

The Value of Scale: A Closer Look for Insurance

by David Sterner and Kathy-Ann Hutson



David Sterner
sternerd@us.ibm.com

Scale economies are well observed in many industries and are touted by many insurers as a strategic and tactical aspiration. However, thoughtful analysis of the insurance industry indicates that scale advantages are elusive and create minimal value. Structural and cultural particularities appear to exist which limit the importance of scale. These include significant regulations; low entry barriers; reliance on investment income; irrational pricing; low fixed costs; and, most importantly, the limited leverage of accumulated experience to improve



Kathy-Ann Hutson

operations. Nonetheless, a limited number of carriers have leveraged scale economies for competitive advantage and value creation by controlling expenses, focusing investment and management resources to mitigate key centralization risks and developing specific capabilities to achieve scale benefits.

Scale economies

While scale economies are evident across various industries, they are difficult to observe in the insurance industry. Scale economies drive value through two primary mechanisms. First, larger insurers are able to amortize fixed costs across greater premium volume. For the majority of life and non-life carriers, this represents 10% to 15% of total expenses. Second, as insurers gain more experience, they are able to improve operational efficiency and reduce marginal costs through learning curve effects. Numerous studies,

across a wide range of industries, indicate that operational costs typically decline by 10% to 30% with each doubling of cumulated output. Applied to the insurance industry, these general observations would mistakenly suggest that insurers with the greatest number of policies, time in business or cumulated premium can become the low-cost, high-growth carriers.

Scale economies are often cited by many insurers as a strategic rationale for mergers and acquisitions. A recent IBM study ana-

David Sterner is a Global Insurance Segment Manager with IBM, USA, and Kathy-Ann Hutson is an Insurance Strategic Researcher with IBM, USA.

Figure 1

	% of Deals	Average Price/Book	Average % Return		
			10 Day	TTD CAGR	Indexed CAGR*
Economies of Scales and Scope	43.8	2.0	-0.8	-6.3	-3.1
Core Expansion	40.0	1.8	2.0	1.0	0.4
Capability Acquisition	8.8	3.3	6.6	22.0	2.9
Diversification	7.5	4.6	-0.5	-4.2	-3.8

TTD = Total to Date
 * Indexed to S&P from date of acquisition to TTD 1/2/04

Source: Mergerstat and IBM analysis, 2005

lyzed the 80 largest life insurance transactions over the past eight years. Nearly half of acquiring companies cited scale and scope economies as the primary driver behind the transaction. However, an analysis of shareholder returns illustrates that these same insurers suffered the poorest short- and long- term results (see figure 1). In contrast, those insurers who achieved the highest shareholder returns indicated that the primary purpose of the transaction was to acquire additional capabilities. A subsequent review of the value destroying M&A transactions indicates that acquiring companies often failed to fully understand the effort required to successfully integrate the two organizations. Many of these transactions led to a more complex and less efficient operating structure. (See Figure 1.)

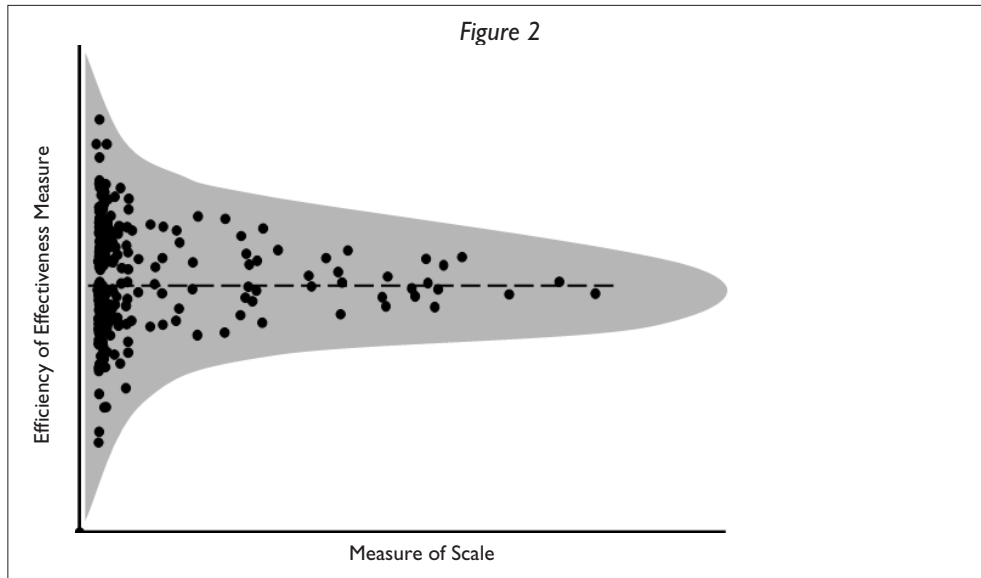
Evidence of scale economies in the non-life insurance segment is equally elusive. An IBM study of the 75 largest U.S. property/casualty carriers over the past 15 years strongly suggests that there is no correlation between size and performance. The study, which focused on shareholder value creation, included an analysis of insurer size measured against several performance metrics. In all cases, larger carriers failed to exhibit superior results over smaller carriers.

IBM's Global Study on Scale in Insurance

This seemingly lack of evidence supporting the existence of scale economies in the global insurance industry provided the rationale for a separate IBM study which covered more than 10,000 non-life and life insurers across 30 countries over the past 5 years. The study focused on evaluating 18 distinct performance metrics relative to scale as measured by premium income. Figure 2 illustrates the typical pattern the study observed across the metrics.

For non-life carriers, selected operational metrics examined included incurred losses and underwriting expenses as a percentage of premiums, while for life carriers operating expense and return on surplus were analyzed. For the non-life insurers the study found no impact from scale on loss results or underwriting effectiveness. Superior claims results were not necessarily linked to scale economies. Large and small insurers performed around the sample average, but small insurers had a greater degree of variance. For life insurers, there was no impact on operating efficiency or ROE that resulted from scale.

The study also looked at selected non-operational metrics including growth, shareholder returns and cost of capital. Most insurers regardless of their size hovered around the mean of the sample for growth. However, the



study did illustrate that smaller insurers had significantly greater shareholder returns relative to larger insurers.

The results were mixed on the analysis of cost of capital. Large insurers had a lower cost of debt compared to smaller insurers. However, they had a higher cost of equity and higher cost of capital overall. Larger insurers in the sample tended to be more diverse geographically, which may lead to greater risk exposure across multiple markets.

Finally, large insurers in the study seemed to do well in attracting highly skilled management to their organizations. Large insurers in the sample demonstrated effective use of compensation to attract the best and the brightest management teams to their organizations.

The study also examined external capabilities such as reinsurance, advertising expense and technology spend. It was unclear whether larger insurers used reinsurance vehicles better or worse than smaller insurers. Insurers seemed to retain around the same percentage of premiums regardless of size. With respect to technology spend, the study did not uncover any correlations to spending patterns based

on size. More detailed analysis of individual companies found that technology spend was often driven by strategic intent, capability and vision, rather than scale efficiency. In addition, the level of spending on technology was influenced by non-scale factors such as geography, products, distribution, regulation and customer segments. Finally, while the level of advertising spend between large and small insurers was approximately equal relative to the size of each company, the higher dollar volume of the large carriers afforded them greater reach in advertising.

Global versus Regional

IBM's study of scale in insurance also suggests that multinational carriers may be at a disadvantage with respect to achieving scale economies. The study categorized carriers as either global or regional and analyzed shareholder returns between the two groups. Figure 3 illustrates that regional carriers achieved significantly higher returns and had a significantly lower cost of capital.

Ideally, global insurers should be able to

Figure 3: Global versus Regional: Return and Cost of Capital

Study		2003 Premium		TSR	WACC
		USD Billions	(%)		
Study (10,112)	Life	1,542	(57)	2.8	5.6
	Non-life	<u>1,163</u>	(43)	4.3	5.2
	Total	2,704			
Global (24)	Life	431	(56)	-4.2	6.6
	Non-life	<u>338</u>	(44)	-5.7	5.9
	Total	769			
Regional (10,088)	Life	1,111	(57)	5.1	5.1
	Non-life	<u>825</u>	(43)	5.7	5.1
	Total	1,985			

Source: IBM analyses, 2005

apply their knowledge and resource advantage more efficiently and effectively across countries. However, a myriad of challenges makes knowledge and resource transfers difficult. Additionally, the greater the spread geographically, the more complex a company's operations become, which makes any advantage of scale elusive and difficult to maintain.

A more detailed analysis of individual companies in the study highlighted several factors impacting the results in figure 3. First, global insurers face business complexities that vary by country. Customer needs may vary dramatically making it difficult to import products from one country to the next. The competitive structure in each country will also vary significantly, creating the need for global insurers to adopt different strategies for each market. Finally, regulatory requirements are typically unique to each country, necessitating separate products, processes and reporting structures in order to adhere to differing sets of regulatory requirements. All of these factors require significant resources and complex operations, which, when not managed correctly, can lead to diseconomies of scale rather than gains in efficiency.

Additional factors outside the direct control of company management may also explain the lower shareholder returns of global insur-

ers, including a higher degree of geopolitical risk embedded in the stock price. In addition, global companies are exposed to a larger number of natural and man-made catastrophes since they operate in a larger number of countries. Finally, investor confidence in multinational insurers may be negatively impacted as financial transparency rules evolve at different rates around the world.

Overall, scale did not lead to measurable improvement in financial or operating performance. Large insurers did not appear to use scale to their advantage but were able to limit any downside risks. These carriers overall failed to reduce redundancy in operations and capitalize on reuse and had underdeveloped metrics and methodologies that failed to improve performance, planning and execution. In addition, the large scale and complex nature of their operations limited the speed of innovation and the level of coordination among business units.

Small carriers exhibited a much higher degree of volatility in their results with some companies achieving superior returns and others suffering dismal performance. Those that underperformed failed to focus on distinct customer segments to achieve benefits from information economies of scale and scope. These carriers had difficulty in attracting and

retaining high skill individuals across the organization. Finally, small carriers had high fixed costs and a limited amount of discretionary spend to support renewal and innovation within their business.

Winning Strategies

From the analysis, the study uncovered two key questions. One, what benefits of scale were large insurers not capturing? Second, how can small insurers achieve consistently high performance by adapting select strategies and capabilities typical of larger insurers? An in-depth review of large carriers that have leveraged scale economies for competitive advantage illustrated some common strategies employed to increase the level of value creation.

- Shifting fixed, nondiscretionary costs to become variable and discretionary across information technology, process and organization by aggressively pursuing sourcing alternatives.
- Value creation through decreased expenses and reduced cost of capital – IT utilization, informational and skill economies, asset redeployment and lower capital costs.
- Investment and management focus to mitigate key centralization risks – decreased degrees of freedom, inflexibility, central staffing excess, lack of business alignment.
- Capability development to achieve scale and scope benefits – asset arbitrage, procurement, data and knowledge leverage, portfolio optimization, skills management.

In addition to the above strategies, large carriers leveraged several key capabilities to create value across the value chain.

- Marketing: Maximized share-of-voice through uniform branding, customer-product-channel focus, and internal and

external consistency in marketing messaging.

- Product Operations: Developed a disciplined product development process executable across the enterprise and which considers customer, product, and channel lifetime value.
- Customer Acquisition: Strengthened current channels while building option value through investments in consumer education and operations to increase viability of alternative channels.
- Underwriting: Maximized customer and household lifetime value through explicit consideration of product and service portfolio across segments.
- Policy Administration: Developed a comprehensive, value-driven, long term core capability vision in the context of the accumulated organizational legacy as well strategic intent.
- Claims: Invested in the required processes and information technology to gather, screen, implement and refine claims best practices on an ongoing basis.
- Customer and Channel Management: Recognized that the fundamental unit of value is the customer and channel relationship and developed strategies, tactics and capabilities to create and capture that value.
- Enterprise Management: Considered both strategic and operating importance in the context of ability to execute when developing enterprise sourcing strategies

Finally, a number of smaller carriers have developed strategies and tactics to address the threats that larger carriers pose. However, given the apparent limited benefits that carriers have been historically able to achieve from scale economies, carriers of all sizes should thoughtfully consider the implications and re-examine their strategies and capabilities.