On Becoming a Cost Effective Company

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On Becoming a Cost Effective Company

Robert D. Shapiro and Barton H. Clennon

Abstract

The 1990s financial services environment requires each life company to identify its distinct capabilities and competitive strengths and to build its future direction from these features. This demands a fundamental rethinking of traditional approaches to planning, organization, and financial management.

Key words and phrases: vision, quality, competitive advantages

1 Introduction

The realities of the 1990s operating environment have become painfully evident to life insurance company executives. The often-conflicting demands for strength, capital, service, and attractive prices are here to stay. Future survival requires the full complement of financial solidity, quality service, controlled expenses, and competitive prices. The increasing emphasis on full value requires that these factors be perceived favorably from the eyes of customers and agents and not merely reflect the hopes of management.

Because most life companies currently have expense levels that exceed pricing assumptions and have had expense excesses for many years, fundamental organizational structuring is necessary.

Whether such cost management and organizational restructuring initiatives destroy or enhance a company's value and long-term soundness depends largely on the strength of three factors:

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2 Barton H. Clennon, FSA, MAAA is president of Clennon and Associates, Inc. Mr. Clennon was a partner in Milliman and Robertson, Inc., an international consulting actuarial firm. He has considerable experience in life insurance company financial reporting, appraisals, and mergers. His present interest is in life insurance company mergers and acquisitions.
2 Articulating the Vision

Every successful company needs a clear vision, i.e., a picture of what it wants to become. Corporate vision must focus the company's limited capital and human resources in a manner that exploits the company's strengths and competitive potentials, emphasizes its commitment to quality and to success, and energizes its employees.

Vision is a "concrete description of where the company should be in five to ten years" (Shapiro, 1992). This definition emphasizes painting a picture, clear enough for all employees, agents, and competitors to see, of how the company will look after the company implements its plans. It provides a consistent framework within which all employees can make critical strategic and organizational decisions.

How will the vision shape a company's cost management approach? First, it determines where and how the company must compete. This determines required price levels, which, in turn, drive allowable expenses. To compete and meet targeted profit goals, the company must shape its organization and related costs to live within the defined allowable expenses.

3 Fitting Company Capabilities

Each company needs to fit its skills and capabilities with the requirements of its vision and related product/service commitments. Different companies have the potential to excel at different things. For example, one company may emphasize innovative product/service features, while another may stress financial strength and safe, predictable returns. Each point of emphasis may demand different capabilities and management approaches, however, and may be valued by customers and agents in different ways. These differences in turn determine the specific level of expense that can be covered in prices.

If the vision is underpinned by special capabilities that provide distinct competitive advantages, the required value-added pricing (and related expense allowances) can be defined and tracked. To warrant the value-added pricing and costing required to reimburse the company for maintaining special capabilities, customers must appreciate these capabilities sufficiently to be willing to pay for them.
4 Commitment to Quality and Success

Although most insurers would argue that they have a strong commitment to quality and success, few have institutionalized this commitment. For example, quality efforts and rhetoric often are reflected in narrowly conceived projects with at best a temporary impact (much like many strategic planning retreats, mission definition sessions, and culture enhancement workshops!).

What does it mean to be committed to quality and success and to the related organizational focus needed to maximize marketing and service effectiveness and minimize costs? First, board level buy-in to the effort is essential to establish needed actions as long-term requirements that transcend current managerial personnel and employee agendas. Second, performance standards must be changed at all levels (i.e., corporate, unit, and individual employee levels). New performance standards (and consistently modified performance appraisal and compensation practices) send loud and clear messages that what is important has changed! Each employee ultimately will change what (and how) he or she does as it becomes clear what is important.

Commitment, like the definition of special capabilities, needs to be linked to vision. Without such linkage, there is no consistent framework for defining quality and managing the commitment to it. The result will be a shallow implementation program that will have limited impact and likely will disappear after a while.

When the vision linkage is present, the focus of commitment is to excel in the special capabilities that drive vision achievement. No company can be the best there is in all areas. Each has to establish its basis of competition and the core of its quality efforts based on the capabilities that can differentiate the firm in the marketplace.

5 Effective Expense Reduction

The narrow, meat-ax approach of many expense reduction actions taken by insurers in recent years has provided only painful, short-term fixes. Lost morale and paranoia may paralyze companies from doing the right things after the temporarily removed bloat returns.

The insurance literature is filled with comparisons of ratios of expenses to premium bases and ratios of expenses to the number of policies in force and unit costs. Although interesting and occasionally informative, these numbers provide life companies with little direction about the appropriate level of expenses and how to reduce costs to this level.
Horror stories of 10 percent to 20 percent across-the-board expense cut programs abound in the insurance industry. Because these expense cuts are generally arbitrary (and are perceived to be arbitrary), employee morale typically plunges and paralysis sets in as cuts are implemented. Productivity drops. Soon the company needs to fix some things to get the growth they seek. Staff is added, often in the same areas where it originally was cut. Costs rise, and the same competitive pressures that led to the original staff cuts reappear. A consultant is hired, expense cuts again are recommended ... and the cycle repeats.

Expenses cannot be analyzed in a vacuum. The framework for reducing expenses must encompass broader planning, financial, and pricing issues. The framework must be linked to the corporate vision to be understood and accepted by employees. Only within this broader framework can expenses be reduced without damaging the company and with an expectation that the reduced expense levels can be maintained.

The framework for effective expense reduction requires that the insurance company first:

- Establish clear, consistent profit and surplus objectives;
- Define target markets, distribution, and products/services;
- Identify future (not past) key competitors and how the company intends to compete against them; and
- Agree on the required level of price competitiveness and related sales expectations over the next four to five years.

Once this framework is clarified, the company’s allowable expenses can be defined and the organization can be reshaped to provide the required service within established expense standards. Normally a one to three year period is required to migrate from the existing expense infrastructure to a new one. The costs of organizational reengineering and related investments in new capabilities are key reasons why actual expenses will run in excess of allowable expenses for a period of time.

6 An Expense Model

Every company must balance what it spends against the price customers/agents are willing to pay for the company’s products and services. An insurance company’s expenses can be considered in this way:
TABLE 1
Total Insurance Company Expenses

<table>
<thead>
<tr>
<th>Expenses of a Low Cost Insurance Company</th>
<th>Reasonable Cost of Extra Services Provided by Company</th>
<th>Inefficient or Nonproductive Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Valued by Customers and Agents</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Not Valued by Customers and Agents</td>
<td></td>
</tr>
</tbody>
</table>

The shaded areas represent expenses that must be eliminated by the company for expenses to cover prices. Stated another way, an insurance company only can afford to spend on extra services what customers and agents are willing to pay for such services. There are some costs such as regulatory compliance, of course, that may not be appreciated by customers and agents but that cannot be eliminated. These costs generally would be mandated for all insurance companies and hence would be reflected in expenses of a low cost insurance company.

Although this broad analysis may seem obvious, it is difficult to identify and cost the specific value-added services that are provided by the company. Insurance companies typically analyze costs at department or function levels and not by process or task. Further, most companies continue to define what they do without substantial analysis of what customers and agents really want and need. Hence, the data needed to determine and eliminate the cost of unappreciated extra services provided by the company are not available.

Nonetheless, each company needs to push its way through this exercise as best it can. While this value-added quantification and analysis is being developed, those existing tasks and operations that are ineffective or duplicative can be eliminated. Hence, the expense reduction process can achieve some immediate successes while the foundation for more fundamental reductions is being established.

7 Refocusing the Organization

It is difficult, if not impossible, to reach full potential in providing valued service without a clear vision of what the company wants to be. A coherent vision will articulate target markets, expected key competitors, required financial standards (e.g., price levels and allowable expenses), and desired operating approaches. The vision also will define activities that must be accomplished in order for the company to be successful.

An insurance company’s organizational structure must be reshaped to focus on these critical activities. New priorities and new employee by employee daily agendas must be established. Activities that are not consistent with the vision must be eliminated.
For example, let’s say the vision demands that the company be the leader in serving the insurance needs of small employers. Assume further that the company historically has organized its operations in life, annuity, health, and group segments. The vision undoubtedly places great value on activities that will capture and serve small employers. It likely devalues other activities that fit the historical operation segmentation (such as stockbroker sales promotions within the annuity line) but that are not within the concentrated focus of the small employer vision. Similarly, many activities that historically were developed within one or more of the life, annuity, health, or group segments need to be reconceived and streamlined within the new vision.

Reshaping operations to provide targeted, quality products and services demands clear articulation of where the company must have the highest quality to achieve the vision. Each current activity should be analyzed by asking the following questions:

- Is the activity essential to the role of the unit in which it is being performed? Are the unit and the activity vision consistent?
- Could the frequency, scope, or precision of the activity be reduced without a significant negative impact on the ability to manage or operate?
- Could the company eliminate, simplify or move all or part of the activity?
- Could the company reduce the cost of performing the activity?
- Could the company improve control methods?
- Are functions and activities grouped in the most effective way, given the stated vision?
- Are jobs designed for efficient performance of assigned tasks?
- Who pays for the activity, e.g., existing policyholders, future policyholders, surplus, etc.?

8 An Example

Let’s take a simple example. Assume we have a life insurance company (ABC Life) that writes only $100,000 face amount life insurance policies, each with an annual premium of $1,000. Assume further that ABC Life has 100,000 policies in force, writes 20,000 new policies per year, incurs noncommission expenses of $20 million per year, prices for noncommission expenses using $500 per policy first year and $50 per policy in renewal years, and has clear profit and surplus goals.
The annual expenses allowed by current prices in the current year amount to $15,000,000 (i.e., 100,000 × $50 + 20,000 × $500). Hence, ABC Life’s noncommission expenses are running 133 percent (i.e., $20,000,000 + $15,000,000) of the expenses allowed for in its pricing ... or $5,000,000 per year of excess expenses.

What can ABC Life do? Three of its options are:

1. Increase prices to allow for 33 percent more in expense. For example, the prices could be increased to allow for $668 per policy first year and $67 in renewal years. Issues include:
   • Will prices still be competitive enough to write 20,000 new policies each year?
   • Can existing policyholders be charged $67/policy? If so, will they continue their policies if their price is increased?

2. Cut 25 percent of expenses (from $20 million per year to $15 million per year). Issues include:
   • How and where should the expenses be cut?
   • Can servicing and support activities be maintained at a high enough level to keep customers and agents happy (and persistent)?

3. Sell more business. If ABC Life can get to where it writes 27,000 policies a year and has 135,000 policies in force, its current pricing expense allowance would provide over $20 million per year (133,000 × $50 + 27,000 × $500).

How should ABC Life proceed? Many companies make a judgment to take one (or a combination) of these options, relying more on hope than solid action plans that customers will continue to buy, expenses can be cut, and/or more sales can be developed. The demands of today’s complex marketplace will require proactive, well-planned actions even in companies that have a track record of success.

History tells us that hope rarely brings success. During the 1980s the majority of life companies had general expenses that were in excess of those allowed in their pricing. Many of these companies embarked on one or more plans to bring expenses in line with allowables, yet most of these plans failed to meet expectations. The main reason for failure was that extrapolated growth and/or cost reduction projections were not realistic in an environment characterized by intense competition, increasing capital pressure, and proliferating regulatory and administrative demands.

Given the above options, the place for ABC Life to begin is at the intersection of ABC Life corporate potential with the opportunities and realities of the expected future financial services marketplace. Where can or should ABC Life compete? Who will its com-
petitors be? What price levels will be required in this market? How much money will these required prices allow ABC Life to spend? To answer this last question, ABC Life must make a judgment about the anticipated relationship between price (and related expense allowables) and sales levels to determine specific price and sales objectives.

Once the target price and sales levels are established, the allowable expenses are determined. Let's hypothesize that ABC Life's analysis determines that:

- Its vision requires it to keep its prices at current levels. Hence, current expense allowances need to be maintained;
- By refocusing its marketing and product approaches to be consistent with its vision, it can write 25,000 new policies per year (with inforce stabilizing at 125,000 policies per year in five years); and
- Current expenses would be reduced from $20,000,000 per year to $16,100,000 per year if the organization were reshaped to eliminate inefficiencies and support modified operations more effectively. It will take three years to reshape the organization, however.

A (simplified) five year quantification of ABC Life's new future expectations might look like this:

<table>
<thead>
<tr>
<th>Year</th>
<th>New Policies</th>
<th>Inforce Policies</th>
<th>Allowable Expenses</th>
<th>Actual Expenses*</th>
<th>(4) - (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>25,000</td>
<td>105,000</td>
<td>$17,750,000</td>
<td>$19,200,000</td>
<td>$1,450,000</td>
</tr>
<tr>
<td>2</td>
<td>25,000</td>
<td>110,000</td>
<td>18,000,000</td>
<td>18,400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>3</td>
<td>25,000</td>
<td>115,000</td>
<td>18,250,000</td>
<td>17,600,000</td>
<td>(650,000)</td>
</tr>
<tr>
<td>4</td>
<td>25,000</td>
<td>120,000</td>
<td>18,500,000</td>
<td>18,100,000</td>
<td>(400,000)</td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td>125,000</td>
<td>18,750,000</td>
<td>18,600,000</td>
<td>(150,000)</td>
</tr>
</tbody>
</table>

* A simplified approximation reflecting potential basic cost reductions, re-engineering costs, and inflation.

ABC Life expects to bring its expenses in line with prices and sales within three years. Current inflation expectations will create another expense deficiency after five years, however, unless something else is adjusted. ABC Life may have to wait a year or two to
reexamine the results of its restructuring and changes in the competitive environment for additional ideas.

9 Conclusion

The 1990s require that each life company look deep into its corporate soul to find its distinct key to future success. Shallow pricing and sales gimmicks will not work and can undermine or destroy a company quickly.

Few companies can afford to dissipate value (which is equivalent to capital). Unless a direction can be sculpted that is anchored in a company's special capabilities and aligned with the realities of the competitive marketplace, the company runs an unacceptable risk of self destruction. For most companies, a fundamental rethinking and an approach to planning, organization, and financial management similar to that described in this article are necessary for long-term financial health and viability.

References


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