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Insurance

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Now what? Exploring initiatives for innovation

By Jamie Bisker and Christian Bieck

The IBM Institute for Business Value recently explored the future of insurance as seen through the eyes of global industry executives and created a study entitled, "Insurance 2020: Innovating Beyond Old Models," which provided insight into the question of why insurance appears to a lethargic industry in the use of innovation.[1] This study shows that insurers focus on the optimization of products and processes and accept it as though it were innovation. However, the power of innovation does not come simply from the use of a specific technology to overcome a problem, but from the willingness to try something different. We believe insurers should move to adopt a new approach or new technology to address persistent operational challenges.

Introduction

A recent study by the IBM Institute for Business Value, "Insurance 2020: Innovating Beyond Old Models," provided insight into the apparent lethargy of the insurance industry in terms of innovation.[2] In summary, the study showed that while market forces demand real innovation in business models, insurers consistently focus on the optimization of products, processes and services. This activity often leveraged information technology (IT) advances over the course of many decades. For many carriers the result was an organization that mistook optimization for innovation.

This approach has produced two outcomes. First, although it is clear that there are some insurance carriers, agencies and brokers that are exceptions, many have little to show for the many years of optimization they practiced. For example, from 1955 to 2006, the U.S property and casualty (P&C) insurance industry had a return on equity (ROE) below the average for all U.S. industries more than 87 percent of the time.[3] Changes in value chain automation, data management, and the use of online mechanisms made over the course of the last several decades were at the tail end of larger technological or societal changes and were directed towards improving existing processes and mechanisms. If they continue to follow this course, carriers will logically see diminishing results. It is likely that either an existing competitor or a new entrant from outside of traditional insurance – such as a retailer, social computing purveyor or other service industry constituent – will capture a portion of the market.

The second outcome from the industry's focus on optimization is in opportunity costs. There is an uncalculated cost from the insufficient, or even absent, application of innovation, especially in business models. So, although making improvements in processes and operations via the use of increasingly advanced technology *felt* like the right thing to do, those activities became a proxy for innovation and supplied a stream of revenue enhancements of sufficient stability to please executives.

Presenting these two primary findings established a straightforward tension among insurance stakeholders: if the insurance industry is reticent about the recognition and use of innovation, how *should* it go about implementing change that incorporates innovation. In short: "Now what?" What can the insurance industry do to embrace the change and innovation needed to succeed? What form does "innovation that matters" take in the insurance value chain as we approach the end of the first decade of a new century?

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Instead of trying to improve current processes, we believe the insurance industry would be well-served by looking at the forces affecting various demographic groups and preparing for a changing future.

Recognize and react to disruptive realities

Two of the four megatrends developed in our original study are the basis for our tactical exploration of innovation. The first megatrend focused on the disruptive potential that changing demographics will bring to insurance industry stakeholders. These demographic realities will impact not only insurance consumers, but also agents, brokers, policyholders and other industry professionals across various demographics.

For instance, will the Generation Y demographic, those people in their early teens to mid-twenties, continue to expect service industries to engage *and* reward them via the Internet? Will those working in insurance distribution *need* to make use of social computing tools in their careers? Insurers need to recognize that opportunities arising from understanding such demographics realities extend beyond optimization of sales channels. They include customer service, claims handling and fraud prevention – as well as chances to engage consumers and clients with more customized products.

The second megatrend that needs the tactical attention of insurers is how technology – and information technology in particular – acts to level the playing fields of the insurance business. One aspect of this is how technology will empower an influx of new players in the traditional insurance space. Already, retail grocery chains, such as Tesco in the United Kingdom and Kroger in the United States, have implemented the distribution of insurance products via their stores. And since virtually all commercial enterprises have access to the same technology and information systems, it can be expected that other types of businesses will begin to explore the adjacent spaces of insurance protection products, in addition to being points of distribution. These adjacent spaces are literally those areas of service or asset protection that are close (i.e., adjacent) in a common-sense way to existing products and services. For example, in addition to selling traditional comprehensive and collision coverages, some automobile insurers have added highway breakdown provisions to their policies. Life insurers could consider adding adult daycare riders to retirement income products to help customers deal with the burden of caring for elderly parents. Insurance companies working to develop a more strategic view of their business should consider that essential systems needed to run an insurance business today can be purchased.

In spite of the previous examples, the familiar message still needs repeating: the insurance industry does not have a technology problem – it has problems in the use of technology due to culture, internal politics and the engrained aspects of human nature that resist change. Disruptive forces will come to the various demographic groups in the form of cultural change, technological advancements and geopolitical realities, such as changes in the environment, the globalization of commerce and world health issues. We believe that, instead of working hard to improve current processes, insurers should be preparing for a changing future.

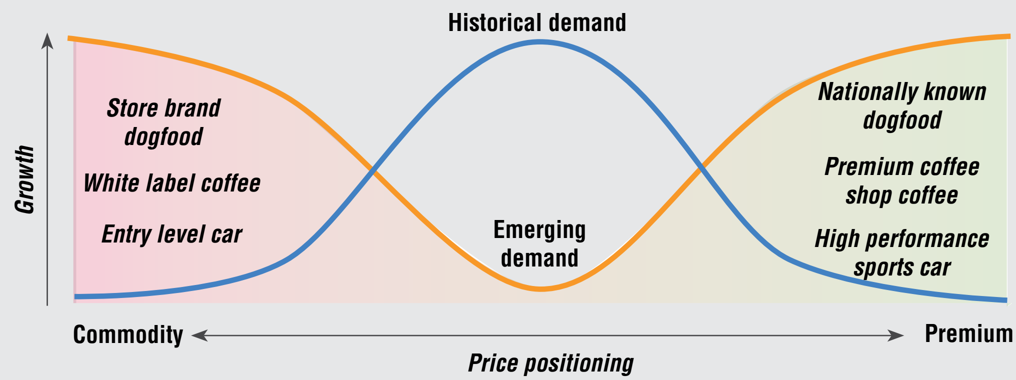
Adjusting to changing customers

As insurance operations grew over the years and more and more lines of business (LOBs) were introduced, the business side within insurance companies developed a product-centric view of the industry. At the same time, information systems grew in capability and became an indispensable component of the business. When systems areas were created and funded, they necessarily formed around the existing LOBs, and thus today's silo approach to IT was born. Only gradually are the terms "one face to the customer" and "single view of the customer" gaining a hold in insurance thinking.

While insurers were maintaining their product centricity, consumers changed in other ways. Consumers were more or less a uniform group 20 years ago, with price sensitivity versus service orientation lying on a Gaussian curve (see Figure 1).[4] Today this bell curve has completely flipped, leaving a market with significant populations of consumers at both ends of the commodity pricing versus premium quality spectrum. As a result, the classic mass market is diminished although still pursued.

On one side, hunting for the cheapest offer has become a popular sport, rendering other product parameters irrelevant. On the other side, consumers are still willing to pay a premium for convenience and service. This forces vendors in all markets, including those in financial services, to be more precise in what they offer. In insurance markets, carriers won't be able to rely on applicants consistently buying the coverages and services they are offered. At the same time, carriers have to contend with market bifurcation as seen in consumer products, as well as the behavioral variance they will encounter among individuals. For example, a younger policyholder is likely to renew an automobile insurance policy at regulatory minimum coverages to keep his

FIGURE 1.
Customer centricity.



Source: IBM Institute for Business Value. The "well curve" concept was described in the following article: Pink, Daniel H. "The Shape of Things to Come." Wired. May 2003.

Insurers must understand the fundamental changes in demographics and arm themselves with knowledge – not only of their policyholders, applicants and claimants, but also of their own employee and service populations.

or her cost low. However, as the same individual grows older and becomes more value and time conscious, he or she will consider riders for roadside assistance and vehicle repair. The breakdowns for these market segments can be complex when considering the dimensions of vehicle type, geographic location, income, household makeup and many other factors.

Why demographics matter

An important point to remember when talking about customer centricity is the reality of changing demographics – not only for their impact on current or potential policyholders, clients and claimants, but also because of workforce considerations. As much as all industries and businesses need to understand workforce demographics, insurance is particularly impacted due to the long learning curve, specialization and licensing required by the industry and its regulators.

For example, in the P&C business, the profession of claims adjuster is facing its own circumstances. These individuals already face enormous workloads and stressful employment conditions. The expertise that insurers require comes from experience – and that quality is rapidly being depleted and not replaced. Approximately 70 percent of claims adjusters in the United States are now over 40 years of age and similar numbers apply in Europe.[5] Keeping up with the realities of a demanding job description, combined with an increasing pool of retiring expertise, means that the industry should take action soon.

Demographics factor not only into customer behavior and portfolio setup, but also into the impact of marketing and the design of regional campaigns. In the United States, while fertility is holding steady around the positive (i.e., growing) reproductive rate of 2.1 children per family, Europe is facing a faster aging and declining population with rates from 2.0 (France) to 1.3 (Italy).[6] For global insurers, this means a constant focus on local data and marketing concepts, even assuming global networking will, over time, equalize cultural differences and behaviors.

Now what?

Insurers can no longer take a back seat to their underwriting peers or their financial service competition in understanding fundamental changes to demographics that are turning their world upside down. In short order, carriers not satisfied merely with keeping up need to arm themselves with knowledge, the only proven weapon against change.

We believe insurance executives need to invest in and execute on collecting and preening data to include existing policyholders, applicants and claimants. They also need to turn their sights inward to better understand their own employee and service populations. For those companies that have already invested in data warehouses, data mining and business intelligence solutions and tools, an evaluation of current uses of these tools is needed to separate out those projects that are optimization-focused and those that have innovation potential. Piecing together knowledge from internal sources, as well as from third parties and industry associations, can empower strategic action in regard to emerging phenomena such as social computing, globalization and micro finance (banking and insurance).

Connect to policyholder demographics

Suggestions for dealing with ongoing demographics change run the gamut, depending on many factors for each carrier. However, personal lines insurers in both life and non-life could take a page from the banking playbook to energize their marketing campaigns. Rather than utilizing the historical practice of relying on industry-specified "life events," such as acquiring a driver license, getting married or having children, an insurer could prepare younger children (10-15) for their eventual interactions with the insurance industry.

Banks have long established programs and accounts for "young savers," and have made available courses on handling credit for teenagers. In the insurance arena, a similar program might involve school presentations on the mechanics of risk, or, rather than the typical sponsorships of sports, taking a logical next step with youth organizations. That step could include activities such as insurance-sponsored clubs that tune kids into the concepts of risk management and practicing safety in the environments where children interact the most, such as home, school and public events. It is important to remember that the first exposure of most young people to insurance comes in a negative way when they are expected to contribute to the cost of their insurance premiums. We believe helping youth understand more about this important aspect of financial management would be of significant benefit to the insurance industry.

Another suggestion, prompted by our study, for what carriers can do to deal with the imminent impact of demographic change is to actively investigate the opinions, attitudes and expectations of policyholders. Although it is a relatively safe assumption that older groups can be approached with well-understood mechanisms such as surveys and promotional campaigns, younger groups will require a more modern approach. Carriers need to leverage social computing tools, including blogs (Web-based logs or diaries of activity made available to specific groups or the public), social computing sites, such as Facebook or MySpace, and online communications push devices, such as audio and video (broad)casting. These tools allow a carrier to integrate marketing outreach and provide near-realtime demographics research that can become a vital component in dealing with younger consumers.

New operational plateaus

The persistent substitution of optimization for innovation within insurance companies has created a point-solution mentality. This way of looking at the world tends to cause insurers to treat the symptoms of persistent problems while ignoring primary causes. The challenge to be profitable – or at least efficient – while maintaining compliance with a plethora of regulations and simply reacting to market realities typically does not help this situation.

To prepare for competition with both traditional carriers and emerging players, carriers need to examine and confront long-held industry beliefs and determine how the various aspects of their businesses should be sourced to provide cost reductions and value enhancement.

Seeing the forest is a first step

In fact, these circumstances are often the reason for carriers focusing on a given problem (i.e., application system) to the exclusion of the broader context of information systems. It is clear that the automation of the insurance business has created a densely interconnected collection of manual and IT system processes. Ironically, the existing depth of complexity found in insurance systems often prevents carriers from working holistically – the trees do indeed obscure the forest.

The focus that a large number of carriers place on modernizing their core processing capabilities and infrastructure provides a great start to achieving the flexibility needed to correct operational problems. These modern approaches have at their center architectures that prevent the creation of systems that are no better than the legacy ones that they replace. The use of industry standards and maturing IT concepts such as service-oriented architecture (SOA) are essential to breaking from the past and enabling support for business and technological innovation.

Carriers must model business processes

Technology is leveling the playing field for traditional carriers, as well as the other players emerging today. To prepare for competition from these sources, carriers need to confront long-held industry beliefs. One of the most persistent beliefs of the industry is that its processes are so specialized that they cannot be handled by third-party software. And, even if third-party applications are purchased, they are often modified to such an extent that they became home-grown solutions.

This observation and similar ones are well known in the industry today, and yet too many insurers appear to be reluctant to act on this knowledge. What needs to happen now is the evaluation of business and IT processes to determine what aspects of their operations could or should be insourced, outsourced or cosourced in ways that provide not only cost reductions, but value enhancements as well. This is possible today through the modeling of business processes into industry standard sets that can be further broken down into functional units called services. Once a company has developed a component-based model of its business, it has, in fact, a common framework for discussing and acting on these issues.

Driving toward collaboration as a key source of innovation

One of the key findings from the IBM 2006 Global CEO Study, which was based on interviews IBM conducted with 765 corporate and public sector leaders worldwide, was that collaboration is a key source of innovation.[7] In the insurance context, collaboration could come from suppliers, peers, competitors, employees or other stakeholders. Observation and engagement with other industries can also supply a much-needed fresh perspective on problems and techniques facing the industry.

For example, the automotive industry has faced a broad series of challenges and continues to deal with them in innovative ways. Although it may not have been the first industry to outsource, it has certainly leveraged the concept to a very large extent. In the not-too-distant past, it was not unusual for an automaker to produce upwards of 80 percent of the components that went into the manufacture of its products.[8] Today that figure is much lower and fluctuates around 35 percent of the parts it uses in manufacturing.[9] What can insurance learn from this seemingly entirely different industry ?

Once you look beyond the nature of the products delivered to the consumer, both industries have existing legacy systems (whether in machinery, process or software), burgeoning regulations and a somewhat fickle consumer base driven by some of the same external forces (cost of money, price of gas, the need to comply with regulations, etc.). The primary difference is that the automotive industry has reacted more quickly to its challenges than insurance. For example, the largest auto firms banded together to reduce the cost of parts and to make their supply chain more efficient by collaborating on the creation of an electronic parts network. They also agreed to adopt the metric system to, in part, reduce the cost of supporting different size standards and allow for greater flexibility in global markets.

Now what? Practicing innovation

It is worth repeating over and over: we believe innovation is the key to future success for insurance. This statement is more evident in other industries. Without its continuous innovative spirit in product design, Apple's products likely would have been off the market a long time ago. In the insurance industry, modifications of existing products advertised as "new" were deemed sufficient. As long as the markets were regulated and customers had to buy what they got, this was true enough. But as we move forward in time toward 2020, this situation will no longer be the case. Customers will know what they want and do not want – the insurer that does not innovate soon will not be ready in time for inevitable change.

Modeling marketing to behavior

Today's behavioral patterns are different than the traditional ones, but still predictable. The concept of predictive analytics as applied to customer behavior follows reaction to controlled triggers (like marketing campaigns) and thus allows companies to "manage" their customer portfolio into an optimal spread on a value/loyalty matrix.

It is worth mentioning again that we can learn a great deal about how to apply technology such as predictive analytics by looking at how it is applied outside of insurance. The airline industry leveraged such a tool to help it better understand loyalty programs – allowing a huge step forward from the simple miles programs to programs focused on marketing real value. Translated to insurance, customer equity management would mean redefining and maybe even re-creation of customer distribution channels more in tune with reality.

The idea for insurance carriers is not necessarily be the first to use a new technology or invent a product, but to encourage the thinking and actions that allow innovation to take place.

The next generation

Customer experience today is interactive. The Worldwide Web, starting with what is now referred to as Web 2.0, is no longer a simple mechanism that pushes marketing content. It is now a conglomeration of views, discussions, trends and offerings that reach self-targeted audiences. It has become the infrastructure for what is now called social computing – and with continued maturation will include innovations such as the semantic Web. Think of this as a network of interconnected Web sites that, by design, publish or make known the meaning of the content they manage and more specifically, the data they contain. This will allow for more efficient machine-to-machine exchange of data and information in support of collaboration among all users including insurance stakeholders.

In the P&C industry, operational innovation is still best seen in the well-known efforts of Progressive Casualty Insurance Company. It innovated in pricing and underwriting by creating and developing the concept of usage-based pricing that leverages telematics. It was the first to sell auto insurance on the Web and is seen as a leader in the direct market as well. Progressive continues to innovate with its high level of claims servicing and dedication to policyholders.[10] GEICO has broadened its offering to include what we have referred to in the IBM Insurance 2020 study as adjacent spaces by offering automobile mechanical breakdown coverage, which acts like an extended warranty for a vehicle if purchased within the mileage limits of the plan.[11]

The use of telematics and remote sensing within the insurance industry is broadening in scope. Risk services that offer prevention – something already happening in industrial (commercial) insurance – become viable in private lines P&C. This allows for new business models on one hand and gives insurance the opportunity to overcome its negative image as expensive and reticent when a claim actually occurs.

The life insurance business has innovated in less obvious ways by combining coverages and adding flexibility to standard coverages. Life companies need to attack the oft-quoted maxim that "life insurance is sold, not bought" and overcome the negative perceptions that plague this profession. The opportunity to leverage new technologies will only be fulfilled when internal impediments to progress receive the same attention that optimization of existing processes receive. Younger generations need to be won over with a new approach to dealing with the realities of complex lives and the new aspects of culture that arise from a world that continues to grow smaller as technology evolves.

Now what?

In review, based on our study, we believe that carriers from all lines of business need to challenge themselves to push innovation to the top of the agenda. The idea is not to always be the first to use a new technology, or to invent a new product or even to establish a new collaboration; the idea is to encourage thinking and actions that allow innovation to take place intentionally.

Following are a few ideas to begin the process:

- Establish an internal patent mechanism that goes beyond a simple suggestion box; reward idea generation and implementation.
- Assign management and staff to be internal change agents on a rotating basis. Develop an internal school for innovative thinking. Leverage social computing mechanisms for internal and external research.
- Understand your own processes thoroughly by modeling the components of your business – what are you good at, what are you not, where are your investments? Why?
- Seek to understand when and what you are optimizing – there's nothing wrong with optimization, but you need to understand there are likely to be diminishing returns from such activity.
- Collaborate – look to all your partners, peers and competitors to, at the very least, learn from them and, at best, work with them on achieving something new – or learn how to approach opportunities from a different perspective.

Conclusion

As highlighted in the IBM Global Innovation Outlook 2.0, "innovation is a culture, not a department."[12] This means a culture of experimentation, of allowing for mistakes and of everybody with a stake or an interest in the organization participating in idea generation for innovation. IBM itself expressed this with the Innovation Jam 2006 – a worldwide online collaboration and idea collection effort with participation from employees, customers and business partners.

Innovating means taking controlled risks – something insurance is supposed to be good at. Still, projects or activities such as the Innovation Jam are seldom seen in the insurance industry – surprising, as the risk involved is very low and the insights gained quite high. Insurance will have to overcome its sluggishness, if there is to be a culture of innovation within the industry.

About the authors

Jamie Bisker is the Global Leader for the Insurance practice of the IBM Institute for Business Value within IBM Global Business Services. Jamie has over 21 years of experience in the insurance industry and is a frequent contributor to publications such as Best's Review, Insurance & Technology, and Insurance Networking News. He can be reached at *jbisker@us.ibm.com*.

Christian Bieck is the Leader in Europe, the Middle East and Africa for the IBM Institute for Business Value Insurance practice of IBM Global Business Services. Christian is an economist by training, he worked in various roles in the insurance industry in Europe before joining IBM as a process consultant and researcher. He can be reached at *chbieck@de.ibm.com*.

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Produced in the United States of America
09-07

G510-7857-00