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Time to Stretch Those Alligator Arms

The Changing Landscape of Strategic Cost Management for Insurers

By Christopher McGrath
October 22, 2009

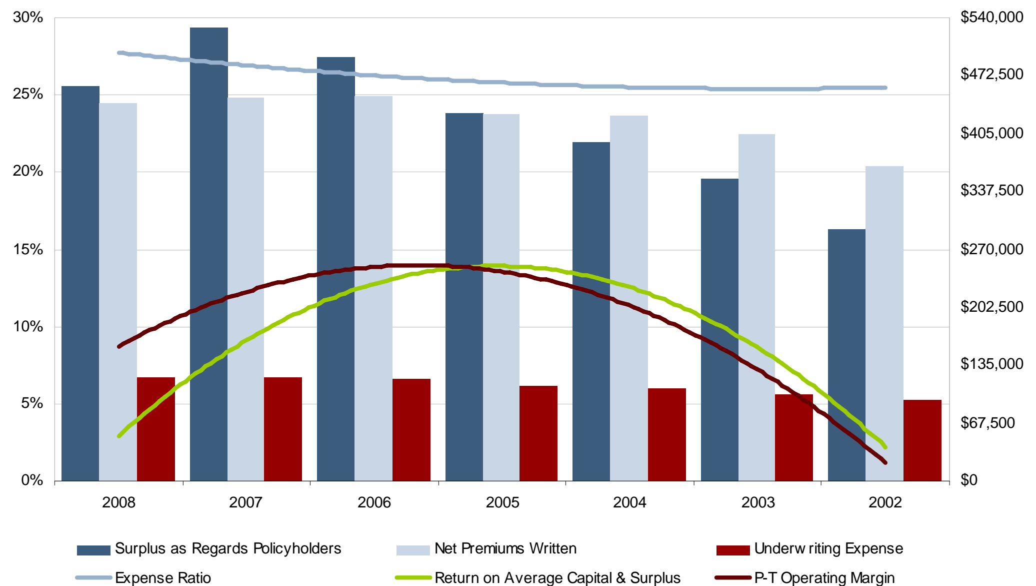
The global financial crisis of 2008 - 2009 has spurred a renewed focus on operational efficiency and Enterprise Risk Management (ERM) not only for (re)insurers but for all organizations. With companies facing the toughest market conditions and economic climate since the Great Depression, challenges and questions loom around every corner. The turmoil we have experienced, and continue to encounter, coupled with an abundance of new and proposed regulatory reforms, presents firms with daunting challenges - and *significant opportunities.*

KEY DRIVERS OF STRATEGIC COST MANAGEMENT

It is in grueling times such as these that organizations with a clear strategy can seize upon market dislocation and take advantage of opportunities to enhance enterprise value, grow market share, improve policyholder satisfaction and retention and set themselves apart from their peers. Organizations are now faced with a spate of changes and reforms, which forces management to juggle various initiatives. There are conflicting calls on management's time and resources from many internal and external stakeholders (many of whom themselves have conflicting priorities and concerns), which is further accentuated by the media.

Insurers face a myriad of harsh conditions in this new business landscape – the primary rate environment remains challenging, reinsurance costs are increasing, investment income is significantly reduced (albeit, recovering), balance sheets have weakened and combined ratios have crept back above 100%. This has resulted in many experiencing tremendous capital constraints while operating at reduced margins.

Exhibit 1:
P&C Industry Aggregate Data



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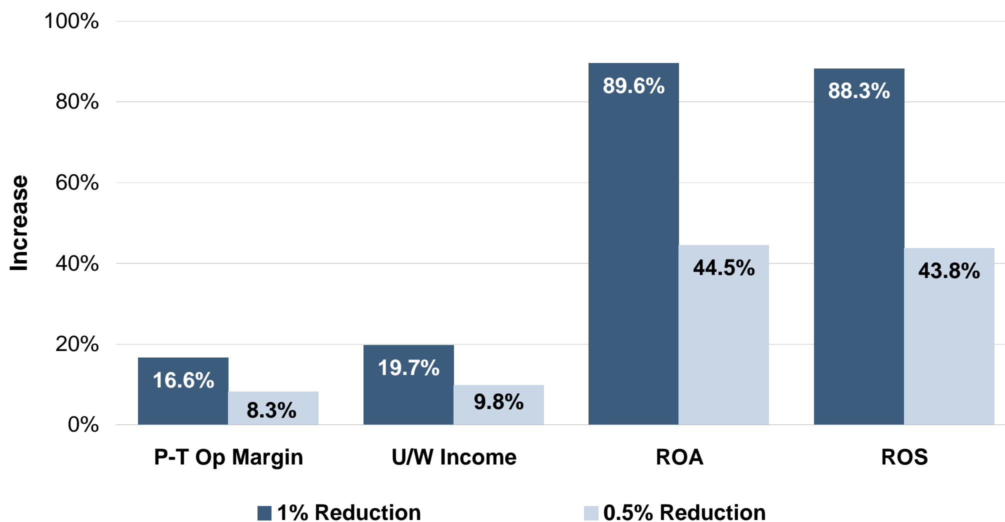
As depicted in Exhibit 1, while surplus and premiums grew steadily from 2002-2007, at 23% and 81%, respectively, that trend was reversed in 2008 with a 2% decrease in premiums and a 13% loss of capital. At the same time, industry expenses have increased on a nominal level from 2002-2008 by 28%, resulting in a 1.8 point increase (or 7%) to the expense ratio. Taken together, this has caused volatility in both returns on surplus and pre-tax operating margins. Historically, (re)insurers have been less focused on expenses and more focused on analyzing losses and exposures and managing the "top line" through the cycle. However, this is changing as organizations face-up to the new business landscape. Expenses are the one variable that can be **controlled**. Losses and exposures, on the other hand, can be mitigated through various means but they cannot ever be completely regulated; we know the ground will always shake, the wind will always blow, accidents/law suits will happen and losses will be incurred.

Therefore, strategic cost management should garner equal footing with loss/exposure management within the underwriting process. This would ensure that premium revenues, loss costs and expenses would all be addressed strategically. It would allow for deeper dives into productivity, performance, capital allocation, profit margins (by LOB, geography, etc) and resource distribution.

To gain a bit of perspective on the impact strategic cost management can have on your organization, consider this: a 1% reduction to the Industry Aggregate's expense ratio (reinvested in underwriting at a 1.5:1.0 leverage ratio) would decrease expenses by over $2.5 billion and increase underwriting income by over $4.0 billion. It would improve pre-tax operating margins by over 15% and returns on assets and surplus by over 85% each. These savings can continue to be reinvested in the company and compounded year over year or they can be translated into policyholder savings. If the later path is chosen, one could then extrapolate the benefits this would have on customer satisfaction and policyholder retention.



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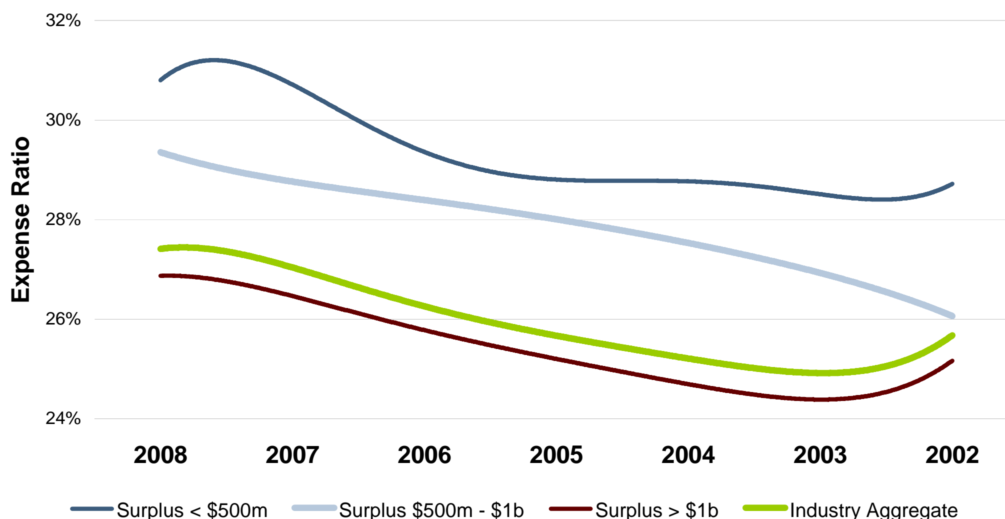
FOCUS ON (RE)INSURER EXPENSES

- For (re)insurers, the expense ratio represents nearly **one-third of underwriting results**, yet is often ignored, or at a minimum, not managed with the same perceived precision as the loss ratio
- Typical **ERM** programs focus solely on loss and exposure management, but fail to delve into expenses and compensation in a meaningful fashion
- **Non-compensation expenses** comprise **over 60%** of the expense ratio - simple changes to existing practices can often yield significant dollar savings
- As Exhibit 2 demonstrates, **size of surplus** – or economies of scale/lack thereof – can have a real effect on an insurer's expense ratio. (Re)insurers with surplus amounts below $500 million have expense ratios, on average, 15% (4 ER points) higher than companies with surplus in excess of $1 billion.

Exhibit 2:
Expense Ratio by Surplus Size



- There is a **wealth of data** available within the (re)insurance industry (multiple statutory and SEC filings, rating agency reports, etc), which is coupled with a **lack of valuable**, granular **analysis**. Public data, while directionally useful, lacks the details required to make true apples-to-apples comparisons and there isn't any one holistic way to look at the interrelationships between accounts.

Initial instinct may lead overzealous management teams towards a "slash and burn" mentality of simply cutting the 'perceived fat' to garner short-term benefits at the expense of long-term returns. But failure to make strategic adjustments that includes both short- and long-term analyses can cause more harm than good. Strategic cost management enables leadership to cut excess in one area while redeploying those savings to other, more profitable ventures, even if that means *increasing* overall expenses. This can lead to increased organic growth in more profitable lines and enhanced value to company stakeholders.

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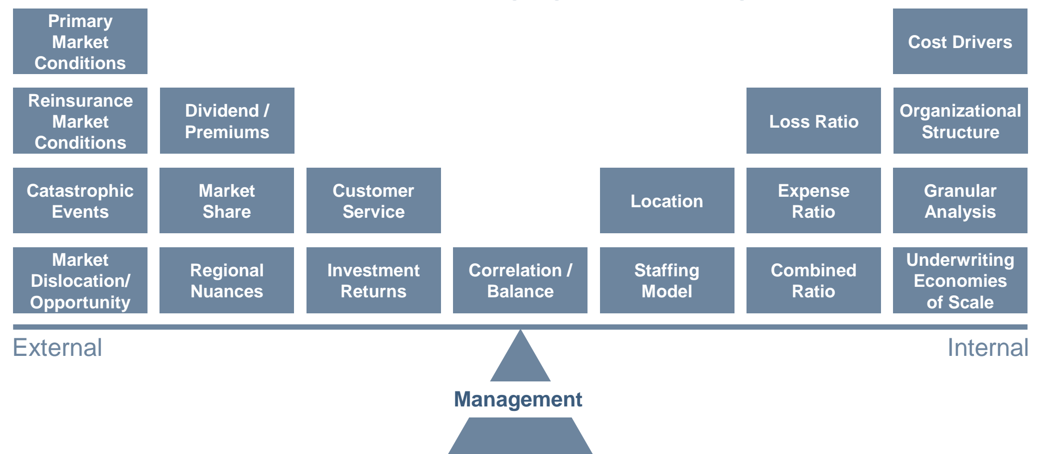
PERFORMANCE AND PRODUCTIVITY – THE BALANCING ACT

Expense management and cost cutting have been part of the business vernacular since the very beginning. Companies, new or old, are always looking for ways to save costs and increase profits. But much like “dieting” versus “living a healthy lifestyle,” strategic cost management is not just a fad or quick fix that should be abandoned once a stated goal is reached. Nor is it about sacrifice and going without. It is about recognizing where your firm is and where you want it to be – to enact a plan that puts the company in a position to become a market leader (or increase its lead). Strategic cost management needs to be an ingrained discipline and a fundamental cog in the ERM engine, not a bandage on a deep wound.

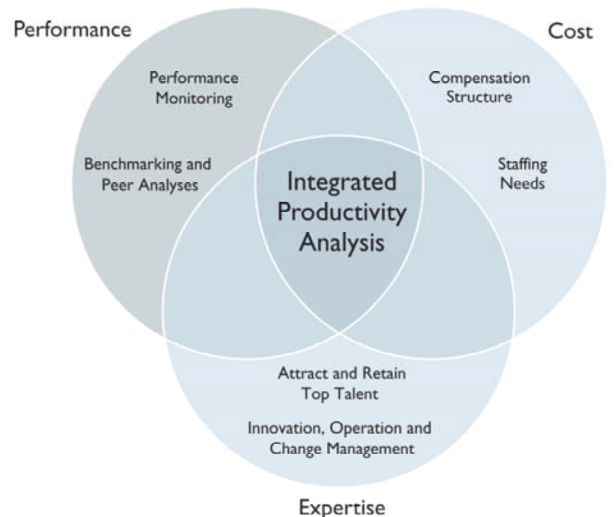
Exhibit 3:
Holistic Approach to Managing Complex Organizations



In order to achieve the “lifestyle” of strategic cost management, both performance and productivity need to be balanced. Having the lowest nominal expenses or even the lowest expense ratio does not necessarily translate to having the best model – firms need to have a clear strategy and understand where on the business spectrum they are (there is no ‘one size fits all’ solution).

To help achieve an optimum balance, organizations need to look at Costs, Performance and Expertise together (not mutually exclusive from one another). It is with the confluence of these three key facets that true integrated performance and productivity analyses lie.

Exhibit 4:



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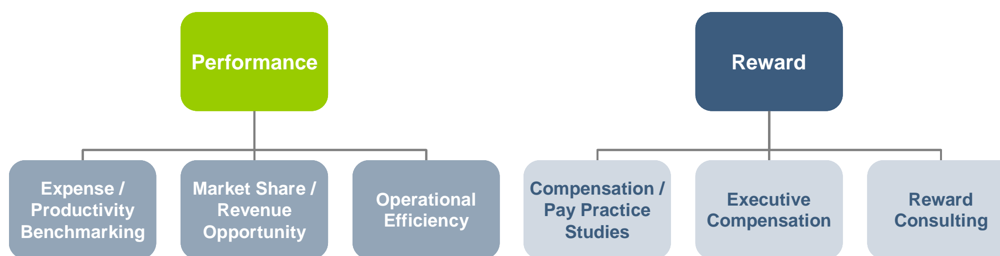
Strategic cost management can help target savings and opportunities to redistribute resources by type of expense, line of busines, distribution channel, function and/or geography.

- Compare revenue and cost per head by business, product and location versus closest peers
- Reallocate resources by growing or shrinking cost base / heads in specific areas
- Address issues in grade pyramid (i.e., seniority of officers) and ratio of revenue : support staff to improve productivity
- Determine efficiency of internal versus external service/alternate sourcing models
- Develop location strategies
- Provide facts that assist in budgeting, planning and change management decisions



CONCLUSION

How firms react to periods of turmoil is what separates the great companies from the good. Companies that are strategic in their approach position themselves to seize upon market dislocation – not react to or become a victim of it. The path taken can have a massive impact (good or bad) on current and future results.

Strategic cost management is not a simple task nor one that should be undertaken lightly, but, when tactically executed - with a scalpel, as opposed to an axe - can drive enterprise value, stimulate organic growth, create significant competative advantages and improve overall customer relations. It is an ongoing process that must not only be a key part of underwriting (yes, even in hard markets) but must also be embedded into a company's overall Enterprise Risk Management methodology.

Management teams must be mindful of the balance between performance and productivity, while keeping an eye on the ripple effects changes will have on its company's personnel and operations. Alternatively, firms that need to change but have no clear strategy how to do so – well, history is littered with cases of knee-jerk management decisions that ultimately destroy franchise value. ■

Chris McGrath is Head of McLagan's Insurance Advisory Services, which offers a full-suite of consulting services to the (re)insurance industry, with a focus on performance/productivity benchmarking and compensation plan structuring. Chris is a Certified Public Accountant with 13 years experience in the financial services industry, with an expertise in insurance and reinsurance.

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