The transformation mandate: insurers address complexity and sustainability

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The transformation mandate: insurers address complexity and sustainability

Across the industry, directors and executives recognize that historical business models are no longer sustainable. A host of well-documented challenging economic, regulatory, technological, and customer-related conditions have made it clear that there is no alternative other than rapid transformation.[1] *"There has not been a point in history that the operating model has been strained so significantly, from so many directions. Insurance rates are falling, global growth is slowing, and interest rates are profoundly affecting us. We can't grow out of these problems,"* said one director. These conditions are exacerbated by the accelerating pace of technological change. But many insurers also agree with one chair who put some of the blame on a failure in internal decision making, specifically a failure to invest in modernization and integration over time: *"We've been a laggard industry in terms of modernization. This is because standardization is so challenging, and we've been built by acquisition with no integration. To take it to the next level, I need one organization."*

While some companies having been slower to respond than others, virtually all complex insurers are now undertaking massive and often near-continuous transformation efforts.[2] Both transformation and the need to stay abreast of the changing environment demand a different approach to governance. One director said, *"The pace of change has accelerated so significantly that organizations that were good at change are now challenged by it."*

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– Director

On December 6, 2016, IGLN participants met in New York to discuss enterprise transformation and the role of the board in transformation efforts. See Appendix A for a list of participants. This *ViewPoints*[3] synthesizes key insights emerging from the meeting and related discussions and centers on three themes:

- **Historical business models are unsustainable, making transformation imperative**
- **Advancing technology, supported by strategy, culture, and talent, underpins transformation**
- **As transformation takes root, boards are rethinking their approaches to governance**

Historical business models are unsustainable, making transformation imperative

The insurance industry is at an inflection point where the risk of inaction exceeds the risks inherent in transformation. Many participating chief risk officers (CROs) agreed with one who said, *"Historically we focused on what could go wrong if we do this or that, but we* *should be focused on what could go wrong if we don't."* Most directors agreed that *"the old ways simply do not work"* and that insurers must change. So, although they have little room for maneuvering, groups are reconfiguring operations with the dual goals of improving services and reducing cost.

IGLN participants and sector experts said that all complex insurers are undertaking, or plan to undertake, significant technology initiatives. The manner of transformation differs significantly based on the group footprint, including the business lines and geographic reach, but insurers seek similar outcomes: drastic cost reductions, elimination of friction across the system, significant improvement in customer service, and enhanced organizational agility. Traditional business models are too rigid and expensive for the increasingly complex, uncertain, and unpredictable current environment. A participant saw potential positives, however: *"There are big issues, but also big opportunities if you can navigate the challenges and if you make the organization agile and nimble enough. One of the biggest challenges for the board is keeping the company competitively ready for the challenges of tomorrow."* An executive added, *"Those that survive are those who are most efficient. We will also need to be much more supportive of new products. We need to be quick and efficient to support iterations."* Finally, one participant observed that if the goals of agility, cost reduction, and customer centricity are to succeed, projects need to tackle all of them simultaneously.

"Historically we focused on what could go wrong if we do this or that*, but we should be focused on what can go wrong if we don't."*
– CRO

Advancing technology, supported by strategy, culture, and talent, underpins transformation

Technology is driving the creation of new, lower-cost, more flexible business models. Speaking on the impact of technology across the business, one executive noted that small product advances could revolutionize whole lines of insurance, while advances in processing power were simultaneously revolutionizing entire corporate functions: *"You see it even in the vast expansion of processing power. We can now run actuarial models in minutes that a couple years ago took two days. Then there are things like the Wi-Fi-enabled battery. You can put it in a smoke detector that tells the home owner and insurers when there is only a 10% charge left. Seventy percent of damage from fires results from simple things like the smoke detector not working."* For insurers, technology both changes the existing business and opens up new opportunities. One executive said, *"There are significant opportunities for adjacencies from our core business. Can we add risk-based services where the customer views us as a trusted partner? The art of the possible is just exploding."*

"One of the biggest challenges for the board is keeping the company competitively ready for the challenges of tomorrow."
– Participant

Even large projects that do not appear to relate directly to technology investment, such as firm culture or talent change initiatives, represent efforts to reconfigure operations to better support digital transformation. One director said, *"Technology absolutely underpins a lot of the transformation in operations, human resources, and products."*

"Technology absolutely underpins a lot of the transformation in operations, human resources, and products."
– Participant

Participants identified the following elements necessary to support successful transformation:

- **Digital enterprise strategy.** Directors emphasized the need to establish an enterprise-wide digital strategy to guide investments and decision making. The digital strategy must be integrated with the overall business strategy and has the dual goals of helping the group manage changing conditions more effectively and supporting value drivers within the existing business. Several directors said the strategy requires groups to balance their internal and external focuses because in the more digital future many opportunities may arise outside of the insurer. Several participants mentioned increased use of partnerships that bring together different skills and expertise, such as AIG's recent partnership with Hamilton Insurance Group and affiliates of Two Sigma Investments to create a technology-enabled insurance platform targeting small and medium-sized businesses.[4]

- **Two-pronged approach to IT.** Like the digital strategy, the approach to IT must both support existing transactional systems and allow for rapid technological development. One director said, *"One challenge is maintaining the existing business while you try to set up for a successful future. You have to be very careful about how you invest in IT to support both."* Chris Skinner, a prominent writer on financial technology, summarized the challenge: "How do you transform a business where the customer expects no risk and minimal change? ... Any fault, glitch or failure gains headlines of gloom."[5]

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–Chris Skinner

- **Improvements in business process and customer experience.** In the drive to reduce friction and cost, and to improve the customer experience, groups are making massive investments in technology for back-, middle-, and front-office operations. Many involve internal "digital journey projects," such as New York Life's push to consolidate actuarial systems into a single finance model[6] or MetLife's launch of "The Wall,"[7] an application that provides customer service representatives with a comprehensive view of a customer's product and transaction history.

- **Analytics.** One participant described the world of data analytics as *"the Wild West,"* but agreed that insurers are investing heavily in mining internal and external data sources for insights on everything from underwriting and product development to marketing and claims.

- **A supportive organization.** One director commented, *"Digital transformation is not about technology, but about how you move your people and culture to the new world."* Leading insurers recognize that for transformation to be successful, it needs to be supported by the organizational model and culture, and appropriate talent needs to be in place. One director suggested, *"The people and cultures who got us here may not be the same as the ones who take us forward."*

"Does the traditional gene pool of insurance fit the needs of the emerging operating model?"
– Director

Talent and culture are at the heart of transformation

Thoughtful and successful transformations require careful planning for incentives, talent, and culture as much as for technology and budget. One director said, *"Our workforce is going to change. There will be half as many underwriters, and they will be replaced by an equal number of data people. They will be very different types of employees."* Participants identified the following ways in which talent and culture support transformation.

- **Talent to lead the transition.** One director said, *"It takes different skills to run the insurer versus change the insurer. How do you separate the two? How do you ensure the important doesn't give way to the urgent?"* An executive agreed,

Talent and culture are at the heart of transformation *cont.*

noting, *"It may be the CEO or a close report who leads the change effort, but the skills [needed for that] are different than [those needed by] the person who runs things in normal conditions."* Executives or board members accustomed to ensuring safety and stability may not be able to spot the unique threats that emerge during transformation. In addition, one expert noted, *"If you look at the top 10 change initiatives in a firm, they generally have the same people involved. There is so much landing on people with day jobs. That introduces risk."*

- **Talent to power the new operating model.** *"Does the traditional gene pool of insurance fit the needs of the emerging operating model?"* asked a director. For most participants, the answer is a resounding no. While these emerging talent needs are still to be defined, they will include skills like coding and sensibilities that are less hierarchical and more entrepreneurial than are common in the traditional insurance workforce.

- **Culture to support and attract the talent.** *"The average stodgy insurance company is not going to fit with the Silicon Valley types. How are you changing the work environment, creating a stimulating work environment to appeal to these people as you go through a transition?"* asked one director. Another participant shared, *"When it comes to digital transformation, it is not a technological thing. We all have chief digital officers and Silicon Valley labs. The real issue is culture."*

As transformation takes root, boards are rethinking their approaches to governance

No one denies the new reality that technology is now central in the insurance industry. One director said, *"We are now more like technology companies that sell insurance than insurers."* This change demands changes in boards' approach to governance. Participants identified several ways in which boards can better support enterprises in transition. See also Appendix B for key questions for boards to consider.

Improve expertise on the board

Many boards are adding new kinds of expertise to the board. *"As you think about the boards you sit on and the expertise in areas like risk, compliance, [and] audit, and then when you then see new things coming in, why wouldn't you need people to oversee these changes and ensure proper governance?"* asked one director. Another director agreed: *"More than ever, we live in a world where the mix of individual skills and the background of the board is critical."* Directors said they are looking for prospective board members with specific expertise in technology, digital transformation, customer centricity, and services rather than products. *"Prior board experience may be less important than tech experience,"* said one director.

"More than ever, we live in a world where the mix of individual skills and the background of the board is critical."
– Director

However, participants cautioned that overemphasis on expertise can cause boards to defer to the expert on highly technical topics, or could limit diversity of thought, another cardinal value for boards. *"If you are going to add tech-savvy people to the board, it is very complicated because these people are not interested in many of the fiduciary responsibilities of the board,"* said one participant. In the rush to find members with new competencies, boards must still keep in mind historical requirements for directors.

Several participants emphasized the importance of competencies like creativity and abstract reasoning. One director said, *"The art of the possible is exploding, so you need a level of creativity at the board that may be new."* Another said, *"Recognizing patterns in the complexity will help boards better engage management."*

"How often do you step back and consider the tech strategy and investment as a whole?"
–Director

Bring in external perspectives

Boards are keen to engage outside experts to help ensure robust board-level discussion. *"What don't we know? What should we be sensitive to? Outside experts can help with this,"* said one director. Participants noted the prevalence and likelihood of blind spots due to the rapid pace of technological change and deference to historical modes of operating and well-established thought patterns. In addition, some directors worried about the board's ability to challenge common narratives, with one asking, *"How do we make sure we don't get drunk on self-speak?"* Outside experts can offer valuable perspectives that broaden the board's outlook and encourage it to engage differently with management.

"What don't we know? What should we be sensitive to? Outside experts can help with this."
– Director

Create structures to elevate technology discussions

One director asked, *"Does the current board structure support the changing needs? The challenge before us is the target operating model and how to transform it. Which routine board committee does that fit into? It just doesn't."* Recognizing that fact, several insurers have created board or advisory technology committees. Directors noted that the act of establishing committees, allocating staff, and creating reporting relationships creates value by ensuring there is frequent, robust, and multiperspective discussion of transformation. One director said, *"We wanted to ensure we institutionalized a board dialogue on major operating transformation projects. We wanted a set place on the agenda so the discussion would be front and center, not episodic."* He added, *"This committee is the future. It will become our most important board committee for strategic decision making."*

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– Director

Take a holistic view of technology strategy and investment

To support transformation, boards must first understand and align with it and its component parts. One director said, *"Most important is making sure you scoped out the project right. Make sure you do the homework up front so you plan it better."* From there, participants stressed that directors need to be able to dive into specific elements of the strategy as well as to pull back and take a more strategic view. One director suggested that management must explain the purpose of each transformation initiative clearly and connect it to the broader strategy. *"How often does the CIO articulate a strategic view of infrastructure? How often do you step back and consider the tech strategy and investment as a whole?"* asked another director.

Enhance benchmarking and reporting related to transformation

Several directors suggested it can take some time for boards and management to identify the best benchmarks and to routinize reporting on transformation initiatives and strategy progress, particularly when investments are new and lack historical data. *"It is common sense, but it can take time to get it right,"* said one director. She continued, *"You need monthly updates to know you are on track, including the major risk areas."* Another said, *"We have to be skeptical. We have to understand the glide path of the initiative in year one, two, three, and so on, as well as what the cost will be. It needs to be sufficiently specific so you can revisit it each year and measure your progress. We need to understand whether the plane will land on the runway or in the trees."* Participants encouraged directors to add value by pushing for better metrics.

"There is a lot of risk and cost in changing your operating model, so you want to make sure you do it well." – Director

Improve understanding of the risks specific to transformation

Technology is making transformations easier and more cost effective, but major organizational changes remain disruptive and risky. In fact, the reported failure rate for large-scale transformative efforts is about 70%.[8] Unfortunately, the risks associated with transformation are also largely operational in nature, making them hard to quantify, hedge, or hold capital reserves against.

Key risks inherent in transformation

The following risks can threaten the transformation process:

- **Inaction, insufficient action, or misdirected action.** One director suggested, *"Perhaps the greatest risk of all is doing nothing."* At present, however, most insurers are undertaking significant efforts. Instead, the concern among many insurers is that priorities may be wrong or investment insufficient to achieve desired results. Several participants noted that firms are prone to underestimating the pace of change, and non-executive directors said they worry that groups will fail to recognize the mistake and respond appropriately. *"In retail, when you are failing, you fail fast. You know immediately about indicators to react to. Insurance is like a tree drying: it might have been for a while and you didn't notice,"* said one director.

- **Lack of alignment and planning.** *"One-third of transformation efforts fail for lack of incentives and planning. This is vitally important,"* said one director. Another encouraged insurers to *"align incentives, crystallize outcomes via Gantt charts, and bake them into annual pay and reward."* Directors agreed that management must be completely aligned for transformation to succeed and that incentives to support transformation are likely to differ from ones that support steady-state operations.

Key risks inherent in transformation *cont.*

- **Systems failures or operational challenges resulting from changes.** *"Anytime there are big changes like this, there are pockets of risk that come up,"* said one executive. Participants cited numerous examples in which projects designed to enhance the digital enterprise or simplify systems resulted in new challenges and even greater complexity. One participant said, "*There are also the unintended consequences. We had a major IT outage. We tried to merge several systems into one pipe, but we forgot to increase the size of the pipe. All of these systems are interconnected, and small things can have a massive effect."*

- **Security challenges stemming from increased digitalization and empowered bad actors.** *"Sometimes it seems as though the more digital we become, the greater the security threat,"* said one director. As firms transform, they need to ensure their cybersecurity strategy anticipates the needs of a more digital enterprise.

- **Regulatory limits on uses of new technologies.** Insurers are enthusiastic about opportunities created by new technologies such as analytics, autonomous cars, the Internet of things, and artificial intelligence. However, many fear that they will invest in these opportunities only to see regulators limit their application.

Finally, while boards have to understand the risks inherent in their own transformation efforts, they also have to scan the landscape to understand how change in other sectors will affect them. One CRO said, *"It is not just insurance being hit with real change. Twenty-two percent of our investments are in the energy sector, mostly in our bond portfolios. What happens to the energy industry when solar panels hit parity? This will be a major impact on all our investment portfolios."* Persistent uncertainty in the external environment exacerbates all risks. *"There is a lot of risk and cost in changing your operating model, so you want to make sure you do it well,"* said a director.

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Insurers face a daunting task: to simplify and become truly digital in the face of growing complexity and uncertainty. To become sustainable, profitable, and digital, insurers are adopting a variety of tactics, including automating processes, improving customer interfaces, and starting up greenfield operations that are unburdened by the constraints of previous systems and approaches. As technology shifts from enabling to driving the business, boards are seeking a more strategic approach to investment across the enterprise and are adapting their governance tools to accommodate transformation.

About the Insurance Governance Leadership Network (IGLN)

The IGLN addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages members of senior management, policymakers, supervisors, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy insurance institutions. The IGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the IGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multi-stakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the insurance industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients and for its communities. EY supports the IGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

Appendix A: Discussion participants

On December 6 in New York, Tapestry and EY hosted an IGLN meeting on the technological transformation of insurance and the evolving US political landscape. In the meeting and in preparation for it, we conducted numerous conversations with directors, executives, regulators, supervisors, and other thought leaders. Insights from these discussions informed this *ViewPoints* and quotes from these discussions appear throughout.

The following individuals participated in these IGLN discussions:

AIG

- Terry Stone, Regulatory and Public Policy Committee Chair

Allianz

- Tom Wilson, Chief Risk Officer

Aviva

- Angela Darlington, Chief Risk Officer

Chubb

- Michael Atieh, Audit Committee Chair
- Theodore Shasta, Non-executive Director

The Hartford

- Teresa Roseborough, Non-executive Director

MetLife

- Marty Lippert, Executive Vice President, Global Technologies and Operations
- Stan Talbi, Executive Vice President, Chief Risk Officer

Prudential Financial

- Nicholas Silitch, Chief Risk Officer and Senior Vice President

QBE Insurance Group

- Marty Becker, Chairman of the Board

Sompo Japan Nipponkoa

- Jan Carendi, Senior Adviser to the CEO

Sun Life Financial

- Marianne Harris, Management Resources Committee Chair

The Travelers Companies

- Alan Beller, Non-executive Director

USAA

- Eileen Collins, Vice Chair, Risk Committee
- Torben Ostergaard, Chief Risk Officer

US Chamber of Commerce

- David Hirschmann, President and CEO, Center for Capital Markets Competitiveness

EY

- Dave Hollander, Global Insurance Advisory Practice Leader
- Nicole Michaels, Principal – Insurance Advisory
- John Santosuosso, Global Insurance Assurance Leader

Tapestry Networks

- Leah Daly, Principal
- Colin Erhardt, Associate
- Peter Fisher, Partner

Appendix B: Key questions for boards to consider

- What is the best role for boards in transformation programs?
- What are the greatest challenges for boards in overseeing significant transformation efforts?
- What expertise, structures, or processes do boards need to support near-continuous transformation? How do these differ from steady-state or historical approaches?
- What objectives are transformation efforts seeking to achieve (e.g., cutting cost, removing friction)? Are management and the board well aligned around these objectives?
- What skills and competencies do emerging operating models require from leaders and throughout the enterprise? How do these future needs differ from today's needs?

Endnotes

[1] For a thorough discussion of the forces buffeting the financial services sector, see Financial Services Leadership Summit, *Revolutionary Change Is Transforming the Financial Services Landscape,* ViewPoints (Waltham, MA: Tapestry Networks, 2016).

[2] Transformation is perhaps the most overused term in business. In this document, it refers to significant change programs rather than organizational redesigns that are limited to addressing roles or reporting or overhauls related to specific lines or businesses within the broader business model. The change programs under discussion in this document affect multiple parts of the operating model or the processes, people, and technology used to run the overall group. These initiatives typically cost more than $20 million and can run up to $100 million.

[3] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

[4] Andrew G. Simpson, "AIG, Hamilton, Two Sigma to Launch Small-Medium Business Insurance Joint Venture," *Insurance Journal*, April 26, 2016.

[5] Chris Skinner, "Is It Fintech or Techfin (Part Two)," *Finanser.com* (blog), February 8, 2016.

[6] "New York Life Reaps Rewards of Actuarial Reform," *Insurance ERM*, October 27, 2016.

[7] "Investing in Technology," MetLife, accessed November 11, 2016.

[8] Michael Bucy, Stephen Hall, and Doug Yakola, "Transformation with a Capital T," *McKinsey Quarterly,* November 2016.