



Virtual Insurance Companies

and their Implications for the Personal Insurance Industry

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Introduction

OVER THE LAST few years, the financial services industry in the UK and elsewhere has experienced an increasing incidence of unbundling of traditional business systems. This has been particularly manifest in certain forms of personal insurance, where the core functions of underwriting, marketing and claims/ administration do not necessarily reside within the same company. Instead, the delivery of personal insurance products is often enacted by loose clusters of independent marketing organisations, risk/ underwriting companies and administration providers often connected via some form of on-line technology.

Evidence of this is widespread. Some retail insurance brokers, for example, have set up 'virtual insurance companies', bypassing primary insurers and using reinsurers to price and underwrite risk and specialist service organisations to handle claims and provide other aspects of customer service. On a larger scale, several strong consumer brands, like Virgin, M&S and Tesco, have entered into financial services using a variety of hybrid delivery models. In many cases, products are supplied by traditional insurance companies. Whether one chooses to see this as insurance companies outsourcing marketing or consumer brands outsourcing manufacturing is a secondary issue: either way it suggests that the separation of core functions is not only viable, but in some cases optimal. More broadly it seems to hint at a certain wisdom that has come to many other industries, but heretofore has escaped insurance: focus is better. Is marketing (even of insurance) best done by marketing-focused organisations (consumer brands, affinity groups, brokers, etc.)? Is administration best done by admin companies who have state-of-the-art technology and no legacy system burden? Is underwriting best done by companies that deeply understand risk and how to price and manage it?

It is likely that much of the existing financial services sector, and in particular the personal insurance industry, will change form radically over the next few years. There is a widening pool of evidence suggesting that the unbundled delivery model has substantial economic advantages, that traditional insurance business systems will come under increasing pressure from more focused organisations, and that this may eventually give way to some level of industry disaggregation along functional lines. Moreover, virtual business systems are likely to favour new entrants as they lower entry barriers. This does pose a threat to traditionally structured insurance companies and their response to this will determine the extent to which virtual structures will change industry structure and competitive dynamics.

If all of this is occurring, it begs a number of questions, in particular:

- What defines a virtual insurance company?
- Why is it occurring *now*?
- What exactly are the sources of economic advantage in the virtual model? What are its limitations?
- What are the strategic implications and how will it change competitive dynamics?

What follows will hopefully go some way towards answering these questions, roughly in the order in which they are asked above.

What defines a virtual insurance company?

The word ‘virtual’ has been used in a variety of contexts with slightly different meanings. Normally, people use it to describe businesses which have some combination of the following characteristics:

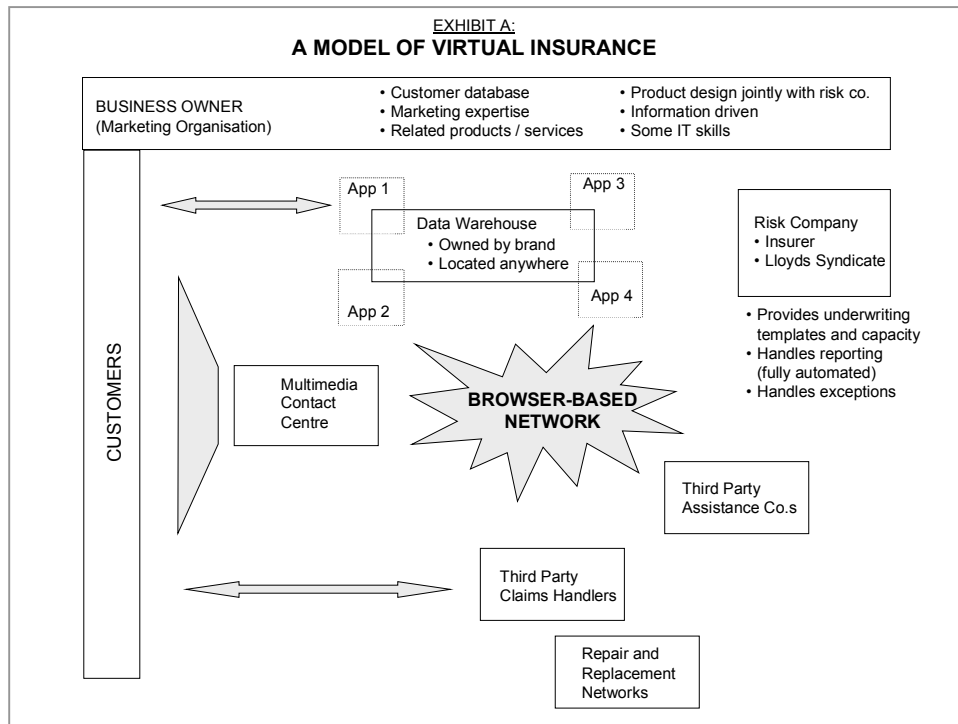
- A high portion of the activity is **unbundled**, i.e. separated into core processes, and **distributed** both
 - Across a number of outside suppliers (outsourced), and possibly
 - Across of number of locations
- Activities and suppliers are connected using **on-line technology** which eliminates substantial costs by, e.g.
 - Establishing electronic (paperless) interfaces between systems which require much less human involvement
 - Increasing speed of response and decision taking (especially important in claims)
- End customers and intermediaries use **e-commerce / the internet** frequently when dealing and transacting with the virtual business, which sometimes can eliminate the need for a physical distribution infrastructure such as high street branches or retail outlets (as in the case of internet retailers such as Amazon.com).
- **Information** is key to building and maintaining competitive advantage. The striking feature of the virtual world at the moment is the lowering of traditional entry barriers such as retail branch networks or broker franchises. The flip side of this naturally is that competitive advantage must rest on new bases. One of these will be firms ability to collect information about customers and use this to gain market advantage. Many industries that are seriously threatened by the internet are likely to consider redefining themselves along these lines, i.e. as information businesses.

A Theoretical Model of Virtual Insurance

So what might a virtual insurance company look like? [Exhibit A](#) illustrates an extreme case, in which each of the three main functions (marketing, admin, risk/investing) is carried out by a different firm. Not all agents are shown here explicitly as it is focusing on core functions only. Banking functions, for instance will be needed in collecting premium and paying claims, but are not explicitly depicted here.

The business system revolves around one central data warehouse which is

- Owned and maintained by the ‘business owner’, which in this diagram is the marketing organisation, i.e. the brand or affinity group that ‘owns’ the customer
- Location independent, i.e. it doesn’t matter too much exactly where it is because the various agents (including customers) can access it remotely either through public or private networks
- Comprised of customer – centric relational databases



The various agents interface with the data warehouse through different applications, so that they have access only to the data they need to carry out their functions. These applications and the interface works on the basis of browser technology which has two important advantages

- The application is held and controlled centrally
- The systems requirements for the agents are relatively minimal, i.e they will need some form of browser technology and their systems will not need to be ‘integrated’ in the traditional way with the central data warehouse

Beyond interfacing with the central data warehouse agents will also interface with each other directly where appropriate, and this can be accomplished in a number of ways depending on existing systems, processing volumes, etc.

I have described briefly how some of the key business processes might work.

Product development. In this theoretical example, the business owner will have good access to potential buyers of insurance products perhaps via a brand or a customer database. The business owner, as the marketing organisation, will drive development of customer propositions, working with the risk company, who will lend underwriting insight and ensure profitability, and admin providers, who will help to configure the service platform.

Customer acquisition and underwriting. Whether customers are notified of the insurance offer via direct mailing, broadsheet advertisement or some other medium, interested prospects will have the option to get a quote / product information either via the internet or via a multimedia contact centre (MMCC). ‘Multimedia’ here refers to the integration of call handling with the internet interface, e.g. quick response call back buttons on the web site. With either route, the prospects details are taken and fed into the automated quoting engine which will provide and immediate quote. Any subsequent fulfilment, i.e. the sending out of policy documents or information, etc., is processed by the multimedia contact centre (most offer this service).

Underwriting exceptions. It is important here to address the issue of exceptions, i.e. policy applications, which are in some respect non-standard and cannot be quoted via the automated quote engine. First, it is not unreasonable to assume that the volume of exceptions can be predicted and perhaps managed down through the joint efforts of the marketing organisation and the risk company. After all, in many cases, the insurance proposition will be put to a relatively ‘closed’ and known market. Large volumes of exceptions should therefore be avoidable. But some volume of exceptions is inevitable and these can be dealt in a number of ways depending on how the business owner wants to be perceived. A very simple, but crude solution is not to deal with exceptions at all. A more accommodating route would be to redirect calls to the insurance/risk company underwriters.

Policy administration. All subsequent policy administration, including renewals and mid-term adjustments are handled either through the internet or the MMCC. While the MMCC channel is always available customers will be encouraged through a variety of incentives to ‘self-administer’ through the internet. So the MMCC here is conceived as an introductory funnel which sets up customers for self-administration over the internet.

Claims handling. When claims arise customers can contact the designated third party claims handlers directly or alternatively claims notification calls coming into the MMCC can be easily re-routed to the appropriate claims handling agency. The claims handlers have the authority to pay claims that met certain criteria e.g. below a certain threshold, and again exceptions would be referred to the risk company. A virtual structure suggests a somewhat different philosophy of claims handling, however, one which is much more focussed on managing and controlling repair and replacement networks/ providers on a book basis as versus controlling individual claims. This reflects the reality that in some instances more money can be saved by controlling costs of repair / replacement and limiting abuse by plumbers, garages, etc. than by focussing on coverage issues on individual cases.

Book underwriting and reporting. The function of the insurance company as set out here in the extreme case is limited to providing underwriting engines / templates or perhaps just setting the pricing parameters, assuming the risk, some involvement in DTI or Lloyds reporting and handling underwriting or claims exceptions that are thrown out of the system.

Why is this happening now?

Related trends

The virtual insurance company is not a completely new phenomenon, but rather a logical progression of related trends and developments.

- **Outsourcing.** Financial services companies have been outsourcing certain back office functions for some time now. Among the most commonly outsourced activities are call handling for direct response advertising campaigns and claims handling and loss adjustment.
- **Self Insuring.** Many large corporations have opted to self insure for employee benefits, employer liability and motor fleets and this normally involves buying in third party administration and stop loss cover. These structures are normally set up by a large international brokerage firm, which subsequently sells in its own TPA services.
- **Unbundled quotes.** The larger brokers have been able to use their market leverage to force insurers to quote on an unbundled basis, e.g. risk without the admin. Again, the broker will typically sell in its own admin services.
- **Brokers integrating backwards into product manufacturing.** Some retail brokers have set up their own insurance companies, bypassing primary insurers and buying in underwriting from reinsurers, setting up their own administration units or outsourcing this to third party contractors.
- **Partnership agreements and own-branding** are further evidence of a separation in the value chain. Here it is the front-end marketing and distribution that splits off, leaving insurers to play the role of wholesaler to a variety of affinity groups, banks and building societies, auto manufacturers, i.e. anyone with a suitable customer base and brand to support insurance marketing.

These developments, taken together, point to three key trends that are clearing the path for virtual insurance companies:

1. The value chain in personal lines insurance is indeed unbundling to some extent
2. The best operations cultures have grown up largely outside of the insurance industry, and...
3. Market power (and perhaps margin) is shifting to those entities that can claim 'ownership of the end customer'

As a result, the competitive landscape in personal insurance is increasingly being defined by functional focus (as opposed to traditional product / distribution channel orientations) as specialist players take greater shares of the value chain. Specialists tend too fall into three, possibly four, categories and their bases for competing are clear and differentiated in each case:

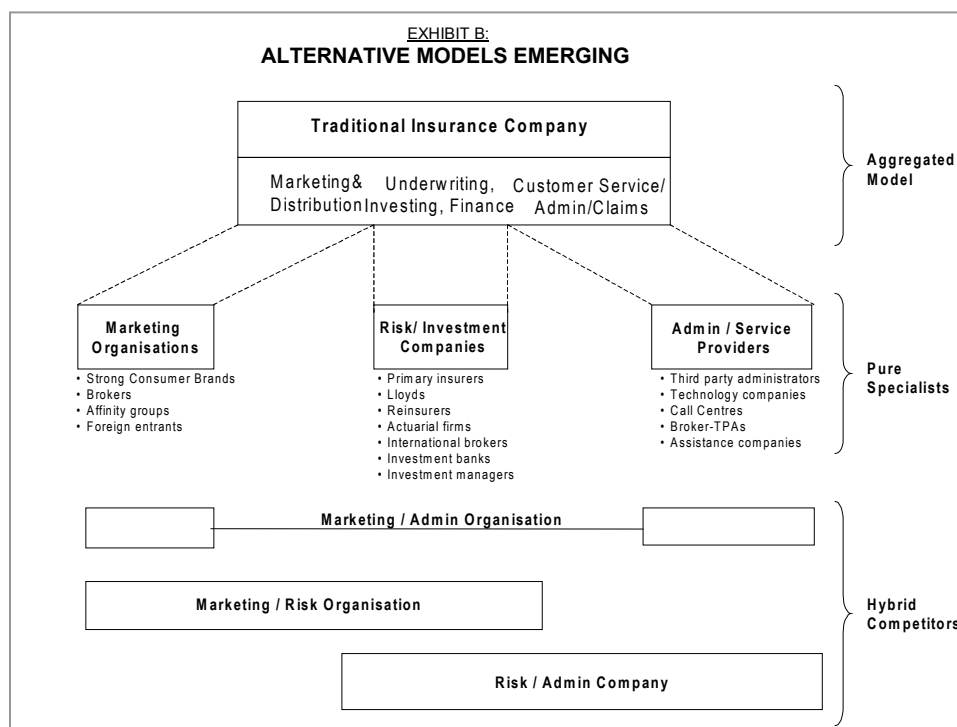
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- **Consumer marketing organisations**, who have access to or even ‘own’ the end customer have been quick to lever their capabilities into financial services. They typically have energetic, creative and customer-responsive cultures and can design and launch new products quickly. They understand advertising media and employ highly evolved marketing and promotional techniques which often have their origins in fast moving consumer goods.
 - **Administration / service providers**, in contrast, are characterised by their heavy use of leading edge back-office, telephony and online technology to minimise costs and improve service delivery. They perform high volume functions such as call handling, claims handling and record keeping and operate on a ‘funnel and filter’ basis, i.e. where non-standard cases are separated out early and passed on to other entities so as not to clog up the high volume processing. Although these technologies and techniques are also employed by insurers in their own internal admin departments, the striking difference is that specialist admin companies often have exceptionally strong ‘ops cultures’ (led by good ops managers). They are skilled in stretching resources and constantly strive (driven by market pressures) to squeeze costs out of the system by simplifying and streamlining processes.
 - **‘Risk companies’** compete on the basis of their understanding of risk. They encompass both independent organisations like reinsurers and Lloyds syndicates as well as groups within more broadly based organisations like primary insurers and investment banks. They see their main activity as developing innovative ways to look at risk which can lead to some market (e.g. pricing) advantage. Although they are highly information-driven and thinking-based organisations, they do let statistics and quantitative models substitute for intuition and personal experience of risk.
 - **Investment management companies** define a fourth category of competitor. Although they are less relevant in most personal lines general insurance markets, they are likely to become especially important in the life markets, especially as the trend towards unbundling of investment from insurance continues and investment management brands become household names. The requirements for operating a successful and competitive investment management organisation are becoming more stringent, however. In particular minimum scale requirements are increasing and factors such as culture, brand and location tend to favour non-insurance entities when competing for talent.

Specialist companies such as those described above, or more broadly speaking companies that lead on one of the above specialisms, are fast gaining ground in the market on the back of highly competitive propositions. This, in part, is driving the trend towards outsourcing (and value chain unbundling in general) and is opening up a whole new range of possibilities for structuring the personal insurance delivery model.

Exhibit B shows the potential disaggregation of the traditional model and begins to suggest some of the clustering options. Three main forms can be postulated:

- The Traditional model, in which most parts of the value chain are carried out under one roof. Most UK composites are operating with this model, although as they outsource more and more of their back offices they are moving towards the marketing-risk hybrid model.

- The Pure Specialist model, in which firms focus on leveraging skills and assets in one of three areas: marketing, risk/investment or admin/service.
- The Hybrid model, in which the firm combines two activities, possibly to realise synergies, and outsources the third.



Within this group, the ‘wholesaler’ model has been most successful to date. In this case, insurers subordinate their brand to that of the distributor / retailer (which is likely to be a marketing organisation) but continue to underwrite and assume risk and handle the ongoing policy administration, customer service and claims handling.

It would be premature, however, to discount the potential of marketing-admin companies or marketing-risk companies. For some competitors, these are preferable. The supermarkets for instance have made the strategic decision for certain financial products to perform all customer service in house. In product markets where they have outsourced or reinsured the risk component, they are pursuing the marketing-admin model. Similarly, some insurers have outsourced the majority of their admin functions in order to focus on marketing and underwriting.

Technological change

Recent developments in technology are facilitating greater degrees of unbundling of the business system and are opening up new distribution channels. Both effects are making virtual insurance companies more feasible and attractive.

The proliferation of browser technology has led to the rapid development of public and private networks which operate on a common set of communication protocols. This enables different computer systems to communicate with each other without needing to be 'integrated' in the traditional (costly) way. One implication is that outsourcing companies can access, and indeed work off of, the client's own systems and databases, which makes outsourcing of even the most entrenched processes more feasible.

The same sort of browser technology supports the internet, which adds other dimensions to the notion of a virtual company beyond outsourcing. Not only does the internet serve as a distribution channel to a growing segment of the market, it also enables customers to perform much of their own policy administration on line.

Consumer acceptance of non-financial brands

Another reason why virtual insurance companies are emerging now is consumers' growing acceptance of non-financial services brands selling financial services. A number of consumer brands have successfully stretched into financial services and as their businesses grow, they build further credibility. These types of organisations, in particular, are increasingly seeing virtual delivery models as a viable and attractive alternative to traditional partnership arrangements.

What are the economic advantages and limitations?

Operational Feasibility

Views on feasibility tend to vary according to one's interests. Outsourcing and technology companies, for instance, will usually claim that anything is possible with a large enough budget, which, in a sense is true. But that sort of response evades the real issue, which is practical experience, for which there is really no substitute. Unfortunately, there is a limited pool of practical experience when it comes to setting up large-scale virtual insurance companies in the UK, although some suppliers can claim experience in certain aspects of the virtual system and in certain product markets. There is much more experience of unbundled business systems in general insurance, for instance, than there is in life and pension. This is probably due to highly complicated product structures in life and pensions and their regulated status. Implementing virtual business systems for general insurance, all else equal, is therefore likely to be much easier than for life.

There are many aspects of feasibility, but technological and regulatory constraints are first order issues and need to be considered in some depth. In general, however, there do not appear to be many insurmountable technological or regulatory obstacles to virtual insurance companies.

Technological feasibility depends largely on one's starting point. An insurer with complex legacy systems supporting multiple products and distribution channels will run into serious obstacles in integrating a virtual business system. If that insurer, or a new entrant, can start from scratch, then a virtual system becomes much more feasible. Browser technology combined with CTI (computer telephony integration) enables most of functionality and electronic interfaces described earlier and neither are cost-prohibitive.

In terms of regulation, there are two main issues: sales process requirements for regulated products (e.g. fact find) and the need for backing from a DTI-licensed insurer or Lloyds syndicate. The regulation of the sales process for life and pensions business does not per se preclude a virtual business system, but the potential liability and cost associated with it will make new entrants more hesitant about entering the life and pensions markets, and new entrants are most likely to implement virtual systems. The second issue of insurer backing is not an obstacle as there is ready supply of capacity and shell companies from both the insurance and Lloyds markets and a willingness to provide these services on an unbundled basis and to subordinate the backer's brand. Reliance on an insurer can be avoided by setting up one's own vehicle, but this will be more costly and can take several months to finalise.

Advantages of Virtual Business Systems

The rationale for virtual business systems is largely based on the economic gains they promise. While these are yet to be validated systematically, there is some evidence and some good reasons to suggest that the economic gains from 'virtuality' are potentially significant enough to have bearing on how industry structure and competitive dynamics evolve. The potential savings from outsourcing alone are huge. Although it is always hard to quantify savings precisely due to the difficulty in costing internal operations and the inevitable difficulty in comparing like for like, savings of 25-40% are commonly quoted in the UK. Some American outsourcing firms claim to be able to cut an insurers expense ratio by as much as one-third.

Moreover, these figures exclude the outsourcing companies' margin, which is healthy in most cases. It is important to note that the magnitude of savings possible depends heavily on an insurer's beginning cost position. One prominent outsourcing company markets its services on the promise that it will move the client into a top quartile cost position. If the client, however, is already top-quartile, the benefits from outsourcing are naturally a lot less.

So far, these savings have come from better technology or better application of technology together with more efficient processes (and processing cultures) found inside outsourcing companies. There are a number of other sources of savings, however, that have been less exploited to date, but offer enormous potential.

- **Simpler processes.** There remains substantial scope for further simplifying and streamlining business processes, and the gains from this are not only in reducing admin costs. Simplifying claims procedures, for instance, can not only reduce claims handling costs, but also reduce the cost of the claim itself.
- **Simpler products.** Much of the complexity in existing insurance processes is driven by complex product structures. Simpler and fewer products intrinsically require less administration. Modular product structures have been effective in some cases in reducing complexity while retaining some degree of product customisation.
- **Simpler underwriting.** In most personal lines, the vast majority of applications should be accepted automatically. Of those exceptions that are reviewed by underwriters, the vast majority are accepted on standard terms. This suggests that the cost of maintaining a human underwriting function may in fact exceed its added value in terms of screening out unacceptable risks. Some may argue (rightly in some lines of business) that the potential liability in removing the underwriting function could be enormous. But in this case, why underwrite exceptions at all?
- **Self administration.** Browser technology and the expansion of interactive media (internet, digital TV, etc.) will enable customers to perform much of their own policy administration on-line. Although it reduces costs for the (virtual) insurer, it can be positioned as a service enhancement for a growing segment of consumers, especially if the option to talk to a real person is always made available.
- **Better use of information.** Virtual business systems enhance the business owner's ability to collect information from customers/prospects, intermediaries and suppliers. This information can then be levered to e.g. generate underwriting insight and spot market opportunities.

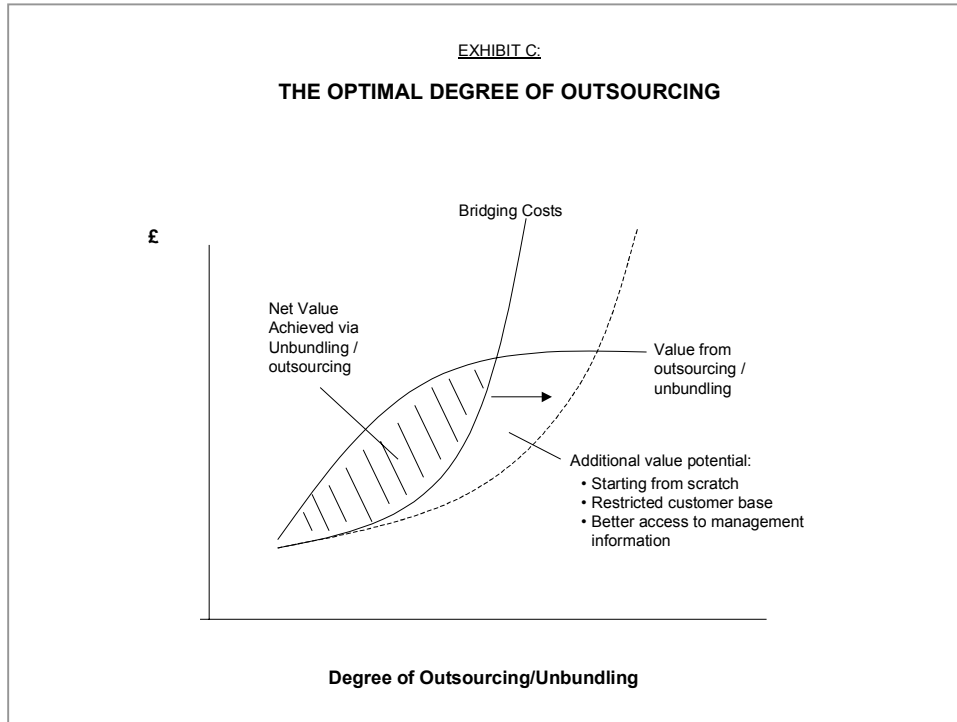
In addition to the above, virtual business systems have, in theory, the advantage of lower switching costs. If the business owner becomes unsatisfied with the service being provided by a third party supplier, it can terminate the contract and transfer the activity to a competing firm more easily than if the supplier were an in-house department. This switching ability in turn allows the business owner to maintain the leverage in third party relationship. In reality however, outsourcing contracts have had rather high switching costs (both financial and non-financial) associated with transferring large blocks of data, setting up new systems and training new staff. As technology becomes more fungible, however, these switching costs are likely to come down.

Drawbacks of Virtual Business Systems

Although virtual business systems offer the potential to realise substantial economic gains, there are drawbacks of the virtual model as there are drawbacks to the extensive use of outsourcing and new technology. I discuss a few of the more obvious drawbacks below and suggest some ways of dealing with them.

- **Vital information does not flow smoothly between different firms executing different business processes.** Often, information collected (perhaps informally) in the claims handling process could be of great use in underwriting, and if these functions were split between different firms, e.g. a Lloyds syndicate and a third party claims handler, the effective transfer of this information may be more difficult to enact. It must be said, however, that underwriting and claims departments within traditional insurance companies are normally run as separate fiefdoms and one must question the extent to which they are presently taking advantage of their proximity to one another in this way. Moreover, the ability to interface remotely via on-line technology should allow vital information to flow more freely between different firms.
- **Customers fall through the cracks of the virtual business system.** As the value chain is separated, there is greater chance that customers (or prospects) with special needs which large scale processes cannot accommodate will become quickly frustrated as they are passed from one entity to the next. This could be extremely damaging to the brands which are sponsoring the virtual business system, especially if these brands are founded on good customer service. It is extremely important, therefore, that virtual businesses establish a 'safety net' that catches those customers with non-standard needs, and that this safety net gives access to knowledgeable people with a birds eye view of the entire business system and some authority to accommodate exceptions when appropriate.
- **The business owner has less control over the customer interface.** This is particularly important in the case of a strong consumer brand that needs to be protected, and indeed, reinforced by a financial services business. Because of this risk, some brands, notably the supermarkets, have opted to set up their own call centres so that they have complete control over the delivery of customer service. This view is not universal, however, as call centres and their customers typically cite guaranteed service levels (e.g. minimum percent of calls answered within x rings, 24 hour call handling capability, etc) as a key advantage to outsourcing.
- **Business owner has only indirect control of key processes, and needs to surrender direct, day-to-day control to third parties.** Need for direct control may be real or may be perceived. The real value of direct control will vary according the business process and the product class, amongst other things. The tools of indirect control are becoming more sophisticated, however, and these include contracts, information (e.g. on-line real time management information to monitor service levels) and the threat of switching (higher as switching cost decline).

- **Conflicts of interest arise that cannot be resolved through contract specification.** Because these drawback result from the schisms created by disaggregating the business system, I characterise them as ‘bridging costs’. As the degree of fragmentation of the business system increases the bridging costs increase exponentially. Exhibit C depicts conceptually the trade-off between bridging costs of virtual business systems and the economic gains they offer (which exhibit diminishing returns to increased levels of unbundling).



What are the strategic implications?

Virtual business systems have great potential to influence industry structure and competitive dynamics. The nature and extent of the impact will depend largely on how insurers respond.

The primary implication of virtual business systems is that they facilitate entry. They make it easier for newcomers to set up their own virtual insurance companies and for recent entrants to extend their reach further into the value chain, and this is a very attractive option for firms wanting to market financial services to an existing customer base. Although virtual structures are an option for traditional insurers as well, 'outsiders' such as strong consumer brands, affinity groups, and overseas insurers are probably better placed to realise the advantages they offer.

An immediate effect on insurers is that partnership / own-branding arrangements will become increasingly vulnerable. Many of these 'partners' who have chosen to 'own-brand' insurance company products are currently reviewing these arrangements and some are likely to be tempted to use virtual systems to extend their involvement in the insurance value chain. In particular, banks and building societies appear to be somewhat dissatisfied in general with playing marginal roles as introducers and are keen to keep ownership of their customers.

Lower entry barriers normally lead to intensified competition, and in the insurance industry, given current conditions, there is a real danger that this will take place mostly on the basis of price. Insurers' margins are already extremely low in personal insurance, especially on the general side, and it is hard to imagine significant further erosion. Increased price competition will therefore put pressure on insurers to cut costs internally, e.g. via outsourcing or perhaps implementing their own virtual systems. This cost cutting offers an opportunity to rethink the business format in a fundamental way and some companies are beginning to grasp this challenge.

One possible response is to try to reflect some aspects of the virtual model internally. In particular, insurers can begin to shift from structuring their organisations around product-channel definitions to structuring them around core disciplines e.g. risk, marketing, admin, investment management. There is a need, in this case, to establish a contracting culture among parts of the organisation in which business units have the option to outsource certain activities to outsiders instead of using internal infrastructure and the servicing groups have the opportunity to market their services externally. This requires a very different attitude toward management and control, however, than exists currently inside insurance companies.

Ultimately, all of this will have the broad effect of clarifying the bases on which firms compete. Traditional insurers currently compete on a variety of bases in the personal insurance markets and most have only vague notions of what their competitive advantage might be. Consolidation is thought by many to be the answer, and indeed it can help to re-establish some entry barriers in some markets by strengthening distribution networks and brands and by increasing leverage with intermediaries. But realising the synergies of mergers and acquisition can take years and many recently merged insurers are finding themselves pre-occupied with systems and process integration, Y2K and the Euro. There is a window of opportunity in the meantime for fleet-footed new entrants operating on highly flexible and low-cost virtual infrastructures to cherry pick profitable niches and build significant insurance businesses.