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Financial Services Industry

Back to the Business of Insurance

A Global Insurance Industry Benchmarking Survey

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Foreword

These are defining years for the global insurance industry. The events of September 11th not only redefined coverage limits and pricing within the industry, but also fundamentally shifted the perceived value of insurance itself. In addition, the global economic downturn has highlighted the industry's long over-dependence on investment income, exposing runaway costs and inefficiencies throughout many carriers' core insurance operations.

To understand how these seismic shifts have affected managements' approach to their business, the Global Insurance Practice at Deloitte commissioned this report from the world renowned Economist Intelligence Unit. In preparing this report the Economist Intelligence Unit surveyed over 80 senior insurance executives at the world's leading insurance and reinsurance carriers. They complemented these findings with interviews at over twenty leading companies in the property & casualty, life & health and reinsurance sectors. From this research the Economist Intelligence Unit has worked with insurance industry experts at Deloitte to identify three broad strategic goals insurers are pursuing in this new environment, along with four tactical priorities critical to achieving these goals.

A survey like this takes significant effort on the part of many professionals. I would like to thank the senior insurance industry executives around the world who participated in the survey and shared their thoughts in the interviews. I would also like to thank my Deloitte colleagues for their diligence and dedication to seeing this project through to completion.

I trust you will find the report interesting and stimulating.

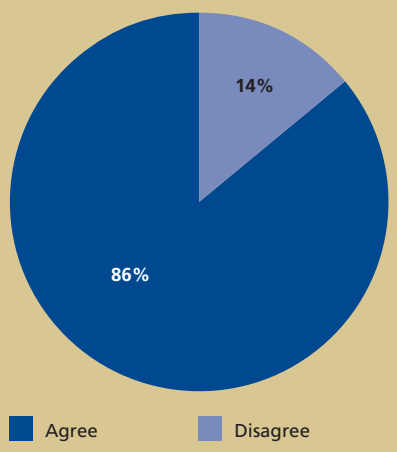
If you have any questions or comments please contact me at oryan@deloitte.com.

Owen Ryan
Managing Partner
Global Insurance Industry Practice

Executive summary

Achieving profitable and sustainable growth is an ongoing challenge for insurers. The downturn in equity markets and rock-bottom interest rates have made execution even more critical, since many insurance companies have been deprived of the investment income and capital gains they once used to subsidize their core operations. With easy returns a thing of the past, "back to basics"—the core business of insurance—is the order of the day.

Chart 1: "Improved insurance operations are the best route to strong profitability"



This conclusion is supported by a recent survey of 80 senior insurance executives: 86% of respondents called improved insurance operations the best route to strong profitability.

Industry executives agree that insurance firms must improve their return on capital, either by reducing the amount of capital needed or by raising the profitability of the insurance operation. In short, that means making money in the business of selling insurance—independent of investment income. As Catherine Rein, President & CEO of MetLife Auto & Home Insurance, puts it, "The fact that the stock market hurt a number of carriers made everybody sharpen their pencils and pay much more attention to profitability."

This report, written by the Economist Intelligence Unit for Deloitte, reveals the degree to which insurance players are striving for improved results by honing key elements of their core operations. The study draws on two main research undertakings:

- The Economist Intelligence Unit conducted a wide-ranging survey of insurance industry executives in August-September 2003. In all, 80 industry leaders took part, representing all major global geographic regions and all industry sectors. Detailed survey results are presented in the appendix (see page 15).
- To supplement the survey results, the Economist Intelligence Unit conducted more than 20 in-depth interviews with senior industry executives and experts in the insurance industry. Their insights complement the survey findings, providing an invaluable qualitative counterpart to the quantitative data.

This report draws on these two research components to analyze the key challenges and opportunities that insurance companies face in a post-bubble economy. The findings are clear: although the emphasis differs from sector to sector, insurers agree that their business needs far-reaching improvement. In practical terms, say industry leaders, insurers must:

- Write better business;
- Enhance claims management processes; and
- Improve operational controls and financial reporting.

In their efforts to achieve these goals, insurance executives identify four priorities:

- Enhancements in information technology (IT) systems;
- More rational product development;
- More effective and efficient distribution; and
- More accurate risk assessments.

Introduction

Insurers have faced a challenging operating environment in recent years. Events as disparate as the 9/11 terrorist attacks, catastrophic weather patterns and the collapse of Enron reinforced an axiomatic rule of insurance: the unexpected can emerge at any time and in many guises. But the biggest problem for insurers has had little to do with insurance per se. The real back-breaker has come from poor investment returns.

The collapse of equity markets has revealed the degree to which many insurers have been relying on investment returns to make a profit, essentially using capital gains to subsidize their core activities. Although investment returns have begun to recover, the market debacle has been a wake-up call.

The Economist Intelligence Unit survey provides a sobering assessment of investment activity. Of survey respondents:

- 79% agree the insurance industry is over-dependent on investment returns.
- 69% concede that lower investment returns have reduced their company's profitability, and 18% admit that that decline has been sharp.
- Only 8% see a recovery in investment returns shaping up over the coming six months, and 36% do not expect returns to reach previous levels again anytime soon.

This downbeat outlook for investment returns has spurred insurance companies to reassess their business models, and to take stock of their traditional core operations. What they see there, while not bleak, is far from uplifting. Only a tiny minority of survey respondents viewed conditions in their sector as "excellent" (4% overall). The largest group, 46%, called them "fair", and 10% admitted they were "poor".

Table 1: How would you characterise the current condition of your sector?

	Excellent	Good	Fair	Poor
Property & casualty	5%	35%	51%	8%
Life	7%	38%	45%	10%
Health	12%	25%	56%	6%
Reinsurance	0%	62%	25%	12%
Overall	4%	40%	46%	10%

Taking stock of external challenges …

Insurance executives say many challenges confront their industry, but chief among them is the difficult investment environment, according to survey respondents. Not surprisingly, the life and annuity sectors have suffered most. Of survey respondents from those sectors, 70% say the difficult investment market is a problem for them, and 38% call it a "major problem".

What's more, the industry does not see poor returns as a transitory phenomenon. With no decisive or rapid recovery in sight, insurance executives have responded by tracking their portfolios more closely, and writing down doubtful investments more quickly and aggressively than in the recent past, rather than holding out hope for a rebound.

The industry is feeling plenty of other external pressures too. For one, 43% of survey respondents are concerned about emerging risks, such as terrorism and corporate fraud. Maurice R. "Hank" Greenberg, the CEO of AIG, recently echoed this fear, in urging US authorities to develop policies that would create a reinsurance market for terrorism (AIG already writes terrorism insurance coverage in some countries.) "The insurance industry on its own, without reinsurance back-up, would not be able to fulfil the needs of Corporate America," Mr. Greenberg warned a Wharton School conference. "A dirty bomb or a nuclear device would exceed the capacity of the industry."

Government regulation was also cited as a problem by about 60% of life insurance respondents, along with 50% of those primarily involved in health insurance and 45% of respondents located in the US.

The finding is perhaps no surprise given that US insurers have long criticized even the basic oversight system, urging a federal regulator to replace state intervention. At least in banking, says one executive, "They make sure both regulatory formats [state and federal] are somewhat competitive without being inimical to the interest of consumers."

Executives complain that state regulation increases costs and can undermine their attempts to compete. For example, to extend a product offering from one state to others requires insurers to undergo a laborious process of getting licensed, having policy forms approved and dealing with compliance issues in each state. Several states are not adequately staffed, and it can take six months to a year for a new product to be approved, says one executive, who like several others asked not to be quoted while lambasting state regulators.

Managing costs to drive profits

There are only two factors in the underwriting-income equation: premiums earned and the costs of settling claims. But the equation's simplicity belies the wealth of opportunities for boosting the bottom-line result by narrowing the expense spread at each stage of the underwriting value chain—from pricing risk appropriately to optimizing the efficiency of claims management.

The results of the Economist Intelligence Unit survey show better cost control is a priority for every insurance segment. Industry executives counsel adopting a culture of smart expense management rather than wielding one-time cost cuts.

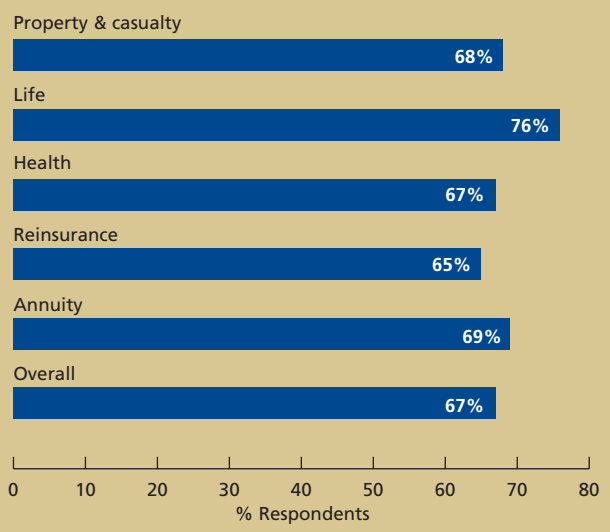
Insurers must first understand the sources and characteristics of their profit streams, executives say. If they have a negative expense spread, for example, what is the cause? Exactly what portion of the operation is at fault? Does a product cost too much to sell or to administer? Just what piece of the operation is not performing efficiently?

Some insurers use activity-based costing or similar accounting techniques to attach a cost to each major business activity. "We slice and dice our dollars 16 ways to Sunday," says Catherine Rein, President & CEO of MetLife Auto & Home Insurance. "We know exactly what product is costing us what, and what office is costing us what."

This approach requires a long-term commitment to monitoring the source of costs and revenues, not a one-time assessment or periodic reviews that fail to account for changing market conditions.

Zurich North America has used activity-based costing for several years. "The main benefits are that each business unit or line of business is charged appropriately. If we're looking at results, we can see that one area is not camouflaging the results of another. So, this helps us make good decisions about how that business is doing and what actions we might have to take to improve it," says Donna Galer, EVP of the Office of the CEO and Chief Governance Officer for Zurich North America.

Chart 2: Better cost control as an effective way to improve profitability



Others concur that granular accounting of profit and expense streams is a must for improving the return on equity for insurers. "When you look at the differences in the activity-based assessments, you can see which parts of the company need more improvement and which are already performing pretty well," says Joe Beneducci, Chief Administrative Officer of Fireman's Fund Insurance. "You can be more specific in terms of where you want to invest further."

… and internal constraints

Along with external challenges comes a plethora of internal problems for insurers. Topping the list, cited by 64% of survey respondents, is creating competitive advantage, along with tight/constrained margins (60%) and cost control (56%).

Not surprisingly, these pressures align with factors that drive revenues and profits. Of survey respondents, roughly two-thirds say better customer service, creating new types of products and services, and new distribution strategies are effective in driving top-line growth, and respondents chose the same factors—alongside cost control (selected by a resounding 67%)—as most likely to boost the bottom line.

Cost control is clearly a major issue. In the survey, 76% of life insurance respondents say better cost control is an effective way of improving bottom-line profitability. Life isn't alone here: two-thirds of respondents from the property & casualty (P&C), health and annuity sectors echoed the sentiment. And 57% of survey respondents even agreed with the statement that "Lower investment returns aren't as big a problem as spiralling costs".

For all the emphasis on cost control, however, executives warn that the point is to manage expenses effectively, rather than to slash costs arbitrarily. Since poor expense management quickly destroys value capital, "You ought to be managing your expenses in good times just as much as you manage them in not-so-good times," says Marita Zuraitis, EVP & CEO of the Commercial Lines Group at The St. Paul Companies. "Otherwise, you're leaving money on the table."

IT investments are a good example of the need to spend effectively, say executives. The outlays can be enormous, but should be more than offset by the resulting business efficiencies and enhancements, and ultimately enhanced loss ratios. Significantly, 68% of survey respondents say more effective use of IT will drive profits.

Other drivers of profitability that respondents tagged as particularly effective include new distribution strategies (61%), strategic alliances (57%) and cross-selling (55%).

These choices dovetail neatly with respondents' emphasis on better use of IT. Open architectures are critical for distribution, cross-selling and building workable strategic alliances, while technology is key for gathering information needed across the business, whether to assess risk, market products or improve business processes.

Chart 3: Stock market reversal hurts profits

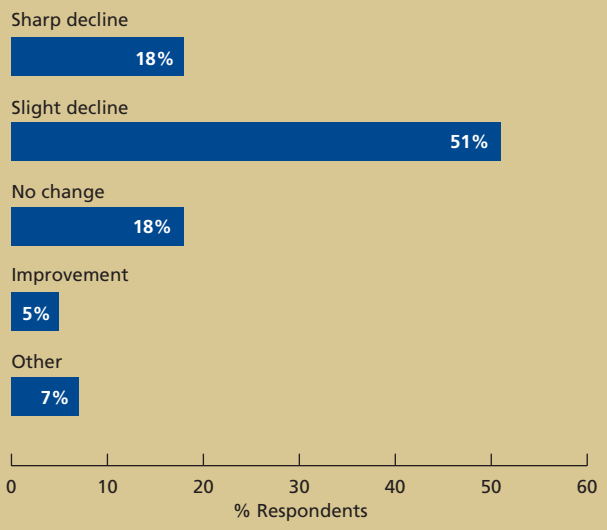
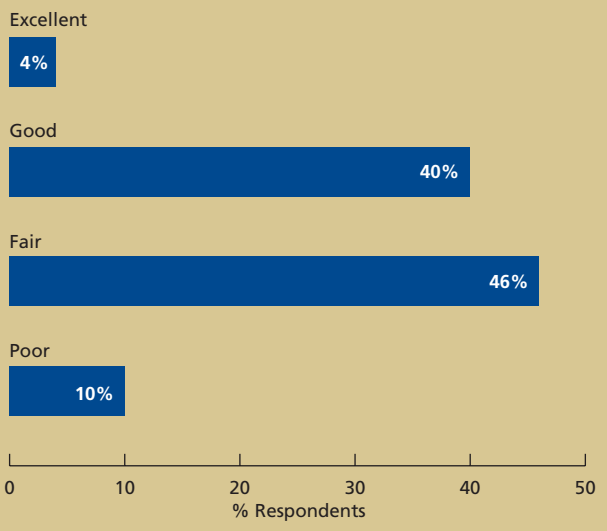


Chart 4: An industry in "fair" condition



Writing better business

In acknowledging the challenges, insurance players are painfully aware they cannot look purely to higher premiums to boost business. While 43% of survey respondents say higher premiums can drive top-line growth, only 35% say higher rates are effective in boosting bottom-line profitability.

Many concede premiums are rising now to make up for losses on the asset side. Indeed, 33% of respondents say the need to compensate for poor investment results is the single most important cause of rising premiums, while 17% attribute the rise to a more risk-filled environment and 14% cite a more litigation-oriented business culture.

Executives assert the premium picture is complex, however. One-half of survey respondents expect rates to remain firm through 2004, but P&C respondents were more likely to say the hard market will not last beyond 2003, or has begun to plateau already. And as P&C executives are quick to note, commercial rates tend to jump more precipitously than personal lines. Some sectors are in fact under-priced, they add.

"The industry has got to stop under-pricing things they know they're under-pricing," advises one P&C executive, citing homeowners' policies as an example. Admittedly, personal P&C insurers face a particular challenge in trying to differentiate their products, which tend to be fungible in the eyes of consumers, often creating competition based on price alone. But executives say the onus is on the insurer to educate consumers about the quality and value of one product over another.

One executive bemoaned the P&C industry's "laziness" in building consumer awareness. "Homeowners should be protecting themselves against real loss, but they do not understand the real value of insurance, or that premiums can be made more affordable by taking more realistic deductibles and co-insurance", says this executive.

Some insurers say certain policies are priced deliberately low as loss-leaders; others say operational costs are simply too high. But all agree they must understand the true costs of covering and administering their policies before pricing them. A key element of pricing is obviously risk assessment and selection, and 67% of survey respondents say better information on risks is the single most important factor in improving underwriting. Indeed, 61% say their firm aims to pursue better risk information in the coming year.

Executives say they need more granular risk assessments than traditional class-based pricing affords, so they are integrating various proxies to try to hone risk assessments more closely to an insured party. MetLife Auto & Home, for example, takes account of how individuals manage their credit. "We have research that shows that there is a correlation between certain financial behaviors and insurance risk. It's not about your income, it's not your credit level or your credit rating, but how you manage your credit," says Ms. Rein. "It is also not a stretch to assume that people who are conservative about managing their financial balance sheet tend to be conservative about taking care of their cars and taking care of their homes. So there is a correlation between those and good risk."

Credit management is just one of the predictive proxies insurers are using. MetLife Auto & Home also employs what it calls "tiering" to combine information on numerous variables in pricing policies. Car insurance premiums, for example, take account of the insured's location, credit-management approach, family structure (e.g., the number of teenagers in the household), history of accidents and other factors. With this approach, says Ms. Rein, MetLife tries "to refine the risk so we are charging the people who are most likely to have an accident more than people who have lower risk characteristics and the best driving record and have handled their affairs the most conservatively".

Executives agree generic class-based pricing has its limits, but concede a certain degree of "profiling" is inevitable since it is hard for insurers to operationalize more granular assessments, especially if they lack the requisite information.

Overall, executives say, the imperative is to eliminate bad risks, rather than bad classes, or to find good risks in bad classes. But even this requires a significant reliance on internal IT systems to house, manage and transfer high-quality data quickly.

Chubb is using IT "to more fully leverage the knowledge and experience that we've been able to gain from underwriting staff, loss control and claims", says Rick Cantor, Knowledge Management Unit Leader for Chubb's Commercial Insurance business unit. "Instead of having the knowledge dissipate into the air or fly out the door, we're looking to capture it, manage it, position it and serve it up when needed to make better underwriting decisions or claims decisions."

Through knowledge sharing and collaboration efforts among its loss control, underwriting and claims areas, Chubb is building a large central repository of business intelligence, which underwriters can use to make better risk decisions. A delivery hierarchy and sophisticated taxonomy ensure that users can access information quickly and easily, and the company can prioritize distribution. For example, procedural documents are posted on a website but critical advisories can be "pushed" to individuals via e-mail.

As Mr. Cantor is quick to point out, however, "technology is maybe 20-25% of the equation." Organizational culture is the real key, he says. "Unless you have willing and enabled people who are providing the information, and people who are managing the information going forward, the whole thing will fail."

At Royal & SunAlliance Canada, the actuarial, claims, finance and underwriting teams work together closely to enhance corporate insights into exposure and pricing, says Rowan Saunders, President and CEO. Twice a year, they pursue a detailed review of the product portfolio, and look at, among other things, external factors, legal factors, claims trends, actuarial, reserving and reinsurance. The insurer does several rate filings a year, and the approach "has helped us make some decisions where we've actually exited certain portfolios", says Mr. Saunders, citing an unprofitable leased-auto program in Quebec as an example.

The desire to assess and price risk more appropriately helps explain, too, why few insurers expect web-based business to become a mainstay, at least for now. Some insurers do quote rates via the Internet, and some say the web is a good way to generate leads. Internet shoppers, they say, tend to be well informed and have access to quotes and rates from many carriers, at least for simple insurance needs like term-life policies.

But underwriters say they are unconvinced they can get high-quality business from such an anonymous vehicle, especially for complex insurance needs. Industry executives are nervous about finding good risks among those who choose to shop for insurance online, though they say an expanded role for the Internet is inevitable in the longer term.

Table 2: What is the most important cause of rising premiums in the insurance industry?

The need to compensate for poor investment results	33%
A more risk-filled environment	17%
A more litigation-oriented business culture	14%
The need to generate reserves for asbestos, mold and other extraordinary claims	7%
Increased customer perception of the value of insurance products	3%
Inefficient operations	5%
Increase in identifiable hazards	4%
Lack of tort reform	1%
Rising medical costs	8%
Other	8%

Table 3. Best steps to improve underwriting (multiple answers possible)

Real-time quoting/issuing	25%
More streamlined and integrated IT systems	40%
More standardized processes and guidelines	28%
Better information on risks	67%
Real-time performance measurement information	16%
More reliance on individual underwriter judgment	15%
Better retention of senior underwriters	31%
Greater user of data-mining techniques	39%
A reduction in the range of products offered	4%
Better cross-training of underwriter talent	25%

Bringing science to the art of underwriting

To note that insurers are risk-bearers seems to be a glaring statement of the obvious. Yet many insurers have been slow to focus on optimizing their performance in underwriting risk, perhaps distracted by the brimming investment-income coffers of the bubble years. Many in the industry now acknowledge the need to give underwriting the attention a core competence deserves.

Sustained, superior underwriting performance requires precision, insight and responsiveness. Respondents to the Economist Intelligence Unit survey place a high priority on improving their capture of data and risk information and their use of IT to enhance underwriting. Executives likewise say they are working hard to ensure that risk assessments are more judgment than luck.

"Underwriting is a science that you constantly strive to get better at" says Mark Zesbaugh, CEO of Allianz Life North America. "A disciplined approach to risk management is key–never being satisfied." Mr. Zesbaugh says successful companies will be fast, nimble and accurate in assessing and responding to changes in the environment around them.

One environmental jolt prompted by 9/11 was the sudden recognition that losses could accumulate for insurers in unimagined ways, says Jim Macdonald, Chief Underwriting Officer of ACE USA. "No one before 9/11 ever thought the largest loss in the history of the property insurance industry—worker's comp, liability and aviation—could or would occur at the same time from the same event. So it created a problem of managing correlated risk." Since 9/11, he says, ACE USA records data across business lines to monitor the accumulated exposure to a major natural or manmade catastrophe, including terrorism.

Table 4: Top drivers and goals for improved underwriting

Better information on risks	67%*	61%**
More streamlined and integrated IT systems	40%*	48%**
Greater use of data-mining and data-warehousing techniques	39%*	39%**

* *respondents saying factor is among the best ways of improving effectiveness of underwriting*

***respondents saying improvement in that area is a goal their firm will pursue in the coming year*

Zurich North America has also been providing its underwriters with technological tools to make exposure accumulations more transparent. Its "underwriting workstation" is putting all the requisite information on the desktop of front-line underwriters, providing them with additional insight for pricing risks appropriately. It will also allow the company to monitor the performance of underwriters.

The workstation is just one example of the continuous improvements required to excel as an underwriter, says Donna Galer, EVP of the Office of the CEO and Chief Governance Officer at Zurich North America. "We want to be an excellent underwriting company and to make an underwriting profit, and we must rely less on investment income than we had in the past. We'd love to see the return of a robust financial market, but our aim is to produce an underwriting profit." But, she says, "It is a continuous change process."

In short, insurers simply cannot deploy capital efficiently unless they truly understand the risks they are underwriting. Before they open the door to risks, they must use every tool in the box to understand business segments, classes and markets well enough to select and price risks appropriately.

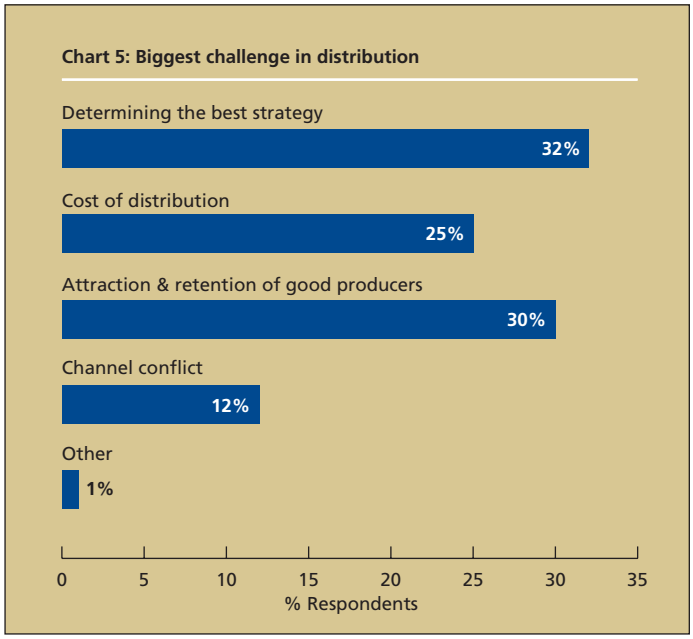
Enhancing distribution and products

Distribution clearly has a significant impact on profitability, since even the best product in the world cannot sell well if poorly distributed. In the survey, 100% of respondents from the annuity segment say distribution affects the profitability of their business, and the same goes for 93% of life insurance respondents and 86% of those from P&C.

However, one-third of survey respondents say the biggest challenge in distribution is simply selecting the right strategy. More than one-half of respondents say they expect to assess the effectiveness of current channels through profitability analyses over the next 12 months. Nearly 60% say they will consider forming alliances to increase channels.

Such decisions have to be made carefully, especially by insurers with a large retail salesforce. Les Lovier, VP at AXA Equitable, says, "Expansion is key, and it involves figuring out who to make alliances with, and ensuring that the profiles of the people are an appropriate fit."

Allianz Life North America has acquired stakes in independent marketing organizations to guarantee shelf space for its products, without carrying the costs of a captive salesforce. "Half of our production comes through organizations where we at least own either a minority or 100% share of them," says CEO Mark Zesbaugh. These distribution channels have multiple relationships with various insurance companies, but Allianz makes sure to nurture their relationships, delivering and innovating around their needs.



"We view the distribution network as the company's customer," says Mr. Zesbaugh. "Their customer is the ultimate policyholder. We obviously have a relationship with the policyholder, but it's not a primary relationship; it's a secondary relationship."

Merrill Lynch employs an open architecture to maintain selling arrangements with all the major players. Nikos Kardassis, head of insurance, says, "It's crucial for Merrill Lynch to provide end-customers with the financial advice they need and with all types of products that meet different needs." Providing clients with the best products the market can offer and growing the business and its bottom line are more important than increasing the proportion of proprietary products sold, he says.

On the annuity side, Merrill manufactures its own products, but the 15 US majors, including MetLife, Equitable, Hartford, Phoenix, ING and AIG, are represented on its platform. On life, Merrill does not manufacture its own products, but works with the seven major life players.

In Canada, Royal & SunAlliance is pursuing a major Internet-based business initiative to enable its intermediaries for personal lines to function more effectively. It is essentially making available a simplified version of its operating, policy rating and processing systems, via the Internet, to its distribution channel. "So, they are able at the point of sale to price a risk for the consumer, enter the data and actually issue the policy, which really eliminates a lot of traditional duplication," says Mr. Saunders. "At the end of 2003, we will have 30% of our personal lines transactions processed [through the web channel]. Our target is to have 70% by the end of 2004, so it's a pretty rapid and fundamental change in the way we're operating the business." He expects small commercial lines to be the next migrants to the web.

Of course, in pursuing superior distribution, insurers should not underestimate the importance of product features and strategy. Especially significant, say executives, is the need to innovate as conditions change and to service unmet demands or segments. This may mean modifying existing covers or providing totally new options.

Annuities players are in a particular product predicament at present, having repositioned their products more as investment vehicles with a lot of guarantees than as the tax-deferment tools they once were. The stock market declines have obviously undermined the performance and attraction of many of these products, so providers must find new twists to boost their perceived benefits.

AXA Equitable is exploring a way to combine an annuity with a life insurance policy, and use the annuity to fund the life insurance premiums, says Mr. Lovier. "The underwriting decision would be made more or less immediately, and the product design would be very simple," he says. The product could offer the consumer an easy way to get some insurance, and tax benefits, with a lump-sum payment

rather than on a premium basis. And the simplicity of the product—a variable product with investment options—means it could be sold by a broker who might not be comfortable with normal life insurance products.

As a term-life distributor, Savings Bank Life Insurance (SBLI) of Massachusetts agrees it needs competitive products, like a new transactional life product it is offering from Empire General, a subsidiary of Protective Life. The policy does not require the traditional Attending Physician Statements or any drawing of fluids. "This is a nice product for the banking channel," says SBLI President Robert Sheridan. "Competitively, what we've been missing is a good product, a transactional product for the banks that somebody can walk into a branch and get immediately. And there's no mortality risk for us because it's not on our paper." Policies are granted based on responses to a questionnaire. Based on experience, the underwriter expects 80-85% of applicants to qualify.

"It's very tempting for insurance companies to focus on known existing products, but we want to make sure we're always rolling out new products," says Mr. Macdonald of ACE USA. "Today's new product will be tomorrow's core product," he says. Among ACE USA's innovations are new units to handle certain weather and environmental pollution coverage and a terrorism specialty unit to underwrite terrorism P&C coverage not covered by the Terrorism Risk Insurance Act.

Product offerings must be aligned, though, with the insurer's broad value proposition and strategic direction. So the aim of any alliance or acquisition is not to increase the number of products per se. The goal, say executives, is to assemble a product portfolio that allows the insurer to serve as many target customers as possible and to respond quickly to the changing needs of the market.

A targeted acquisition strategy is vital for fulfilling strategic aspirations, supplementing business lines and making them more efficient, says Jim Prieur, President and Chief Operating Officer of Sun Life Financial of Canada, which acquired Clarica in June 2002. And building scale, he adds, has become crucial for competing in the US, since technology has opened up access across geographic boundaries: "Geography isn't as important, because you can access someone else's distribution. What you need are large amounts of volume in each business line. You can't compete on geography any more. You've got to compete based upon your strength in business line."

MetLife is another example. In buying the personal lines business of St. Paul Companies, the firm acquired an upscale-market offering it lacked. It now has a "packaged product" that offers more high-end consumers a single policy to cover multiple vehicles and homes.

Products are, after all, tools with which to manage the overall customer relationship. And executives note that insurers may need to offer linked or competing services to cater to a client's overall coverage need.

Captive insurance structures, for example, arguably compete with traditional insurance coverage. But providers have observed that companies pursue the captive route as a specific response to their individual cost and risk characteristics and goals. In short, clients seeking a captive arrangement can rarely be swayed back into traditional insurance coverage, so advising them on their captive structure, or running it for them, is the best way to meet their needs, especially since they will probably still need ancillary products.

"If a company says this is what they want to do, we're basically giving the client what they want," says Paul Obolensky, President of Captive Management Services for AIG Global Risk Management. AIG's involvement may be limited to establishing the captive structure, but it may also extend to managing key aspects of the captive's activities, from fronting and reinsurance to claims management, asset management, investment management and loss-control engineering. "We're helping the client create professional management of the risk they're taking on," says Mr. Obolensky.

The ability to service clients' needs, rather than simply selling them products, is increasingly becoming a differentiator, executives say—especially in the P&C sector, where insurers have a tough time standing out in the marketplace on the basis of product capability. In these conditions, service and execution become key—and that includes knowing when not to offer certain products and services. Insurers cannot afford to participate in activities where they cannot execute effectively, efficiently and accurately.

Fireman's Fund Insurance has "spent a lot of time and effort refining what the focus needs to be for our core products, and who those products and services should really serve," says Joe Beneducci, Chief Administrative Officer. "In the past couple of years, we have exited certain markets and bolstered our product lines and services in other markets where we believe there is a stronger opportunity." Fireman's Fund is using "customer focus groups, quantitative and qualitative research mechanisms—feedback from the market, from customers and also from agents—on what they really value from us, what we do well and what they're willing to pay for. Based on that feedback, which is very objective, that's where we're actually placing more emphasis," he says.

Too many insurance companies invest in sectors they would like to see grow, rather than using data, research and feedback to drive their decisions. This approach is short-sighted, many executives say, because while it may generate premiums, it will seldom drive net income or healthy returns on equity.

Improving claims management processes

Assuming insurers can generate net income on paper, surprisingly few seem to be optimizing claims management processes, a key contributor to profitability and customer satisfaction. In fact, say executives, underwriters simply cannot excel if they drop the ball on claims management.

Among survey respondents, only 15% of respondents describe their claims management process as excellent. Fewer than half of respondents say their processes are "good" and the remainder admit they are just "fair". This is hardly a glowing endorsement for an activity described by executives variously as "the moment of truth", "our defining moment" and "the point where the rubber hits the road".

"For an insurance operation, claims had better be a core competence, or you just won't be successful," says George Ruebenson, Head of Property Casualty Claims Service Organization at Allstate.

Executives agree that technology is critical for effective claims management: 62% of survey respondents say implementing technology to replace manual processes would have a palpable effect on the efficiency of their claims management, and 57% see efficient gains from implementing technology to control workflow based on business rules. Many say the impact of technology would be major.

"People want to be paid the fair amount of whatever is due them, but they also want their claim processed very quickly and efficiently, and with as little hassle as possible," says Ms. Rein of MetLife Auto & Home. "We spend a lot of money on expert computer systems to help us be quicker and more accurate in our claims-handling approaches." MetLife Auto & Home is also increasing the Internet options for its policyholders, but like many other executives, Ms. Rein says few policyholders are likely to make claims through the Internet today. The claims process is too personal, executives say, since it invariably follows a negative experience for the insured.

Ms. Zuraitis of St. Paul is among those industry executives emphasizing tighter interaction between claims and underwriting. "The commercial lines group can handle claims effectively because of a partnership with underwriting," she says. The claims department "knows what we've sold, and understands the underwriting intent. The contracts are clear, and then they're handled efficiently, competently and quickly on the back end."

Others concur that claims handlers must be skilled and knowledgeable about products—something that requires information to flow freely across the organization. It should be transparent to claims staff, for example, when coverage was bound, what other policies are in place for the insured and what the elements of coverage are.

Sophisticated IT systems are vital for managing business intelligence, but technology is also important for making internal processes more efficient and cost effective.

Only one-quarter of respondents say a major effort to cut costs in claims management is planned for the next 12 months. Executives say claims must be run efficiently at all times, regardless of whether the bottom line is thriving or not. And because claims management is a core competence, few expect to outsource it, though they see benefits in outsourcing various specialist activities, from collecting medical files to subrogation.

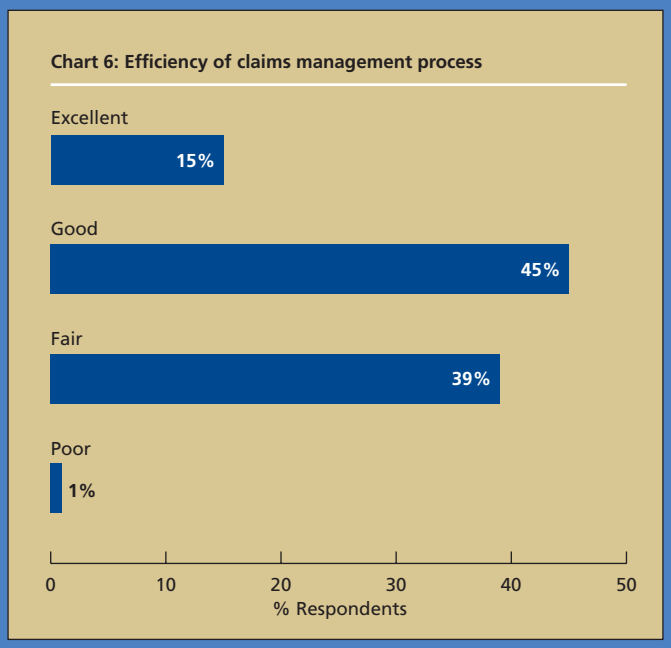
More than half of respondents say implementing technology to connect the internal claims department with external service providers would contribute to improved efficiency. The goal of technology is not just automation. The imperative is to link billing systems to eligibility systems, provider systems, claims systems and reporting systems. Many executives (and half of the survey respondents) say re-engineering processes, procedures and organizational structures can pay dividends for claims management.

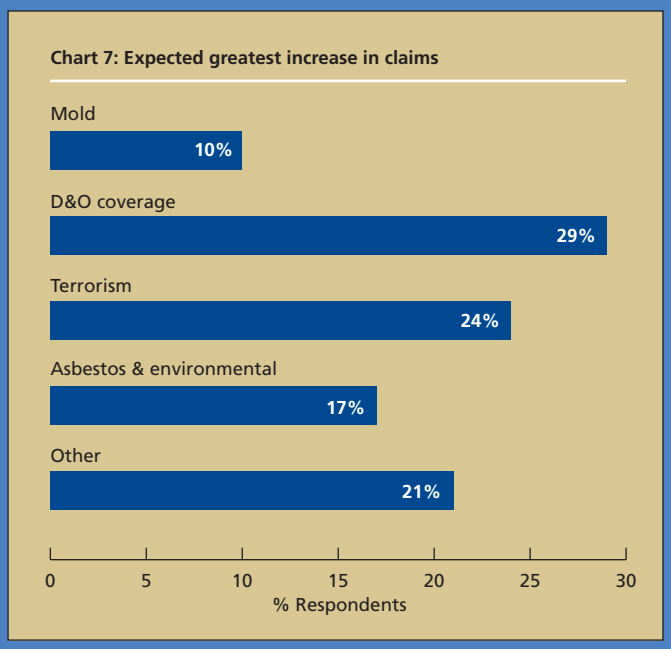
Health insurance is a good example. Administration costs wipe out perhaps 10% of health premiums written, so shaving even a couple of percentage points from the cost of the claims process produces a tangible impact on the bottom line.

Uniphyd is a health plan management company that enables physicians and other providers to own a provider-sponsored organization (a PSO is a health plan similar in structure to an HMO). Its technologies will, for example, allow a doctor's staff to enter a claim while the patient is still in the office. "The claim will be accepted, and essentially paid immediately. It will be a bank transaction that will appear the next day," says CEO Robert Trinka. This approach is consistent with Uniphyd's aim to empower physicians, give them the means to manage utilization and thus to manage costs while improving quality, he says.

However, Mr. Trinka concedes Uniphyd is in an enviable position as a new entity. "It's easier for me to have state-of-the-art systems than it is for an existing company, because I don't have to do a conversion [from legacy systems]", he says. He also notes, "IT has reached the stage where there are less expensive, web-enabled health plan information systems that run on the Microsoft technology platform. These systems have developed to the point where they are usable, reliable and dependable."

Other insurance sectors are also restructuring processes aggressively. Allstate expects to have delivered US$100m in savings by 2004 from a bricks-and-mortar consolidation, a processing innovation called "auto express" for handling simple auto claims and the pursuit of scale economies between claims and procurement, according to Mr. Ruebenson.





Claims management is not just a business process; it can be a competitive advantage, says Mr. Ruebenson. "If we can keep the rate of increasing cost lower than the competition, the necessity of rate increases, price increases to consumers, is less. Therefore the product becomes more competitive and more attractive. The objective is to keep our costs lower than the competition and to have our customer service be better. A lot of operations say, 'Which of the two do you want?' It's been my experience that you can do both."

Still, the most complex piece of the claims picture, say executives, is obviously the unknown. Long-tail liabilities are clearly of major concern to life, health and P&C insurers. About 30% of survey respondents say they expect the greatest increase in claims in the short term to be from mold, asbestos and environmental issues, infectious diseases and other medical conditions. This compares with the 29% who see the biggest rise in the claims burden coming from D&O coverage, and the 24% who cite terrorism.

Insurers in long-tail areas have so far been able to command greater premiums in the market, in part because state regulators have approved the high rates for fear the insurers will quit the business or go insolvent from the claims burden. But the imperative, again, is to price those risks appropriately, and to make sure the cost of paying those claims does not wipe out earned premiums.

Developing better business control and reporting

In keeping with the imperative to pursue sustainable growth, insurance executives say there is one more thing they can do to make better business decisions: improve internal controls.

Only 23% of survey respondents say their company's internal control environment is always reliable, while 24% concede it is often unreliable. The primary reason to improve controls is to allow for better business decision-making, say 49% of respondents.

The major concern, for an overwhelming 56% of respondents, is operational risk, but many executives say the risk picture should become clearer as insurers move to more granular reporting systems, albeit prompted in some cases by regulatory pressure.

Senior managers in US-based public companies, which are now required by the Sarbanes-Oxley Act to certify business results, are demanding their own forms of certification internally. Even companies not directly affected by Sarbanes-Oxley are adopting the paradigm, encouraging business people to understand, define and manage risks at the business-unit level, and put appropriate controls in place.

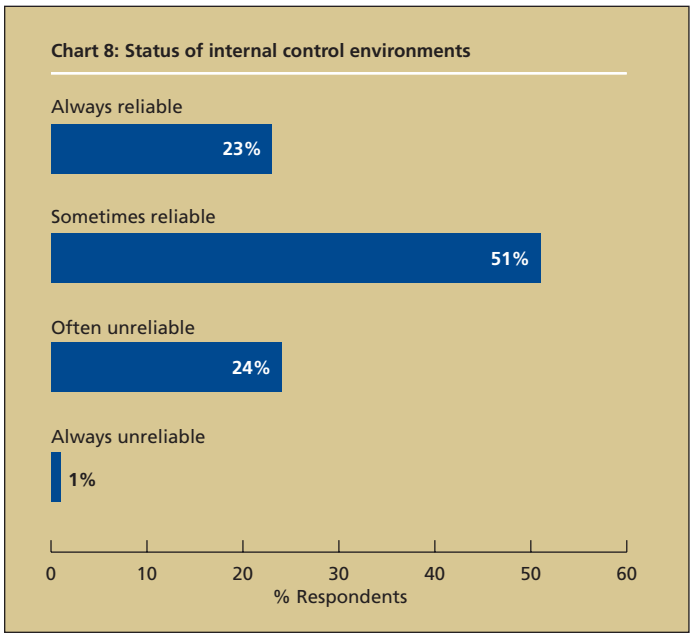
"We really want to push the risk management down to the business people," says Mr. Sheridan of SBLI. "You've got to know your risk. How do you control that risk? How do you manage your business line accordingly? Ultimately, the business people will be the ones responsible for the risk management, which is in my mind the way it should be."

This approach, Mr. Sheridan concedes, requires education, orientation and training. Many survey respondents agree: 32% say organizational culture is the most critical factor in improving controls, not IT or processes.

Prudential Insurance is also "making sure people understand their responsibilities and how they contribute to financial reporting, and understand their responsibilities to monitor the effectiveness and design of those controls," says Bill Eckert, Vice President and Insurance Division Controller. Mr. Eckert says the company has undertaken a huge initiative to ensure that it has the right framework for monitoring financial information, communicating issues and putting the right controls in place. The initiative "thinks about our operations, not just domestically, but globally, in terms of the impact and the risks that could be inherent in financial reporting".

Prudential already has risk officers for each business line, and they are responsible for helping management keep abreast of the company's operational risks. "It's a structure that we feel works because it helps in communication throughout the business about operational and other risk," says Mr. Eckert.

Executives say there are other benefits to looking more closely at financial data. One is an enhanced ability to benchmark performance against historical activity and competitors in the field. The Commercial Lines Group at St. Paul Companies has stepped up "the availability and rigor of financial data" available to the organization, says Ms. Zuraitis. "Underwriters now have a very detailed scorecard, a report card that I get every month that I can compare with my peers and other offices so we can actually measure more clearly how we're doing more often."



Thanks to technology, says Mr. Macdonald of ACE USA, "Price monitoring and benchmarking—understanding the adequacy of the premiums you're receiving—have never been better. And auditing internally has never been more aggressive."

Insurers that let governance slide will pay the price in the capital markets, say executives. "People are not just looking for stability in product, but stability in company," says Mr. Zesbaugh of Allianz Life. "They want companies that are highly rated and stable, particularly when we're talking about retirement-income-oriented products. The last thing that individuals want to worry about is, 'When I need my money, are they going to be able to pay it to me?'"

Customers—both buyers and agents—take very serious consideration of an insurer's financials these days, concurs Bob Needle, Managing Principal of Syndication at Aon, which is predominantly a broker. "There is probably more focus on the financials of insurance companies than I can ever remember," he says. "We would rather recommend a highly rated company, based on Standard & Poor's, A.M. Best and Moody's ratings, than a company that is more thinly capitalized," he notes, especially given ongoing concern about long-tailed risks.

All the more reason, executives say, for insurers to create a corporate culture focused on capital preservation and creation.

Conclusion: A new paradigm

For insurers, equity-market declines and rock-bottom interest rates have exposed the weakness of focusing too heavily on the asset side of their business and neglecting core activities. Many executives concede they must get back to basics, but it is no mean feat to turn even a growing top line into a healthy bottom line.

To succeed, insurers agree they must excel at a number of goals:

Strategic cost management
Companies that can conduct a granular accounting of profit and expense streams are able to gain a better understanding of where inefficiencies lie, and where best to invest capital

Precision risk assessment and pricing
Moving beyond class-based risks to a more targeted approach gives insurers the ability to price products more appropriately and precisely, and thus bolster profits

Customer focus in product development and distribution
Companies that can tailor their product lines and distribution channels to tested customer needs, with a focus on service, will win competitive advantage

Efficient claims management
Companies able to connect claims management to underwriting and other parts of the insurance operation can expect to reap cost efficiencies—and deliver results swiftly; and

Better control to inspire customer trust
Insurers able to demonstrate mastery of their internal control processes will win consumer loyalty, as good financial health provides customers with evidence of longevity.

Technology is crucial to providing solutions to all of these challenges, although insurers caution that reinvented processes and a free flow of information are also essential.

Many insurers have tackled these challenges because they have no choice; lackluster investment returns and low interest rates have deprived them of a comfortable cushion. But what happens when the market picks up again? Will insurers fall back into bad habits? Not the good ones, it seems. As the current movement "back to basics" in insurance suggests, a new paradigm is emerging: those who best master their core business now stand both to boost profitability over the short term and to gain tools they need to mitigate future dramatic swings of what is inherently a cyclical business.

Appendix: Survey results

The survey was administered on-line in August and September 2003 and collected responses from 80 individuals across the insurance industry.

Respondent Demographics

In what area of the insurance industry does your firm primarily operate? (multiple responses possible)

Property & casualty	49%
Life	38%
Health	21%
Reinsurance	23%
Annuity	17%
Other	18%

What is your firm's primary business focus?

Insurance carrier	37%
Independent agent/broker	28%
Full-service financial institution	14%
Third-party administrator	4%
Investment services firm	4%
Other	13%

Which of the following best reflects your title?

Chairman, CEO, Board Member	9%
President, COO, Managing Director	19%
SVP	4%
EVP	3%
Vice-President	11%
CKO/CIO/Technology Director/CTO/	4%
Director of Marketing	8%
Other Director	4%
Other Manager	16%
Other	23%

Where are you personally located?

United States	28%
Canada	4%
Europe	33%
Asia-Pacific	22%
Latin America	8%
Middle East & Africa	5%

Redefining the Core Business of Insurance

How would you characterize the current condition of your sector of the insurance industry?

Excellent	4%
Good	40%
Fair	46%
Poor	10%

What are the biggest external problems faced by your sector of the insurance industry today? (rated on a scale from 1 to 5, where 1 equals "insignificant" and 5 equals "major problem")

	1	2	3	4	5
Credit risk	11%	16%	35%	34%	4%
Interest rate risk	8%	26%	39%	20%	7%
Emerging risks (terrorism, corporate fraud)	11%	24%	22%	26%	17%
Asbestos & environmental reserving position	38%	22%	21%	12%	7%
Increased government regulation	5%	20%	30%	33%	12%
Difficult investment market	4%	8%	32%	36%	21%
Weak demand	16%	24%	34%	19%	7%
Overcrowded market	8%	37%	30%	16%	9%
Rising medical costs	17%	20%	22%	24%	17%
Tort expenses	16%	24%	30%	19%	11%

What are the biggest internal problems faced by your sector of the insurance industry today? (rated on a scale from 1 to 5, where 1 equals "insignificant" and 5 equals "major problem")

	1	2	3	4	5
Tight/constrained margins	3%	13%	25%	42%	18%
Cost control	1%	13%	30%	40%	16%
Lack of systematized business processes	4%	18%	33%	36%	9%
Creating competitive advantage	1%	14%	21%	53%	11%
Retaining and attracting top talent	0%	13%	33%	37%	16%
Keeping pace with technology developments	1%	20%	38%	26%	15%
Poor underwriting	11%	29%	39%	14%	7%
Inadequate distribution networks	8%	26%	34%	25%	7%

Which areas of your business are most in need of improvement? (multiple responses possible)	
Asset management	29%
Operational and financial controls	39%
Risk management	43%
Underwriting	23%
Marketing	44%
Distribution	42%
Claims processing/management	32%
Billing	10%
IT systems	48%
Cost control	35%
Product development	44%
Workforce planning (resource deployment, downsizing, retention, etc.)	42%
Other	1%

What is currently your company's core business?	
Underwriting insurance products	34%
Designing insurance products	9%
Servicing insurance products	8%
Distributing insurance products	21%
Selling investment products	7%
Investment/portfolio management	7%
Other	14%

What will be your company's core business in the future?	
Underwriting insurance products	34%
Designing insurance products	8%
Servicing insurance products	10%
Distributing insurance products	18%
Selling investment products	8%
Investment/portfolio management	8%
Other	14%

How does your company assess the following as ways to improve "bottom-line" profitability? (rated on a scale of 1 to 5, where 1 equals "least effective" and 5 equals "most effective")

	1	2	3	4	5
Higher premiums	1%	24%	40%	24%	11%
Better cost control	0%	12%	20%	43%	24%
Better customer service	0%	11%	34%	36%	20%
Elimination of immeasurable risk coverage (e.g., terrorism coverage)	17%	33%	28%	17%	6%
Acquisitions	22%	30%	27%	21%	0%
Better underwriting	10%	25%	21%	30%	15%
Better asset management	14%	16%	29%	30%	11%
Developing new, non-insurance businesses	25%	28%	17%	19%	11%
Creating new types of policies/products	3%	16%	19%	47%	15%
Improved claims management	6%	17%	32%	31%	14%
Outsourcing core business processes	21%	21%	29%	21%	8%
More effective use of IT	4%	4%	23%	49%	19%
Divesting of non-strategic, non-core business	17%	23%	25%	25%	10%
New distribution strategies	4%	13%	22%	36%	25%
Cross-selling across the organization	11%	18%	16%	32%	23%
Strategic alliances	10%	18%	15%	28%	29%

How does your company assess the following as ways to promote "top-line" growth? (rated on a scale of 1 to 5, where 1 equals "least effective" and 5 equals "most effective")

	1	2	3	4	5
Higher premiums	10%	14%	33%	19%	24%
Better cost control	8%	21%	29%	29%	14%
Better customer service	4%	8%	23%	33%	32%
Elimination of immeasurable risk coverage (e.g., terrorism coverage)	22%	36%	28%	10%	4%
Acquisitions	14%	21%	18%	31%	17%
Better underwriting	12%	21%	27%	26%	14%
Better asset management	16%	23%	22%	25%	14%
Developing new, non-insurance businesses	19%	14%	30%	27%	10%
Creating new types of policies/products	7%	9%	20%	35%	28%
Improved claims management	13%	19%	31%	21%	17%
Outsourcing core business processes	25%	25%	29%	14%	7%
More effective use of IT	5%	12%	24%	41%	18%
Divesting of non-strategic, non-core business	21%	27%	27%	18%	7%
New distribution strategies	10%	6%	21%	38%	25%
Cross-selling across the organization	14%	8%	22%	30%	26%
Strategic alliances	7%	14%	20%	25%	34%

Managing Lower Investment Returns

How would you assess the insurance industry's recent experience with asset management? Please indicate whether you agree or disagree with the following statements.

	Disagree	Agree
The insurance industry is over-dependent on healthy investment returns.	21%	79%
Improved insurance operations are the best route to strong profitability.	14%	86%
Insurers need to concentrate on improving investment management techniques.	32%	68%
Current problems in the industry are part of a fairly predictable cycle and will largely resolve themselves as the global economy regains its health.	64%	36%
Lower investment returns aren't as big a problem as spiralling costs.	43%	57%
Insurers must write business for immeasurable risks (e.g., terrorism coverage) and increase premiums further to compensate for uncertainty.	65%	35%

Have lower investment returns affected your company's profitability?	
Yes, profitability has declined sharply	18%
Yes, profitability has declined slightly	51%
No, profitability has remained unchanged	18%
No, profitability has improved	5%
Other	7%

When do you expect to see a recovery in investment returns?	
Within six months	8%
Within one year	27%
Within two years	28%
Don't expect returns to reach previous levels again soon	36%
Other	1%

Writing Better Business

What is the most important cause of rising premiums in the insurance industry?	
The need to compensate for poor investment results	33%
A more risk-filled environment	17%
A more litigation-oriented business culture	14%
The need to generate reserves for asbestos, mold and other extraordinary claims	7%
Increased customer perception of the value of insurance products	3%
Inefficient operations	5%
Increase in identifiable hazards	4%
Lack of tort reform	1%
Rising medical costs	8%
Other	8%

How long do you expect the hard market to continue?	
Pricing has already begun to plateau	16%
Through the end of 2003	21%
Through 2004	50%
Through 2005 and possibly beyond	13%

What steps would improve the effectiveness of your underwriting? (only the three most important factors)

Real-time quoting/issuing	25%
More streamlined and integrated IT systems	40%
More standardized processes and guidelines	28%
Better information on risks	67%
Real-time performance measurement information	16%
More reliance on individual underwriter judgment	15%
Better retention of senior underwriters	31%
Greater user of data-mining techniques	39%
A reduction in the range of products offered	4%
Better cross-training of underwriter talent	25%
Other	3%

What key underwriting goals will your firm be pursuing over the coming 12 months? (only the three most important factors)

Real-time quoting/issuing	18%
More streamlined and integrated IT systems	48%
More standardized processes and guidelines	37%
Better information on risks	61%
Real-time performance measurement information	21%
More reliance on individual underwriter judgment	15%
Better retention of senior underwriters	28%
Greater user of data-mining techniques/data warehousing	39%
A reduction in the range of products offered	8%
Better cross-training of underwriter talent	31%
Other	8%

Do you plan to offer real-time quoting, application approval and policy issue to customers or agents via the Internet?

Yes	35%
No	48%
We already offer web-based quoting	17%

To what extent does distribution affect the profitability of your business?	
Very much	38%
Moderately	47%
Not significantly	11%
Not at all	4%

What is your biggest challenge in distribution?	
Determining the best strategy	32%
Channel conflict	12%
Attraction and retention of good producers	30%
Cost of distribution	25%
Other	1%

Which of the following distribution changes will you be considering over the next 12 months? (multiple responses possible).	
Assessing effectiveness of current channels through profitability analyzes	52%
Expanding current channels geographically	38%
Supplementing current channels via Internet product offerings	27%
Eliminating channels because of cost/ineffectiveness/change in strategy	21%
Forming alliances to increase channels	56%
None	5%
Other	5%

Enhancing Claims Management

How would you characterize the efficiency of your claims management process?

Excellent	15%
Good	45%
Fair	39%
Poor	1%

What would make claims management at your company more efficient? (rated on a scale of 1 to 5, where 1 equals "least effective" and 5 equals "most effective")

	1	2	3	4	5
Outsourcing of claims management	41%	17%	23%	18%	1%
Instituting better controls	10%	17%	29%	35%	10%
Implementing technology to replace manual processes	7%	7%	24%	39%	23%
Implementing technology to control workflow based on business rules	4%	4%	35%	38%	19%
Implementing technology to connect the internal claims department with external service providers	8%	11%	21%	38%	21%
Making targeted staff reductions	24%	33%	28%	13%	3%
New monitoring techniques	8%	15%	36%	35%	6%
Re-engineering processes, procedures and organization	6%	10%	34%	37%	14%
Developing strategic alliances with niche vendors	19%	13%	35%	23%	10%

Does your firm plan a major effort to cut costs in claims management over the next 12 months?

Yes	29%
No	71%

In the short term, where do you expect the industry to experience the greatest increase in claims?

Mold	10%
Asbestos & environmental	17%
Terrorism	24%
D&O coverage	29%
Other	21%

Improving Financial Controls

How would you currently describe your company's internal control environment?	
Always reliable	23%
Sometimes reliable	51%
Often unreliable	24%
Always unreliable	1%

Which of the following elements is the most critical for improving financial controls?	
Organizational culture	32%
IT systems/data accessibility	23%
Management–the "tone at the top"	20%
Processes	23%
Other	1%

What is the primary motivation for improving financial controls?	
To make better business decisions	49%
To gain (or regain) investor trust	3%
To comply with applicable laws and regulations	14%
To gain competitive advantage through streamlined operations	34%
Other	1%

Does your company plan to appoint a chief risk officer, or equivalent?	
Yes	8%
No–but think it is required	23%
No–don't think it is necessary	31%
Already have a chief risk officer (or equivalent)	39%

What area of risk is of most concern to you?	
Credit risk	12%
Interest rate risk	15%
Operational risk	56%
Terrorism risk	4%
Corporate fraud risk	7%
Other	7%

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