CORPORATE PLANNING IN GENERAL INSURANCE

The Report of a Working Party established by
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1. Introduction

1.1. The need for flexible but effective strategic and operational planning in insurance has been brought about by a number of factors. These include the growth in complexity of the business, the rapid changes in the economic and operating environment, integration with developing disciplines and practices in related and wider industries, and increasing competition.

1.2. Whilst early forms of formalised planning were often somewhat rigid and academic, the emphasis is now on a pro-active discipline which can be adapted to different styles of management, corporate structures and business environments. It can also provide the essential communication vehicle for actions and intentions between decentralised units (inevitable in insurance) and global central management, whether for a small specialised operation or a large multi-national firm.

1.3. Corporate Planning is about managing the business in its entirety. The main areas of focus include:

- improving the quality of decision making;
- creating awareness of the environment of the firm and of its competitors;
- managing and profiting from change;
- anticipating;
- monitoring;
- acting and reacting;
- integrating aims and resources methodically and systematically;
- motivating and communicating.

As such, it needs active involvement and commitment throughout the organisation, ranging from the chief executive involved in strategic orientation and major decision-making down to personal motivation and guidance at the micro level to ensure that each activity is in step with and progresses the overall goals of the organisation.

1.4. This working party paper is therefore intended

- to provide a general introduction to the subject, which is largely missing from actuarial literature;
- to cover basic planning elements common to all businesses;
- to highlight certain features specifically relating to general insurance;
- to discuss aspects of actuarial involvement in planning;
- to give suggestions for further reading.

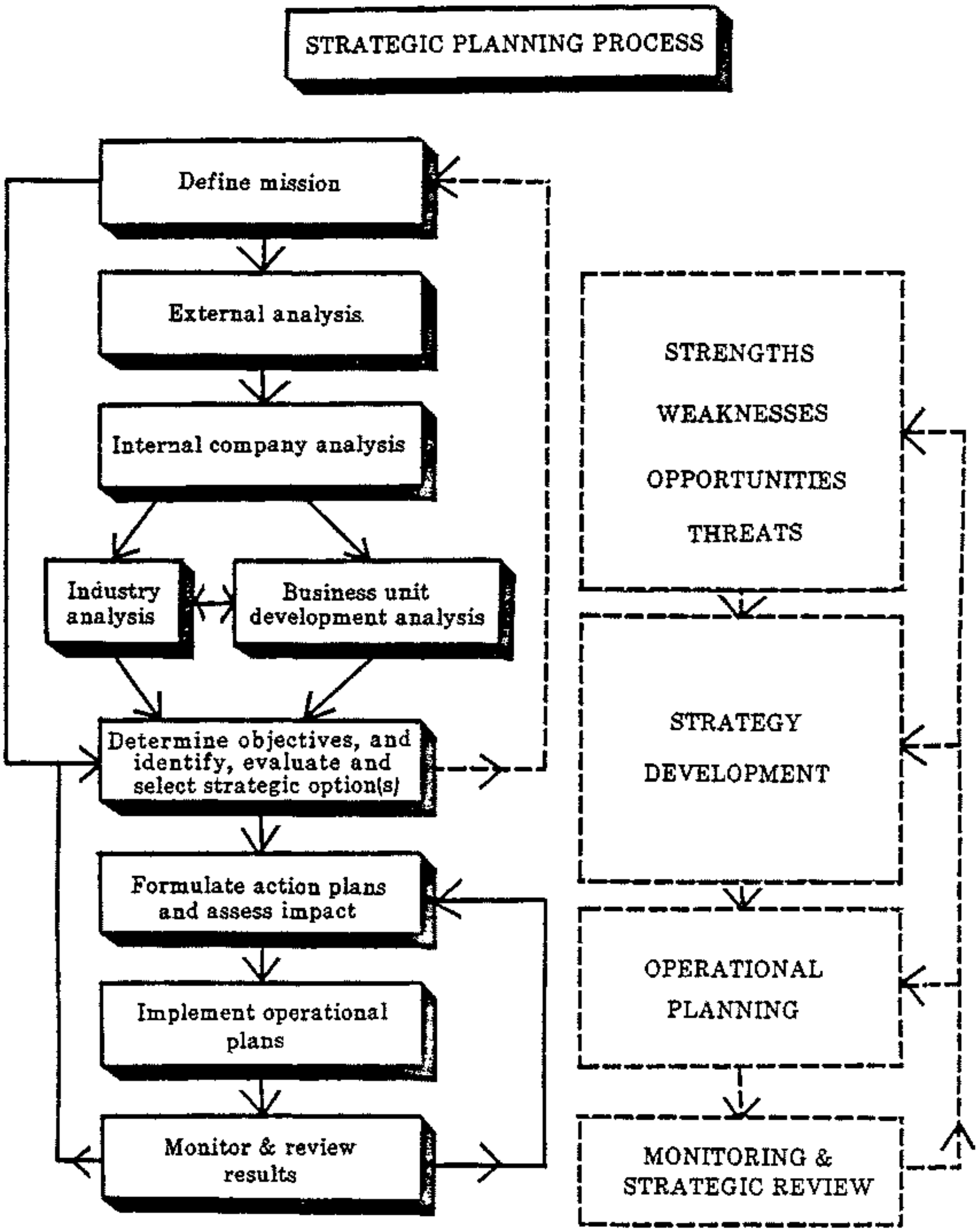
1.5. While much of the approach to strategic planning as described in this paper is (or should be) straightforward commonsense, the formulation of a strategic plan can prove a major challenge in practice. For students, it may also be helpful to have a case study available and it is intended to review one possible (hypothetical) outline example at the GISG Convention, with a view to determining whether further development of such a study is felt useful.

1.6. Little comparative information is widely available as to the varied forms of planning and management information in current use in different insurance companies, and its distillation into a limited number of key items for senior management purposes. This applies to both life and non-life insurance, and could prove a useful area for further research.

2. Strategic and Operational Planning

2.1. The planning activities of an organisation are multi-layered. These activities are carried out in different ways in different organisations, depending on their size, complexity and ethos. Much has been written on the subject (for a selected bibliography see Section 12). Whether it is carried out in a structured and formal manner or unstructured and informal; whether through segregated departments or through the vision and insight of an individual with power or influence, the process exists. The success of planning is not guaranteed by any particular structuring. Indeed there may be two or more simultaneous planning processes going on in an organisation at the same time, with formalised structures being adrift from the reality of office politics. Chaos has still brought its successes (see 12.17) and planning its failures.

2.2. One typical description of a strategic planning process is shown in the following diagram:



There are many similar descriptions, but the above diagram introduces the concepts and much of the 'classical' jargon (except for the key word 'key').

2.3. This representation is of necessity an over-simplification. Strategic planning considers the determination of a vision as to where the organisation wants to be in the future ('future' often being in practice five years or less), and the outline route to that vision. Operational planning is concerned with the nuts and bolts of how to turn that vision and outline into reality, and in particular with the one year framework determined by annual accounts.

2.4. The orientation of this paper is towards the planning process in the general insurance industry. The first concept to recognise is that 'planning' by management wearing a 'shareholders interest' hat may differ from that of management wearing a 'business unit' hat:

- the former may for example be considering the return that the shareholders are receiving on their investment and its opportunity cost; whether or not it is best deployed elsewhere, and the extent to which it should be distributed or further capital requested;

- the latter will assume that the business unit is in business to transact general insurance business. Its planning is geared to that basic assumption although it may consider horizontal and vertical diversification.

2.5. Financial economists assume that the objective of managers should be to maximise the value of the organisation. As with general insurance, where there is no norm for the measurement of the value of the firm by the players who management perceive as counting, (eg current marginal or potential shareholders of a listed company), then proxy measures may be used which are not coincident with academic theory, such as actual values as illustrated by stock market listings, or profits reported to shareholders as 'true and fair'.

2.6. A general insurance company is legally required to produce a business (ie, operational) plan when it requests an authorisation or when it is in breach of statutory solvency requirements. Such plans are seen to approximate to a modelling exercise, pulling together coherent budget, pricing, sale volume and investment assumptions based on likely figures, or as undertaking such a process for purposes of goal management.

2.7. The first steps in the more usual planning process are often iterative, involving the formalisation of the corporate mission, which together with internal and external analysis, leads to the setting of objectives and the selection of appropriate strategies to achieve them. To find both acceptable objectives and realistic strategies harmonising with the agreed mission may require more than one circuit through these stages of analysis.

2.8. The first step, the definition of the operating philosophy in the corporate mission statement, will give the background to the company's ethos, and involves consideration of:

- What business is the company in?
- Why is it in that business?
- What type of business structure is currently involved "eg, public company, private company, mutual" and why?
- Whose interests have to be considered, "eg, shareholders, policyholders, employees"?
- What is the style of the organisation "eg, aggressively profit orientated, paternalistic towards staff, high profile marketing image"?

2.9. This mission statement will be determined at the outset of the formalised planning process, if it does not already exist. In the remainder of this paper, we deal with the detailed considerations that flesh out the periodic strategic and operational plans and monitoring thereof, once this first important step of mission determination has taken place.

3. Setting Objectives and Developing Strategies

3.1. Objective setting and strategy determination is an iterative process. As outlined in the following sections, it is first essential to have conducted the analyses of strengths, weaknesses, opportunities and threats and related these to the external market situation and internal capabilities. As options are evaluated or further information is obtained, it is frequently necessary to go back and reassess earlier stages. This is to bridge the 'planning gap' that can often occur initially between what is desired and what is realistic.

3.2. In considering the development of objectives, there are three generalised concepts:

- A 'maximising' concept - although obviously right in theory, the achievement of such objectives can never be properly quantified;.

- A 'satisfying' concept - the business will have to satisfy a number of specified objectives and constraints. This approach is more pragmatic, but it can still be difficult to prioritise objectives when they conflict. The specified items could well also change with time or situation, leading to the need for periodic revision of objectives;

- An 'adaptivising' concept - both the above approaches are concerned with setting acceptable values in certain key areas. Adaptive planning places more emphasis on the assessment of the exposure of the organisation to various contingencies and ensuring that the organisation has the ability to react to adverse, or favourable, contingencies as and when they arise. This adaptive emphasis does not necessarily preclude setting objectives through either of the first two approaches.

3.3. Any conflict in objectives needs to be resolved. Above all, objectives need to be practicable, challenging, measurable, accord with real intentions and actions of management and staff and be capable of achievement within the future timescale of the plan horizon.

3.4. Problems of measurability and quantification of objectives are often substantial. For example, a company may feel it wants to obtain a particular market share, but this can only be judged in retrospect. The company could determine how much premium income it expects to be necessary and use premium income, which is capable of being monitored, as the corporate objective (or other measures relating to expected benefits, such as improved efficiency). Equally, any return-on-capital objective will be affected by fluctuations in unrealised market values, unless some smoothing process is utilised both in profit measurement and in the definition of capital employed.

3.6. Examples of possible business objectives are:

1. To obtain a specific competitive edge and maintain it (distribution systems may make this difficult, particularly for personal lines);

2. To maximise profits (woolly) or to increase earnings per share by a% (more specific);

3. To increase market share to b% or by c% (a very difficult objective to monitor; objective 4 may be more appropriate);

4. To increase premium income by d% pa (quite possibly above expected market average);

5. To increase dividends to shareholders by e% pa;

6. To strengthen the company's financial base in some defined way;

7. To broaden the company's operations into specified new products, markets or new areas;

8. To achieve a defined level of staff productivity or expense efficiency;

9. To utilise staff to maximum efficiency (woolly);

10. To maintain the company's position as market leader in a particular product line;

11. To increase the company's net worth (appraisal values, share price) in real terms in some specified way:

12. To maintain solvency at or above f%;

13. To obtain a certain minimum return of g% pa net on capital employed.

3.6. In addition, most companies would also recognise obligations to the industry, society, staff and policyholders, and the intention to hand on an efficient, sound operation to future management.

3.7. An example of conflicting objectives might be:

a. to maximise profits, <u>and</u>

b. to maintain staff at current levels

where a reduction in staff levels might be essential to improve productivity and profits.

3.8. Subsidiary objectives are often introduced within overall objectives, eg, the main objective could be a 20% overall increase in premium income but brought about by increasing premium income by 100% in one line whilst maintaining the existing level of premium income in another.

3.9. Once objectives have been set, strategies are evolved to provide the routes to those destinations. These will often largely have emerged during consideration of realistic objectives - 'if we do this then, ...'. In other cases, they may need to be developed in more detail and supported by a series of action plans, eg, to grow by acquisition, requiring a number of detailed subsidiary strategies and action plans.

3.10. The end result commits the company to a course of action, the consequences of which it has to live with for a number of years. It will also be necessary therefore to assess the sensitivity of expected results to the particular assumptions made (see modelling in Section 7), and review the flexibility of the chosen strategies to adapt to any foreseeable adverse or more favourable scenarios.

3.11. The emphasis will be on broader aspects of the business in a medium-term timescale, and be related to concrete options that are available (developing, acquiring, changing, closing down, etc). The process will be much assisted by the external and internal analyses outlined in the next two sections.

4. Analysis of External Factors

4.1. No company is an island. The best laid corporate plans can be upset by external factors in the environment in which a company plans to operate. A study of the industry background should thus be an early part of any planning process; how the market works, what the entry barriers are and so on. There is not usually time or resources available for an exhaustive analysis, although the soundness of the plan will rest heavily on the quality of these underlying external and internal analyses. We now list some of the various headings that should be examined.

4.2. **Economic Background**

- What are the prospects for economic growth?
- What are the economy's growth sectors (eg, by industry or geographical area)?

4.3. **Financial Background**

- What are likely levels of interest rates (eg, higher interest rates should boost investment income)?
- What are likely levels of inflation (eg, high inflation increases uncertainty in premium rates)?

- What are the likely movements in currency values?

- What fiscal developments are likely?

4.4. **Market's Growth Potential**

- As the economy expands, insurance tends to expand more quickly, yet in most advanced economies (eg, US) insurance might be nearing saturation relative to GDP. What are the current prospects?

- Will growth in demand be held back by the creation of captives?

- How are changes in the operating environment and interaction with developing services in other industries likely to affect the existing market structure?

4.5. **Legal Environment**

- Eg, the unhappy unpredictability of US courts, strict liability etc.

4.6. **Regulatory Environment**

- What, if any, is the system of premium rating controls or agreements?

- How onerous is the tax regime?

- How readily available is a licence to operate?

- How might trends in social attitudes affect regulatory attitudes?

- What is the likely impact of any regulation of intermediaries?

4.7. **Consumerist Environment**

- How loyal are consumers to their insurers (eg, what are lapse rates)?

- How price-sensitive are consumers?

- How might attitudes change in relation to large court awards (etc)?

4.8. **Distribution Systems**

- Are these a barrier to entry (eg, the tied agent systems of Japan and much of Continental Europe represent a formidable barrier to entry)?

- Are these cost efficient (less cost efficient systems will gradually decline in importance - note the growth of the direct writers in the US at the expense of the independent agency system)?

- What alternative distribution systems might be developed?

4.9. **Technological Developments**

- Do these allow substantial cost savings on established competitors (eg, by facilitating direct writing or lower management expense ratios)?

- Do they facilitate better data analysis to allow market segmentation?

4.10. **Optimum Size**

- Do the big companies in the market out-perform (eg, through savings of scale, wider distribution systems or better reputations)?

- Or are they hidebound by inflexibility?

4.11. **New Products**

- Often not a major issue in the insurance industry as there is not patent protection.

- But there could be areas of comparatively light coverage (eg, perhaps legal expenses insurance in the UK)?

- Or are there inefficiencies in the market rating structure which allow segmentation (eg, the over 50s' market for motorists)?

4.12. **Competitive Cycles**

- How disciplined is the market-place (eg, are there cartels/do one or two companies have dominant market shares/how supportive of insurers are the authorities)?

- How easy is entry (see earlier points on regulatory environment and distribution systems)?

4.13. **Results Record of the Insurance Industry**

- Is this a profitable area?

- How volatile or cyclical are results?

The table below shows, for illustration, the profit history and volatility in different markets.

4.13.1. Underwriting Margins 1975-84 (1)

The following tables illustrate selected national underwriting margins and their volatility based on published data for all lines of business.

	Japan	UK	USA	Canada	W. Ger.	Australia	France
1975	.153	.010	(.086)	(.037)	.039	(.094)	(.064)
1976	.141	(.019)	(.037)	.005	.007	.012	(.066)
1977	.136	(.012)	.015	.016	.023	.022	(.062)
1978	.151	(.007)	.015	.016	.017	(.018)	(.070)
1979	.177	(.028)	(.015)	(.035)	.027	(.042)	(.080)
1980	.146	(.017)	(.036)	(.102)	.014	(.199)	(.096)
1981	.100	(.012)	(.064)	(.143)	.002	(.197)	(.111)
1982	.066	(.080)	(.101)	(.068)	.005	(.162)	(.112)
1983	.066	(.071)	(.123)	(.042)	.020	(.093)	(.099)
1984	.074	(.131)	(.182)	(.122)	.018	(.093)	(.095)
Mean	.121	(.037)	(.061)	(.051)	.017	(.078)	(.085)

(1) Ratio of underwriting result to premiums.

4.13.2. Volatility of Underwriting Margins 1975-1984

	Japan	UK	USA	Canada	W. Ger.	Australia	France
Standard Deviation	.043	.046	.066	.060	.012	.076	.021

Source: Wood MacKenzie

These results of course need to be related to available investment returns and currency factors before they can be interpreted in relative profitability terms. Two of the countries (Germany and Japan) with better and more stable underwriting results would however appear to be those with the most significant practical barriers to entry (including distribution channels).

4.14. In the light of the above, there would appear to be significant areas where actuarial analysis can contribute to a deeper understanding of market behaviour and the relationship to major economic variables.

5. <u>Strengths and Weaknesses, Opportunities and Threats</u> (SWOT)

5.1. SWOT analysis usually forms an early part of the strategic planning process and is used to assist in determination of where a company is now and where it wants to go. The technique is not only used for strategic planning, but in many other spheres such as marketing. Some of the strategic issues raised will have been involved in the mission statement, and as with all aspects of planning, demonstrate the inter-connected nature of the whole process.

5.2. SWOT analysis consists of the answers given to the following key questions:

- Strengths: What is the company good at?
- Weaknesses: What is the company not good at?
- Opportunities: What opportunities are there?
- Threats: What dangers lie ahead?

These questions are posed both in relation to the current position of the operation, and its potential position in the market as it is expected to evolve during the plan period. A short example is given in Section 5.12.

5.3. One immediate purpose of the questioning will be to identify what the company's most urgent problem areas are, what each manager must do to tackle them, and also to help to identify the particular substainable competitive edge(s) of the company and its management.

5.4. The technique is applicable in both internal areas (where a company has most influence) and the external environment, and in so doing can also

- test the accuracy of the company's information;
- ensure the information is up-to-date;
- clarify and test people's values (their perception as to what the company is trying to achieve);
- build team identity.

5.5. Looking first at the internal environment of an insurance company, consideration should be given to applying the technique in the major operational areas, ie,

- management
- underwriting
- sales
- marketing
- accounting
- finance
- systems
- claims
- personnel
- training
- information
- investment
- administration

5.6. Next focus is turned to the external factors (see Section 4. for more detail).

5.7. Here the focus in particular will be on strategic aspects of the position of the firm in relation to these external factors including:

- Political - UK, Europe, 1992 etc
- Economic - trends
- Financial - trends in profitability, integration of services, distribution
- Sociological - trends in population changes, wealth, education
- Technological - the influences of technology on business practice, industry and education

5.8. After this is completed the results need to be integrated into key areas of strategy, for example:

- Policy/philosophy: Company mission
- Products and distribution: What is to be sold and how
- Organisation: How organised/financed/marketed
- Information: How obtained/maintained and disseminated
- Systems: What are available/how used
- Evaluation: How is the business to be monitored/measured

5.9. The benefits of analysing strengths and weaknesses, opportunities and threats stem largely from the honesty and perception with which the questions are usually collectively answered. Problems can arise in practice through some managers

- being resistant to change
- not understanding the value of planning
- having corporate myopia - seeing only their own company's virtues or vices
- underestimating the cost or the benefits of good service
- not being consistent in their thinking.

5.10. Widespread involvement and participation can help to ensure that an objective view of findings is formed and related to perceived external industry standards. As noted earlier, this analysis is a fundamental ingredient for the subsequent development of objectives, strategies and action plans.

5.11. Regular review will also help to monitor the changing profile of the organisation, encouraging long-term thinking and orientation.

5.12. SWOT ANALYSIS: OUTLINE EXAMPLE FOR COMPANY X:

STRENGTHS	- Developed skills and knowledge/close to clients and intermediaries/large client base/substantial assets
WEAKNESSES	- Poor data analysis/cash flow/poor public image
OPPORTUNITIES	- More money available for a wider range of insurance products/more non-insurers can distribute products/integration of services/ 1992 in Europe
THREATS	- More companies entering insurance/ intermediaries cost increasing/ efficiency lagging

6. Profit Measures and Financial Management Issues

6.1. The aim of the corporate planning process is to make the company more successful - but how is this to be measured financially for the overall operation and its profit centres? Is it for example, by

- pre- or post-tax profits?
- return on capital?
- appraised values?
- share price?

6.2. The traditional approach has been to measure success by reference to profit - either by underwriting profit or operating profit. This approach has important advantages; it is consistent with the approach used in Companies Act accounts and by share analysts and it gives a measure (rightly or wrongly) comparable with results of other businesses.

6.3. Pre- or post-tax profits have major problems as adequate measures of success. For example:

- profit is a subjective measure, particularly for long tail business;
- reserving bases and treatment of investment returns may not be consistent from one year to the next, or from one company to another;
- insurance results can be highly variable or cyclical, owing to the nature of the risks covered, one year's results cannot be viewed in isolation;
- development projects such as computer systems may have payback periods extending over several years;
- external factors such as currency fluctuations or investment conditions may add to the problems of variability and inconsistency;
- a major element in investment returns is often capital appreciation, which gives rise to many problems of measurement and recognition for profit purposes.

6.4. These problems may be summarised as:

1. subjectivity and inconsistency;
2. variability of insurance results;

3. non-uniform emergence of profits;

4. lack of recognition of changes in profit-earning power.

From an actuarial perspective, many of these problems stem from the requirement of a one-year accounting cycle for business which is not best suited to such treatment, and also from the impact of traditional practices in non-life accounting and profit recognition which compound the problems. Insurance contracts may not yield a final profit figure for many years and there is likely to be considerable variation in experience from one year to the next.

6.5. Such problems are not unique to insurance, but affect results to a relatively high degree. Subjectivity and variability can be improved for planning purposes by more systematic reserve estimation, together with the use of comparative measures based on relative performance. Presentation of results can be stabilised to a degree by three year accounting, claims equalisation reserves, and other methods, but many of the underlying risks and uncertainties in both assets and liabilities cannot be substantially removed without an intrinsic change in their nature.

6.6. A form of wider 'profit' measurement, common in the rest of industry, is evaluation of the return on capital employed. Unfortunately, it is no easier to define 'capital' than it is to define 'profit' in insurance operations. Shareholders' capital may include amounts hidden in margins in the published reserves. Asset price movements mean that the amount of 'free' capital is changing daily. The problems of subjectivity and inconsistency apply just as strongly to identification of capital as to profit,and measurement over a period to smooth out some of these elements is often necessary. One significant aspect is whether any return on capital objective is expressed in absolute terms (eg, 15% pa net), or relative to an index (x% above inflation or gilt yields etc). Further practical problems arise in interpreting such an overall objective into trading terms at different operating levels, including currency/ inflation effects in international operations. A distinction is often useful between the capital deemed necessary for trading and any element which is surplus to that, but which happens to be invested via a particular business unit for wider management reasons.

6.7. Although not yet widely used in general insurance, success measurement might be assisted by introducing appraised values, which can consider different profit sources or potential sources over a longer period, but at the expense of increased subjectivity. The value placed on goodwill, derived in as objective and consistent a fashion as possible, is a measure of the building up of a company's value over and above its visible intrinsic worth. Appraised values could prove a helpful tool for internal measurement of success - but not a full solution, and would need careful consideration in terms of tax and accounting implications before being adopted for published accounts. A more volatile proxy is the 'appraised value' placed on the company by the market share price, if it is quoted.

6.8. One partial solution for planning purposes is to work with specific, measurable, objectives as previously outlined (non-financial as well as financial, comparative as well as absolute) which in composite over an appropriate period will also be designed to meet any overall financial criteria. In this process, there would therefore appear to be scope for substantial actuarial input.

6.9. **Profit Centres**

As we said in the introduction, insurance requires a large number of decisions to be taken daily, which inevitably leads to considerable delegation of authority and decentralisation. This brings with it all the problems of 'matrix' management, including the need for good communication and clear lines of authority between the operational and functional managers involved.

6.10. Whichever side predominates, overall profit objectives will need to be broken down into sales objectives, productivity objectives, claims cost objectives, investment performance objectives etc, and/or into a number of profit centre objectives, with each centre being responsible for achieving a certain level of total profits.

6.11. The use of profit centres must be allied to the profit measure being used, since it must be possible to measure such a profit for any such centre. For example, it must be possible to allocate expenses to each centre. This can be a real problem in practice and can lead to a great deal of fruitless discussion concerning the basis of allocation.

6.12. Profit centres may have different objectives reflecting local conditions (regional profit centres), business conditions (product profit centres), or degree of risk. For example, with international operations, the overall return in Sterling might be the product of high (low) returns available or required from operating in that local market, offset by expected depreciation (appreciation) of the Sterling value of assets or 'sale value' of the operation in appraisal terms.

6.13. It will almost certainly be necessary ultimately to manage the business mix centrally to achieve an acceptable overall result, since it is unlikely that all products or operating units can be made equally profitable or can be developed at equal speed over the plan period. This could conflict with the use of profit centres to delegate responsibility and highlights the need for specific and agreed local objectives to be set within the overall plan framework. Central management will need to balance short- and long-term considerations and resources in any case to achieve longer-term strategic objectives (eg, market share in a particular area). This can be compared to the smaller scale problems of 'package policy' management and international business insurance for multinational corporations where adequacy of rating may need to be averaged over the overall policy.

6.14. The profit centres can either retain control over all aspects of the business or else the results in some areas must be averaged between profit centres. For example, a profit centre might retain control over investment decisions or alternatively investment income could be allocated on a notional basis. In some companies, however, the creation of profit centres has unnecessarily led to duplication of specialist functions.

6.15. By delegating the responsibility for achieving success, it is likely that the key people in each profit centre will show a greater commitment to the profit objective. For example, if a branch is targeted only on sales then an underwriter may be under pressure to cut rates merely to obtain business. If the branch has agreed objectives which balance growth and profit, then the underwriter has a real interest in making good underwriting decisions, but ones which are not unduly conservative. This can be reinforced by linking pay to performance against objectives to a degree in each profit centre.

6.16. A danger is that profit centre managers will tend to think parochially. Some benefits of the large organisation may be lost. For example, acceptance of large lines of business could be a problem and might be cut back if local retentions are related to the size of the profit centres as though they stand in isolation. Small profit centres may therefore need internal reinsurance to avoid fear of isolated large claims or catastrophes preventing them from accepting sizes of line appropriate to the strength of the overall organisation. This is provided that the extra administration this entails is more than balanced by the extra profit margin thus retained. Even if internally reinsured, random large claims will still remain a major monitoring problem for profit centre assessment.

6.17. Another danger is that managers may ignore subsidiary objectives (such as staff training) in favour of the profit objective. As with all management processes, non-financial as well as financial objectives need to be brought into review of performance, with managers held responsible and accountable only for that which they are able to control directly.

6.18. For branch and regional profit centres, a more practical concept may be that of 'contribution centres', in which profit targets are replaced by contribution targets. This may avoid some of the problems associated with profit centres (such as fixed expense and investment allocations) at the expense of some apparent loss of responsibility on the part of the centre managers. The contributions in total need to be sufficient to cover total overheads and required profit margins, and to achieve this in practice, higher local 'targets' may need to be set which allow some slippage in providing the overall required plan contribution level.

7. Modelling

7.1. Strategic planning has to answer the question 'Where does the organisation want to be?'. This involves:

- the creative function of identifying the possible alternative strategies for the organisation, and

- the evaluative function of weighing up the pros and cons of each alternative.

7.2. In order to evaluate the options open to the organisation, and therefore to have a rational basis for selecting one, the planner must:

- decide on the criteria which will be used in the decision;

- set up a system of measurements which will indicate to what extent the criteria have been achieved, and then

- assess the effect on these measurements of each option.

7.3. The modelling process is a means by which these assessments can be considerably assisted. The model is a quantitive (ie, mathematical) description of the way the organisation, or a part of it, works.

7.4. However, modelling need not simply be a tool for evaluating various strategic and operational possibilities. It can also be at the centre of the management information system to keep the managers informed of what is happening in the business. If adequately written and integrated into this management information system, the model can be used to:

- monitor actual development against planned development, with the intention to pick up divergences at an early enough stage for corrective action to be taken;

- provide updated projections of business development to give an estimate of the implications of what is currently happening upon future results.

7.5. Models can be built at a range of levels. A regulatory authority or large market player might be interested in modelling the entire domestic insurance market. It will be concerned with:

- demand for insurance products of various kinds, and changes in the demand because of demographic, economic, legislative and perhaps other conditions;

- the capacity of the insurance firms to meet this demand, including the capacity of the worldwide reinsurance market.

Such a model would need to incorporate macroeconomic forces and allow for trends and cyclicality in market conditions.

7.6. At an ordinary company plan level, the requirement will be to determine the end result and sensitivity in revenue, profit-and-loss and balance sheet terms of various courses of action or external variations in key elements - for example, to examine the consequences of various growth scenarios, to assess capital requirements through an underwriting/business cycle, to investigate different investment policies, etc. This will require the ordinary dynamics of a company to be integrated in the model, and may need to allow for various business units to be modelled independently before consolidation. This is probably the most usual type of model for overall planning purposes, one stochastic version of which has been developed from the original solvency working party model, and which will be discussed separately at Harrogate.

7.7. At another level, an insurance company may want to 'profit-test' one particular aspect of operations - for example, its motor insurance business sold through a particular branch or outlet. It will then be concerned with:

- expenses of acquisition, administration and claims handling;
- claims costs;
- new business production and lapse/renewal rates.

These in turn will depend on:

- rates of recruitment and retention of sales and other staff;
- staff productivity;
- factors external to the company - such as competitors' products;
- advertising and other marketing efforts including sales incentives.

These models could be used in either a purely operational way - for example to determine appropriate remuneration arrangements for sales staff - or for a strategic purpose - for example, to assess the value of the 'goodwill' of an operation (that is its ability to produce further new business and associated renewals to contribute to future profits) as part of an overall appraisal value for sale or acquisition of the operation.

7.8. At yet another level - the tactical level - a model may be produced to assist the evaluation of capital projects, for example, the timing of the next stage of possible computerisation. The important features to determine in such a particular case might include:

- the effect of computerisation on total and unit production costs;
- the effect on the total capacity of the administration system;
- the effects of alternative methods of financing the project.

There will also be non-tangible effects which will need to be evaluated, such as:

- the effect on the level of service (which will require a suitable definition);
- the effect on the perceived value to the customer (either the policyholder or the agent).

Which effects will be given most weight will depend on the objectives of the organisation. For example, proprietory insurers will not necessarily have the same objectives as mutuals.

7.9. Drawing together the common features of the above examples, a model will in essence consist of:

- a set of factors which are assumed to affect the outcome - these will be called parameters or assumptions - these may be under the control of the management of the organisation (for example premium rates, staff salaries) or may be external (for example, tax rates, claims cost inflation);

- a set of factors which are regarded as indicators of the progress or success of the organisation - these will be called the results, and

- a link between the input parameters and the output results.

7.10. All but the simplest of models will require a computer because of the complexity of the interrelationships and the range of projections that will be needed. To some extent there is a conflict between realism and complexity. How complex the model is will depend (not necessarily in this order) on:

- the importance of the decision to the organisation - the more important the more detailed the model;

- the resources available to the planner, both time and expertise - the less resources, the less refined the model can be;

- the uncertainties of the environment - the greater the uncertainties the less beneficial a refined model will be.

The planner will need to judge, on cost-effectiveness grounds the most suitable structure for the model in the given circumstances.

7.11. The following is a list of factors which tend to increase the complexity of the model:

- an increase in the number of factors which are assumed to affect the outcome and are taken as parameters in the model;

- an increase in the number of factors which are regarded as indicators of success and are to be considered in the model's output;

- integrating different parts of the business into one model;

- an increase in the time-horizon of the model - for example carrying out a ten-year projection instead of a one-year projection;

- an increase in the number of intermediate stages - eg, if the model is to provide monthly cash flows instead of annual;

- the introduction of stochastic elements and other means of showing the degree of variability of the results.

7.12. Any model will be imperfect because it cannot possibly incorporate all the dynamic influences of the future business environment, which will depend on future decisions both internal and external to the organisation. There is therefore uncertainty, and hence risk, involved in any strategic or operational decision. A good model used intelligently should be able to evaluate that risk to a degree by indicating the order of variability of the outcome.

7.13. Variability can arise in a number of ways:

- by the emergence of one of a number of substantially different scenarios (eg, because of tax or law changes);

- by changes in key assumptions from those which were considered most likely;

- by random variations in the values of the assumptions about a central figure, caused by accumulations of external influences.

7.14. Modelling can cope with each of these sources of variability by:

- having separate models for each scenario;

- using 'what if?' projections to show the sensitivity of the results to the assumptions;

- building stochastic features into the model (c.f. the Daykin/Hey model being outlined in the solvency working party session.)

7.15 Stochastic features can be incorporated by

- building in probability distributions to the computation of the results
- using simulation techniques : this will involve carrying out many projections, each one of which is a "what if?" projection on the basis of a set of assumptions which are drawn "at random" from given probability distributions, in order to measure the relative frequency of deviations from the "expected" result.

7.16. Simulation has become possible only with the increase in power of computers and their accessibility. It has the advantages that:

- it enables virtually any parameter variation to be simulated;
- the concept is relatively straightforward to explain to the organisation's management.

However, its disadvantages are:

- it is costly to implement (both in terms of time and other resources);
- it can take a lot of time (both computer time and real time) to carry out the process;.
- it can produce such a wide range of results as to give little guidance for marginal decisions.

For these reasons, simulation techniques are used sparingly. This situation may change in future with increasingly powerful computers becoming available at lower costs.

7.17. The output from the projections of the model will typically take the form of a whole array of results variables. These

- are essential for a complete picture of the alternative, but
- cannot easily be compared with one another.

7.18. Alternatively, some single-index figure can be computed which summarises all the results into a point on a numerical scale. This

- makes the results easy to compare, but

- disguises some potentially important features of the alternative.

The calculation of any single-index figure, such as the discounted value of future cash flows, is necessarily a judgement by the planner of the relative weight to be given to each specific measure of the results.

7.19. Many of the features inherent in general insurance modelling are directly comparable with actuarial experience of integration of complex financial, economic and business factors into projections in other fields (eg, life and pensions valuations). Actuaries may therefore have a particularly valuable contribution to make to this developing area of general insurance management.

8. Monitoring

8.1. It is vital to monitor plans and to gear the organisation to take action in consequence, otherwise plan preparation becomes an academic exercise.

8.2. It is also natural actuarial practice to compare actual with expected, and to analyse reasons for variances or for success or failure. As stated before, this leads to the requirement that plans need to be expressed in terms capable of being quantified; however, many important aspects (eg, image) may still require substantial subjective judgements.

8.3. Monitoring is required at two levels - strategic and operational - with usually different requirements.

8.4. Strategic monitoring focuses on the most important parts of the plan in the rapidly changing financial services marketplace; requiring

- 'milestones' for measurement of acceptable progress towards long-term goals;

- internal monitoring of progress towards achieving these strategic goals (eg, change in mix of business; development of new channels of distribution; quality goals for levels of service; staff objectives; information technology capabilities);

- external monitoring of legislative, economic and investment factors, trends and developments in the general insurance market and financial services, and competitor activity;

- a preparedness to change strategies if plan assumptions prove invalid;

It may be appropriate only to 'update' strategic aspects annually, but in a fast-changing environment, even this might not be adequate. In other more stable circumstances, a full strategic review might be required only once every two or three years.

8.5. Operational monitoring is required at various levels (corporate/division/department etc) with different degrees of detail. Requirements for monitoring reports could include:

- monitoring of progress against specific business plans and action plans in all functions of the organisation, including for example focusing on the levels of rate increases/ decreases achieved and growth in real volumes of business (ex lapses);

- monitoring of results against financial projections and budgets, including quarterly, year-to-date and rolling twelve-month figures and comparison with prior years;

- a practical approach to recognising random aspects, commentary on reasons for significant variances in key financial elements and ratios, together with revision to forecast results for the year;

- standardisation wherever possible of reserve evaluations on a consistent basis for central reporting;

- comparisons with market and competitors' results where available;

- all regular management information to be integrated with monitoring requirements;

- frequency of monitoring normally to be at least quarterly, depending on the size of organisation; there may not be the need of such regular reviews for some 'action plans'.

A balance is required for reporting purposes between the need to highlight key parameters to keep senior management adequately informed, and the need to avoid time-consuming and expensive bureaucracy. The planning process should ideally be integrated electronically with normal accounting and other processes, such that different levels of comparative information are available according to need with a minimum amount of extra paperwork.

8.6. One major pitfall is often in concentration on figure variances and short-term results, as noted earlier in respect of the perpetual difficulty of forecasting general insurance results accurately, and for example, the effect of random large claims. A critical focus remains on what are 'acceptable' deviations and what are adverse development trends requiring remedial action - an area where statistical/actuarial interpretation can be of considerable assistance.

9. Participation, Communication and Planning Structure

9.1. This section covers participation and communication in more detail in both strategic planning for an organisation and the (possibly) more mechanical aspects involved in assembling an operational/budget type of annual corporate plan.

9.2. The company culture/ethos will affect the level of participation and communication:

- leadership style
- decentralised vs centralised;
- autocratic vs participative;
- ability to handle change, and the varying pace of change;
- any need to be more, or less, 'entrepreneurial'.

9.3. Involvement of all relevant parties in the corporate planning process is vital:

- the motivation of each 'profit centre' management team 'owning' their own plans and contributing to the whole organisation's future;
- in particular, full senior management participation and commitment;

A cardinal rule from experience is:

- do not leave planning to planners; it is too important!

9.4. Insurance business is not just about numbers; it is a market - moods, attitudes and people affect results.

9.5. To ensure realism, everyone needs to understand the issues involved:

- knowledge of people and their style helps to assess what is really happening;

  - optimistic or cautious?
  - analytic or intuitive?
  - traditional or forward-looking?

- on the ground, perceptions of organisational strategy and objectives matter, as does the image of top management, both creating loyalty and belief, or the opposite;

- the need for top down/bottom up interaction and dialogue (see 10.5.) to help ensure clear thinking, to avoid the plan being unrealistic and yet sufficiently 'visionary';

9.6. The organisation needs to share conceptual frameworks for planning and for the mission statement:

- common goals and shared values;

- unity of purpose.

9.7. The written word can be misconstrued:

- written communication is not always clear, or the background reasons insufficiently explained;

- major plan issues often need to be discussed or presented face to face;

- there is need for senior managers to feel personally committed to their plans, and also to be fully aware of contents often prepared by supporting managers. A live presentation to and acceptance ('blessing') of the plan by the chief executive or Board can encourage such commitment;

- any subsidiary plan also needs to have been 'vetted' prior to such acceptance by the central planning manager and any functional managers not directly involved in its preparation.

9.8. In developing its strategy, the organisation needs to consider all the important arguments:

- not just the loudest voice;

- it needs to avoid the easy compromise;

- or prejudice and bias.

Also it needs to encourage participation of all those with 'know how' - gaining expertise from the ground up.

9.9. The chief planner in any organisation should always be the chief executive. The role of the planning manager is one of coach/secretary - not necessarily the doer, rather the one who encourages self-organisation, facilitates communication, and asks questions. His or her role is to:

- to examine consistency of structure and integration with overall objectives;

- to provide feedback on actual results;

- to highlight issues of control, accountability and responsibility;

- to ensure action and commitment ensue from the planning process, not just verbal acquiescence.

In a large organisation, the planner may well be a full-time senior manager, supported by a team of specialists. For smaller units, planning responsibility might be allocated in conjunction with other responsibilities. In whatever structure, we believe the essentials as set out in this paper will still apply. The greatest danger is for planning to become distinct from management or action at any level in the organisation.

9.10. Beware also:

- of individuals' psychology;

- 'politics';

- getting things done through people inter-play of human relationships;

- of time lags between communication and implementation: understanding aims often 'seeps' through only gradually to the grass roots and it can take one or two years for attitudes to reflect planned thoughts!

- of over-simplifying or making too complex - especially when communicating 'down the line'. For example, stress on either profit or growth in 'we want profit and growth' can get magnified into 'rein back' or 'go for it' if not carefully conveyed to individual underwriters at the coal face.

9.11. Constant communication is needed - planning is not just an annual exercise. Communication is required to all staff - increasing the sense of awareness in overall company interests and what is expected of them. Make sure that there is full communication also upwards to the main Board: planning can result in greater individual freedom of action for senior management if the main parameters for action are spelt out and agreed in advance - and sufficient communication mechanism exists to ensure that all who need to know are kept in the picture as events progress.

10. Some Other Practical Aspects

Some other practical points in overall strategic and operational planning:

10.1. How large should the Plan be?

Idealists say three pages for the strategic plan. We have not heard of this being achieved. One type of short strategic plan can consist of largely of the key accountabilities of various senior managers, with all operational detail only appearing in operational plans at business unit level, while another type might set out the mission statement, main objectives and an outline of how these are to be achieved, with timescales and responsibilities. Annual operational plans will usually be much more substantial, often built up from separate detailed plans at each major reporting level. Nevertheless, a planning objective should be only to provide the key information required at each level. Much of the process, especially in figure terms, will now be computerised, with only necessary summaries produced in hard copy.

10.2. How should the annual cycle be timed?

We have not heard of any cycle being problem free. Strategic planning and strategic reviews are best separated from the regular annual planning round, and might take place early in the year, once annual results have been finalised. Operational planning around a calendar year means basing say, 1989 plans on projected

1988 figures. The first date for starting development of the operational plans for 1989 may be in May/June of the previous year. There will be a continuing string of revisions, and the question of when the Plan figures goes firm is a variable event which could be up until, or even after 31 December. Subsequent monitoring might be against Plan or Adjusted Plan.

10.3. How and how far are the contents of the strategic and operational plan disseminated?

Of course there is no unique answer to this. Market, staffing and competitor sensitive information should not be divulged without careful prior thought. However, staff and union relationships may be helped by dissemination of operational plans in as much detail, and involving as many people as possible.

10.4. 'Top down' or 'bottom up'?

Top down plans are based on estimates of what senior management believe should be achievable by the operation as a whole, based on global data, whilst bottom up plans are based on plans prepared at grass roots levels and consolidated to form a totality. An iterative process may be needed to remove any 'planning gap'. In general it is therefore likely that strategic plans will by their nature tend to be top down, operational plans bottom up. A key element is that the planning process integrates all spheres of diverse activity into a unified whole. This requirement is as much 'side to side' as it is 'top to bottom'.

10.5. Functional versus operational plans?

Very often, functions within an organisation will prepare plans for their entire scope of activity (for example data processing) which would form a matrix with integrated operational plans for individual business units. It is preferable in our view that functional management participate in the preparation of business unit plans (if these are distinct) but leave responsibility for the overall plan with the business unit manager.

11. Potential Pitfalls of Planning

11.1. These include:

- overplanning;
- planning = budgeting = targeting;
- short-termism;
- too high expectations of result predictability;
- lack of senior management involvement ('the planning department');
- lack of wider involvement or too much secrecy;
- inadequate analysis of the external environment;
- narrowness of thinking;
- unpreparedness to change or evolve ('more of the same');
- unpreparedness to acknowledge weaknesses;
- bureaucracy and over-complexity;
- internal politics;
- conflict with traditional management styles ('each manager is an island');
- responsibility without accountability;
- plans which cannot be monitored;
- over-optimism (the 'hockey-stick syndrome' where planned results always improve in two to three years' time regardless of trend).

11.2. At the end of the day good planning is essentially good management. Planners should not over-sell the benefits of planning - it is the quality of judgement, degree of awareness and effectiveness of action, and not the size or structure of the planning process, which determines the success of the organisation. Whatever the style of management, we believe that well-structured planning can greatly assist in the orientation and communication necessary for insurance organisations to deal with an increasingly uncertain and competitive environment.

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