In an industry facing massive disruption and change, marginal efficiency savings can no longer guarantee survival and success. How can you pinpoint resources and sharpen operational capabilities in a way that enables you to set the pace in a fast-evolving marketplace?

More for less: Five steps to strategic cost reduction

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Introduction

Insurance CEOs recognise the scale of the disruption within their industry[1], which is creating opportunities for some, and threats for others.

This is an industry facing a perfect storm of soft rates, low investment yields and new regulation. And by 2020, the impact of new technology, shifting customer expectations and nimble InsurTech entrants means that prevailing business models and the companies competing in the market will look very different from today.

Tight margins have naturally heightened the focus on cost – 70% of the insurance business leaders taking part in our latest Annual Global CEO Survey plan to implement a cost reduction initiative over the coming year, more than any other financial services sector[2].

Yet, squeezing a few percentage point savings from slow, stretched and unfocused operations isn't going to be enough to sustain competitive relevance in this disrupted marketplace. The insurers out in front have embarked on a much more fundamental transformation in strategy and operational capabilities. They're determined to get much closer to customers and many times faster, sharper and more innovative in responding to their needs – what's come to be known as a '10X' differential.

The crucial priority isn't the costs you cut, rather where you focus resources to stimulate growth and differentiation – strategic cost reduction. This includes digital transformation that can not only sharpen the precision of risk selection and pricing, but also deliver more tailored and targeted client solutions at a fraction of the cost. And beyond technology are opportunities to refocus resources away from low returning business towards higher value and higher return opportunities, both in fast growing geographical markets and underinsured exposures such as cyber and environmental risks. Indeed, the key differentiator within strategic cost reduction isn't technology so much as the strategic ambition and underlying culture of innovation and customer focus within the organisation.

Five steps

The problem is that many cost optimisation programmes struggle to deliver or fail to stick. However much you cut the costs, there are some products where the returns still won't be viable, either because customers don't value them or there is always someone else prepared to offer them cheaper – the primary focus should be on value potential rather than volume or cost. We're also at the point where the quick cost wins have been largely accomplished, leaving tougher and more strategically far-reaching choices ahead. The hard wins are likely to include withdrawal from unviable markets, significant shifts in business model and complete automation or even elimination of certain processes.

As we outline in this paper, making the right choices and moving the business forward requires a rethink of strategy, costs and, most important of all, how they align. The five steps we set out here focus on optimising rather than just cutting expenses to ensure your business can sustain competitive relevance and maximise its potential.

1. Start with strategy: Have a clear view of your strategy and ensure it is consistently understood across the organisation.

1 If we put the disruptive forces of change together, the only sector facing greater disruption than insurance is entertainment and media. Based on responses to PwC 19th Annual Global CEO Survey (2016) 'Seizing the future' (www.pwc.com/ceoinsurance). Disruption defined as significant CEO concerns over overregulation, new market entrants, the speed of technological change and shifts in consumer spending and behaviour (www.pwc.com/ceosurvey)

2 101 insurance CEOs were interviewed for the PwC 19th Annual Global CEO Survey (2016) 'Seizing the future' (www.pwc.com/ceoinsurance)

2. Align costs to strategy: Look across the whole organisation and differentiate the strategically-critical 'good costs' from the non-essential 'bad costs'.

3. Aim high: Be bold, be brave and be creative – use technology, innovation and new ways of working to radically optimise the cost base.

4. Set direction and show leadership: Deliver cost optimisation as a strategic, business transformation programme.

5. Create a culture of cost optimisation: Ensure you embed a culture of ownership and incentivise continuous improvement.

There are huge top and bottom line rewards for getting this right. Your business will be more differentiated and equipped to deliver on its objectives. You'll also be less reliant on pricing to compete in the market as resources are targeted at high earning growth business. Without this clear sense of what costs to keep and what ones to eliminate, you run the risk of being left behind.

Stephen O'Hearn
Global Insurance Leader, PwC

Good costs and bad costs

The key priority in strategic cost reduction is targeting resources where they can earn the best return, rather than just cutting costs in itself.

The starting point is differentiating the capabilities needed to fuel profitable growth ('good costs' targeted for investment) from low-performing business and inefficient operations ('bad costs' targeted for overhaul or elimination).

Good costs are capabilities that differentiate your business, move it closer to customers, and enable it to develop new value propositions. Determining and focusing on what really matters to customers in today's market.

Bad costs are non-essential areas of spending.

10X: Aiming higher

10X, a concept pioneered in the digital and InsurTech sectors, looks beyond marginal efficiency savings at how to achieve a game-changing boost in capabilities. Improving efficiency by a few percentage points means that you're probably doing what you've always done, just a little better, and all your peers are likely to be doing much the same. A 10x improvement enables you to reshape customer expectations and set the competitive bar for others to follow.

Rethinking strategy and cost

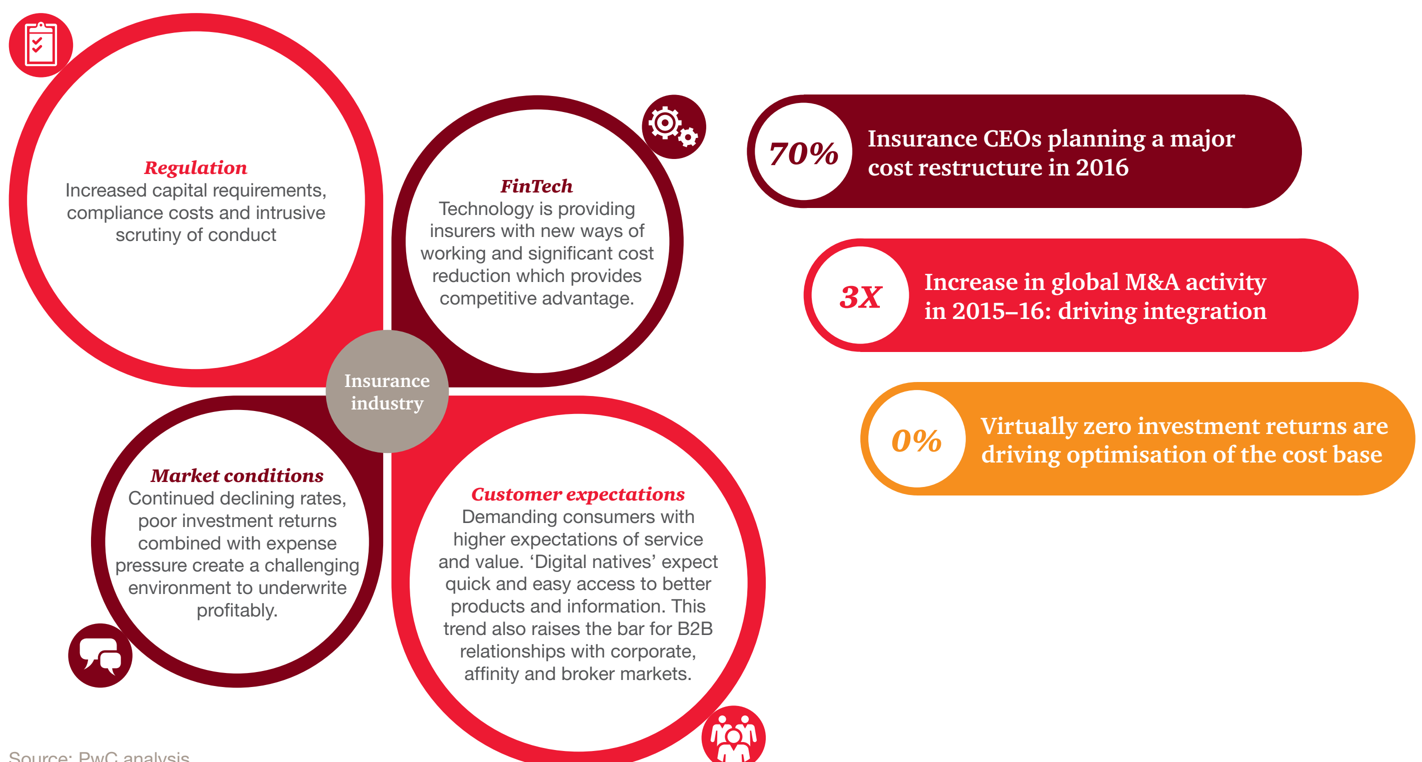
Delivering strategic change and putting in place the operational capabilities needed to deliver it have always been difficult. Yet, we now have both the compelling drivers and the practical means to make strategic cost reduction realisable and transformational.

Many of you will have had bruising experience of cost initiatives that have failed to deliver lasting gains. Why is this such a difficult challenge? All too often, ambitions aren't set high enough on the one side and the difficulties of execution are under-estimated on the other. This is especially so now that we're moving from the quick win to hard gain phase of strategic cost reduction.

The underlying challenges include resistance from the organisation. This encourages boards to cut a little from each division as a politically acceptable way to share the pain, rather than looking at where resources could be best deployed or the underlying reasons why costs in some areas are needlessly high. Lack of buy-in can be compounded by the hurdles of operational complexity and a lack of direction, accountability and dedicated resources allocated to cost initiatives.

Now, however, accelerating disruption has created the burning platform for transformation in both strategy and cost (see Figure 1). And the current market also offers the technology and openings for innovation needed to cut through complexity and transform operational capabilities.

Figure 1: Burning platform for a rethink of strategy and cost



Source: PwC analysis

Case study – Saving to grow[3]

Challenge

Group decided that many of the areas of highest cost were not adding competitive advantage and chose to pass these on to a third party provider. It wanted a partner that could not only deliver efficiency savings, but also help support its drive into mobile distribution.

Solution

Undertook a significant programme of strategic outsourcing, using a partner to provide technology and business operations and upgrade robotics and data analytics capabilities.

Outcome

Released hundreds of millions of dollars of cost, which the group invested in creating new digital propositions and building strong customer relationships.

Sorting the good costs from the bad

The key to realising this opportunity is making sure that maximum resources are targeted at the drivers of profitable growth (good costs), while freeing up and minimising bad costs. So what are the good costs and bad costs in this fast-changing market and what marks out the insurers and reinsurers who are out in front?

1. Distribution

Bad cost

Distribution and policy origination are needlessly costly, a problem compounded by poorly targeted marketing and low conversion rates within many businesses. The expense of distribution within insurance can be as high as 30% of the cost of the product. This isn't sustainable over the long-term.

Good cost

Sharpening customisation and conversion: The businesses out in front are using machine learning, advanced analytics and sensor technologies to target clients, evaluate their needs, develop fully bespoke solutions and price risk in real-time. The strategic cost benefits include more focused sales and marketing investments and more favourable outcomes for policyholders – products are bought not sold. The greater precision in risk selection and customer customisation can also provide the basis for keener pricing and reduced claims costs.

2. Transactional processes

Bad cost

Underwriting, claims and finance are littered with low value transactional processes and wasted costs (in underwriting, for example, up to 80% of the sales time can be spent on administration). These processes often rely on heavy manual workarounds, including re-inputting of information onto multiple systems.

Good cost

Robotics: Front-runners are moving to robotic process automation (RPA) and straight-through-processing (STP). As Figure 2 highlights, robotics have already been proven to deliver significant savings over 'old style' onshore and offshore solutions.

Digitising claims: A new generation of monitors and apps can allow policyholders to initiate a claim instantaneously, making it easier for policyholders and speeding up processing. In a car accident, for example, the in-car sensor could record the speed and direction of travel, while a photo texted from the scene would show the damage and get repair and settlement lined up straight away. Technology is also strengthening fraud prevention and detection as behavioural, pattern recognition and other fast developing analytical techniques enable insurers to quickly scan for people who may be likely to commit fraud and identify suspicious claims. Further developments include predictive models, which can set benchmarks for how much a batch of similar claims should cost. It's then possible to compare the results against actual experience to detect signs of leakage and tackle the causes.

Sharpening underwriting: Automation and artificial intelligence are already cutting costs by speeding up routine underwriting and providing a more informed basis for pricing and loss evaluation. The emerging opportunities include using tracking data in areas ranging from equipment sensors to the GPS transponders on container ships to offer real-time risk monitoring, pricing and protection. Advances in cognitive computing also allow you to move from analysing what's happened to anticipating what will happen and when (predictive analytics) and proactively shaping the outcome (prescriptive analytics).

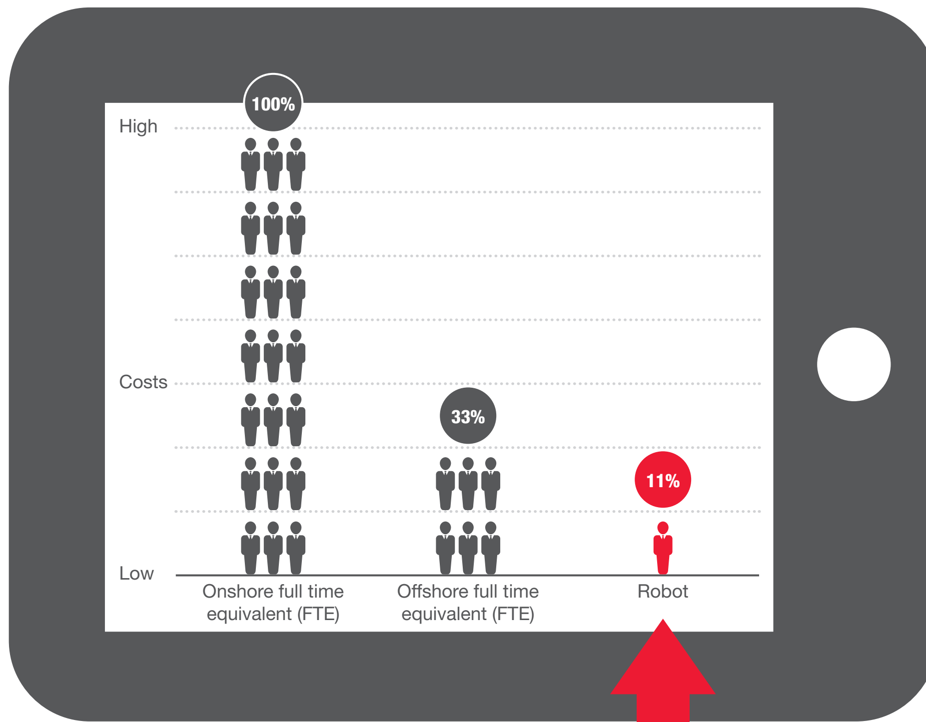
Blockchain: Blockchain applications can cut processing time and cost of placement and KYC/AML. They could also speed up decisions over claims and improve customer experience
In reinsurance, we believe that blockchain could reduce expenses by 15%-25% of expenses ($5-$10 billion industry-wide)[4].

3 http://www.csc.com/insurance/success_stories/104821-metlife_modernizes_a_traditional_business

4 We explore the potential further in 'Blockchain: The $5 billion opportunity for reinsurers'www.pwc.com/blockchainreinsurance

Figure 2: The robotics potential

Results found by using software robotics



Operational benefits	
Lower costs/risk	Management information
Non invasive	Work performed on demand
Scalable	Integration with Artificial intelligence

3. Property

Bad cost

From head offices to back offices, many insurers are spending far more than they need on property: having static, flag-ship offices where employees spend hours commuting to sit at a prescribed desk.

Good cost

Front-runners have cut their physical offices to a minimum by investing in virtual working and deploying collaborative working technologies that their people can access from any location.

4. Service providers

Bad cost

Third party service spending largely fails to reflect the value it generates. Weaknesses include poorly managed arrangements or simply outsourcing an inefficient process without tackling the underlying weaknesses first.

Good cost

Front-runners are rethinking how they operate (e.g. Lean, robotics, etc.) before engaging with service providers. They generate the efficiency themselves and then pass it to a service provider to continue to drive efficiency. They do this through professionalising their third party service management with a Service Integration and Management (SIAM) capability that is wholly focused on value and outcome-based solutions

Case study – Cutting through to what counts

Beginning in 2014, an international general insurance company has sought to combine a major transformation in customer service, policy administration, claims and pricing, with sizeable efficiency gains and expense reduction.

The programme, which has included technology improvements and divestment of non-core operations, has already delivered annualised savings of more than $250 million and is on track to achieve a further $200 million in cost reductions by 2018.

What marks out the programme has been the scale of the ambition, close alignment between strategic objectives and operational capabilities, and commitment to lasting gains rather than one-off savings.

The way forward

Our five steps are designed to provide a more informed, systematic and sustainable approach to strategic cost reduction.

Step one

Start with strategy: have a clear view of your strategy and ensure it is consistently understood across the organisation

The starting point is a clear understanding of your strategy, your operating model and the risk-adjusted returns from these operations.

It's not only important to look at the returns and costs on a block of business now, but how viable this will be in five years' time in the face of new technology, changing customer expectations, competition from new entrants and other disruptors.

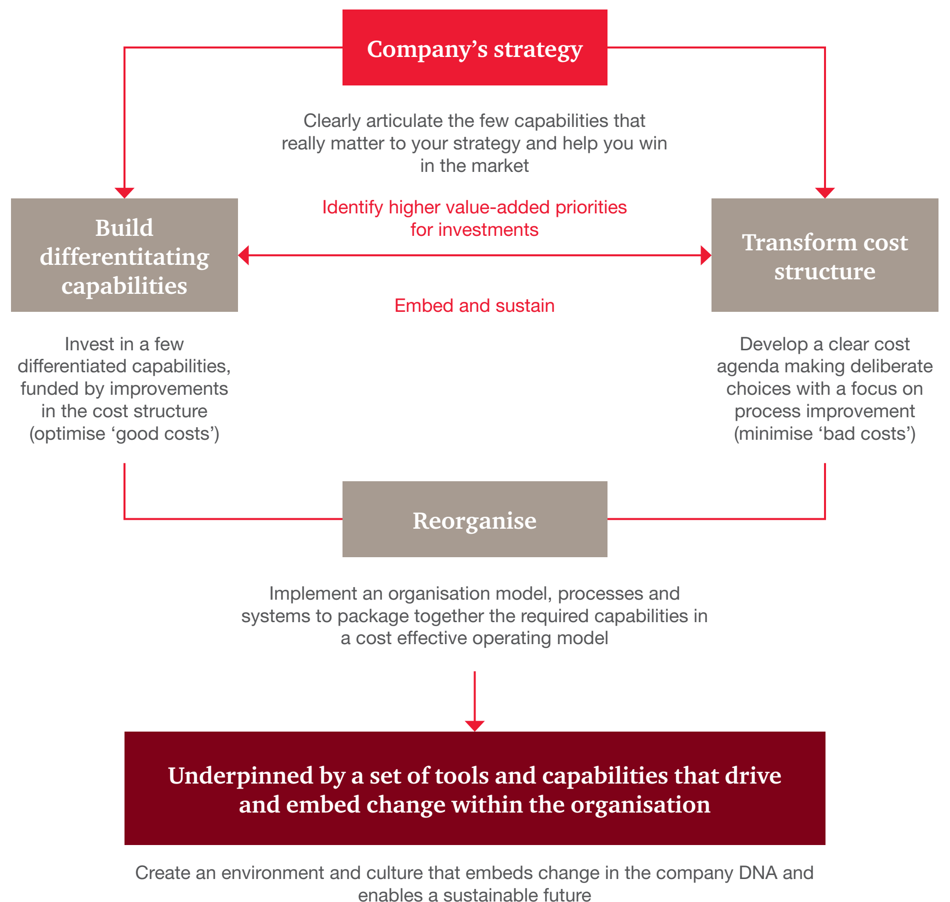
It's also important to understand the interactions between business units/ areas and the cost this generates, rather than simply using market-wide benchmarks to judge whether costs are justifiable. For example, high costs within the back office may actually stem from overly complex front office operations in areas ranging from rigid divisional siloes to a tangled knot of managing general agent arrangements. In our experience of working with a range of insurers, streamlining and simplifying the front office can not only improve efficiency in the back office, but also create a clearer line of sight to customers.

Step two

Align costs to strategy: Differentiate the strategically-critical good costs from the non-essential bad costs

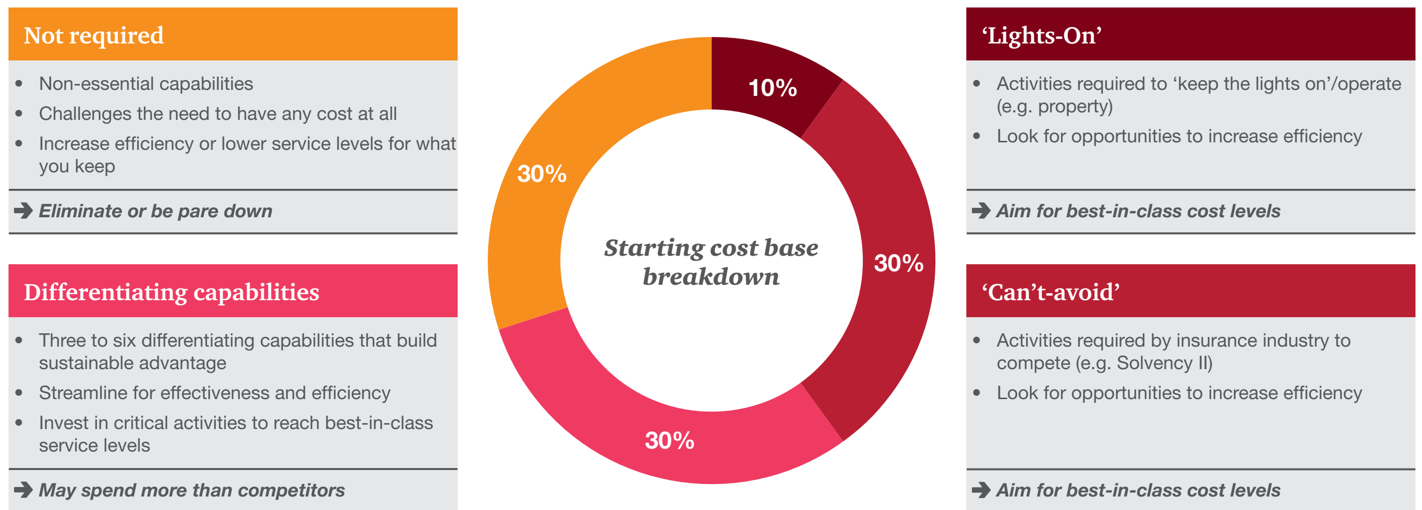
Identify the differentiated capabilities needed to get closer to customers and meet their expectations and then compare what you have with what you need (see Figure 3).

Figure 3: Judging what capabilities you need to compete



Source: PwC

Figure 4: Judge what costs to eliminate, reduce and increase

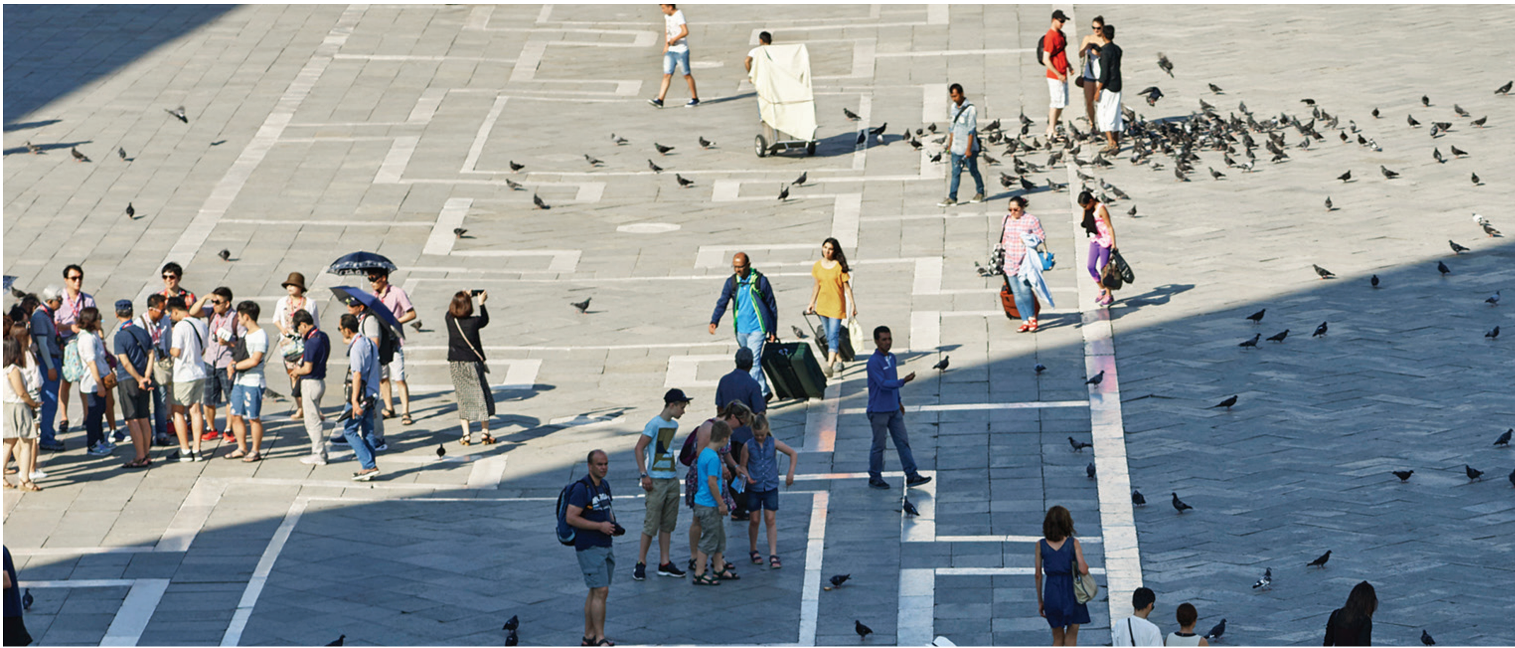


Source: PwC

You can then target investment at winning capabilities and draw up plans for minimising the bad costs.

As Figure 4 highlights, some costs can be eliminated altogether, either because the real returns are so low (e.g. poorly performing business lines) or customers don't value what's being offered (e.g. high cost investment management when some customer segments would be happy with a lower fee tracker fund).

Some expenses are still necessary to 'keep the lights on' in areas such as leases, property management and legacy system maintenance, but there is significant room for savings. You can use the end-to-end cost analysis to see what activities are being carried out, what value they deliver and how they could be changed. Examples include assessing manual or high cost processes to determine if they could be automated.



Step three

Aim high: Be bold, be brave and be creative

There's no point looking at cost reduction in terms of benchmarks or percentage targets any more. The real differential is the strategic ambition to set the bar higher (10X) and explore all possibilities, rather than settling for marginal gains. As Figure 5 highlights, there are opportunities across the value chain.

Being bold means the courage to withdraw from markets or streamlining product lines so that resources can be better focused – cutting back redundant parts of the organisation so it can thrive.

Being brave means cutting the costs that have seemed too difficult to tackle, such as property, structural inefficiency and complex legacy operations.

Being creative means looking beyond what's always been done, and asking why and what are the alternatives. Examples include the opportunities opening up in robotic underwriting or automated claims handling. Crucially, it also includes real insights into what customers value and are prepared to pay for. Now that life and pensions customers in the UK have to pay for financial advice, for example, many are opting for DIY investment instead. But they are prepared to pay for defined outcomes. A good example is helping customers to understand the trade-off between how much they want to live off now and their desired standard of living when they retire, and then creating solutions to meet these goals. Product boundaries would become redundant within comprehensive solutions that could embrace mortgages, equity release, tax and inheritance planning, as well as pensions and life cover.

Figure 5: Exploring all possibilities

Source: PwC

Step four

Set direction and show leadership: Deliver cost optimisation as a strategic, business transformation programme

Strategic cost reduction can't be delivered in a piecemeal way or by people working on it part-time. It needs to be run as a strategic initiative with the same board sponsorship, direction and accountability as any other strategically critical initiative, such as an acquisition, market entry or broader business model change.

It's important to ensure central governance, secure senior management agreement and buy-in, engage the workforce at all levels and develop ways to encourage personal ownership and organisational collaboration.

Step five

Create a culture of cost optimisation: Ensure you embed a culture of ownership and incentivise continuous improvement

Strategic cost reduction priorities should be regularly reviewed and updated in the same way as your business assesses the relevance of its strategy and the opportunities ahead.

Priorities include enablers for periodic review and instilling a culture of awareness and continuous improvement in the business. Reward and incentivise staff to continuously look for improvement opportunities – build a culture of good versus bad costs.

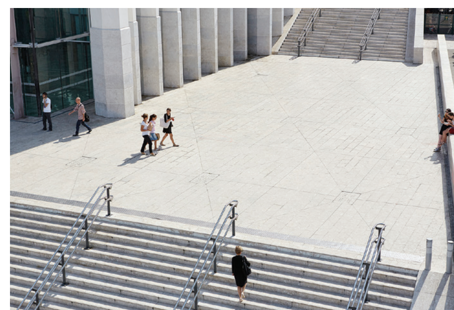
Conclusion: Key questions for your organisation

The survival and success of your business depends on a transformation in your competitive capabilities and underlying cost base. The only way to make this work is to think strategically and think big from the outset – be radical, don't tinker.

The transformation starts by aligning cost to strategy – investing in differentiated areas and cutting back the rest. It's important to understand what really adds value in your organisation. You're likely to find that a large proportion of spending is still being directed towards unnecessary tasks or on activities that can be performed much better, faster and more cost-effectively by doing them in different ways or by passing them on to others.

We believe there are two key questions your business needs to address in turning cost from a competitive challenge to a source of clear-cut advantage:

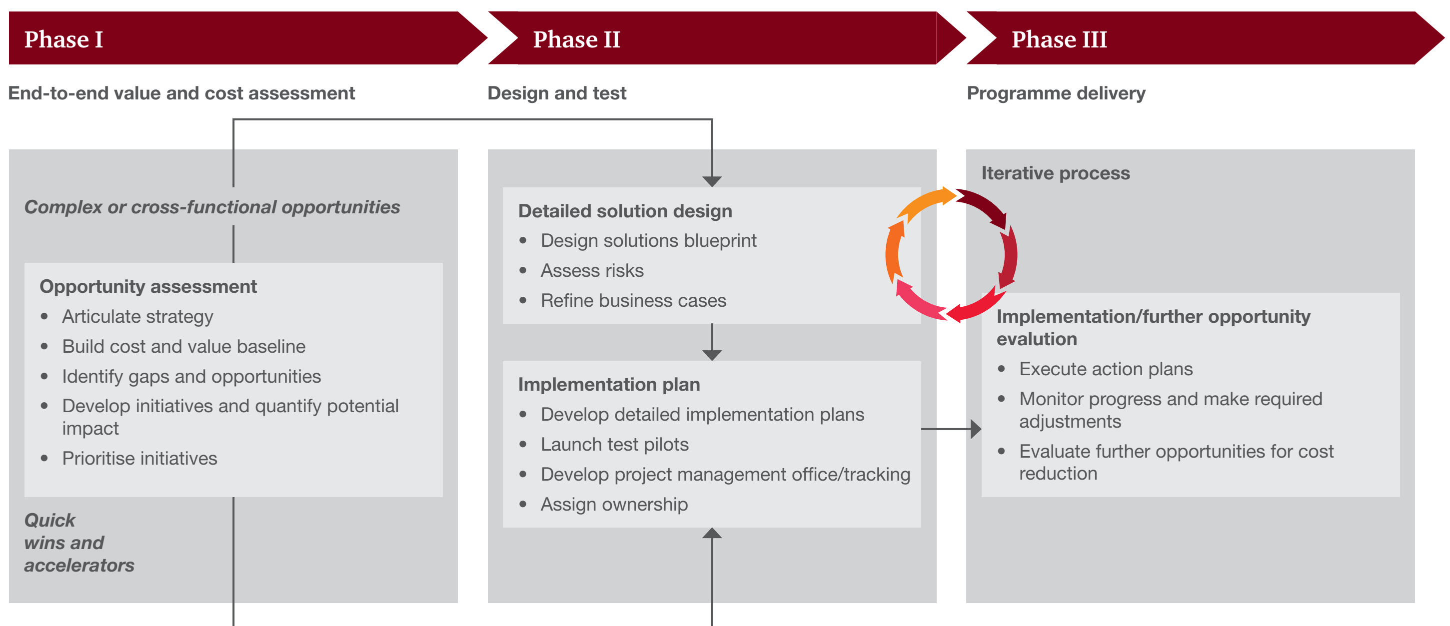
1. How can we target investment more precisely to maximise strategic advantage ('good costs')?
2. How can we cut out the low performing business and inefficient operations ('bad costs') that waste resources and hold back returns?



The front runners are already securing the competitive differential from effective strategic cost reduction. And the edge they've gained will continue to increase as the market becomes more disrupted and slower moving peers struggle to sustain relevance and returns.

Our approach

We take a detailed analytical approach focused on identifying the value generating potential within the business in a changing marketplace and differentiating the good and bad costs.



Source: PwC

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