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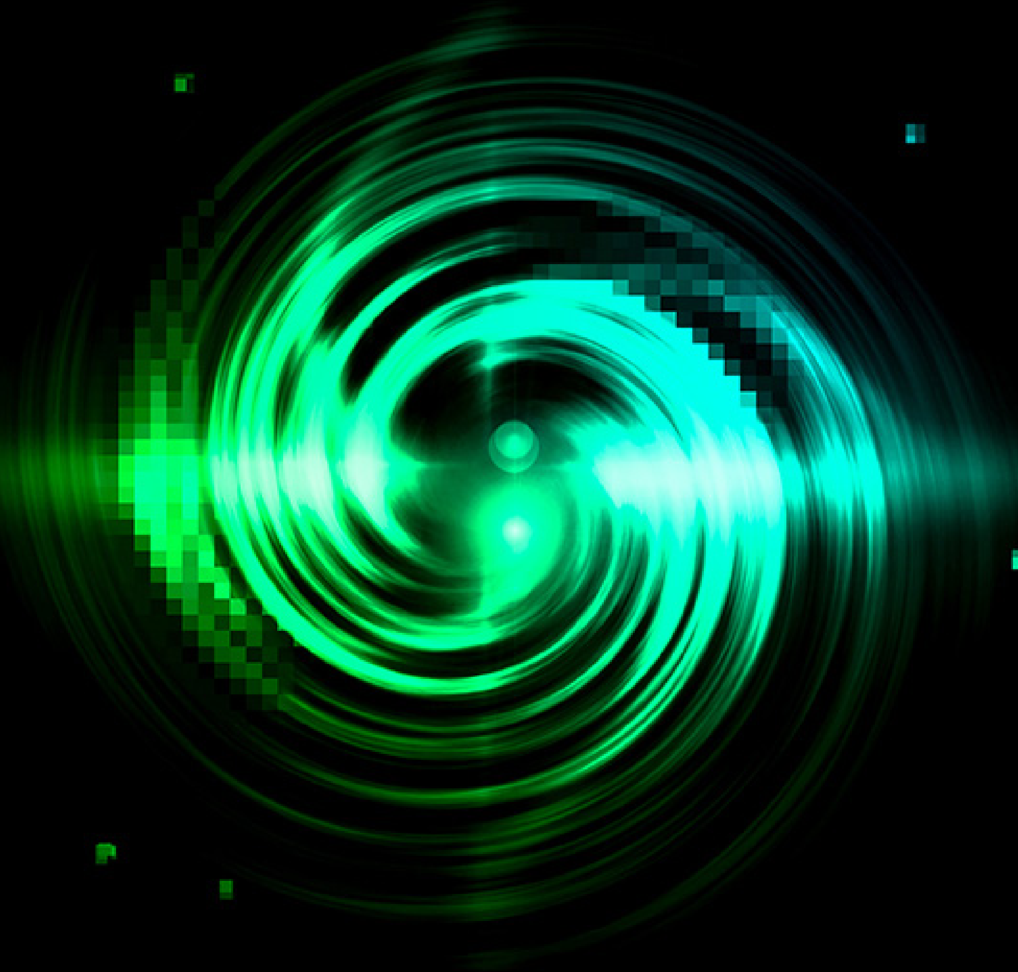

Financial planning for insurance companies during COVID-19

Guidance for insurance CFOs

Planning season is around the corner. What considerations should insurance CFOs and planning leaders contemplate when conducting such a crucial forward-looking financial activity with a global pandemic in progress?

The times we are living in are historic and unprecedented. With some health professionals equating the current scenario to the 1918 Spanish Flu pandemic, there is a lack of recent historical business context to look to for guidance. This lack of context can make the already challenging task of predicting future market and consumer behavior even more difficult. The world will be remade by the COVID-19 crisis, and resilient leaders are assessing different economic, political, and health scenarios that may emerge. How should organizations approach financial planning given the level of uncertainty? This perspective will not prognosticate on the future of the economy or how plans will change based on different economic scenarios. Rather, it will identify strategies and techniques to help organizations execute the planning process in a valuable and efficient manner.

Insurance organizations leverage annual financial planning for many purposes: aligning organizational priorities and strategic investment opportunities, identifying staffing levels and related expenditures, projecting policy counts and associated loss and benefit levels, and identifying economic goals by which leadership and the broader organization will be compensated. The planning process is lengthy, requiring both art and science—numerous interactions between organizational leadership and individual business units translate high-level goals into detailed, bottom-up financial plans while coordinating across functional groups to align on operational drivers.

In a normal year, planning is a complex effort. With the instability of the current world, many organizations are facing additional discomfort and lack of confidence in future projections, driving a near-constant need to develop and model scenarios. Reliance on excessive manual iteration within the process can drain resources and cause strain in the face of urgent need for decisions and courses of action. This process of prediction is especially crucial in the current environment. In response, CFOs and financial planning and analysis (FP&A) leads should look to take immediate action that can help mitigate uncertainty during the current cycle while enhancing processes over time to develop a more dynamic, effective planning organization.

As organizations prepare to plan for 2021 during the current pandemic, the following strategies can help mitigate uncertainty to enable a more effective, useful financial plan:

Seek feedback from business units prior to disseminating targets: Leading-practice organizations begin the planning process by setting strategic guidance, translating the guidance to targets, and disseminating those targets to business units. Global organizations may want to consider a different approach this year. While financial markets are globally connected, the manner in which countries are responding to the crisis is not. The speed at which business overseas will be able to execute in a somewhat "business-as-usual" fashion will differ from that of the US economy. As such, corporate FP&A teams with a global business footprint may be better served by building a planning calendar, where local teams submit ranges based on the likelihood of potential outcomes. After reviewing the ranges submitted by the local teams, corporate FP&A can develop and disseminate targets informed by local conditions to yield a more realistic, effective outcome.

Adopt a probabilistic, range-based planning mentality for scenario planning: Many organizations conduct planning by having business units submit a select number of targeted scenarios (for example, high, medium, and low) before identifying the most likely scenario and finalizing a single set of financial results. Rather than trying to arrive at a single number, organizations should consider identifying a range of outcomes with special consideration paid to the bottom of the range (worst-case scenario). Leading-practice organizations can use observed volatility to bolster ranges with assigned probabilities, allowing leadership to plan for a wide variety of possible outcomes while considering likelihood of occurrence.

Strengthen scenarios through driver-based planning: Leading-practice organizations use driver-based plan logic to tie financial outcomes more closely to underlying economic and organizational drivers. In times of increased volatility and minimal historical precedent, driver-based plans tend to have an inherent advantage over their simpler, trend-based counterparts. While trending may have been sufficient in the past, historical results may no longer be a reliable indicator of future performance in today's volatile economy. Organizations should look to expand driver logic, as appropriate, throughout the planning process and rely on input from those in the organization who are closest to each respective driver when establishing scenarios and plan ranges. (Note: This does not mean organizations should try to make every plan item driver-based. Materiality should always be considered—if a line item makes up less than 2 percent of the total plan, even a 200 percent actual-to-plan variance may not move the needle). An increased reliance on external economic drivers should also be considered during periods when activity is heavily influenced by market forces or economic shocks. For example, setting gross domestic product (GDP) as an external driver, a company can identify that if GDP decreases 10 percent, the top line is expected to be within a specific range. As GDP shifts throughout the year, forecasts can be adjusted based on actuals and to verify the predicted ranges. The plan for next year will likely be as dependent on external economic drivers as internal ones.

Enable "stage-gate" review cycles that allow for adjusted focus based on the changing environment: Reviews of financial plans typically take place over two to three staged rounds. During each round, the executive team reviews plan figures in totality. Review conversations and meetings can be lengthy and unproductive. While the figures may change, the questions are often the same. What growth rate did each business unit assume? Why are expenses continuing to grow when our strategic guidance was to keep figures flat? During such dynamic times, an end-to-end review cycle may yield ineffective discussions or lack feasibility from a timing perspective. Instead, organizations should concentrate each review session on a specific target, motivated by the current operating environment (for example, a shift in focus from profitability to liquidity, portfolio prioritization, and short-term expense management). By focusing the conversation, organizations can have the meaningful, targeted conversations needed to execute in a more analytical fashion.

Organizations should carry these practices forward and layer in the following to help build a more effective planning process that is robust, flexible, and shock-resistant.

Leverage the power of a rolling, monthly forecast: Many insurance organizations perform a quarterly forecast (if they execute a forecast at all). Leading-practice organizations will execute a Q1 forecast and leverage the data as a starting point for their plan. However, the days of only executing a forecast quarterly are being challenged. Many executives are increasingly expecting a forward-looking view of the financials updated on a monthly basis. Though this does not necessarily mean a full income statement, balance sheet and cash flow are required. Insurance organizations should consider forecasting key line items or drivers on a monthly basis, including top-line growth, combined ratio, and investment income. Given changing market conditions—near-zero interest rates;[1] increasing social inflation (resulting from the rising costs of insurance claims due to more litigation);[2] increasing workers' compensation claims; consumer requests to refund car insurance premiums during times of staying indoors, social distancing, and reduced driving; and expected regulatory updates in light of the virus (such as reevaluating coverage exclusions for business interruptions)[3]—identifying the key drivers by which insurance organizations evaluate forecast versus actuals variance on a monthly basis may be a more valuable exercise for the organization than executing a detailed plan.

Consider the impact that changes to the financial planning process could have on incentive compensation planning: Implementing the strategies above may have implications for organizations that tie compensation to actual versus plan performance. As changes to the strategic planning and financial planning process are identified, it will be crucial for these changes to flow through to how incentive compensation will be planned and executed.

Conclusion

In times of uncertainty, financial planning gains added significance. Identifying and discussing potential scenarios in a scientific manner can help organizations prepare for the future. To deliver effectively, finance organizations may need to challenge the existing mechanisms by which they are executing their planning and forecasting processes. Targeted challenges using the short- and long-term strategies above can bolster planning capability and unlock the value that is uniquely offered by financial forecasting and its ability to inform and strengthen strategic decision-making.

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Endnotes

1. Insurance Information Institute, "Global macro and insurance outlook," March 4, 2020.
2. Telis Demos, "The specter of social inflation haunts insurers," *Wall Street Journal*, December 27, 2019.
3. Deloitte, "COVID-19 impact to property and casualty insurance," April 2020.

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