions to work together to identify opportunities to hit them. When tackled function by function, cuts may be made at the expense of other functions, thereby cutting capabilities others need to perform well (e.g., eliminating required fields at the first notice of loss may impact the granularity and timeliness of underwriting analysis), or simply shifting costs from one area to another (e.g., eliminating information gathering in the underwriting process means processing will have to do it, likely resulting in inefficient back-and-forth when gathering information). Additionally, changes in one area may be justified by cost savings in others (e.g., removing a coverage option simplifies both the billing and claims handling). Lastly, success in one area has potential benefit elsewhere in the organization (e.g., RPA in processing also could apply to claims). Fostering collaboration across the enterprise (and even incorporating feedback from distributors and customers) can uncover new insights and opportunities, as well as promote the cultural shift that sustains a cost-focused mindset.

3. Cut features and services, not just costs

Choosing where not to invest can be difficult; defining a strategic "way-to-play" is the first step to understand which products, services, channels, and/or capabilities can be eliminated to better manage costs. For example, continuing to support legacy products and features (e.g., pay plans) can add significant complexity to an insurer's operating environment, which adds cost and can stall efforts to upgrade platforms or add new features for future products. Choosing to transition existing customers to the latest products and features (or even exit certain markets) can be difficult, but it can be the right move to unlock growth, profitability, and cost savings across the rest of the portfolio.

Customer segmentation also can help insurers determine where to invest and what to cut. Not all customers require the same level of risk analysis and customer service and identifying which segments are currently overserved can help align cost with customer value. For example, underwriting reviews could be triggered by changes in risk exposure rather than annual or once-every-three year reviews. Loss control visits could vary by industry, size, and length of relationship. Distributor service levels (e.g., turn-around times, quote negotiations) could be tailored to the value of the relationship. Taking a closer look at customer and distributor needs and value can help cut costs without sacrificing revenue or profitability.

4. Put new technologies front and center

When it comes to cost cutting, the traditional levers have not changed. Commissions, headcount, and IT remain significant areas of spend for insurance companies. However, there are innovative ways to reduce these costs. Offering certain value-added services to agents (e.g., taking on servicing) can indirectly bring down commission expense, artificial intelligence and robotics offer new ways to reduce headcount, and the cloud lowers IT costs and enables a more variable "pay-as-you-go" model.

Too often, cost management efforts that focus on immediate savings put new technologies in a "parking lot," treating them as a future-state opportunity that will take significant up-front investment for questionable down-the-road benefits. However, immediate benefits are now readily available. Many insurers are partnering with InsurTech companies to quickly enhance their capabilities and realize long term savings. Moreover, new technological capabilities are leading insurers to rethink their broader business models.

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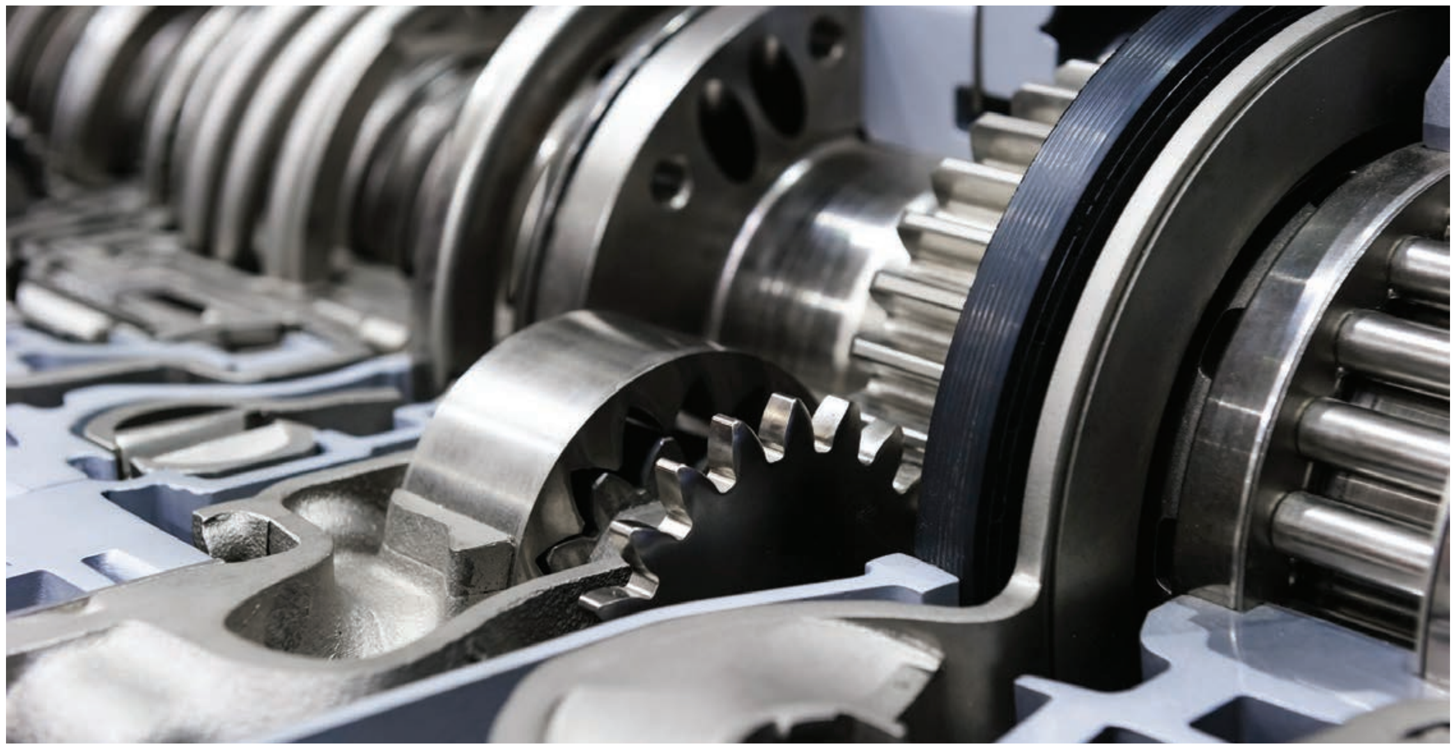
Implications

- Although a cost advantage has not driven commercial lines performance to date, times have changed.
- In the short-term, cutting costs will help insurers fund strategic initiatives that better position them for growth and profitability in their target markets.
- In the mid-to-long term, insurers with a sustainable cost advantage empowered by efficient operations and a flexible cost structure will be able to compete more aggressively on both price and service and have the flexibility to allocate capital to the most promising market opportunities.



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