THE APPLICATION OF STRATEGIC MODELS TO NON-LIFE INSURANCE MARKETS

2005 GIRO Working Party Paper

Working Party Members

Veekash Badal	Roger Massey (Chairman)
Matthew Ball	Pengkee Ooi
Mark Flower	Buu Truong
Graham Fulcher	Graham White
Sejal Haria	Martin White
Mark Julian	Richard Winter

Keywords

Strategy; Strategy Theory; Competitive Advantage;
Porters Five Forces; Value Chain; PESTL; SWOT;
Product Lifecycle; Value Innovation; Blue Ocean Theory

Abstract

The purpose of this paper is to provide a summary of the key tools used by strategists to understand the competitive nature of an industry and formulate company specific strategy, and to discuss the application of these models to the non-life (re)insurance markets. We offer our thoughts on the applicability of these models and attempt to draw some comparisons between the theory and the real world. The aim of this research is simply to provide a readable paper that may provide some insights and/or provoke further thought.

CONTENTS

Appendices

1 INTRODUCTION

Scope of Paper

The aim of this research was simply to provide a readable paper that we hope will provide some insights into the role of strategy within the non-life (re)insurance industry and ideally provoke some further thought. Please note the views expressed in this paper are not necessarily those of every member of the working party, or indeed of any member of the working party or their employers or anyone else who could possibly be the target of litigation!

Whilst there has been much written about strategic analysis of the pharmaceutical, airline and automotive industries we note the (re)insurance industry at large has to date remained relatively free of investigation. In this paper we examine some of the key tools used by strategists to understand the competitive nature of an industry and formulate company specific strategy and we apply these to (re)insurance companies. The tools and theories covered are:

- Competitive Advantage
- Porter's Five Forces
- Value Chain
- PESTL (Political, Economic, Social, Technological, Legal)
- SWOT (Strengths, Weaknesses, Opportunities, Threats)
- Product Lifecycle
- Value Innovation & Blue Ocean Theory

We illustrate our thoughts without risk of reproach for misinterpreting any particular company's strategy by making reference to two imaginary companies, a mono-line motor insurer and a large catastrophe reinsurer. More on these two shortly.

We move on to offer our thoughts and observations on how these models fit together, and which one most reliably reveals the all important "winning strategy". We then conclude by putting this all back into the context of the world in which we all work. What do non-life (re)insurance companies actually do when setting strategy? What should they be doing? How can our newly acquired insight be of help? Or, to put it bluntly, "So What?!"

This paper is not intended to replace any of the readily available strategy theory text books, but we have provided some more detail on each model examined in Appendix A. If you are particularly interested in any of the models you should find it relatively easy to obtain a number of text books or internet sites that will describe all of the models at great length, but only in very general terms.

Also included as Appendix B is a list of public statements made by various (re)insurance companies regarding their "strategy"; this has been revealing and provides some further food for thought. We hope that reading this paper might change your perspective on some of these statements. It did ours.

Our Story

We started off on a grey day last winter, on a quest to reveal the role of strategy within a (re)insurance company, and to understand how (re)insurance companies formulate strategies. Our initial intent was to discover whether (re)insurance companies actually have strategies, then discuss whether these could make or break a company, and whether there were models available which may be useful to a Board when embarking on a strategic plan / evaluation.

The journey was a pioneering one, and took the form of a series of enjoyable discussions punctuated by exploratory research and documentary work. This paper reports our findings.

Strategy often appeared elusive. Examination of several company statements of "published strategy" to shareholders was revealing. "Strategy" was often confused with mission statements or a generic description of company aims and targets with no details of plans to achieve these. Company strategies often adopted a "business as usual" approach; however there are some indications that this view will need to change, as new entrants with non–insurance backgrounds use more innovative approaches to shake up the industry.

Which led us to the question: "*Should a 'winning' strategy be published anyway?"* As a source of possible competitive advantage, one might imagine that many strategies were closely guarded secrets; but then again one might imagine many things! Anecdotal evidence suggests many strategies are not captured, or have difficulty escaping the lofty confines of the boardroom and being delivered to the employees to execute; and some of those that do escape don't make it as far as implementation before being abandoned for another grand scheme…

On the other hand, it isn't difficult to find examples of very successful companies where the strategy seems pretty clear, either because they publish it (Berkshire Hathaway) or because we can all see what they are up to anyway (Direct Line). Indeed, it seems that one differentiator between successful and less successful companies may be the existence or otherwise of a simple, appropriate, clearly defined and well communicated strategy.

But knowing a strategy that works for someone else is one thing; turning that into a successful strategy for your own company and executing it effectively is quite another.

So what about the models? Are these the magic solutions or the silver bullets? Our journey indicated that models were insightful, but did not provide the panacea hoped for. There is some overlap between the models (less than we expected) and in the most part they offer a framework around common sense and intuition rather than revolutionary insight. In particular, we noted that whilst providing a good analysis of the environment a company was operating in and hinting at strategies that may be successful, the models analysed had very little to say on the process of strategy formation: there was a deep gap.

So what does a "winning" strategy look like anyway? And what of the future? (Re)insurance is becoming a more dynamic industry; strategies pursued by companies now are far more innovative and it is increasingly difficult to compete on cost alone in many sectors. In the brave new world strategies will need to be inventive, insightful, and above all ready and able to respond to future trends. The day of the Boardroom Visionary may be yet to come!

Background and Definitions

The word strategy is frequently used and often inappropriately. What does it actually mean?

Dictionary Definition of Strategy

The roots of strategy lie firmly in the world of military combat. The term itself derives from the Greek word strategia meaning “generalship”, itself formed from stratos, meaning “army”. The concept of strategy is however much older than the word. In around 500BC Sun Tzu wrote The Art of War which is widely considered the first treatise written on what we now call strategy. Many dictionary definitions still include military references, including:

Cambridge International Dictionary of English

> *A detailed plan for achieving success in situations such as war, politics, business, industry or sport, or the skill of planning for such situations*

Oxford Pocket Dictionary

> *The art of war, especially the planning of movements of troops and ships etc. into favourable positions; plan of action or policy in business or politics etc.*

Our Definition of Strategy

Transferring some of these properties to the corporate environment and in particular the (re)insurance marketplace, the definition of strategy that we came up with for the purposes of this paper (after a surprising amount of debate) was:

A strategy is a long term series of actions designed to take a company from its current state to its desired future state, and aims to provide a sustainable competitive advantage over other companies in the same market.

Our paper relates purely to the non-life (re)insurance market place. It should be noted that what the paper considers is often referred to as “Company Strategy” as opposed to “Corporate Strategy”. Corporate Strategy focuses on what businesses an organisation should be competing in, whereas Company Strategy considers how best to compete in the Company’s chosen market.

By market we mean “a place where people / companies converge to trade and compete”. In the context of non-life (re)insurance there are many markets but we felt that these could be segmented into two broad categories:

- Domestic market – where there is regional competition, e.g. personal and small commercial lines;
- International market – where there is global competition, e.g. property catastrophe (re)insurance or marine and aviation.

What is Strategy not?

It is also worth noting that:

a) Strategy goes beyond pure business planning and in particular considers a wider breadth of issues. Formulating a company’s strategy requires an understanding of the market it is competing in, where it sits relative to its competitors and how it will compete and outperform its rivals.

b) Strategy is also not tactics; the two are often confused. Tactics tend to be short term measures and described in significant detail. Strategy is broader themes / features / styles that a company may want to exploit.

So now that we think we know what “strategy” means, let’s have a look at the models…

2 THE MODELS

We considered each of the following models:

1. Competitive Advantage
2. Porter's Five Forces
3. Value Chain
4. PESTL
5. SWOT
6. Product Lifecycle
7. Value Innovation & Blue Ocean Theory

Here we will run through each model offering a very brief précis, with suggestions as to how they might be applied to help with strategy formation for companies operating in non-life markets. We have deliberately kept this section of the paper quite brief in the interests of readability, but include some further discussion of each model in Appendix A for those readers interested in digging a little deeper. If you want to dig a *lot* deeper, as we mentioned before, the internet is fertile ground to search and there are also plenty of readily available text books out there…

Once each model is introduced, we will offer some comment to provoke thought and promote discussion. How do they fit together? Are they good or bad, helpful or unhelpful, and in what respect?

But first, let's introduce two hypothetical companies that we'll be using for illustrative purposes: "Motor Co" and "Prop Cat Co". (Imaginative names, huh?)

- **Motor Co** is a medium sized, mono-line UK motor insurer. It is a public company (i.e. owned by shareholders) and services both the direct and broker markets. It has a diversified portfolio across the UK (both geographically and demographically) and retains all the insurance functions in-house (including claims handling, actuarial, reinsurance purchasing etc). It has grown to its current size mainly through acquisitions over the years.
- **Prop Cat Co** is a large, global property catastrophe reinsurance company and a subsidiary of a much larger non-insurance group. They have been around for more than 10 years and are domiciled in Bermuda, but write business worldwide. They service the global broker-fed subscription market. Prop Cat Co has a very strong capital base and a top quality (AA+) rating from the major rating agencies. They were started with a sizeable capital injection from the parent company and have grown to their current size through organic growth over the years.

On to the models…

2.1 COMPETITIVE ADVANTAGE

According to the text books, a company is said to have a competitive advantage when it is able to operate in such a way that it can sustain above-average profits. The model describes two key potential sources of competitive advantage: “cost advantage” and “differentiation advantage”:

Cost advantage

> This exists when a company can deliver the same product or service as competitors but at a lower cost, enabling it to offer this product or service at a lower price and/or with a higher profit margin. A good insurance example would be when Direct Line first cut out the brokers (and their associated commissions) by selling directly to their customers by telephone, combined with low operating costs as a result of a well designed green field start up.

Differentiation advantage

> This exists when a company can deliver a product or service that is <u>*perceived*</u> to be superior to their competitors’. In this instance the consumer may be less sensitive to price, allowing the company to charge more and hopefully generate a better margin. This can be particularly strong where the product is non-standard, such as in many traditional “London Market” classes, for example, casualty reinsurance.

The model suggests that a successful strategy is one set with the aim of achieving one or other of these two types of competitive advantage. For example, Motor Co might struggle if their core strategy was focused on differentiation since their core product is generally perceived as a commodity. Having said that, a differentiation strategy might work for certain niche books sold by Motor Co, such as high value classic car insurance.

Having said that, now that we are in an internet-powered world with buyers able to compare quotes side-by-side, some UK motor insurers do appear to be trying to differentiate themselves through promotion of such schemes as guaranteed courtesy cars.

<u>Bowman’s Strategy Clock</u>

A closely related model that develops this idea further and offers an approach for analysing a company’s competitive position is “Bowman's Strategy Clock”. Bowman considers competitive advantage within the two-dimensional framework of price and perceived added value.

We explore this further in Appendix A.1.

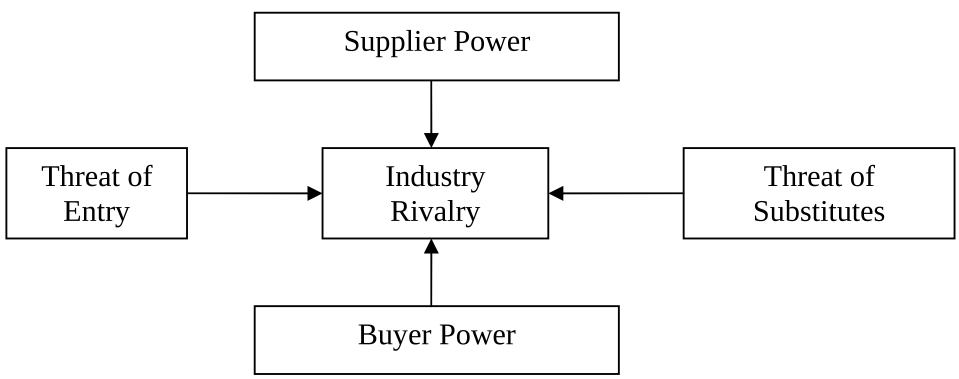
2.2 PORTER'S FIVE FORCES

Porter asserts that business (any business) is about value creation, and competition will drive who gets this value (i.e. profit). Porter's 5 Forces is a widely used framework for classifying and analysing the factors that influence competition and therefore steer the profitability between the various players. It does not suggest a strategy, but it offers a way for companies to identify what strategy suits their product and their position in the market.

The 5 forces are listed as follows:

- **Industry Rivalry** – The competition between established rivals in a market;
- **Threat of Entry** – The effect of new companies joining the market;
- **Threat of Substitutes** – Most products have an alternative that buyers can turn to if the price of the product is too high. Examples of (re)insurance substitutes could be captives, self-insurance or ART;
- **Supplier Power** – The bargaining position of suppliers to producers in the market (e.g. reinsurers to insurers) will affect the profits retained by producers;
- **Buyer Power** – The bargaining position of buyers in the market to the producers (e.g. insureds to insurers) will also affect the profits retained by producers.

The usual way of presenting their interaction is as follows:



The Porter's 5 Forces model entails consideration of each force in turn, breaking them down into sub-factors and getting a broad-based understanding of the market and where you sit in that landscape, and then using this understanding to stress test your chosen strategy (assuming you have one in the first place, of course!)

Taking each of the five forces in turn we offer here a few simple examples of factors to consider when setting your strategy in the (re)insurance context. Appendix A.2 contains a more detailed analysis, including a number of other factors to consider and some more (re)insurance related examples.

Industry Rivalry

- *Competitor Diversity* – Is everyone playing the same way? The greater the diversity, the more downwards pressure on prices. For example, if Prop Cat Co and their rivals all used different pricing models the market pricing levels would be lower as the brokers would always seek out the cheapest markets for each risk.
- *Product Differentiation* – Are you selling fundamentally the same stuff as everyone else? Similar products lead to price sensitivity and low margins. For example, Motor Co's buyers view motor insurance as a commodity so rates are heavily suppressed.

Threat of Substitutes

- *Buyer propensity to substitute* – Do your customers have any alternatives? Closeness of substitute will affect the buyer's willingness to adopt it. For Prop Cat Co the captive route could be an option for their larger customers. For Motor Co, reduced cover (TPFT or large excesses) are options, as is not buying any insurance (illegal!)

Threat of Entry

- *Capital requirements* – These can offer a significant barrier to entry, for example any potential new competitors to Prop Cat Co would first need to find some BIG money!
- *Access to distribution channels* – It can be difficult to break into a market without good access to the customers, and once established in such a market it is important to maintain that access.

Buyer Power and Supplier Power

Buyer/Seller pairs in our context include Insureds/Insurers and Insurers/Reinsurers. Other suppliers could be capital providers or outsourcing specialists. The factors determining these balances of power are categorized into price sensitivity and bargaining power:

Price Sensitivity

- *Cost of product* – The more significant the cost is to the buyer, the more price sensitive they will be. E.g. Motor insurance can seem very costly for young drivers.
- *Product importance to customer* – The greater the importance to the buyer, the less sensitive they can be to price (but the more sensitive they may be to insurer security).

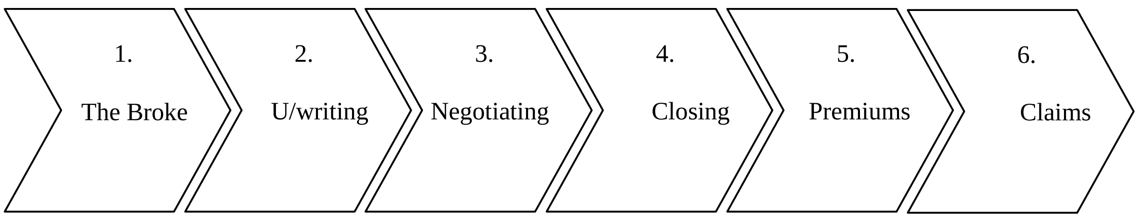
Bargaining Power

- *Switching costs* – These barriers can help you generate additional margins from your existing customers before they decide to swallow the cost of going elsewhere.
- *Buyers' information* – If they can readily compare terms and prices, your buyers are more likely to go elsewhere if you attempt to charge more than "the going rate".

2.3 VALUE CHAIN

"Value chain" is a method that allows other analyses to be applied to a business or process in a methodical way. The essential concept is the splitting of a business or process into various key activities or components. These components may then be analysed separately, using the other models, to investigate how to maximise long term competitive advantage.

For example, a simple Value Chain review for the underwriting operations of Prop Cat Co might look something like this:



1. The Broke – How do we make sure we see the best business, get great information, and have the maximum possible time available to review and the minimum of fuss?

2. Underwriting (and modelling) – How do we ensure common understanding between all involved parties (underwriters, actuaries, modellers, etc) and run the best and most up to date models quickly, accurately and flexibly?

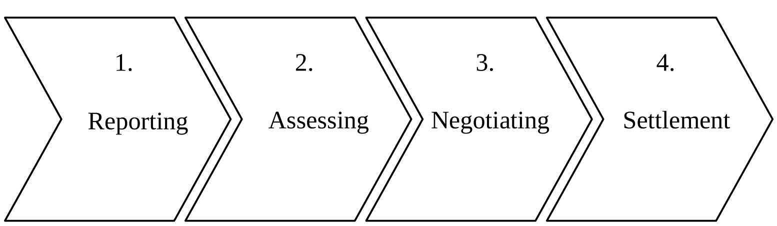
3. Negotiating – How do we strengthen our negotiating position with the brokers and with the insureds? How do we keep a handle on our competitors' pricing positions?

4. Closing – How do we get the line sizes we want? How do we get the legal situation watertight, i.e. robust and clear cover notes etc before we are on risk? No legal issues or unexpected coverage wanted here, thank you very much!

5. Premiums – How do we ensure we always get what we are owed, when it is due?

6. Claims – How do we ensure we offer a great service to our customers, whilst only paying appropriate amounts on valid claims?

Clearly we could expand this further, and / or drill down into "sub-chains". One obvious example would be the claims handling process:



We talk a little more on this subject in Appendix A.3.

2.4 PESTL

The PESTL (sometimes PEST) model offers a framework for reviewing the macro-economic environment whilst you are reviewing your strategy. It is a guide to help you evaluate the external forces that matter most. The name is an acronym based on the key areas that have the potential to fundamentally change the competitive environment in which you operate:

- Political
- Economic
- Social & Cultural
- Technological
- Legal (often combined within "Political")

A good PESTL analysis focuses on each of these environments in turn and considers what events or trends might happen in future with fundamental consequences for your company. It then uses these potential scenarios to help in setting a strategy that is able to exploit any such opportunities and blunt any such threats as and when they might occur.

The text books offer a laundry list of considerations within each of these headings, including:

Political / Legal	**Economic**	**Social / Cultural**	**Technological**
Forthcoming elections	Exchange rates	Demographics	Inventions
Employment law	Tariffs	Lifestyle changes	New discoveries
Consumer protection	Inflation	Population shifts	Research
Environmental regs	Interest rates	Education	Energy sources
Industry-specific regs	Consumer confidence	Trends and fads	Communications
Competitive regs	Import/export ratios	Diversity	Obsolescence
	Production levels	Em/Immigration	Internet
	Growth trends	Health	Manufacturing
	Business Cycles		IT developments
	Employment levels		

The key is to concentrate only on the issues of <u>fundamental</u> importance and not get swamped in the detail of trying to cover everything. You are only looking for things that could have a dramatic impact on:

- you (your staff, your systems, etc);
- your suppliers;
- your customers; or
- your competition.

In Appendix A.4 we offer example PESTL reviews for both Motor Co and Prop Cat Co.

2.5 SWOT

A "SWOT Analysis" simply entails consideration of your Strengths, Weaknesses, Opportunities and Threats and then using this to help set your strategy. For example, applying SWOT to Motor Co we might have:

Strengths (relative to competitors & potential competitors)

- Experience (great staff, tried and tested processes, extensive data etc.);
- Established name – our brand is strong, we should capitalise on this;
- Control of customer experience – we control most aspects of the relationship;
- Focus – We know our particular corner of the market better than anyone.

Weaknesses

- Multiple legacy systems burden us with inefficiencies and limitations;
- Multiple distribution channels cause conflicts and additional servicing costs;
- Delays in premium receipt from brokers costs investment income and adds credit risk.

Opportunities

- Selling different products (insurance and non-insurance);
- Selling in different markets (e.g. Europe) – export our knowledge;
- Move to more efficient environments (could be capital, regulation or other);
- Efficiency improvements through outsourcing functions?

Threats

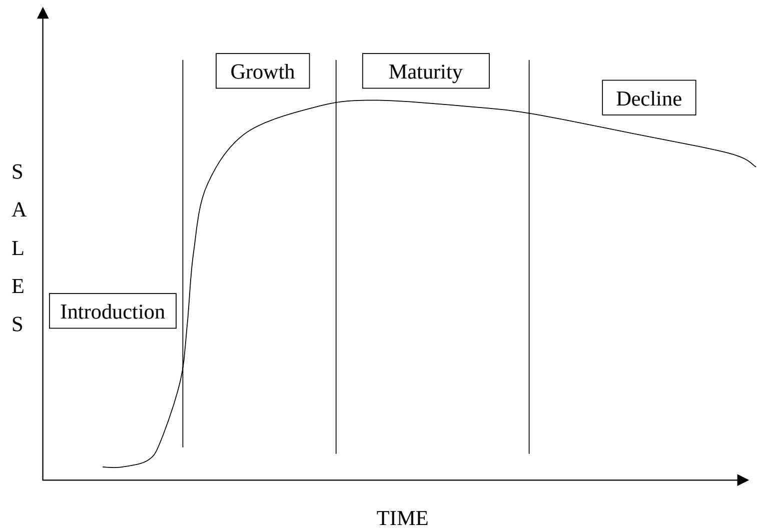
- New Entrants (with no baggage, such as our legacy systems);
- Car manufacturers offering free or discounted cover on cars purchased;
- Increased buyer power from brokers due to market consolidation;
- Brokers/distributors becoming underwriters (remember Broker Direct?)

In fact, many of the above points would apply equally well to Prop Cat Co…

With an understanding of SWOT the idea is that a company should be better placed to form and implement a successful strategy that plays to their strengths whilst defending the weaknesses.

2.6 PRODUCT LIFECYCLE

"Product Lifecycle" entails analysing the maturity of your product relative to four phases in a lifecycle, and using this information to better assess what strategies might be successful.



The four phases are:

- **Introduction** – a new product is launched. The primary need of the supplier is to get attention for their new product. This could be accomplished by advertising, sales launches – or if it is a start up by face to face sales or word of mouth recommendation. A large proportion of product launches will only ever be in this phase.
- **Growth** – when there is a significant increase in sales as a product catches on. In the early stages of this phase there may be only one supplier, although as soon as a product appears popular it is likely that competitors will enter the market. While there is little competition there is the opportunity for supernormal profits (or recouping the cost of research and development)
- **Maturity** – the market reaches a stable level of sales. At this point the competition will become well established, and within this phase the sort of advertising being used will tend to be more brand-focused than product-focused. This phase may be characterised by commoditisation.
- **Decline** – eventually sales reduce significantly, through saturation of the market (everyone has one) or redundancy (replacements have been developed)

Understanding the product life cycle of your business is essential to maintaining growth (or market share). Note that there may well be a disparity between consumers and insurers as to what constitutes a product – while insurers may offer several different motor products, for example, the consumer may not really differentiate between them.

We have applied this to the UK motor insurance market in some detail in Appendix A.6.

2.7 VALUE INNOVATION & BLUE OCEAN THEORY

The phrase “Blue Ocean” refers to unexplored and uncharted waters – in strategy terms uncontested market space. We think of it as the strategy equivalent of “Blue Sky” thinking.

Most traditional strategy tools assume that an industry’s structural conditions and environment are fixed and strategy is about the best possible competitive approach within these given boundaries. Clear examples of this form of strategic analysis are Porter’s Five Forces, Value Chain and PESTL analysis, which, as already described, focus on describing and understanding existing structure so as to compete most effectively within it.

In practice this leads to companies attempting to outperform each other in a crowded market using similar strategies, the industry offering becoming commoditised and in turn to bloody competition based on price-cutting strategies. At best companies try to carve out small niches for themselves in the existing market structure. This traditional thinking is termed “Red Ocean Strategy”.

Looking at the current states of their market, both Motor Co and Prop Cat Co could quickly conclude that most of their competitors pursue these types of strategy – with personal lines insurance seemingly commoditised and with most players in the reinsurance market believing the existence of the subscription market and regular profitability cycles as inevitable.

In stark contrast to this view, Blue Ocean thinking is predicated upon a belief that an industry’s boundaries and structure do *not* have to be taken as fixed, and that the best way to approach strategy is to think laterally about how to reconstruct these so as to eliminate the competition. This involves challenging various assumptions of the existing market such as: the industry definition; the assumed buyer groups; the products and services offered.

The main approach behind Blue Ocean strategy is “value innovation”. The four fundamental questions a value innovator needs to ask are:

- Which of the factors that the industry takes for granted should be eliminated?
- Which factors should be reduced well below the industry standard?
- Which factors should be raised well above the industry standard?
- Which factors should be created that the industry has never offered?

By considering these questions a value innovator creates a fundamentally different value proposition than its competitors and so opens up a brand new market space with much lower competition. A simple graphical tool called a “strategy canvas” is used to illustrate the different value proposition.

This is arguably a more interesting area to explore than some of the more traditional models. See Appendix A.7 for more on this subject including some examples and a detailed case study. We also discuss (re)insurance examples where this has been done successfully in the past, and offer some thoughts on how both Motor Co and Prop Cat Co could use this thinking to transform their industry.

3 THOUGHTS AND OBSERVATIONS

Here is a quick side-by-side comparison of the various models we reviewed, which we've tried to order in increasing terms of "breadth of thinking" (or, equivalently, in decreasing terms of how tightly they are constrained by the current environment):

Model	Internal / External Focus	What does it do?	How does it help?
Value Chain	I	Breaks the business into sequential processes to facilitate analysis and identify opportunities	Helps reveal areas with scope for reduced costs or increased differentiation
Competitive Advantage	I	Focuses attention on cost advantage or differentiation	Encourages strategy to be focused on appropriate area
SWOT	I (or E?)	Identify your strengths, weaknesses, opportunities and threats	Guides your strategy setting towards capitalising on strengths, defending weaknesses etc
Lifecycle	E (or I?)	Identify where your product sits in the cycle and consider implications	Helps choose appropriate strategy, e.g. with regards to marketing
Five Forces	E	Explains the major forces at work in a competitive market environment	Possible moves in short term between players
PESTL	E	Study the environment, identify the major forces that could impact you, your customers, etc	Encourages a flexible strategy able to capitalise on opportunities and blunt threats as they arise
Blue Ocean / Value Innovation	E	Attempts to redefine the market space, change the rules and make the competition irrelevant	Encourages thinking "outside the box", opening the door to potentially revolutionary ideas

Model overlap

Some overlap between the models is perhaps to be expected, but in fact there is surprisingly little overlap between them. A company could justifiably consider most of them; indeed this may well be desirable to get a more complete picture of the operational environment. Which models are the most important for you will depend on your circumstances, for example whether your strategy setting and innovation is focused internally or being driven externally.

Departmental applicability

Different models can feed into different departments within the organisation. They therefore can have outputs that add value at an operational as well as strategic level, for example:

- Output from the Life Cycle model would feed nicely into the marketing department;
- Output from a PESTL analysis may help in an ICA risk register;
- A value chain approach for the claims department could benefit the operational effectiveness of that department.

So, which model tells me the ideal strategy then?

Most of the models are descriptive / analytic. Some hint at possible strategies, but in the main their focus is geared towards stress testing any particular strategy that you have already developed through inspired genius, complacent repetition of what you've always done, sheer fluke or wherever. The BIG QUESTION is "How on earth do I come up with that winning strategy in the first place?!!"

It seems to us that none of these models offer this on a plate, and that developing a strategy from the ground up requires further synthesis. However, the lateral thinking encouraged in particular by Blue Ocean and SWOT could certainly help to stimulate that "Eureka moment".

All of the models can certainly help to channel thoughts, spark ideas and add value to the strategy setting process. Based on the models, we have suggested some questions that a company could use to help brainstorm possible strategies and select between them. You'll find this list in the next section of the paper. Clearly this list is far from exhaustive, and we simply offer it to be illustrative.

Strategy or Tactics?

As we said right up front, strategy and tactics are often confused, with tactics commonly being held up as being "strategy". The lines are often blurred between business plans, strategy, mission statements, objectives, tactics and so forth. Appendix B presents a number of excerpts from various published statements made by (re)insurance companies with regards to their "strategy", some of which illustrate this point nicely.

Looking back at the models we've reviewed it is clear these are largely focused on strategy-proper, but even within the models there are areas where this division gets blurred. The Value Chain model in particular could easily be used to make process-related decisions at the operational level, i.e. tactics.

What else is out there?

Other potentially interesting models exist that we simply have not had time to research. For example:

<u>ManyWorlds</u>

We came across some work published by a company called ManyWorlds, Inc., who is in the business of offering strategy advice to leading companies. ManyWorlds observe that this is a complex subject and that everyone has their own way of approaching it. They attempt to simplify the problem by looking at two fundamental perspectives:

- **External**: Where do you fit within the spectrum of possible views of your operating environment? The two extremes offered are that your environment is either "unpredictable and complex" or "comprehensible and controllable";
- **Internal**: Where do you fit in the spectrum of possible views of your own business? The extremes offered here are from "rational, able to be reduced into segments for the purpose of setting strategy" to "complex, political, messy and unpredictable – strategy setting needs an holistic approach".

This framework is then used to build a two-by-two matrix and (rather like we just attempted to do in a one-dimensional manner at the beginning of this section of the paper) categorise the various strategic models as to where in the matrix they fit. For example, Five Forces and Value Chain are based in a world where the external view is "comprehensible, controllable" and the internal view is "rational, reducable".

Many of the ideas set out by ManyWorlds seem consistent with our own thinking. We would have copied some of their charts into this paper if they weren't protected by copyright! Have a look on their website if you want to find out more: www.manyworlds.com.

<u>Strategy Safari</u>

Another example of a strategic model we have not reviewed is interestingly called "Strategy Safari". The applicability to the (re)insurance market, with its predators and prey, is surely there for the making!

4 CONCLUDING THOUGHTS / SO WHAT?

As the reader will see, we have hedged our bets in the title of this final section.

We came to this subject with the intention of learning what material was taught in business courses on the subject of strategy and seeing what insights we could gain relating to non-life (re)insurance. We didn't find any generally applicable "you do it like this" guides, but we did find a mass of tools for representing and understanding the competitive world in which companies operate. We ran quickly through a selection of these in this paper and include more detail in the Appendices.

We found that the published material on strategy contains very little by way of case studies, indeed very little discussion altogether, relating directly to (re)insurance. On the other hand, we also found that the information published in business plans, annual reports and so on from the (re)insurance companies themselves commonly reveals very little about their strategy, always assuming of course that they have one in the first place. (Berkshire Hathaway is one notable example where such insight *was* readily available.)

In fact, when companies do outline a "strategy" (Berkshire Hathaway excluded of course) they often make bold claims that they actually have little or no direct control over, and thus we believe don't really make sense as "strategy". Common examples include:

- To generate an X% ROE (or Combined Ratio or whatever) over the cycle
- To be in the top X% of our peer group, ranked by whatever
- To be the "insurer of choice" in XYZ sector

On the face of it these kinds of statements sound okay (maybe it's just down to familiarity), but when you think and look a little deeper they are pretty meaningless in terms of setting a strategy. These aren't strategies at all; they are simply goals they aspire to. So, coming back to the "so what", we have put forward in this section some further ideas which readers may find useful, or which might just generate some discussion.

In order to facilitate decision making and simply to operate coherently, a (re)insurance company needs to have some objectives and these objectives need to be translated into actions and behaviours that the personnel can at least hope to carry out. However, this is already one step beyond strategy. How often does management take the all important "step back" to re-consider where they are heading, how they are approaching life and whether there is a better strategy open to them?

We haven't spent much time in this paper discussing explicitly what is so special about (re)insurance. As an industry, its function is to accept and manage financial uncertainties which its customers don't want to keep themselves. So it is inevitable that financial results will be especially volatile, even after careful risk selection, pooling and management. And it is so easy to delude yourself about how well you are doing. But the real killer factor faced by the insurance industry is that it is so easy to increase the supply of the product, and to do so instantaneously. Only after large financial damage has been suffered by the industry is there a real shortage leading to widespread pricing power. This ease of entry and ability to manufacture the product immediately upon demand would not be so damaging if the participants in the industry did not frequently place an irrationally high value upon market share, being prepared to lose money in the short term in the hope of longer term reward. Putting an appropriate value upon market share given the circumstances of the company and the markets in which it competes must, we suggest, be a core element of the strategies of all (re)insurance companies.

Most of our actuarial readership will not be heavily involved in setting the strategic direction of companies. Some will simply not be interested enough in these issues to become involved. Others may be interested but find it difficult to have an influence. But many, through generating useful management information relating to profitability, will have an important indirect influence on a company's strategy.

Given that you are still reading this we can assume that you are at least curious about the competitive situation of companies, what succeeds and what does not, and what options are open to managers and shareholders.

Obliquity and the Shareholders' Perspective

Naturally, we approach this subject from the perspective of the shareholders, who are the ultimate owners of the net wealth created in most (re)insurance businesses.

But there is a school of thought that the creation of value for shareholders cannot generally be pursued directly; instead, it is a by-product of running the business well. This suggests that the focus should be on satisfying your set of customers more effectively than your competitors, rather than purely following lofty (and sometimes arbitrary) financial targets.

Whilst financial targets, or at least certain financial criteria for decisions, are a necessary part of life in the (re)insurance world, the requirements for a well-motivated, effective and happy workforce are much more complicated and frequently have little to do with financial measures. Consider your own experiences – what makes a happy, effective, and profitable (re)insurance organisation? It is always better to learn from others' mistakes than from your own. And (re)insurance offers so many good teachers.

In a competitive and unpredictable world such as (re)insurance, it seems naive to believe that you can safely predict future financial outcomes. Yet isn't that frequently what business planning amounts to? We can see the logic in putting together one scenario for the outcome of the forthcoming year and using that scenario as a way of focusing the effort of the management and the workforce. But many companies appear to believe that their predictions will come true, instead of accepting that they must adapt to the market and simply do their best. A symptom of this could be a company targeting a predetermined premium income, ignoring the fact that the market has become less profitable.

Surely this is a core area where good, worldly-wise and experienced actuaries should be contributing, possibly greatly?

The apparent wish of so many companies to present a smooth earnings flow is another example of wishful thinking and ignoring reality. Whether or not this smoothing desire will be diminished in our post-Spitzer world, only time will tell. But to manage a (re)insurance business effectively, a cold appreciation of reality (which includes fully accepting the huge uncertainties involved) is absolutely vital. Some investor education could well be helpful here, shifting the focus away from the volatility of returns and on to long-term risk adjusted returns. (Or maybe we don’t want to go there, but that’s a whole new subject on its own!)

This line of thought seems to be taking us towards an exploration of what is required of leaders of, or investors in, general insurance companies so let’s turn to something else.

Will an effective company always have a "strategy"?

Near the beginning of this paper, we set out our definition of Strategy. It took us some time and discussion to arrive at that definition. It was apparent at the outset that strategy means different things to different people. You see marketing blurbs for courses and books that refer to "winning strategies". Or you can think of strategy as the making of one or two big decisions, which set the ship onto a successful voyage thereafter.

Always searching for the "so what" from our discussions, we have concluded that a "strategy" in the simple senses captured above, is nothing like enough. What is needed is a never-ending (and possibly always changing) series of steps and decisions – and here creative thinking also counts as a valid step, asking a series of questions and acting upon them.

But what questions?

This is where the models and tools set out earlier in this paper can come in handy. Everyone will bring a different style to determine their precise list of questions, the order in which they are attacked and their relative priorities, but we have set some possible questions below.

It is the answers to some of these questions which the sophisticated shareholder should want to know, rather than what will be the declared earnings next year. These questions will have a bearing on the business's earning capacity over a much longer period.

- What are the most important ingredients for **success** in our industry today?
- What are the most important ingredients for **failure** in our industry today?
- How do we measure up in each of these ingredients?
- How do our competitors measure up in each of these?

Note that "success" and "failure" need to be evaluated by people who really understand what creates and destroys value – a management who is given to self-deceit in relation to earnings etc is doomed to eventual failure. Honest self-evaluation at all levels is vital. It is interesting that all the questions set out here could come within the scope of the "operating and financial review" which is now mandated within the UK as part of a company's annual report.

- What are the competitive trends? (No point fighting yesterday's battles if the competitors are re-arming with a better technology)
- Any brilliant ideas? (May get lucky, but don't expect it!)

- Think laterally about our market place:
    - What factors, assumptions or boundaries does the industry take for granted?
    - Of those, what could we eliminate or do completely differently?
    - What would happen if we did twice as much of something as everyone else?
    - What about if we only did half as much?
    - What could we introduce that nobody else does at the moment?
- What are our strengths, weaknesses and ability to change in those areas where companies distinguish themselves from their competitors? Where relevant, one could ask these questions for each market where the company is present, or has a viable option of going into. Possibilities include:
    - Technical skills (on many levels – underwriting, investment, project management, training...);
    - Ability within the organisation to make the right decisions (as opposed to the political ones);
    - Effective leadership;
    - Alignment of interests throughout the organisation;
    - Adaptability / flexibility of our organisation and our people;
    - Right objectives in the operating units (customer-service related operating units, for example);
    - Market presence, reputation and relationships (a business which is small may not have the easy option of getting big);
    - Capital exposures;
    - Capital resources;
    - Relationship with capital resources (owners);
    - The "right" culture within the business.
- What are the costs of any changes of state which are open to us now?
- Given all the above, what are the broad areas where we should be putting our effort?
- What should we do now?

An effective review of strategy should include the option of calling it a day and winding up or absorbing the company into another, if the company appears doomed to destroy value taking into account the capital it absorbs.

It's all a game really…

One can think of the picture which emerges from this thinking as something like a position on a multi-dimensional chess board (many players, not just two), but with the game of chess being subject to more uncertainty than the traditional game with its inflexible rules. We can describe our position today as today's "state", a vector which encompasses all of our relative strengths and weaknesses and defining all of the moves we could make tomorrow.

Today's moves will change our state tomorrow, as will the moves of all our competitors. We have to make choices, we have limited resources and managers can't focus on too many things at once. We need to be able to place relative (financial) values on different potential states we may move to in the future. We can think of the value of the business today as the cash generated in the forthcoming year (less the costs of any "investment" to improve our state), plus the present value of the cash generating power defined by our state one year hence. So improvement of our "state" from year to year is more important than a single year's earnings.

So What?

The title of this paper (and the associated working party) was "The Application of Strategic Models to Non-Life Insurance Markets". As we said at the outset, our journey did not reveal any magical winning strategies or elusive silver bullets. To be honest, we never really expected it to. The world is far too complex for us to have even imagined that this might have been possible.

What we have done, though, is discuss the insights that can be gained from using some of these models and suggest some practical thought processes that could hopefully prove useful when setting strategy in our world.

We will be happy if this paper has spurred the reader into their own thinking, whether that thinking agrees or violently disagrees with ours.

We will be ecstatic if this paper spurs some of you into taking a more pro-active role in the strategy setting for your companies, or if it is at all helpful to those of you who already do.

We think that what distinguishes one insurer from another is its people and its culture, rather than its positional assets. Clearly there are certain companies with a very strong market position, which are likely to generate large amounts of shareholder value in future. But a few years' poor management can destroy any insurer and we would suggest that getting to know the managements of companies, analysing the efficacy of their strategies, encouraging the good ones, and managing to avoid the worst is a pretty good strategy for shareholders.

APPENDIX A

OVERVIEW OF MODELS (CONTINUED…)

Appendix A picks up from the relevant sections of the report and continues our exploration a little further. The seven sections do not stand alone from the main narrative of this report as drafting them this way would have involved a lot of duplication and wasted paper…

A.1 Competitive Advantage

A.2 Porter's Five Forces

A.3 Value Chain

A.4 PESTL

A.5 SWOT

A.6 Product Lifecycle

A.7 Value Innovation & Blue Ocean Theory

A.1 COMPETITIVE ADVANTAGE

Cost and Differentiation Advantage Examples

A few examples of ways in which (re)insurers can deliver cost advantage include:

- Reduce overheads, acquisition expenses, claims handling expenses – ways in which companies have sought to achieve this include moving offices to cheaper locations e.g. out of London, selling direct rather than through intermediaries (e.g. phone or internet), outsourcing policy and claims admin to cheaper parts of the UK, or to other countries such as India;

- Reduce claim costs – e.g. some UK motor insurance companies no longer offer courtesy cars, a benefit that not all customers will notice when purchasing insurance; some companies are more aggressive in the way in which they handle claims.

A few examples of ways in which (re)insurers can deliver differentiation advantage include:

- Protecting elements of risk that would typically be excluded for selected customers / circumstances only e.g. a reinsurer could include terrorism cover in a catastrophe programme, or offer broad "follow the fortunes" language without numerous exclusions;

- Market reputation – e.g. for prompt claim payments, or for sticking with core customers even when rates are low;

- Credit rating – higher credit rating = lower bad debt reserve and more likely to still be around and able to pay claims when they are needed the most, all other things being equal;

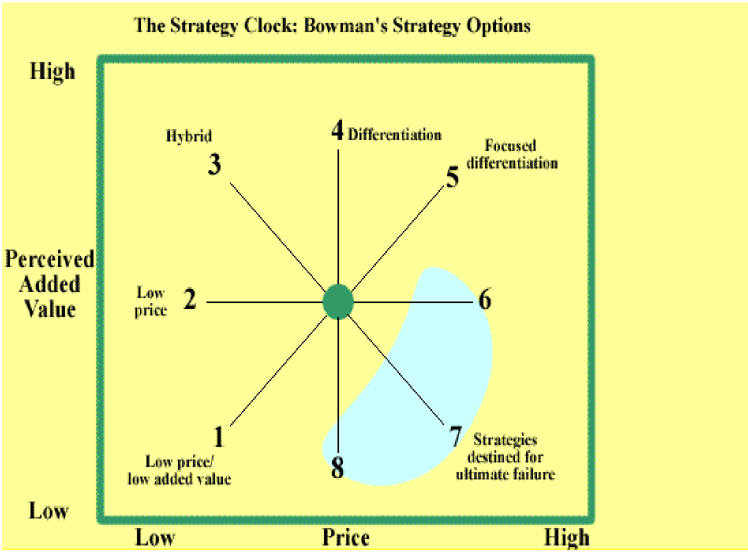
- Provision of additional services e.g. an insurer with expertise in premises general liability might offer advise on best practice risk management, thereby reducing exposure and claims costs, or prompt assistance for claim remediation.

Obviously, both cost and differentiation advantages rely on buyers' perception of value.

Bowman's Strategy Clock

One means of analysing a company's competitive position is via Bowman's Strategy Clock. Bowman considers competitive advantage (i.e. cost advantage / differentiation advantage) in terms of a tradeoff between price and perceived value.

According to this model, there are eight core strategic options that a company can choose between:



Option 1 – Low price / low added value

- Likely to be segment specific

Option 2 – Low price

- Risk of price war and low margins/need to be a 'cost leader'.

Option 3 – Hybrid

- Low cost base and reinvestment in low price and differentiation

Option 4 – Differentiation

(a) Without a price premium
- perceived added value by user, yielding market share benefits

(b) With a price premium
- perceived added value sufficient to bear price premium

Option 5 – Focused differentiation

- Perceived added value to a 'particular segment' warranting a premium price

Option 6 – Increased price / standard

- Higher margins if competitors do not value follow / risk of losing market share.

Option 7 – Increased price / low values

- Only feasible in a monopoly situation

Option 8 – Low value / standard price

- Loss of market share

A.2 PORTER'S FIVE FORCES

Following on from the examples given in the main narrative, here are some more:

Industry Rivalry

Factor	**Explanation**	**GI examples**
Concentration	More concentration in a market can lead to profits increasing, as prices become more "fixed" either on purpose (collusion), or due to business decisions being made in a small number of similar companies.	In general insurance markets are becoming more concentrated.
Excess capacity and exit barriers	Excess capacity could be cyclical or structural (and therefore may not leave the market). Exit barriers include durable and/or specialised resources, and employee protection.	Motor Co – Excess capacity has pushed rates down; Prop Cat Co – Exit barriers are no problems so long as we stick to our knitting, but critical to keep staff and keep them happy / motivated!
Cost conditions	When excess capacity leads to competition, the lowness of prices depends upon the cost structure of the products. A higher proportion of fixed costs in comparison with variable costs will mean that many products are made (It costs very little extra comparatively to make the marginal product).	Motor Co – High fixed costs of advertising/technology spend. Prop Cat Co – "Fixed" costs include overheads and the cost of maintaining capital at a critical mass size, "variable" costs include brokerage and marginal cost of capital

Threat of Substitutes

Factor	**Explanation**	**GI examples**
Relative price performance of substitutes	This is the advantages and disadvantages of each product and the different costs.	Motor Co – The substitutes / alternatives are riskier or illegal.

Threat of Entry

Factor	**Explanation**	**GI examples**
Economies of scale	Many industries that are capital, research, or advertising intensive, need large scale operations to make them efficient. In that situation, a new entrant will have low volumes to begin with, and must decide whether to enter on a small scale (with therefore high unit costs), or on a large scale (with the risk of drastic under-utilisation of capacity).	Motor Co – Advertising / Technology / Research intensive, but many companies have entered the market. Prop Co – A critical mass is required to properly diversify and balance a portfolio of cat risks, so this is a barrier to entry
Absolute cost advantages	Established producers may have lower costs because they entered earlier	Motor Co – This is not always true given the advances in technology making existing insurers' systems and processes outmoded and inefficient. However, the product is seen as homogeneous and very price sensitive so cost advantages are valuable. Prop Cat Co – Not a barrier

Product differentiation	If strong differentiation in the market, then established producers may have a strong brand. New entrants may need significant advertising costs	Motor Co – Not huge differentiation, but brands are very important and there are significant advertising spends, but not just for new entrants. Prop Cat Co – Not a barrier
Government and legal barriers	Examples of markets with significant barriers to entry include Broadcasting and Telecommunications.	Motor Co – Strong regulation is a price of doing business, and barrier to entry. Capital requirements are less onerous. Prop Cat Co – Not onerous
Retaliation by established producers	For example, established producers could start a "Price War" if new producers enter the market. Just the threat of this could be enough to discourage new producers	Motor Co – Price wars can and do happen.

Buyer Power & Supplier Power

Factor	**Explanation**	**GI examples**
Product differentiation	The less differentiated the products of the supplying industry, the more willing the buyer is to switch suppliers on the basis of price.	Motor Co – Not differentiated hence pretty cut-throat. Prop Cat Co – N/A: Syndicated market

Size and concentration of buyers relative to suppliers	If the buyer/supplier is larger, the greater the risk to the counterparty of losing that business, and therefore this will affect the price.	Motor Co – Lots of individuals so this is not relevant. Even fleets don't tend to be large enough. Prop Cat Co – We're big enough to fight our corner on these battles
Competition between buyers	More competition between buyers, may step up pressure on suppliers, as buyers look to reduce costs.	Motor Co – This doesn't seem appropriate since the buyers are individuals. Prop Cat Co – Possibly something in this at the bottom of the insurance cycle?
Buyers' ability to backward integrate	This is the ease or difficulty to the buyer in doing the suppliers' job itself.	Motor Co – Reduction in RI for an insurer. Prop Cat Co – They can't!

A.3 VALUE CHAIN

Value chains are relatively unique to the process of the company and are a tool to help management understand their business as much as it is to help their business. Although the main analysis will be undertaken on each component independently, it is important to remember the inter-connectivity of the components (i.e. the activity of one component will impact one or more other components) and the fact that the value chain under investigation will itself form part of a larger value chain system.

No matter the contents of the chain, however, the items to consider in this sort of analysis include:

- Could the activity be better / more cheaply performed outside the organisation? For example, outsourcing IT or a claim call centre.
- Are there any economies of scale that could be utilised?
- Are there any linkages with any other activities within the value chain or to other value chains/business units that could offer a reduction in duplication? For example, having one source of reference (e.g. scanned policy document) for both claims and underwriting.
- Could increased learning/training be incorporated (e.g. leading to a reduced head count)?
- Are physical locations causing inefficiencies (e.g. claim and underwriting departments being separated)?
- Is the value chain fully integrated within the organisation?
- Can we take advantage of the regulatory environment? For example, set up in a territory that requires a lower level of capital.
- Could the value chain be re-structured to be more cost effective? For example, if the claim department all deal with all types of claim, it might be more efficient to have dedicated teams to look after individual types of claims (e.g. own damage, TP damage and bodily injury).

A.4 PESTL

Examples for Motor Co

Political / Legal

- Compulsory cover – What would be the effect of a change of the compulsory third party only cover requirement to fully comprehensive insurance?
- Limits of liability - Or a change from unlimited third party liability to something with a finite limit?
- Rating factors - The potential for gender to not be allowed as a rating factor due to EU discrimination laws
- Uninsured drivers - An increased punishment for uninsured drivers creating more incentives to purchase insurance.

Economic

- Recession - Theft and the number of uninsured drivers would increase. These affect profitability and fraud.
- Outsourcing - More of a shift to overseas call centres? Will this change the cost model of the modern insurer?
- Inflation - Parts / labour inflation is linked to general levels of RPI.

Social / Cultural

- Compensation culture – A continually topical subject which has direct impacts on mainly the injury side of motor. To what extent can US experience guide us here?
- Going green - More use of public transport / shared vehicles. Is this the future of commuting? Such schemes have been highly successful in other countries.
- Speeding – What if speeding became as socially unacceptable as drink-driving has become. How would this affect the frequency and severity of road traffic accidents?

Technological

- Route to market – In an increasingly connected world, sale of policies through mobiles or the TV may be next. Telephone sales may eventually be left in the history books…
- Electric cars – What a revolution this would be. But how would it affect the insurance market?

Examples for Prop Cat Co

Political / Legal

- Consumer protection – What if a "Spitzer" type enquiry was launched into the Property Cat and / or Reinsurance world? How would we fare? What opportunities might arise? Would we be well placed to seize them?

- Industry-specific regs, competitive regs – What fundamental changes could be anticipated in Re/insurance legislation? How quickly might they be implemented? Would we be able to react in the kind of timescales that might be given?

- Inter-country relationships & international trade regulations – Any noteworthy changes possible here? Collateralisation requirements? Rate controls? Tax rates?

- Pricing regulations – Unlikely for our core business of Property Cat reinsurance, but what about ancillary lines, either current or planned?

- Terrorism – Can changes be expected to the current TRIA rules? What would we do if Bermuda was hit by a terrorist strike? How would we respond to another event on the scale of 9/11? How are we managing our accumulation exposures to such an event?

Economic

- Exchange rates, Inflation / Interest rates – What basis risk do we run on all of these, and how do we manage this? How bad might it get if a key currency saw an extreme rise or fall? What can we do to minimise this?

- Business Cycles – Insurance cycle…

- Employment levels / Wage levels / Availability of specialist skills – for underwriters, etc.

Social / Cultural

- Population shifts, Housing trends – Implications for cat models? How up to date are the models we are using? Do we have any "basis risk" here?

- The laundry lists in the text books don't seem to be hugely relevant to Prop Cat Co, but they can be far more relevant to other lines such as WCA and Comp Cat.

Technological

- New discoveries – What if a new fault line was discovered running through a previously benign area? How do our aggregates look outside the traditional hot-spots?

- Research – What if our competitors get hold of some new science that dramatically improves their ability to underwrite a certain peril? How do we keep pace with the latest developments in the key fields?

- Obsolescence – How sensitive are we to the major cat modellers releasing updates that can have a significant impact on PML and EML curves? Is our modelling capability up to date and on par with our competitors? How do we know? How do we keep it that way?

- Distribution – Are we getting the best possible service from the broker network? Do we need to use the brokers all the time? How do we manage this? How do we tell if a broker isn't showing us all their "best" risks?

A.5 SWOT

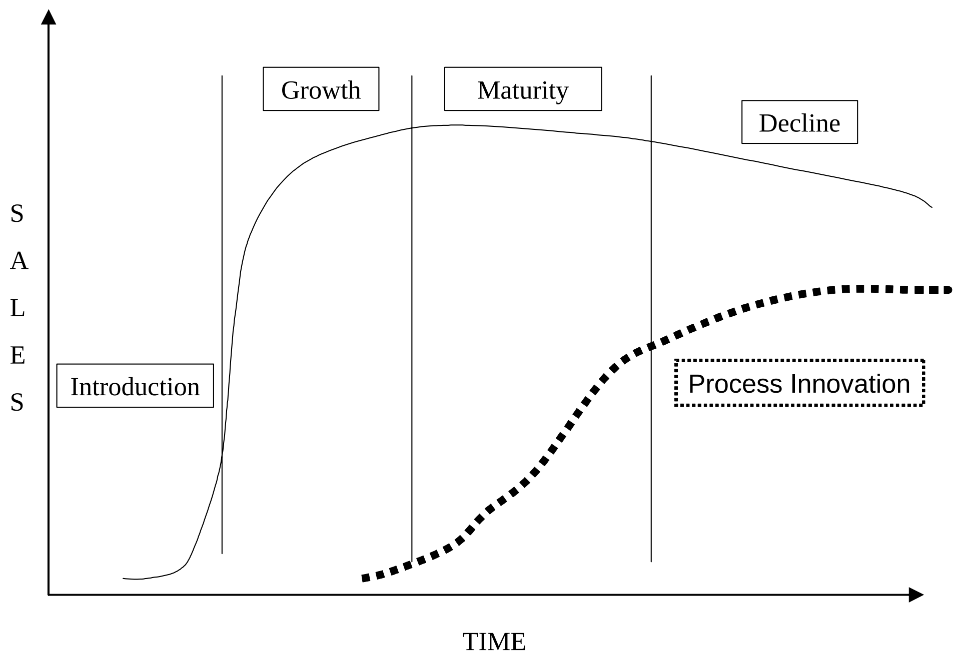
SWOT analyses will be one of the better known models to the reader. We can't be sure that is necessarily because it is a 'better' model; perhaps it has just been better marketed, or maybe because it is so intuitive. We therefore wouldn't want to promote it too much further here! The SWOT analysis seems to be fighting its own corner pretty well.

A.6 PRODUCT LIFECYCLE

The usefulness of this model depends on how broadly "product" is defined. If the product was defined as, say, mobile phones then the market is in the mature phase and may even be heading into decline. If the product is narrowed to camera phones then the market is growing currently; if the product is "currently trendy phones" the market is at the introduction stage.

If a product is defined quite broadly, then it can be argued that the life cycle curve is actually made up of a series of enhancements to products, although in a mature market it is quite possible that any advantage gained from innovation is quickly removed as it is copied. Again in a mature market there may be a simple substitution of goods.

A more useful model to consider for the insurance industry may be when a second curve is added. This is to consider the rate of process innovation – a particularly important concept when it comes to what is essentially a service industry. The idea is that once a product has become established, the focus needs to shift towards developing and refining associated processes in order to maximise the potential profitability of the product.



On the following pages we have applied the thinking of the Life Cycle model to the UK motor insurance market.

Motor Co

Motor as an insurance product is very mature. Below is a brief history of motor insurance in the UK.

The motor insurance product we know today is almost as old as the car itself.

In 1896, the Locomotives on Highways Act abolished the need for a man to walk in front of the car with a red flag, and introduced a 14mph speed limit. In the same year, the "National Cycle and Motor Car Insurance Company" was formed, with the specific intent of exploiting this new market. Unfortunately, it was not soundly run, and folded just a couple of years later.

Moving along to 1930, the Road Traffic Act introduced compulsory third party bodily injury insurance (extended to third party property damage in 1988), making the purchase of motor insurance a necessity for consumers.

It can be argued then that the core of the motor product has been around for around a century. There has clearly been massive growth in the insurance industry since then, but this has not been driven so much by product innovation as by the number of vehicles on the road. The product has clearly evolved over time, but given the nature of the tariff market for many years there was no individual company who gained a significant product design advantage over any significant period, and the main source of competition was price, with the general public perceiving most motor products as being virtually identical – a perception that remains pretty much to the current day.

If you define your product as being aimed at the UK motor market as a whole, then it is virtually impossible to gain an advantage by product design – if a feature is successful, it will quickly be copied; if it is not successful then all that has happened is that extra cost has been introduced into the process without getting the benefit of extra sales to compensate.

However, the problem here is not the model; it is the definition of the market. Effectively, the motor insurance market is seen to be a commodity market. One way to succeed in such a market is to find consumers who will pay extra for differentiating features, no matter how small the differences, and then marketing to them. There are many examples of this in the current market place, for example:

- Policies sold only to people with no recent accidents, with the guarantee that full no claims bonus will be maintained forever;
- Policies designed and marketed to over 50's only;
- Policies sold only to people who are teetotal;
- "Gold" products which include other products such as breakdown insurance.

While the above are examples of products aimed mostly at those drivers seen to be good risks, there are also companies that have successfully targeted less obvious risks, such as:

- Young drivers;
- Drivers in higher risk areas such as London; and even
- "Drunks and skunks" (those whose driving or criminal record is such that they find it hard to get insurance).

Most of the above are attempts to identify a group of motorists who are "Cross-subsidising" other riskier motorists, and by means of the product excluding the undesirable risks. Another innovation of this kind would be to be able to introduce a mileage rated policy, where people pay for the number of miles they have driven.

Another distinctive type of motor product is where the insurer is producing a "white-label" product for another distributor to brand and market. While again this may not be a new concept, in terms of distribution it is an increasingly important one.

There is also scope for insurers to deliver products in distinctive ways, with the most radical changes in recent years being the introduction of direct telephone sales, tele-broking and more recently internet distribution.

If you extend the idea of the product to include the way in which the product is delivered to the consumer (which is not unreasonable given that for the majority of motorists in any one year the only experience they have of the product is to buy it and receive the policy documents through the post) then the product life cycle becomes a useful tool.

On this basis, a motor product delivered through brokers is in the decline phase, via telephone sales is probably mature, internet sales and "white label" are in the growth phase, while "internet only" motor policies where all transactions are carried out remotely are probably in the development phase. For broker and phone distribution the key area of competition is likely to be cost; for white label and internet there may still be scope for product innovation, and there are clearly opportunities to think of a completely new delivery proposition.

The key to success is likely to be identifying market segments correctly and ensuring that products are appropriately tailored and marketed to get the best return out of each segment.

A.7 VALUE INNOVATION & BLUE OCEAN THEORY

In this appendix we offer the following relating to Value Innovation and Blue Ocean Theory:

- Some background;
- A non-insurance case study (Southwest Airlines);
- Some simple examples from the world of insurance;
- Example value innovation thinking for each of Motor Co and Prop Cat Co, which will hopefully prove inspirational!

Background

W. Chan Kim and Renee Maubourgne of INSEAD have pioneered the theory of value innovation in articles in the Harvard Business Review over a number of years. They have now produced their first book on the topic "Blue Ocean Strategy". The phrase "Blue Ocean" refers to unexplored and uncharted waters. In strategy terms the authors use this to mean uncontested market space. This is explicitly contrasted to much of current strategic thinking which involves taking as given the environment and market in which a company is competing, and simply trying to compete as effectively as possible in this market. The authors call this "Red Ocean Strategy".

Their introductory description of an industry where everyone is competing using Red Ocean Strategy is in the following passage:

> "*In the Red Oceans, industry boundaries are defined and accepted and the competitive rules of the game are known. Here, companies try to outperform their rivals to grab a greater share of existing demand. As the market space gets crowded, prospects for profits and growth are reduced. Products become commodities and cutthroat competition turns the Red Ocean bloody*".

This would seem a pretty accurate description of the various insurance markets – personal lines and wholesale / commercial.

The authors categorise most traditional strategy tools as based on a "Structuralist" or "Environmental determinism" point of view, that is that they assume that an industry's structural conditions and environment are givens and strategy is about the best possible competitive approach within these given boundaries. Clear examples of this form of strategic analysis (which are discussed elsewhere in this paper) are Porter's Five Forces, Value Chain and PESTL analysis. Another example of Red Ocean thinking is niche marketing, which seeks to carve out profitable niches within an existing market structure.

Blue Ocean thinking is based on the view that market boundaries and industry structure and not givens and that the best way to a winning strategy is to re-imagine and reconstruct these, as the subtitle of the book says "*to create uncontested market space and to make the competition irrelevant*".

Value Innovation and the Strategy Canvas

The strategic approach the authors put forward they call "Value Innovation" as it involves placing an equal emphasis on customer value and innovation as opposed simply to attempting to compete on better value (but without offering anything other than a "me too" offering) or technological innovation (which is not based around delivering customer value). It means pursuing differentiation and low cost simultaneously, not trading them off.

The four fundamental questions a value innovator needs to ask are:

- Which of the factors that the industry takes for granted should be *eliminated*?
- Which factors should be *reduced well below* the industry standard?
- Which factors should be *raised well above* the industry standard?
- Which factors should be *created* that the industry has never offered?

The main graphical tool the authors suggest is a "Strategy Canvas". This is a chart where on the horizontal axis is shown the range of factors the industry invests or competes in. The vertical axis is (for each competitor in the market) the offering level that the customer receives in each of these areas. Each company's value curve is plotted as a different value curve on this graph. In most industries these curves are almost overlapping. A value innovator aims to offer a very different curve to its competitors.

The authors propose that for such a Blue Ocean strategy to be compelling, as well as being divergent from the standard value curve a company's value curve has to be focused (concentrating on offering value in a small number of areas) and one whose new value proposition can easily be summarised and understood by the customer. We would also add that it needs to offer an attractive alternative to customers.

Reconstructing the Boundaries

In terms of reconstructing market boundaries the authors suggest that this involves challenging various assumptions of the existing market:

- **The industry definition** (e.g. Net Jets opened up a new industry between the existing industries of first class airline flights and private jets)

- **The strategic groups within an industry** (e.g. Sony Walkman combined the high quality of boom boxes with the low price and mobility of transistor radios)

- **The buyer group** (purchaser, end user, influencer / agent) on which companies focus (e.g. Bloomberg focused on the trader as end user in contrast to Reuters and Telerate's concentration on the purchaser – the IT procurement manager)

- **The products and services offered** (e.g. Borders transformed the book store from simply a sales outlet to a place of browsing and leisure)

- **The functional / emotional orientation of the industry** (e.g. Swatch transformed watch purchases from a functional decision to a fun fashion statement. Interestingly Direct Line is quoted as an example in the book for removing the "comfort" of broker service in exchange for a more clinical / efficient process and passing on the savings to customers in lower costs.)

- **The customers reached by the market**. Rather than focus on existing customers of a market/product a Blue Ocean approach would involve targeting non-customers who are currently perceived as not interested in the industry's products.

- **Existing pricing levels**. Rather than taking market prices as given reinventing the value proposition will fundamentally involve rethinking what price range fits the required strategy. From this price the firm can deduce the costs it needs to meet to have a viable level of profit (this is in contrast to traditional approach of pricing equals "costs plus" profit). Achieving these costs may involve rethinking two other industry practices …

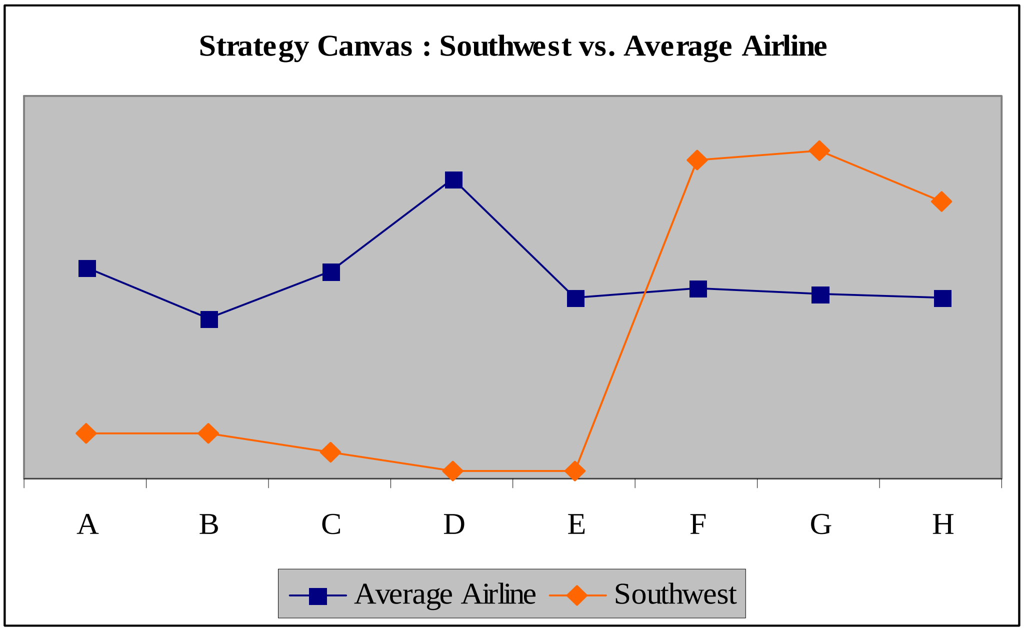
- **Processes**

- **Pricing structure** (e.g. differential pricing, leasing/renting versus outright sale)

Case Study – Southwest Airlines

An example of a company whose success could be attributed to a Blue Ocean strategy would be the first of the low cost airlines – Southwest Airlines who offered a radically different value proposition to existing airlines at the time.

A strategy canvas for Southwest compared to standard airlines is shown below.



Factor:

A. Price
B. Meals
C. Lounges
D. Business & First Class options
E. Hub connectivity
F. Friendly service
G. Speed of turnaround
H. Frequent point to point departures

Southwest chose to eliminate almost entirely factors that had previously been taken for granted: free in-flight meals; business class lounges; choice of class and (particularly important in America) hub and spoke connectivity of flights. This enabled them to very significantly reduce costs. By contrast they raised aspects such as the fun factor in flying, speed and frequency of point-to-point departures between midsize cities.

By doing this they created a whole new market in which they were competing as much with the option of long distance car journeys as with other airlines.

Simple Insurance Examples

<u>Direct Line</u>

- Pioneered selling direct over the phone (see above)
- Sell cars through "Jamjar"

<u>Progressive</u>

Progressive Insurance Company in the US has consistently been in the unusual position of being both a large and profitable auto insurer through its innovation. Two examples are:

- Since 1994 if a Progressive customer gets into a minor accident, he or she can phone the company from the scene and will be met by a member of its Immediate Response Vehicles (specially marked and outfitted vehicle that carry trained claims professionals to wherever customers needed them – even to the scene of an accident). These often arrive at an accident scene before the police. As well as providing customer service the IRV drivers are authorised to write cheques on the spot which can reduce expensive court cases as well as reduce the potential for fraud.
- In 2003 Progressive launched its concierge level of claims service, becoming the first in the industry to take responsibility for managing the entire vehicle repair claims process and providing customers with a simpler way of getting their cars fixed after a loss. Customers simply drop off their cars at a designated claims centre and pick them up once the repairs are complete – Progressive takes care of everything in between. By managing the entire claims and repair process, Progressive provides one-stop convenience and peace of mind to customers in select markets across the country. The claims centres unite "retail-like" front offices with garage space in which representatives on the spot could inspect vehicles.

<u>Norwich Union</u>

Norwich Union are currently piloting "Pay as You Drive" insurance by collecting real-time vehicle data using 'black box' devices installed in vehicles. This will allow monthly insurance payments to be calculated based on how often, when and where drivers use their vehicle. Furthermore, it can be safely assumed that the drivers of these vehicles who are aware their driving is being monitored by a black box (and, indeed, are happy to act chauffer to Big Brother) are likely to drive more safely than the average motorist. We doubt many 17 or 18 year old men driving Citroen Saxos with blacked out windows and big exhausts would embrace the scheme…

With the increasing adoption of road pricing this would seem an idea whose time has come. Further the technology allows NU to offer other in car services such as emergency assistance and real time route planning. It will be interesting to see how NU ties this in with Aviva's recent proposed purchase of RAC.

Example Value Innovation for Motor Co

Red Ocean thinking is that companies are providers of insurance against first or third party physical damage or bodily injury associated with cars.

However possible Blue Ocean definitions of the industry are:

1. Enabling people to drive cars
2. Helping people get from A to B
3. Helping people get on with their lives and smoothing their financial outgoings

Using these definitions led us to the following possibilities:

1. A wider product offering including: learner driver instruction, continual training and assessment with the results of the assessment reflected in the premiums charged;
2. Sell in-car navigation and communication system. The costing of the system would include pay-as-you go insurance. The services offered from the system would not just be satellite navigation but also advice or help line on motor issues (such as advice on changing wheels), ability to quickly access roadside assistance, and parking advice when arrive at destination (including a valet and parking service at major destinations);
3. A combined motor / household / travel / critical illness / private medical insurance / permanent health insurance / accident sickness and unemployment policy with provision of financial advice / guidance. A kind of “all risks” policy for individuals.

A few other specific ideas (all with catchy names):

- ***Street Plan***: Possible pooling / experience based pricing arrangements for everyone living on a particular estate/area. Could be charged for within council tax. Perhaps this would just provide legal minimum cover and there could be provision for buying more.
- ***Family Plan***: An experience based family insurance policy covering motor, household, travel, critical illness, PMI, PHI, ASU. A proportion of the premium could be retained by the insurer to meet compulsory claims. The remainder goes into an experience account to meet non – compulsory claims. The account could go into deficit and any deficit then becomes a loan to the claimant (head of family).
- ***Car Plan***: A policy that covers you for as long as you own the vehicle. This would encourage people to keep cars for longer, which fits with reducing re-cycling and could mean that a portion of the premium could be obtained from the government.

Example Value Innovation for Prop Cat Co

Currently the catastrophe reinsurance industry offers annual policies with limited reinstatements covering all catastrophes in pre-specified territory/peril combinations with claims paid in arrears on an indemnity basis (or occasionally with an industry loss warranty trigger).

The basic concept of both risk and event excess of loss was invented by Cuthbert Heath in discussions with the Hartford following the events of 1906 San Francisco earthquake (an event incidentally which he used to help establish the reputation of Lloyd’s in America by famously instructing his agent to “*pay all our policy- holders in full irrespective of the terms of their policies*” while local insurers sought to avoid claims).

Heath was a true Blue Ocean thinker a century before his time. He invented such concepts as: insurance for consequential loss of profits following fire; burglary cover; all risk cover; jeweller’s block as well as pioneering workers’ compensation, trade indemnity, earthquake and hurricane insurance.

Some thoughts on Blue Ocean thinking for the 21st Century – based around insurance for Atlantic hurricanes:

- *New value proposition*: Pay claims not on an indemnity or ILW basis but on a modelled basis – i.e. based on running an agreed storm model say 24 hours after the storm has struck. This approach loses the advantages of indemnity but gains on security and speed of payment and avoids insurance disputes (more like a standard futures type agreement). By eliminating model risk for the reinsurer it should also reduce costs;
- *New customer definition*: Sell catastrophe insurance direct to major companies or to state funds (Ren Re have tended to follow this idea of accessing all points of the catastrophe market);
- *New services*: Run companies catastrophe modelling for them and as well as providing standard reinsurance and also provide insurance against any errors in the modelling;
- *New products*: Offer spread betting on the total industry loss from named storms or in the hurricane season. This could also widen the customer base by encouraging speculators to enter. Offer storm specific covers – either in advance of the hurricane season or once a depression is declared as a named tropical storm.

As a closing comment, it is perhaps much easier to see how value innovation could work for personal lines insurance. It is much more challenging for the international wholesale market operating on a subscription basis. However an industry which regularly sinks into the bloodbath of Red Ocean thinking and whose fundamental structure / products and practices often seem as though they have been unchanged for a century (in fact since Cuthbert Heath) would seem ripe for some Blue Ocean thinking.

We leave this as a challenge for the reader who wishes to be the next Cuthbert Heath!!

APPENDIX B

INFORMATION ON PUBLISHED "STRATEGIES" FROM VARIOUS COMPANIES

In this section we have reproduced various comments and statements made by non-life (re)insurance companies over the years relating to their so-called "strategy". In some instances we have looked back over a number of years to see how consistent these messages have been.

All of this is taken from published sources, commonly their annual report and accounts or their website.

We have not commented on these, but having now given due consideration to Strategy (not to mention learning from the seven models explicitly reviewed in this paper) we have our own views on some of these statements! We hope that having read and considered the content of our paper, you too will now have some stronger views on these statements than you might otherwise have had…

RSA

1999	2000	2001	2002	2003
Combined ratio of 103%	Combined ratio of 103%	Combined ratio of 103%	Combined ratio of 102%	Combined ratio of 100%
Key to our strategy is the focus on customer needs.	Our strategy is to produce maximum shareholder value by growing our [global] business profitably while placing the customer at the centre of everything that we do	We have carried a significant amount of 'baggage' from the past, which hurt our reported earnings. Our actions will reduce much of that burden and will enable us to move forward on a stronger footing.	We will focus on business that has a sustainable competitive advantage.	Our structure and business focus. We have reviewed the business to make sure we are writing the right risks in the right markets, and at the right price.
Growth strategy for commercial business is to …leverage [multinational] relationships, skills and balance sheet strength to drive superior returns in local business units		We have sufficient capital available internally to support our ongoing business and to fund organic growth.	We will ensure capital prioritisation	Our management. Looking at the group as a whole, one of my priorities is to develop a stronger performance culture. Part of that is making sure we have in place the right people with the right capabilities.
Our proposition to them [personal customers] is based on offering full range of general, life and investment products as a combined ….. package		One of the key strands of our strategy for future growth and success is our emphasis on the customer.	We will enforce the strictest underwriting principles	Our balance sheet. We've strengthened the balance sheet in a number of ways, including the rights issue, but challenges remain.
In mature business sectors, with strong competition and limited opportunity for strong growth or profit , it is necessary to deliver efficient and quality service to carefully chosen target markets			We will put strong emphasis on performance	
[Lots of acquisitions and how these will add to strategic success]			We will ensure rigour and control across all disciplines and procedures	
The resulting efficient organisation together with operations focused on maximising return on their properly allocated capital, is a firm base from which to deliver consistently superior returns to shareholders.			We will focus on adding shareholder value	

AVIVA

2001-2003
To grow our long-terms savings business aggressively and profitably.
To build a world-class fund management business.
To take a focused approach to general insurance, with disciplined underwriting and efficient claims handling.
To build top-five positions in key markets.
To withdraw from lines of business or markets which do not offer the potential for market-leading positions or superior returns.

BERKSHIRE HATHAWAY

1999	2000	2001	2002	2003
At Berkshire, we strive to be conservative and consistent in our reserving. Even so, we warn you that an unpleasant surprise is always possible.	At Berkshire, we strive to be both consistent and conservative in our reserving. But we will make mistakes. And we warn you that there is nothing symmetrical about surprises in the insurance business: They almost always are unpleasant.	What counts in this business is underwriting discipline. The winners are those that unfailingly stick to three key principles.	If our insurance operations are to generate low-cost float over time, they must: (a) underwrite with unwavering discipline; (b) reserve conservatively; and (c) avoid an aggregation of exposures that would allow a supposedly "impossible" incident to threaten their solvency. All of our major insurance business, with one exception, has regularly met those tests.	Our results have been exceptional for one reason: we have truly exceptional managers. Insurers sell a non-propriety piece of paper containing a non-proprietary promise. Anyone can copy anyone else's product. No installed base, key patents, critical real estate or natural resource position protects an insurer's competitive position. Typically, brands do not matter either.
		They accept only those risks that they are able to properly evaluate (staying within their circle of competence) and that, after they have evaluated all relevant factors including remote loss scenarios, carry the expectancy of profit. These insurers ignore market-share considerations and are sanguine about losing business to competitors that are offering foolish prices or policy conditions.	The entire organisation now understands that we wish to write only properly-priced business, whatever the effect on volume.	The critical variables therefore are managerial brains, discipline and integrity. Our managers have all of these attributes.
		They limit the business they accept in a manner that guarantees they will suffer no aggregation of losses from a single event or from related events that will threaten their solvency. They ceaselessly search for possible correlation among seemingly-unrelated risks.	Finally, we are making every effort to get our reserving right.	Too often the industry has reported wildly inaccurate figures by misstating liabilities. Most of the mistakes have been innocent. Sometimes however they have been intentional, their object being to fool investors and regulators. Auditors and actuaries have usually failed to prevent both varieties of misstatement.
		They avoid business involving moral risk: No matter what the rate, trying to write good contracts with bad people doesn't work. While most policyholders and clients are honourable and ethical, doing business with the few exceptions is usually expensive, sometimes extraordinarily so.		

FAIRFAX

1999-2003
We expect to earn long term results on shareholders' equity in excess of 20% (15% for 2002/3) annually by running Fairfax and its subsidiaries for the long term benefit of customers, employees and shareholders - at the expense of short term profits if necessary. Our focus is long term growth in book value per share and not quarterly earnings. We plan to grow through internal means as well as through friendly acquisitions.
We always want to be soundly financed.
We provide complete disclosure annually to our shareholders.
Our companies are decentralised and run by the presidents except for performance evaluation, succession planning, acquisitions and financing which are done by or with Fairfax. Cooperation among companies is encouraged to the benefit of Fairfax in total.
Complete and communication between Fairfax and subsidiaries is an essential requirement at Fairfax.
We are team players - no "egos". A confrontational style is not appropriate. We value loyalty - to Fairfax and our colleagues.
We are hard wording but not at the expense of our families.
We always look at opportunities but emphasise downside protection and look for ways to minimise loss of capital.
We are entrepreneurial. We encourage calculated risk taking. It is all right to fail but we should learn from our mistakes.
We will never bet the company on any projection or acquisition.
We believe in having fun - at work!
Share ownership and large incentives are encouraged across the Group.
Fairfax will always be a very small holding company and not an operating company.
Honesty and integrity are essential in all our relationships and will never be compromised.
We are results oriented - not political.

GERLING

2000	2001	2002	2003
We will continue to concentrate on core areas of business and target further growth in specific, clearly defined markets.	The profit-geared underwriting policy we adopted last year will continue to be implemented in 2002, so premium revenues generally will reach last year's level.	In 2003, within the framework of the "New Gerling" project, we will sharpen the strategic focus on Property and Life business for industrial, commercial and private clients. Products will be geared to profit, processes shortened and more economies achieved, especially in administrative and internal services. Our core strengths - high degree of expertise in risk management, individual and innovative concepts for Property and Life insurance solutions, and strong client and service orientation - will thus be enhanced.	The new corporate structure of the Group enables us to harness positive synergistic effects while keeping insurance carriers separate as required. We are now again in a position to shape our own future and will do so by strengthening our core expertise and fearing operations more closely to profit.
We will therefore continue to concentrate on dovetailing risk management, underwriting and claims adjustment and systematically keep up the implementation of measures designed to improve results.	We will continue to concentrate on linking risk management, underwriting and claims adjustment and will make this a product focus as well as regional effort.	After a number of difficult years for industrial insurers, corrective market forces kicked in and resulted in a scarcity of insurance and reinsurance capacities. The chances for the remaining insurers will depend on their ability to form their own homogeneous groups of risks. And risk management will be the key competitive factor. Gerling positioned itself clearly and successfully here at an early stage.	The strategy of focusing on profitable, expertise-driven segments in which risk management skills give us a competitive edge has proven a resounding success.
Owing to the introduction of Internet-based business processes, we will cut costs and heighten the profitability of industrial business.	Putting industrial business on a profitable footing remains a primary objective on our plan to further strengthen our leading position.	We will further intensify the efforts we have made [the industrial segment] here since 1999 and continue to pursue systematically our integrated approach to risk management.	Our systematic underwriting policy will continue to be based on close interlinkage with risk and claims management; for the risk exposure of our capital, we will at all times demand premiums commensurate with risks.
We will use our good contacts with industrial companies to increase the volume of client staff business conducted by our commercial and private client arm Firemen-und Private-Service AG.	Building on our very good contacts with industrial companies, we will expand client staff business and extend our business links with professionals.	In Property business with commercial and private clients, we will continue to implement the multi-channel strategy adopted to cater to the diverse nature of our clientele.	The implementation of our core/service market strategy has led to a marked reduction in costs and an increase in the flexibility and performance in our international network.
The Credit Insurance Group will strengthen its market position and press on with the development of its international network.			In the commercial/private client segment addressed by GKA and GG&A, we will secure our operational successes through clear positioning.
The Gerling Reinsurance Group will profit from the consolidation of the market by making systematic use of our competitive advantages. We will strengthen our presence at the world's biggest financial centres and boost our market position with innovative insurance solutions. We will pursue our internationalisation strategy with particular vigour in the growth markets of Asia and Latin America.			

KEMPER

1999	2000	2001	2002	2003
	Late in 1999, KEMPER laid out a strategic plan to guide its development in the new century. We said then that we would continue to develop our ability to respond to change, that we would fix any problems in our business lines, launch new profitable growth efforts and make bold strategic moves to reposition ourselves for the changing financial services environment.			