BRIDGE STRATEGY GROUP LLC

A View from the Bridge

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Five Cost Management Strategies Often Overlooked

With no shortage of techniques available for managing and reducing costs, from activity value analysis to reengineering to automation, an outside observer might think little remains to be done on the cost front inside most insurance companies. Our outside observer would, of course, be wrong. These techniques tend to involve significant upfront investment and a degree of uncertainty as to when, or even whether, they will pay off. As a result, companies are reluctant to make use of them. This month's View from the Bridge describes five specific strategies for managing costs that have high potential and can be undertaken with relatively modest upfront investment, yet are often overlooked by insurance companies. A number of them can be made to pay off quite rapidly - potentially of interest to companies battling a soft market, rising reinsurance premiums, and stagnant (at best) investment returns.

Renegotiate Existing Contracts

Strategic sourcing is a discipline companies use to make the most of what they spend on the products and services they buy from third parties. While many insurance companies have become quite good at executing scheduled sourcing events, fewer realize the potential that exists, particularly in a deflationary environment, for renegotiation of existing contracts. This is a price that suppliers in competitive markets will often be willing to pay to maintain customer good will.

The way to approach such an effort is to tap into personal and professional networks for directional pricing "benchmarks" from companies that have recently sourced targeted categories, and then compare these benchmarks with existing pricing to identify high potential contracts and suppliers. Each category and supplier is deserving of its own strategy, but since these negotiations will not be overtly competitive, it's generally best to ask for desired pricing at the outset and proceed from there.

Contract renegotiation is among the most appealing cost management strategies, because savings drop right to a company's bottom line, and it is not focused on headcount reduction at a time when employees are understandably nervous about job security. It can be applied to everything from roadside assistance and investigative services to office supplies.

Focus Marketing Spend Where Return is Greatest

Insurance companies have long wondered whether large and often growing expenditures on marketing were actually paying off, but lacked the tools to know with any confidence whether this was the case. Direct writers dependent on advertising to steer customers to a website or call center saw little choice other than to pour ever larger sums into advertising if they were to grow, or in competitive markets just maintain, market share.

More recently, analytical techniques and software tools for determining the impact of various forms of advertising on revenue and profits have actually gotten quite good, particularly for measured media (e.g., click through on websites or dedicated phone numbers). It is no longer the case that insurers must simply spend and hope for the best. Analyzing which expenditures pay for themselves in increased revenue and profits and which don't can free up funds to be directed to more productive uses, or simply drop to the bottom line.

Reassess and Update Project Portfolio

Over time, a company's project portfolio can come to resemble a weekend sports enthusiast's basement, with idle paraphernalia collecting dust, unlikely ever to be used as intended, if at all. It's not hard to figure out why. Projects can take a long time to complete. Management changes. Strategies and priorities change. Even companies that make it a practice to manage portfolios actively are slow to challenge politically powerful patrons, cancel or re-scope projects with materially changed business cases, or admit outright failure when that is the only reasonable course of action. They will, of course, eventually get around to terminating at least some of these projects, but not before a great deal of avoidable spending has occurred.

Indiscriminate cancellation of projects is not the answer. That is a recipe for underperformance when the economy turns, as it undoubtedly will. The goal, even in a recession as difficult as the one we're currently experiencing, is to achieve attainable benefits at a substantially lower cost. The key to this is a dispassionate process that plots up-to-date assessments of each project's benefits against costs, risks, and barriers to implementation and eliminates - or re-scopes - those that fail to clear the necessary hurdles. It may also be advisable to delay projects with uncertain or intangible benefits, if greater clarity is likely to emerge and benefits unlikely to degrade over time.

Convert Fixed to Variable Costs

Lower claim counts and reduced severity should be good news for both customer and insurance company, but carriers may find profit margins dropping when they try to pass savings on to customers. The primary culprit is fixed costs. Costs associated with Finance, IT, and other forms of corporate overhead have historically been viewed as fixed, but this need no longer be the case. Outsourcing is now a very viable option for insurance companies interested in relieving themselves of at least some of these responsibilities and, with the right provider and a properly structured contract, a way to transform previously fixed into variable costs. Activities like payroll and T&E (travel and entertainment) reimbursement can be outsourced rapidly at manageable implementation cost. Mature markets now exist for core functions such as first notice of loss taking and claim adjusting as a whole - think TPAs and temporary adjusters. Cash strapped companies may welcome an injection of funds from the "sale" of existing operations and assets to a third party provider. Large scale outsourcing is not, of course, right for every company, but selective outsourcing is an option that all insurers interested in moving to a more variable cost base should seriously consider.

Review and Realign Shared Service Incentives

Many companies have chosen to organize functions present in more than one business unit, for example customer service call centers, procurement, document production, and information technology, into shared services. Those that haven't might want to consider this idea, since it has proven an effective way of both managing costs and raising service levels. Having done this, some have then put in place cost recovery methods that are at best neutral and at worst actually incent behaviors the company should be trying to avoid, behaviors like overconsumption (transfer prices too low) or discontinuing use of infrastructure or services like procurement or mainframe capacity that benefit greatly from scale (prices too high). Cost leakage can be significant, as in the case of one company that rewarded shared service leaders at bonus time when their operations produced "profits." This company found itself growing its capacity in a number of areas far faster than its revenue as shared service utilization dropped and usage of third parties rose dramatically.

Transfer pricing and chargeback can be very effective tools for helping a company to reduce its usage of products or services that are out of favor and to take maximum advantage of scale economies. The key is to invest as much thought in internal as external pricing. One note of caution: pricing schemes that are difficult for users to decipher will fail to produce the desired result, as users will not be clear on exactly which behaviors the company is trying to incent.

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This month's ***View from the Bridge*** discussed targeted cost management strategies, a topic much on the minds of insurance executives these days for obvious reasons. It should not, however, be the only topic occupying their attention. Much has been made of the Obama Administration's belief that a crisis should never be wasted. Insurance companies might also benefit from this line of thinking. Now, when even well managed companies find it virtually impossible to sustain earnings and revenue trajectories, might be the time to think the unthinkable. This might be a once-in-a-career chance to launch initiatives and take other actions that in more normal times might be dismissed as too risky - introducing new services, exiting unprofitable businesses that may have helped to plug a revenue gap, shifting to more productive or cost effective channels, or even changing (e.g., via reinsurance) where the company chooses to take risk. Difficult times may bring with them extraordinary opportunity.

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