Creating Value in New Ways for Insurers:

Same Questions…Changed World…New Capabilities Required

Part 1

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Surprises are seldom a good thing… but here we are

COVID-19 is not and will not be the only "shock" to insurers and their customers. It is certainly the greatest shock to the industry since the financial crisis of 2007-2008. In the wake of the pandemic, the insurance industry – across the board – has underperformed the market by 12% as the sector's substantial asset risk was exposed by falling interest rates, widening bond spreads and equity markets that melted down.

What the industry does won't change: get new business, improve underwriting and optimize claims while reducing loss ratios and leakage. **How** it does so, however, will. Dramatically. It must. For two reasons.

First, a wide variety of economic performance is masked by the aggregate numbers between the top and bottom quartile of insurers (and we'll focus on life and property & casualty in this post). For example, the Return on Tangible Equity (RoTE) for the top quartile averaged 38% yet only 8.7% for the bottom quartile. The "so what" here?: 75% of insurers had Return on Equity (RoE) close to our below their Cost of Equity meaning they were destroying rather than creating value. (Source: BCG, Insurance Value Creators Report, 2020.) And this was prior to COVID. What COVID has done is expose these numbers making it crystal clear what has to happen to create value – because clearly doing more of the same will only exacerbate the economic pressure on the majority of the industry.

Second, and it gets worse here since a significant percentage of value, historically, has been realized by investment returns on assets. Yet, governments have cut interest rates to extra-ordinary low levels. The implication? Negative effects on investment dependent revenues and returns. As of June, 2020, insurers had underperformed the market by 12%. They have been the 4th worst-performing sector surpassed only by the hospital, banking and energy sectors. The sector's asset leverage has become a significant liability since interest rates, credit spreads and equity markets all took a bath in parallel.

Combine this with the yet to be determined "final bill" of losses in commercial and reinsurance lines with its negative ripple effects on underwriting performance, and the uncertainty of where growth will come from only grows. Particularly for the majority (75%) of the insurance players who are already significantly behind the top quintile economic performers.

In the short term (the next 6-12 months), the imperative is pretty clear: protect the business and our employees through saving cash and taking this as an opportunity to re-evaluate where to play, what drives economic value and, critically, the new capabilities needed to execute in a changed competitive world.

In the longer term (12 months +), the imperative is equally clear: be well on the way towards executing on how to make sure RoTE exceeds CoE. Which, itself, centers crisply on improving the foundations of:

- Profitability metrics
- Balance sheet health
- Forward growth expectations, and
- Business mix.

And here it gets interesting.

Back to basics, with a twist

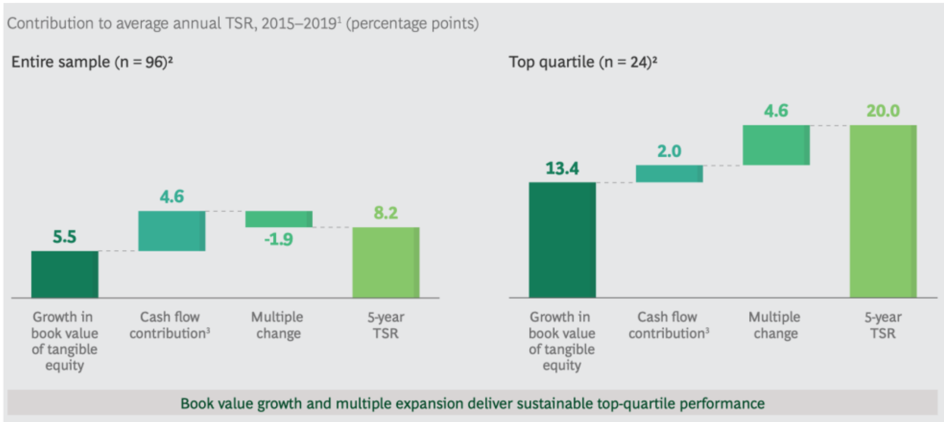
The next set of years is uncertain. The outlook for interest rates is poor with investment returns likely to continue to contract. With a pragmatic implication: replace the reduced investment spreads with higher underwriting and fee margins while cutting operating and distribution costs.

Ok, that's part of the equation. But there's another piece of the puzzle important to play, one that may provide a tight focus on how to drive economic value given that some of the pathways of value are now closed off.

In P&C, again relying on the recent BCG report cited above, underwriting margin and investment income contributed about the equal amounts to economic value. However, this segment has had significant variations in performance between the top and the bottom performance. Top quartile performers recorded 10% RoE higher than the median, an indicator of clear differences in terms of capital and operating productivity. However, with the collapse of investment spreads as a profitability option, everyone, no matter the pre-existing quartile, needs to find new ways to drive value through higher underwriting and fee margins.

And this requires looking at what has been the primary driver of value creation.

Over the past 5 years, growth in book value has been the primary driver of value creation, followed by cash flow contributions. And, as a recent BCG report states, "over the past 10 years, book value growth has been the differentiating driver for the best performers, accounting for close to 80% of top-quartile… [economic] performance." (Source: BCG, Insurance Value Creators Report, 2020, and see figure below from the report).



Growth in book value has been the primary driver of value creation up to now. And going forward. The question is: where, and how to realize it?

So, what do we know?

First, that a significant proportion of what generated value before is under significant pressure.

Second, what the overall exposure to the COVID liabilities will be uncertain a period of time (what we know is that it will be significant, not when the "bills come due and for long they do so").

Third, what insurers do doesn't change – e.g., create new markets, underwrite, and manage claims.

And Fourth, growing one's book value is the greatest opportunity for driving sustainable economic value.

Regarding #4, what will happen to revenues, and loss ratios over the next 2-3 years, what markets – by location, segment and product – will drive the greatest growth, and how do we "nudge" the behaviors of potential customers "into" these new markets are all open questions. But, they are "answerable" once a crisp focus of "what" to focus on exists.

Yet, here again, it gets interesting.

Because, yes, COVID has changed the world. Giving us the opportunity to step back – quickly – to cut through the noise and isolate what a) did and now b) will create economic value assuming that one:

1. Makes effective tradeoffs among where and how to increase book value

2. Recognizes that what drove a significant percentage of economic value to now won't going forward (requiring a new business mix) and
3. Figures out – and aggressively focuses on – new capabilities needed to support #1 and #2.

Here's a "no-kidding, Sherlock" observation. There will be other "COVIDs" – shocks to the industry. Yes, COVID has been brutal, fast and urgent. Yet, others will come. And so, the opportunity window COVID has opened is one not to squander.

Same Questions. New Competitive World. New Capabilities. To Support Planning for New Growth.

So, what are some of these new capabilities to help answer the same questions given a changed competitive world?

You can get a list from any number of advisory firms on what to do – e.g.,

- Invest in advanced technologies – because, as digital maturity correlates strongly across industries with economic performance. And for insurance, this would involve a focus on distribution, customer service, operations, and claims handling.
- Execute on M&A around new books of business – particularly compelling given the number of distressed partiers there are now – creating a rich opportunity of deepening capabilities, products and customer sets.
- Focus on methods to improve profitability metrics through productivity and balance sheet health.

Got it. And to these, we say, of course. These is a nice list of "what" to do. But "how" do you do it and where "do" you invest, execute and focus. Let's explore this a bit by going back to the three imperatives to create sustainable economic value given our uncertain competitive environment of:

1. Making effective tradeoffs among where and how to increase book value

2. Recognizing that what drove a significant percentage of economic value to now won't going forward (requiring a new business mix) and

3. Figuring out the new capabilities to support #1 and #2.

Our businesses now exist in an uncertain economic environment. What worked before will not as well as it did previously. Which requires asking (some of) the same questions (a topic for a different post), but in new ways, powered by new capabilities. (see the book Topple: The End of Firm-based Strategy and the Rise of New Business Models for additional new questions to ask, and answer).

Previously, business planning was pretty straight-forward. Increment what you did previously by x% and monitor what leaders did and taking advantage of some of those insights every now and then.

Now, however, an opportunity exists to make bigger bets with less clear outcomes in a less predictable world but with the opportunity to carve out new books of business more predictably.

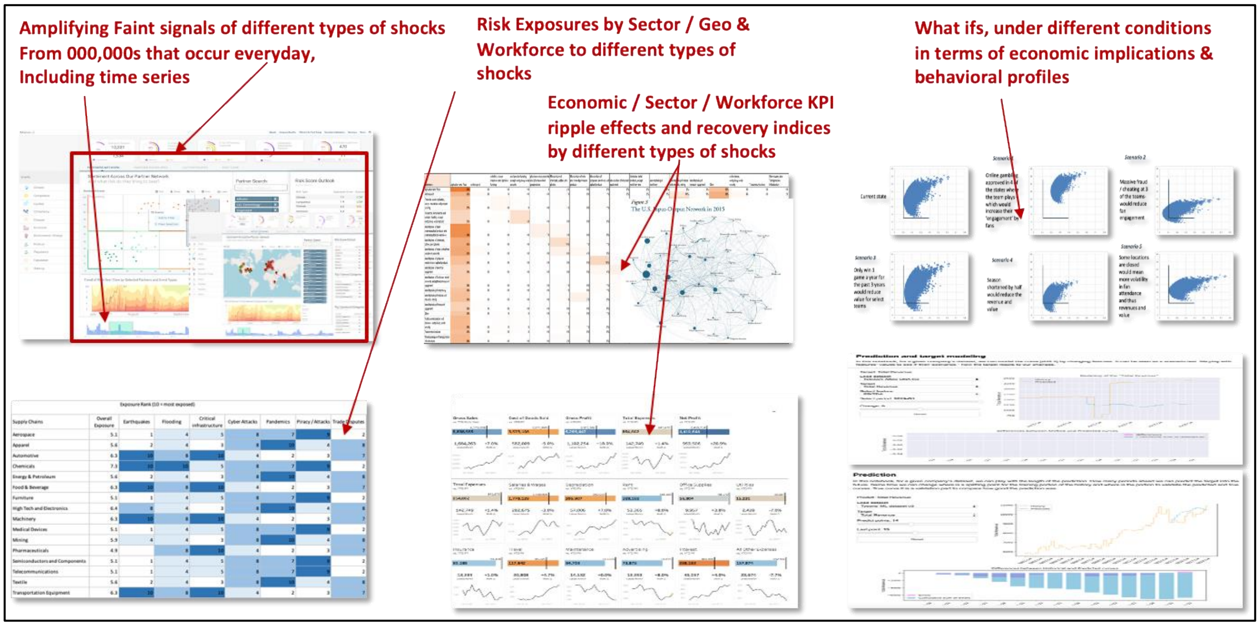
Sounds contradictory. But it's not. And it points to what some of the new capabilities are that improves the likelihood of capturing new books of business in new ways.

Much of traditional planning is based on lagging indicators, or a set of modeling risks that is well tried and true. But, the surprise of COVID, and as we've mentioned already, other shocks yet to occur, suggests that new methods of "amplifying faint signals" of risks, and opportunities, are no longer nice to have, but critical to use.

Now, however, an opportunity exists to make bigger bets with less clear outcomes in a less predictable world but with the opportunity to carve out new books of business more predictably.

What if… you had insight, in hours, rather than weeks (or never) into:

- Different types of shocks that could impact your business among the millions that occur (in time series or otherwise) blindly to your organization every day?
- Risk exposures by sector/geography/workforce/etc. associated with each type of shock?
- Economic/Sector/Workforce KPI "ripple effects" and recovery indices by type of shock?
- Economic implications and behavioral profiles for an unlimited number of "what if" scenarios based on advanced algorithms and rich taxonomies?
- Ability to simulate new books of business under different conditions?



How?

Through the use of targeted techniques of natural language processing, machine learning, algorithmics and math – to quickly strengthen planning capabilities with a crisp focus on re-evaluating investment portfolios, building leading-indicators into possible new profit pools, behavioral profiles and simulations of economic impacts under different conditions… in days rather than months, powered algorithmically, and delivered “as needed.”

A call to action:

Same Questions. Changed World. New Capabilities. For Planning under Different Conditions – quickly.

About the Author:

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