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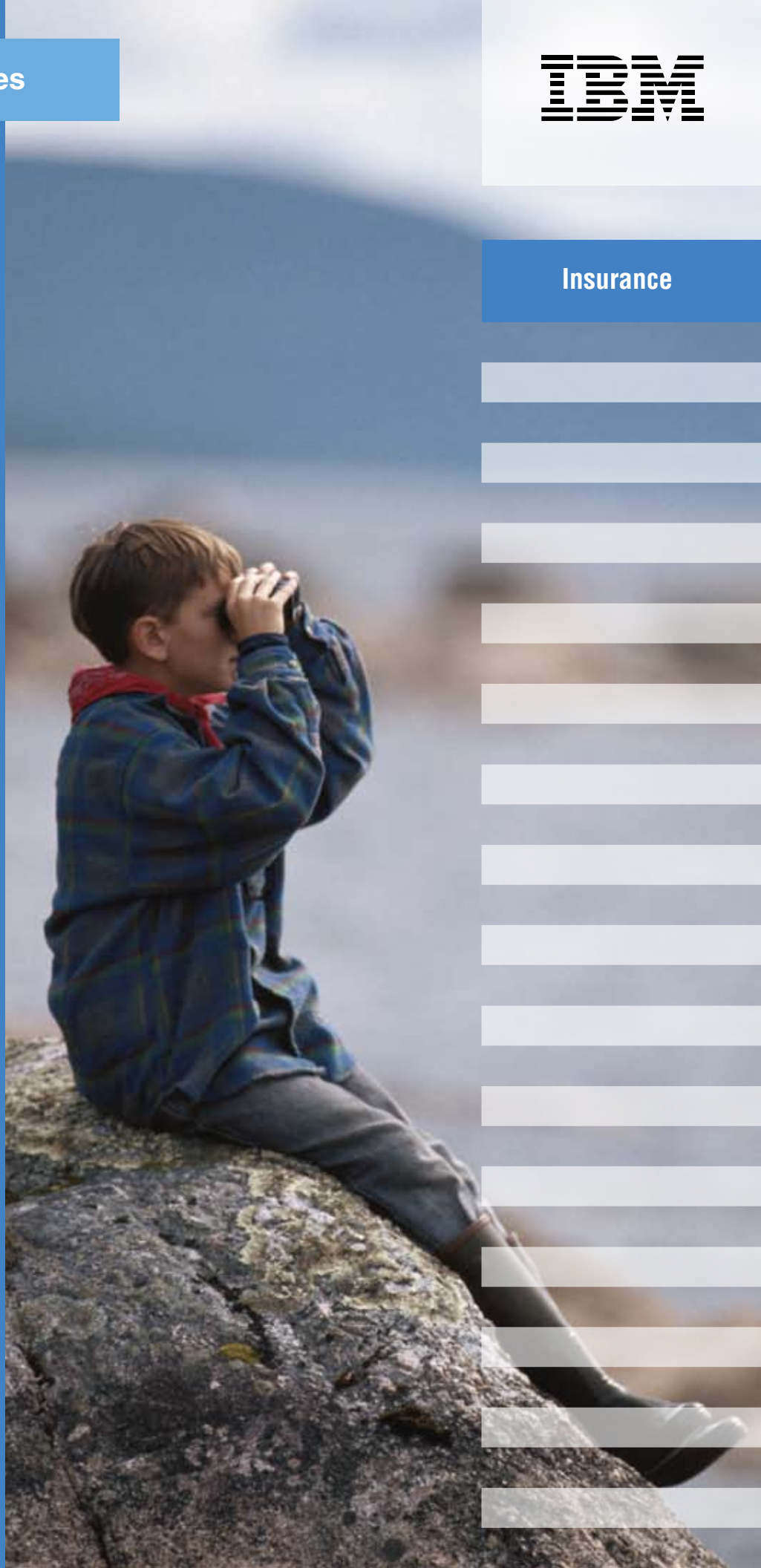
Insurance 2020

Innovating beyond old models



Insurance

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IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior business executives around critical industry-specific and cross-industry issues. This executive brief is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to iibv@us.ibm.com for more information.

Insurance 2020

Innovating beyond old models

Executive summary

Predicting the future of insurance can be somewhat straightforward. Both the history and temperament of the industry constrain the realms of potential changes for this industry. This business is steeped in the paramount nature of its guiding principles and is equally tied to the information provided by the record of its transactions. Periodic forays into the art of forecasting by insurers just confirm doctrine instead of establishing a foothold for change. The projected uses of technology tend to focus on point solutions or keeping up with market peers. Overall, predictions tend to be short range and aimed at optimizing current operations and are linear projections for business outcomes.

Over the ensuing decades, it is easy to see the potential for robust market activity. The combination of classic protection products and an increasing number of financial services in an expanding global economy creates a target-rich environment. Traditionally, the task going forward would be to navigate the opportunities while efficiently servicing stakeholders. However, as we approach the end of the first decade of a new century, it is very important to increase the scope of our vision and consider what the insurance industry could become.

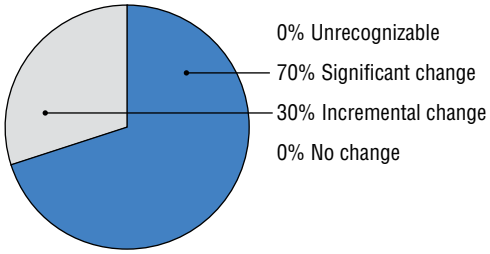
There is a concern that the current mode of operations, regardless of the line of business in question, will reach a point of diminishing returns in the near term. The aggregate capabilities of current technologies and the unexplored potential of emergent ones almost guarantee that the next several years will mark a fundamental change in the insurance industry. The question is how can insurance carriers profit from these changes? How can consumers be better served?

To gain a perspective on the challenges insurers will confront in the future and the strategies that can be employed to create new levels of performance, the following questions must be considered: What fundamental trends will shape the insurance marketplace? What strategic challenges will serve as catalysts for change? How must the industry evolve to meet the needs of demanding customers? And how can companies distinguish themselves in a market where the playing field is increasingly leveled by technology?

Such inquiries need to be considered over a time span that would reasonably allow for a chance of action and change. A view 15 years into the future of insurance escapes the constraints of traditional strategy creation, which typically only looks forward three to five years. It also incorporates the fact that the current pace of change within most companies will initially impair their ability to transform at an optimal rate.

The IBM Institute for Business Value considered all these elements in the course of conducting interviews and market research among global industry executives about the future state of the insurance industry. It became clear that change is on the mind of insurers around the world (see Figure 1). The analysis of the collected information determined that there are four large-scale trends that will likely confront insurers and their stakeholders in the year 2020.

Figure 1. Amount of change expected in the insurance industry by 2020.



Source: Insurance 2020 Survey 2006 (Sample size = 30).

The four large-scale or "mega-trends" are:

- *Active and informed consumers across demographic groups reward nontraditional operators* – The impact of modern information networks and the ongoing transfer of financial responsibility to end customers will drive attitudes regarding increased services and convenience. Applicants and policyholders from a range of demographic groups will give business to carriers that consistently meet their expectations.
- *Technology virtualizes the value chain and lowers barriers to entry* – The rising tide of technology will enable an increasing number of niche service providers from inside and outside of the traditional value chain. The 15-year time frame will inevitably produce a greater number of partially and even totally virtual insurance companies to meet the needs of consumers and businesses.
- *Mainstream insurance products are dynamic and provide more consistent performance* – Dealing with a global population that eagerly consumes and thrives on communication and personalization will drive carriers to develop products that are flexible and adaptable. The aforementioned rising tide of technology also empowers insurance underwriters to bring their products closer to realtime interaction via sensor networks and enlightened privacy regulations.
- *Regulatory coordination and use of affirmed industry standards broaden to global scales* – The globalization of all industries and the need for efficiency drives the coordination of consumer and business protection across geographies. The same search for efficiency drives increasing automation, which demands industry standardization.

Given these trends, the potential for a dynamic and successful future state within insurance is clear. Getting to that state will require something more than existing mechanisms and business models. To be clear, the existing model of insurance operation would achieve success, but it would very likely produce suboptimal results. To realize the full potential of these trends requires a new context.

This context emerged as a theme from the research and analysis of the industry's potential future as compared to similar periods in its recent past. The theme is centered on the idea that simply optimizing today's "business as usual" will not be enough to create value and achieve success in 2020. This is a clear case of hoping that previous performance is not indicative of future returns.

Key findings

The trends frame the discussion of how insurers can respond to the impending realities of technological and social change. Upon review and analysis, this framework supported the following key findings:

- The mega-trends will force the industry to innovate
- Old modes of thinking threaten the industry's ability to innovate
- Interlopers will increasingly disrupt traditional insurance operations
- Industry leadership will require experimentation in operating models, processes, products and customer relationships
- Strategic investment in innovation today is critical to success in 2020.

These findings address the fact that the transition to the future will take effort and intention. It may be as simple as walking through a door into another range of possibilities but that threshold needs to be crossed.

The four mega-trends as outlined earlier force the industry to change and innovate because they will not be denied. By this we mean that even though a carrier could ignore changes in demographics, or stick to a traditional value chain, there will be an increasing number of companies that will react to these changes, produce innovative services around them and profit by doing so. There will be inherent value in trying something new and investing to make it work. Learning to be innovative in a consistent manner is in itself a major goal in this time frame.

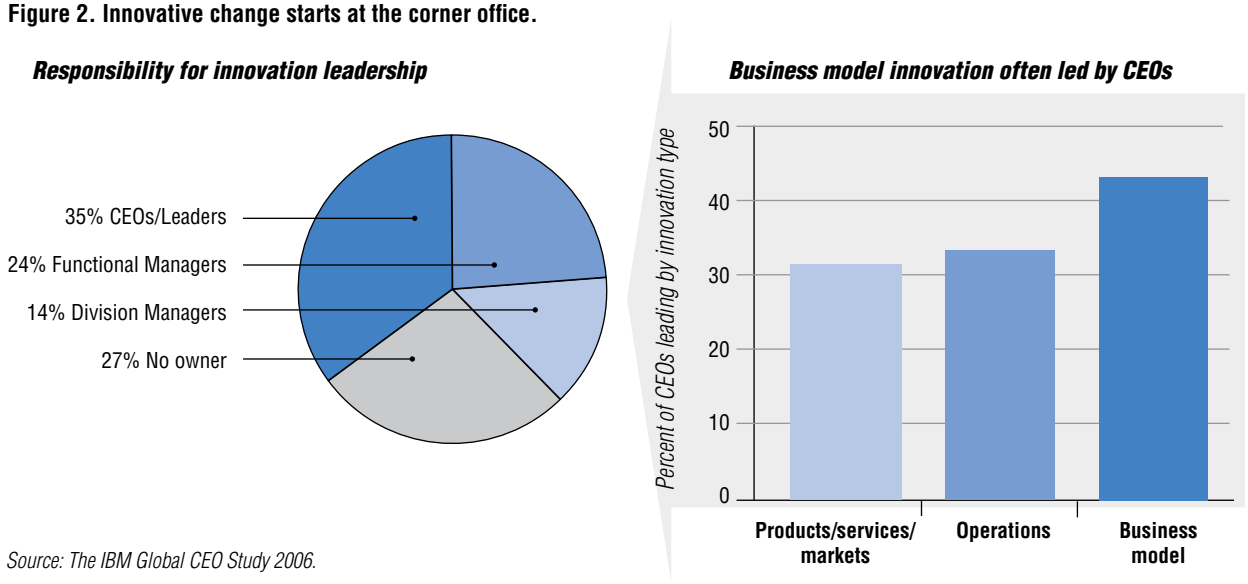
Next, it is crucial to recognize that the current operational mode among the majority of carriers is deeply rooted in the past. The fallback position or retort for this behavior is that it has provided relative security over time. The problem is that we are now in an era in which technology can transcend nagging industry problems. Some carriers, such as Progressive and Allstate, are already exercising technology to win the old game. They are not succeeding because of a given set of IT tools, but because they recognize the power of the available tools to execute business strategies – they are innovating to help maximize their positions. And yet this is all being done in the old model of insurance.

Around the world, traditional carriers have integrated banking and insurance services to deliver what is commonly known as bancassurance. Its success varies from geography to geography, but where it works at all, it usually works quite well. This is an example of an interloper (banks) integrating their service offerings as it occurs today. Over the next 15 years, we expect that technology will enable a broader class of enterprises that provide parallel products and services. Insurance carriers will need strategies to deal with these market intruders as competitors or as partners. Some companies may settle into the role of manufacturer for the virtual insurance service providers that will appear on the scene in this time frame.

One of the most important research findings is the need for experimentation. This is coupled directly with the power of innovation, especially as it refers to the development and nurturing of new ideas. Without experimentation, insurers will be caught in the old cycle of process optimization. This has gone on for so many years that it has developed into a proxy for innovation.

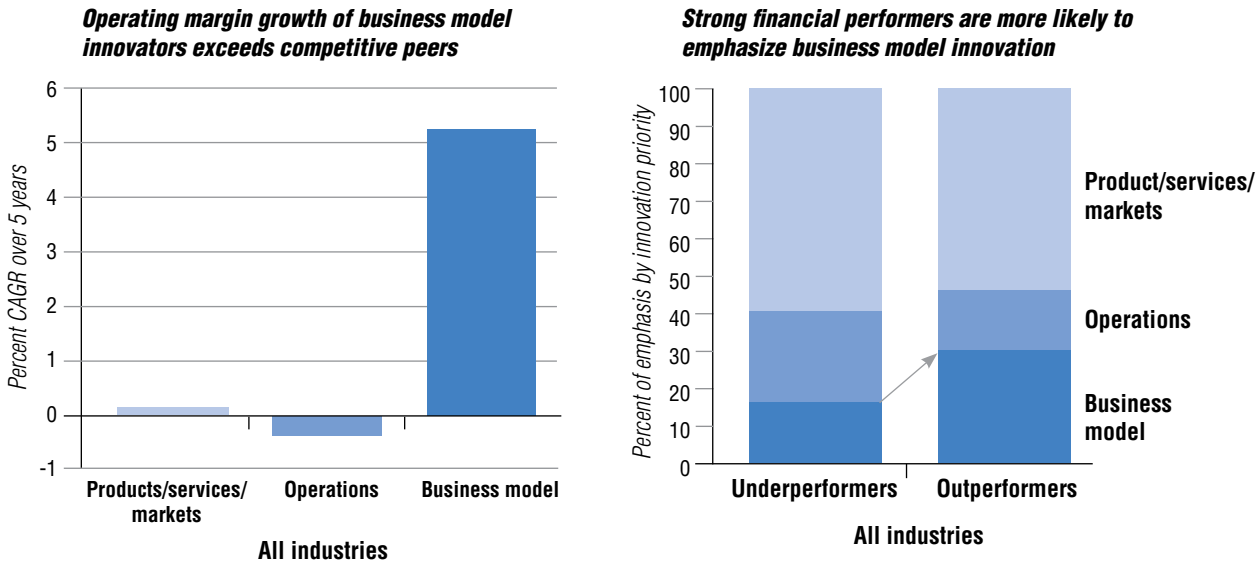
Executives need to provide the leadership within their companies to emphasize the importance of innovation, especially when insurers need to create new business models. This conclusion was verified by the 2006 IBM Global CEO Study which showed both the need for executive leadership in innovation and the important role of business model innovation in profitable growth (see Figures 2 and 3). Finally, investing in innovation also means committing to the build up or creation of flexible and adaptable IT infrastructures. These empower an organization to take advantage of opportunities as they occur.

Figure 2. Innovative change starts at the corner office.



Source: The IBM Global CEO Study 2006.

Figure 3. The IBM 2006 Global CEO Study findings independently validate the concept of "innovating beyond old models."



Source: The IBM Global CEO Study 2006.

Insurance industry mega-trends

Active and informed consumers across demographic groups reward nontraditional operators

Just like death and taxes, the grouping of individuals for a variety of reasons is something you can count on. Governments, marketers, popular entertainment vendors as well as a host of others all rely on the classification and enumeration of a human population within a given geography. The commonly used term of a "generation" used to simply imply a 20-year span of time, but really includes people that shared events, like marriage, education or being born in a specified period. For example, the "Baby Boomers" are that group of people who were born to the survivors of World War II. Another demographic group might be more specific and refer, for example, to the Chinese population that was directly affected by the construction of the Three Gorges Dam in Hubei province (about 1.2 million people, not counting the laborers). That project started in 1993 and is scheduled to be completed in 2009.[1]

In 2020, the insurance industry will need to deal with the broad diversity of demographic groups and their needs. At the same time, it will have to recognize the commonalities among groups such as increasing familiarity with and confidence in electronic commerce. Carriers will need to exploit analytics (including psychometrics and psychographics) to engage consumers with products that meet their needs and reflect their shared experiences. Somehow, the current concept of customer relationship management seems inadequate to deal with this reality; its successor will have to work in a world where customer centricity is the rule, not the exception. Truly placing the customer ahead of product considerations will mark the nontraditional operators.

The world in 2020 will include several generations that have worked and lived with an increasingly networked society. Service-oriented architecture will be considered old technology, and the population will be focused on the quality and convenience of the active risk management services available. A nontraditional operator in this context refers to any player, even an insurer, that can meet the requirements of a population that has come to believe in the new catchphrase for the industry – "trusted convenience."

Technology virtualizes the value chain and lowers barriers to entry

In discussions held today around the topic of business process outsourcing (BPO), the insurance perspective has been a cautious "wait and see." This timid approach is ironic considering the number of carriers that already outsource portions of their value chain.

The modern value chain is the collection of processes and services that are linked together to create, develop, sell, deliver, process and service an insurance policy over the life of the contract.

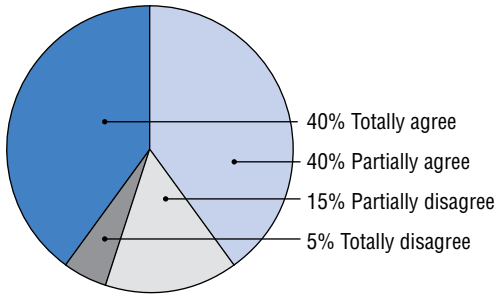
Already, insurers outsource their sales and distribution functions to independent agents, brokers or other distribution channels. Many companies also offload the processing of active and closed books of business to outsourcing firms to save money. Some insurers outsource marketing or actuarial portions of their business. Others use third-party administrators to handle claims and customer service functions. What will be different about this approach over the next 15 years will be the impact of automation and intelligent systems, in particular on the dispersal of value chain elements.

An increasing number of insurance companies in the future will make use of standardized Web services (or whatever the follow-on mechanisms are called by this time) that they did not create themselves. Large, mainstream companies will do this for specific lines of business, and smaller companies can contemplate the degree to which they want to "go virtual."

Enterprises that wish to specialize in providing insurance services will subscribe to software companies that specialize in creating specific insurance service components. Once the prescribed number of components is selected, they will be reviewed for accuracy and then tested as a system to determine if they can work with the library of Web services the company already uses. In this way, the business elements needed to facilitate a virtual value chain will be procured, combined and then used to meet business goals.

What is intriguing about this approach is that the enterprise that wants to provide insurance services may not be an insurance company. It could be a firm that provides superior customer care in a services business and feels that its in-house developed Web services could make a profitable difference in the local insurance market. With barriers to entry lowered by technology in this manner, we can be assured that competition will change in 2020. Study participants felt that partnership and collaboration will be crucial in the insurance economy of the future (see Figure 4).

Figure 4. There will be increased partnership and collaboration across stakeholders in 2020.



Source: Insurance 2020 Survey 2006 (Sample size = 30).

Mainstream insurance products are dynamic and provide more consistent performance

In the past, property and casualty (P&C) insurance products were basically in force for a period of time that balanced the cost and effort needed to renew the policy in mechanical terms with the need to assess the potential change in risk exposure that the policy represented. The normal duration for an auto policy was six months; for a home, it was 12 months. New information was assessed at renewal time and changes in premium were relayed to the policyholder. While the duration was more fixed in the life insurance business, these companies also based their price structure and therefore their profit potential on the aggregate statistics of mortality tables and the skill of their underwriters to allow for existing health issues or dangerous occupations. The pace of insurance was measured at best.

The forecast over the next decade calls for a significant increase in the flexibility of insurance products and use of pervasive computing technology to make this possible. We expect that calculating the cost of a specific risk, regardless of whether it is a personal or commercial exposure, will make use of inexpensive sensors tied into the next-generation Internet. The data provided by such sensors supports the near realtime calculation of risk based on the collection of appropriate data and tallies a running charge for the proper amount of premium based on the actual risk presented. This works equally well for life risks as it does for property ones.

These same mechanisms also support a broad range of potential policy durations. They will facilitate "just-in-time insurance" as a person moves through a set of "spaces." Each step of the journey represents a different risk such as car-to-train-station, train-to-city-station, station-to-office, and so on. Each leg of the trip truly represents a varying amount of risk. A "pay-as-you-live" product would trade some location and time-of-day privacy data for lower insurance bills overall. And in the spirit of active risk management, the same network of sensors could also provide convenient information (such as advice on avoiding an overloaded expressway) relayed on the appropriate device such as the car audio system, a phone and, then, in e-mail or as a phone call in the office.

Each step helps assure maximum efficiency in risk pricing, which reduces underwriting leakage and supports longer retention via services that enhance the quality of the policyholder's life. This mechanism also serves to dampen the underwriting cycle in P&C insurance, while reducing anti-selection for life insurers.

Regulatory coordination and use of affirmed industry standards broaden to global scales

Insurance is one of the most heavily regulated of all industries, and even when it is afforded some deregulation (in the form of the Financial Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act or GLBA), the result is more rules. The United States is struggling with decades-old provisions that set the individual states as masters of their own insurance markets. Calls for an optional federal insurance charter are growing louder at the same time. In Europe, the "Comité Européen des Assurances," or CEA, works to coordinate European insurance regulation and faces challenges from individual countries that try to maintain both tradition and national advantages. In the emerging economies of Asia, regulators are trying to strike a balance between deregulation, the need for controlled growth, and consumer protection. As the world works to engage these markets, as well as ones in Africa and Eastern Europe, there will be opportunities for experimentation and exploration of business models.

Despite these challenges, certain concepts and rules are finding their ways around the world. The advantages of having common regulatory frameworks generally exceed any individual country's need for sovereignty, especially in a climate of intense globalization. Some of the executives polled for this research did not foresee much progress along these lines even in the 15-year time frame of the study, especially in light of existing national struggles with cross-border agreements. Other important global business regulations, such as the International Financial Reporting Standards, are moving forward and will further support globalization of business.

The calls for increases in the development and use of insurance IT standards around the world are significant since such efforts broaden the applicability of commercial software, and will be crucial for the global maturation of service-oriented architectures. Insurance executives need to be active in standards organizations to accelerate adoption as part of the foundational support for innovation (see Figure 5).

Figure 5. Standards organizations influencing the insurance industry's use of IT.

ACORD	Association for Cooperative Operations Research and Development
CIECA	Collision Industry eCommerce Association
CLIEDS	Canadian Life Insurance EDI Standards
CSIO	Centre for the Study of Insurance Operations
eEG7	Western Europe EDIFACT Insurance Group
GDV	German Die Deutschen Versidherer
IFX Forum	Interactive Financial eXchange Forum
LMBC	London Market Brokers Committee
Polaris	Polaris, UK Ltd.
ORIGO	Origo, UK-based, life insurance standards

Imperatives for 2020 success

How can carriers prepare for the mega-trends that solidify as we approach 2020? Carriers must transform to prepare for new business and operational models while salvaging the value of knowledge and experience from today. The plan has to start from both the top of an organization's management structure and at the bottom of its IT infrastructure.

The transformation that starts from the top is probably less expensive in terms of hard dollars and will likely be more expensive in terms of time spent realizing it. This plan is the installation of a culture of change and innovation. To develop new business and operational models, companies must encourage experimentation and establish a rugged, but not too rigid, process for innovation. IBM established the following innovation lessons from the 2004 Global Innovation Outlook initiative:[2]

- Innovation is increasingly:
  - Open
  - Collaborative
  - Multi-disciplinary
  - Global
- New business designs emerging that thrive on collaborative innovation
- Standards must take hold in every industry
  - Beyond IT standards
  - Intelligent intellectual property reform
- The world revolves around the primacy of the individual.

These concepts can help form the basis of an innovation plan for a company that is committed to achieving more than just optimization.

The bottom-up process of establishing a flexible and adaptable infrastructure keys directly into the fourth 2020 mega-trend. The new model of infrastructure is flexible because it makes use of open standards for IT development and invests in the development of corporate architectures, including service-oriented architectures.

Another imperative for the insurance industry is to make the switch to customer versus product centricity. In the highly connected world of 2020, policyholders will have much greater access to products and the ability to make decisions on their own. The concept of agency will eventually succumb to the power of advocacy so that individuals will look to financial services advocates to provide advice as they navigate insurance and financial services markets. The traditional agency channel will not be gone by 2020, but will likely be in decline in the face of smart software and the salaried advocate model.

Social innovation. Another idea to help deal with establishing some sort of positive control over how an insurance organization addresses institutional change is a form of social innovation. When carriers look to undertake change, they are often faced with an amalgamation of cultural, political and otherwise human factors combined with the cyclic nature of insurance that creates specific patterns of behavior. These patterns of behavior worked their way into policies and survived as examples of heuristics or "rules of thumb" that became part of the fabric of the business. Another name for these patterns of behavior is a meme.

A meme, which is pronounced "meem," is an idea, style or the above mentioned pattern of behavior that is passed from person to person, usually by an observer copying an aspect of another person's or group's behavior in various situations. This mechanism accounts for the way that styles are spread throughout a population, or how urban legends propagate even though they seem unlikely. A meme can describe any number of behaviors or ideas, but all share properties that are remarkably similar to genes in that they can be passed on to other people, they can be mutated and they can combine to produce new ideas or trends. And memes are passed around not by biological processes like genes, but through simple imitation and the persistence or reinforcement of the concepts they entail. The concept of memes was first introduced in 1976 by Richard Dawkins in his book, *The Selfish Gene,* as a way to abstract the concepts of biological evolution and genetics into the world of ideas and behaviors.[3]

So, how do memes impact insurance? It appears that perhaps the most powerful reason behind the lack of significant innovation in our industry is that our memes are particularly strong and persistent, given the risk-averse nature of insurance. Individuals, departments and even companies observe what works and then copy the memes. But what sets insurance apart, and makes our memes more of a restrictive force? One theory is based on the fact that operational realities such as down-trending equity markets, merger and acquisition activity, restrictive regulation and catastrophes all tend to reset the existing population of memes back to the fail-safe level that is required to meet our obligations. Memes involving innovation are too often caught up in the rush to return to solid ground and are lost when the waves of any storm come crashing in.

Dealing with animosity. One of the persistent challenges that have faced the insurance industry over the years is public animosity. There could be any number of reasons that individuals and groups feel the way they do, or take actions that are literally designed to spite our industry.

Animosity seems to be generated, in large part, due to emotional reactions to situations where consumers feel cornered by a lack of process understanding, incorrect information or bad process execution within the insurance value chain. This state of affairs leads to soft fraud in the form of padded claims, shortened retention and expensive legal actions, some of which even threaten the basis of insurance law. The question that remains is what can be done to change this situation? Or, more appropriately, how could insurers innovate to produce a change or at least encourage a better situation?

An innovative approach might entail broad public education campaigns that are coordinated among all industry players. Today, individual carriers publish full-page advertisements after catastrophes to engender emotional connections with claimants. Others produce thinly veiled marketing campaigns that hint at the overall need for understanding of complicated issues. What insurers could do is create public service announcements that educate and promote understanding of the industry. Such campaigns would need to be persistent and work across the spectrum of insurance stakeholders from the uninsured, to policyholders, agents and brokers, claimants, and service providers.

Active expectation management. Once an approach to educating the public was underway, carriers could integrate active expectation management into customer relationship activities. This innovation would use intelligent

systems technology to recognize situations where consumers and policyholders are likely to believe in and be influenced by negative memes about the industry or a specific process in the value chain. Customer service representatives would be prompted to correct misconceptions or misinformation by systems that monitor the context and semantics of a conversation. Investing in the active education and management of potentially negative situations could lead to higher retention, reduction in soft fraud, and even higher revenues as consumers come to understand the intrinsic value of risk management and how the purchase of insurance can increase their economic viability overall.

Conclusion

Innovation needs to become part of every business and operational model within the insurance industry. The ability to create new modes of operation will rely on the aforementioned transformations to improve corporate infrastructures and support a new foundation of IT that is flexible and adaptable.

This bottom-up method helps to ensure that the inflexible and confining approach that produced the legacy system problems of the past is not repeated. Once the transformations to modern architectures are completed, and innovation makes its way back into the collective mindset of the industry, then the type of competitive advantage that insurers have sought for decades will be at hand. Finally, remember that the future of the insurance industry is not controlled by technology as much as it is controlled by the will to be innovative in pursuit of strategic business goals.

Call to innovation – questions to ask yourself:

- Do you have a vision for the next 15 years?
- Are you investing to realize the vision?
- What are your company's impediments to innovation?
- How are you preparing your team for a future of technological, economic and cultural change?
- What metrics will you use to measure game-changing performance?

To learn more about this IBM Institute for Business Value study, please contact us at *iibv@us.ibm.com*. For a full catalog of our research, visit:

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