Smart cost management: Making every cent count

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Ever-increasing competition is intensifying the pressure on European insurers to drive down costs. Yet, traditional cost-cutting initiatives can often prove short-lived and may impede the company’s ability to achieve its strategic objectives. In an interview with Ray Kunz, Editor of Insurance digest, Chris Carson, a partner with PricewaterhouseCoopers (UK), outlines how a more informed, sustainable and strategically focused approach to cost management could help to ensure that limited resources are targeted where they can deliver the most value.

SMART COST MANAGEMENT: MAKING EVERY CENT COUNT

Chris Carson has spent nearly 20 years working as an operations specialist within the insurance industry. Since joining PricewaterhouseCoopers (UK) in 2005, Chris has advised a range of insurers on the delivery of complex change management programmes. The projects have not only helped companies to reduce their costs, but also enhance the focus and efficiency of their operational management and hence their ability to meet their overall strategic objectives.

Ray Kunz:
Everyone wants to cut costs. What in your experience are the potential pitfalls?

Chris Carson:
The most common pitfall is when companies look at their operational expenses in isolation and then set arbitrary targets for reduction that do not reflect their basic needs, strategic objectives, or the organisational structure of the front office.

Despite consuming considerable management time and energy, the resulting solutions can therefore often prove unsustainable or even strategically disruptive. For example, having axed or rationalised certain posts, the company subsequently finds that it has to rehire all the people it let go as it cannot function efficiently or grow in the long term without them. While this would appear to be an obvious hazard, such failings are still common, especially in the current climate when consumers, analysts and investors are focusing ever-more closely on costs and pricing.

Ray Kunz:
What in your opinion would be a more effective approach to strategic cost management?

Chris Carson:
A number of successful companies have flipped the question on its head by viewing cost as a necessary element of the running of any organisation and hence asking themselves, ‘How is our cost base supporting the delivery of our strategy?’

In a market marked by increasing competition, regulation and globalisation, the most impressive and enduring cost reductions have been achieved by companies that have looked at expenditure as an investment in the future by asking, ‘Where do we want to go?’ and ‘What do we need to get there?’

The primary focus within this more strategically aligned approach to cost management becomes the costs you keep rather than the costs you cut.

Ray Kunz:
In practical terms, what is the starting point for this ‘smart’ cost evaluation?

Chris Carson:
Traditional cost allocation models have tended to attribute the cost of activities such as IT or marketing according to fairly rudimentary measures such as the number of policies or number of customers. This approach largely fails to take account of the real contribution or relative business benefits being conferred on the product and may therefore artificially increase or decrease its profitability. For example, does it really make sense to charge the costs of marketing programmes aimed at new customers to policies that have been on the books for years?

More granular allocation models such as activity-based costing (ABC) can provide a more detailed view of the cost-benefit of a particular function. Companies can then pinpoint investment to where it can generate most value.
In a simple example, why spend money on improved internet access when your proposition is built around tailored service. Taking yourself out of the service loop might save money, but destroy the value this offering brought to the market.

Ray Kunz:
How is this approach being used to challenge costs and profitability and so sharpen the company’s competitive edge?

Chris Carson:
The key to smart cost management is the ability to measure the cost of any function against its strategic benefits. The result is a more visible evaluation of the profitability of a particular product or the value of a business process. For example, one UK insurer thought 75% of its new business was creating value. Yet after a detailed ABC analysis it realised many of its products were absorbing an unnecessary allocation of overheads associated with new business. When these costs were reattributed the company realised only 25% of its new business actually added value. Within a year, the company decided that the best way to enhance shareholder value was to abandon new product developments and direct their resources at more profitable existing product lines. A more effective direction of resources can also be seen in moves to outsource closed books of business to specialist consolidators, which can greatly reduce the running costs per policy, so releasing funds for reinvestment in active business.

Ray Kunz:
How extensive are the necessary changes to achieve a more effective alignment of a company’s cost base to areas that add value?

Chris Carson:
It is very important that companies seek to gauge their appetite for change. As Figure 1 highlights, there are a number of different activities that could have a significant impact on costs, ranging from ‘quick wins’ such as a tighter marketing focus and management of expenses through to outsourcing, IT platform consolidation and other major operational realignments. However, these actions require a different level of commitment to changing working practices and organisational structures.

It is vital that senior management plays an active role in the process from the outset. It is also important that the nature and rationale for change are clearly communicated across the organisation and its affected stakeholders, rather than just those directly involved.

Ray Kunz:
What are the keys to achieving the ‘quick wins’?

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**Figure 1**

What is your appetite for change?

There are a number of different activities that could have a significant impact on costs. However, these actions require a different level of commitment to changing working practices and changing organisational structures.

- **Quick wins**
  - 10% reduction
  - Tighter management of travel and expenses
  - Reduced marketing spend
  - Refocused allocation of overheads

- **Performance improvement**
  - 20% reduction
  - Site consolidation
  - Process re-engineering
  - Reducing data issues
  - Centralise transaction processing

- **Operational realignment**
  - 30% reduction
  - Offshoring
  - Shared Service Centres
  - Automating customer service
  - Outsourcing
  - IT platform consolidation

- **Ongoing embedded cost management**
  - 20% reduction
  - Global Infrastructure

Increasing implementation time and costs

Source: PricewaterhouseCoopers
From our experience, most organisations can expect to achieve a 5-10% reduction in expenses such as travel, recruitment, marketing and communications, by simply announcing a review and increasing management focus on ensuring that guidelines are upheld. Benchmarking against peers can also be helpful. A medium-sized bank was able to reduce its international expenses by more than a quarter through comparisons with competitors and subsequent revisions of many of its policies. Finally, it pays to align expenses with performance. For example, a securities house took travel expenses out of its traders’ bonuses.

Ray Kunz: Where and how can performance be improved to manage costs more smartly?

Chris Carson: Many companies’ operations suffer from duplication and inefficient processing. Finance is a case in point. Many insurers find they have staff dotted around in a number of locations, often doing overlapping work or dealing with intra-group interface or communications issues that can raise costs and increase turnaround times. In turn, manual processing and variations in data sourcing standards mean that up to a fifth of finance staff in some companies spend much of their time resolving data quality issues. Streamlining and, where possible, automating operations can improve delivery, reduce costs and ultimately enhance the focus and added-value of finance teams.

Ray Kunz: Operational realignment can in theory deliver the most telling cost reductions, but how easy is this to achieve in practice?

Chris Carson: Clearly some programmes such as outsourcing or the development of shared service centres are more costly and complex to deliver, though the payback can be significant. If we look at outsourcing, for example, the potential benefits include bringing the cost base more into line with changing strategic objectives and market demands by allowing companies to switch from fixed to variable costs. This is also a highly competitive and rapidly evolving market and the savvy operator will keep up to date and be able to exploit the latest developments and opportunities. However, I would add a note of caution on outsourcing and similar initiatives. Companies must keep track of market developments. In the UK five years ago, for example, the going rate was £25 (€35) per year for servicing a policy. Following the subsequent wave of outsourcing and closed book consolidation, the figure is now below £10 (€15). You must stay current to ensure you are getting value from your outsourcer. And do not forget the basics. Companies need to ensure that their chosen contractors and service level agreements reflect consumer expectations, while ensuring that delivery is underpinned by sound governance, regular review and well-controlled regulatory adherence. Their strategic choices should also seek to mitigate the potential risks, for example by limiting the concentration of policies being managed by an unregulated service provider.

Ray Kunz: Being cynical for a moment, a consultant like you has come in to shake up the organisation and then left the company to deal with all the changes. How can the cost reductions be sustained over the long term?

Chris Carson: Naturally, it is important to be realistic about what can be achieved and how quickly. This includes seeking to balance the quick wins with the longer term performance improvements and organisational realignments. Ensuring sustainability is more complex. A key element is tracking the benefits and developing management information capable of providing visible measures of product profitability and the underlying costs. Being able to track and challenge costs over time helps to ensure that cost management evolves in line with strategic objectives and the value gains can be sustained over time.

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