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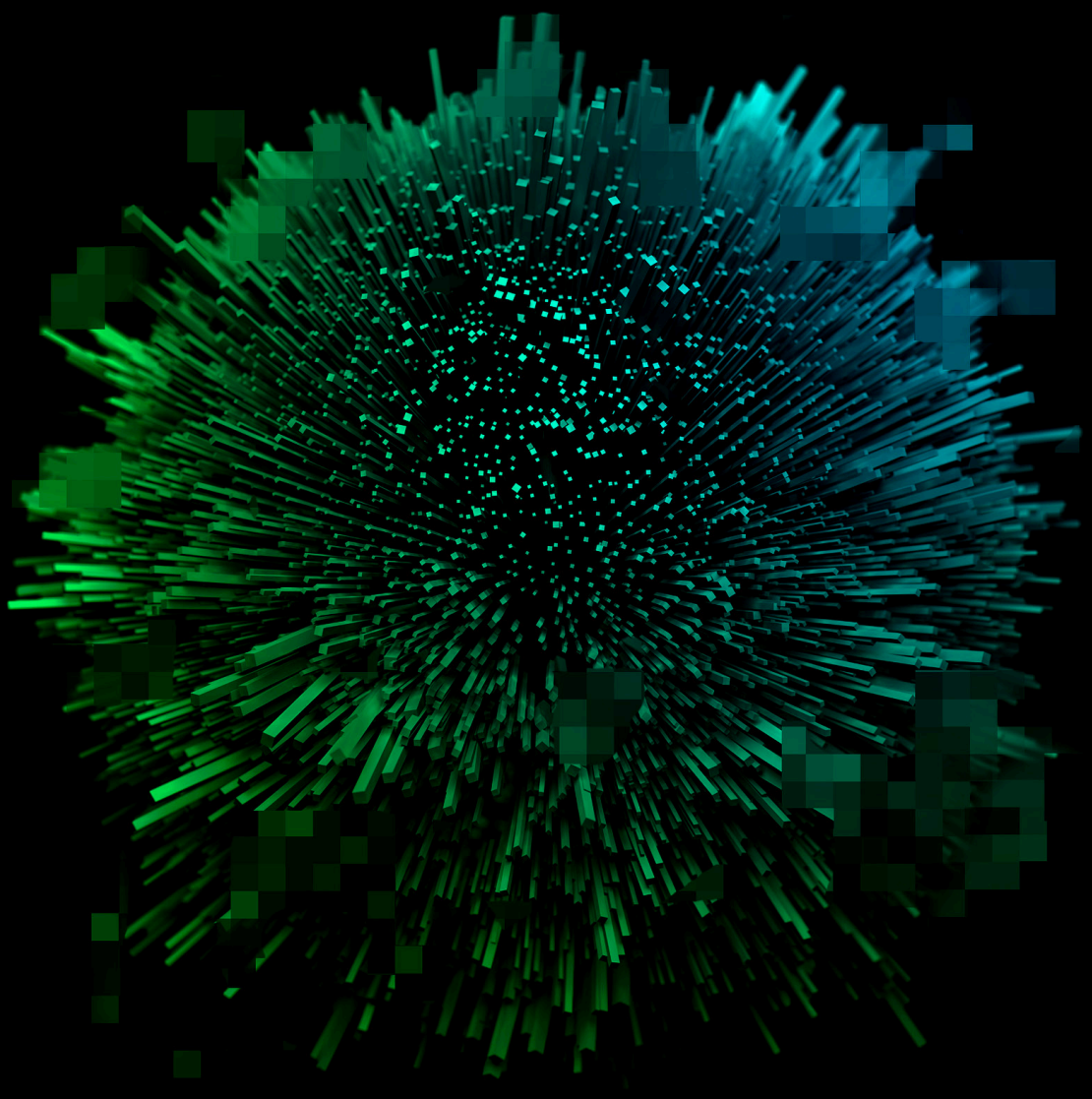

Managing allocations effectively in the insurance sector

Executive summary

For organizations to improve profitability and accountability, it is critical that all products and services receive their appropriate share of revenue and cost allocations and that organizations understand the "cost to serve" their customers.

In today's world of bundled pricing, centers of excellence, and shared services, organizations must actively manage profitability and accountability across products, customers, regions, and channels—driving the need for structured and sometimes complex allocations. For organizations to improve profitability and accountability, it is critical that all products and services receive their appropriate share of revenue and cost allocations and that organizations understand the "cost to serve" their customers.

Finance organizations seek to provide comprehensive, credible, and actionable information about their expenses. For companies leveraging a variety of business units, shared services, and locations to offer multiple products, meeting such objectives is more challenging, given the high level of indirect costs to allocate in the insurance sector. Cost allocation pools and dynamic drivers are developed to face this challenge but are onerous to manage and explain. Furthermore, the allocation process becomes an exercise of making contra entries across the organization, rather than an initiative to manage and reduce costs.

In this current unique period, the convergence of aging legacy platforms, complex market dynamics, and a mature vendor landscape has made transformation a top priority. We expect core system transformations related to compliance and profitability management (including allocations) to continue to be a top priority for insurers in the future.

This paper defines challenges and best practices for expense allocations in the insurance sector.

Challenges for the insurance industry

A highly intermediated distribution model, as well as high regulatory granularity and transparency, drive insurers to develop complex cost allocation models.

In the insurance industry, cost allocations are critical due to two trends. First, tightening margins and increased competition heighten the need to scrutinize expenses; second, insurers' highly intermediated distribution models and regulator requirements for granularity and transparency drive insurers to develop complex cost allocation models. Due to these factors, steering business margins in the insurance industry is more important than ever.

While insurance demand is on the positive side, margins are moving the other way. The property and casualty (P&C) sector faces high losses related to natural disasters and more expensive automobile claims. The life sector is struggling to enable consistently positive financial results due to low fixed-income yields over several years.

On the supply side, behavioral evolution and "insurtech" push for enhanced user experiences and the use of analytics. These impose a required level of investment for innovation, transformation, and technology.

The following factors push insurance cost allocation models toward high complexity:

- **Complex business model:** Insurers' business development relies on a mix of direct distribution and intermediation through brokers, partners, and reinsurers, each bringing different cost structures. For the business to obtain a full picture of profitability, distribution channel and reinsurance information need to be integrated into allocation models. These views add to standard cost hierarchies, including nature of the cost (acquisition vs.

renewal), geography, business unit, legal entity, and product. Additionally, insurers may allocate to activity, process, and service to enable profitability analysis.

- **Role of regulators:** The insurer's role in the overall financial system has consistently led insurance regulators to be among the most demanding. Moreover, insurance companies trading under different jurisdictions face multiple regulations, namely state, national (long-duration targeted improvements [LDTI]), regional (Solvency II), and global (International Financial Reporting Standards 17 [IFRS 17]). Requirements on expense reporting include the presentation of fully allocated expenses across numerous lines of business and accounting destinations. The portion attributable to contracts and deferred acquisition costs also needs to be distinguished. All of these dimensions need to be provided with granularity and traceability that satisfies both regulators and auditors.
- **Reliance on high-technology spend:** Insurance companies need advanced technology to obtain insights on the high volume of business and actuarial data. This, combined with the volumes of data required by regulatory requirements, makes technology costs one of the major expenses affecting profitability. Insurance leaders overwhelmingly consider information technology as the greatest cost and expense management challenge—far outpacing the challenge of regulatory and accounting compliance.

These complexities lead to difficulty and a lack of transparency for reporting end users trying to understand the origins and drivers of costs.

In their efforts to standardize and ensure a fair representation of the impacts of insurance contracts, both IFRS 17 and LDTI to US GAAP translate into requiring additional details and transparency of expenses. This includes grouping and presenting insurance contracts with similar risks.

Additionally, new standards require companies to project future cash flows for the whole duration of contracts. An important component of cash flow and fulfilling contracts is attributing expenses; therefore, continuous energy must be dedicated to defining the right amount of attributable overhead costs and expense recharges to present the most advantageous projections on financials. Granularity, transparency, and "what if?" analysis capabilities will help organizations face these challenges.

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Distinctive business challenges for insurance subsectors

Each insurance subsector faces unique cost management and allocations challenges. Variances across insurance subsectors are mainly driven by corresponding product life cycles and transaction volumes.

P&C companies

P&C insurance market trends drive increased scrutiny on cost efficiency. As demand for insurance products increases, profitability may decrease due to increasing costs and losses. In the coming years, premiums are expected to rise due to population and commercial business growth (especially middle-market and large accounts). In turn, demand for property insurance (due to expected increases in natural disasters), automobile insurance, and specialty insurance will grow. However, loss levels are also expected to increase due to distracted driving and costly damage from natural disasters.

The focus on cost efficiency is even more critical when considering the need for P&C companies to invest in digitization to develop usage-based coverage models, as well as customer experience focused user interfaces.

Other P&C characteristics that make expense reporting complex include high volumes of transactions, shorter contract durations, and fewer specific workflows, such as subrogation. Part of P&C's cost-management objective is to highlight the relationship between marketing expenses and policy renewals and to illustrate the costs supporting efficient customer-centric policy acquisition and claims management processes. Additionally, for P&C commercial lines, expense and cost allocations can be challenging due to how they change year-over-year, given the nature of the business.

Life and annuities (L&A) companies

Despite a significant increase expected in sales of L&A products, the subsector is focused on profitability improvement due to low interest rates and the relatively high-level cost of intermediation (both on the production and the distribution end). Additionally, the need to invest in product simplification and streamlining the policyholder application process has made increased cost transparency extremely important.

L&A cost allocation models typically require detailed metrics on acquisition costs, financial management costs, and commissions. Management also evaluates metrics such as customer experience scores to prevent early terminations—a key aspect that erodes an L&A company's profitability levels.

Reinsurers

Reinsurers interact with the cost structures of their insurance markets, as well as manage their own costs internally. In addition, their business model relies on profitability assumptions often associated with strict cost-ratio targets, enhancing the need for efficient cost models.

A reinsurer's cost base can be affected by talent policies targeting top-tier actuarial skills in attractive locations, resulting in high salary and housing costs.

Information technology is also an important expense. Driven by high volumes of data found in treaties and contracts, reinsurers require customized computation and analytics to derive the required insight from their data.

Composite companies

Composite companies combining L&A, P&C, and/or reinsurance businesses must not only aggregate all their business specificities, but also design a universal cost model that can be applied to heterogeneous components.

Composite organizations typically come with more organizational complexity and a greater need for coordination from corporate functions, the use of shared services or centers of excellence, and operations across multiple countries and jurisdictions. These operating models not only lead to higher levels of indirect costs—for which a consensus on allocation drivers must be found across businesses—but also need to comply with multiple regulatory reporting requirements. As each business increases its consideration of the various required management-reporting dimensions, the potential complexity of the cost allocation model also significantly increases.

Allocations: Self-inflicted complexity

There is no transparency in the process—who is allocating to whom, and how, is a mystery for the various customers of the cost allocation.

In a finance team's efforts to develop business insights and comply with regulators, one common pitfall is to propose cost allocation models that are extremely complex and lack transparency. Most companies experience similar issues—the time to run allocations is long and the allocation preparation work requires a significant amount of time to coordinate because it involves reaching across the organization for rates and rules. There is no transparency in the process—who is allocating to whom, and how, is a mystery for various customers of cost allocations. Allocation solutions are the ultimate "black box" in most organizations. One of the key consequences of this is the business's lack of ownership over expenses, drastically reducing its ability to manage costs.

Several challenges are faced when trying to transform cost allocation models for insurance companies:

- **Lengthy execution time:** Time to run the allocation process is long and requires a significant amount of effort and coordination.
- **Lack of transparency and traceability:** Process is viewed as a "black box" with no drill-back capability from the allocated amount to the allocation driver. Allocation processes are based on unstructured data hierarchies and rules that only provide limited transparency.
- **Significant debate on the results:** Significant time is spent debating the output regarding accuracy of the allocated amount, allocation driver, and/or amount of the chargeback.
- **Lack of reporting and decision support:** Post-allocated reports are at a level higher than the business requires, limiting the ability to conduct analytics.
- **Complexity and lack of proper systems:** Existing systems are old, inefficient, and have data-volume limitations that significantly disrupt the allocation process.
- **Lack of focus on cost management:** Focus is more on making contra entries across the organization rather than an initiative to manage and reduce costs.
- **Lack of governance processes:** Lack of governance results in unstructured hierarchies and unstructured drivers for allocation of costs.

Examples of how allocation model complexity is related to organizational practices are as follows:

- **Unstructured hierarchies and data model:** In an attempt to simplify the process of allocations (in the short run), cost centers and products are represented as financial accounts in allocation technology solutions. While this may simplify the process of allocations, it complicates governance and maintenance in the long run. This makes governing hierarchies more difficult in the future, as members created strictly for the allocation process do not fit into the formal definition of the hierarchy.
- **Precision is confused with accuracy:** Emphasis is more on creating business rules to allocate dollars down to the last penny, with little emphasis on understanding the appropriate cost pools and cost drivers.
- **Heavy use of spreadsheets:** Spreadsheets are a powerful tool; however, when used for allocations, they create precisely the wrong results and lead to a lack of transparency. Most of the allocation rules are created dynamically on a month-to-month basis, which unfortunately produces a strong temptation to use spreadsheets to create cost pools, drivers, and resulting allocations.
- **Lack of ability to capture direct costs appropriately:** Most accounting and costing systems cannot capture and directly align costs to the necessary product, state, or distribution channel at time of booking. The inability to directly align costs means all costs must go through the allocation process. This adds an additional step to the allocation process, making it less efficient.

Solution perspective

Allocation framework

The allocation framework, including cost pools and drivers, must be developed holistically with organizational consensus and an appropriate governance model. When firms approach the allocation process, they should consider the following framework:

- **Philosophy:** The goals of the process must align with business objectives and corporate structure. Management and reduction of costs must be key objectives for the organization.
- **Methodology:** The cost methods, pools, and level of granularity utilized to drive the overall process. Consistency and governance must be more important than trying to achieve precision for cost allocations.
- **Drivers:** The various statistics and metrics used to push down expenses to various parts of the business must be clearly defined and obtained in a streamlined manner.
- **Systems and tools:** The tools and technologies used to facilitate and operationalize the allocation process must be scalable and efficient.
- **Reporting:** The ongoing reports to detail on costs and create allocation transparency across the organization. The reports and the output of the framework must facilitate decision support for better decision making versus purely reporting on the allocation of costs.
- **Roles and responsibilities:** The ownership of various elements within the process, including governance, model management, and interactions between corporate and business units. Roles and responsibilities should be clearly defined, documented, and understood by all participants in the process.

Allocation leading practices

Leading allocation practices aim to link allocated costs to business drivers that are controllable and therefore actionable by the business.

- **Design with the end in mind:** Before redesigning the allocation methodology, it is crucial to understand the level of profit and loss (P&L) and expense reporting that a company's decision makers need. It should enable them to make actionable decisions in a timely manner. Additionally, recent technology advancements have made it possible to convert data into actionable insights in unprecedented ways, and this must be considered while designing the target solution.
- **Lay the foundation:** As a first step in overhauling the process, companies must start with the foundation—the hierarchies, structures, and code block elements that make up the process. They must evaluate where costs are booked and where they are allocated and develop a complete definition that should describe every member in the hierarchy. One of the key elements of this exercise is the rationalization of the cost center hierarchy to ensure that unnecessary elements (such as temporary cost centers that are not required anymore) do not burden the future-state process. Also, this is the step where organizations should ensure that all direct costs are being captured outside the cost pools for direct attribution of costs to products, markets, and customers.

- **Involve cost center owners and stakeholders early and often.** The allocation process includes stakeholders from across the organization, such as cost center owners, product owners, lines of business executives, and actuaries involved in deferred acquisition costs (DAC), and pricing. While the guiding principles and methodology design can be centrally developed, the project will not succeed if stakeholders from across the organization are not involved in the process from day one.
- **Just because you can do it, does not mean you should.** Throughout the design process, the stakeholders will inevitably ask if they can create a complicated methodology in the new solution. While new technology can handle more complex rules than what is enabled in organizations in the current state, that does not mean that organizations should do so. The project team must stop and ask, "Will the new method be any more accurate?"
- **Data visualization tools help make the process more transparent.** Even the best redesigned allocation processes produce a significant amount of data. When reporting processes are evaluated, organizations should investigate data visualization tools such as Tableau or Qlik to help them understand their post-allocated results by turning raw data into actionable insights. Building a visual allocation trace map that allows users to step through the allocation process, from the result to the initial driver of the expense, is a powerful value proposition for understanding post-allocation results.
- **Run as many simulations as possible, understand where the breakage is, and communicate accordingly.** Redefining the allocation methodology will likely result in post-allocated amount differences from the allocation results in the current state. Organizations should expect and plan for this. Going live with a new process for the plan instead of the actuals helps in accounting for the breakage. Additionally, conducting simulations of the new allocation method on a historically pre-allocated data set, then comparing results between old and new post-allocated data, will be extremely important for reporting purposes. Those results should also be shared with stakeholders across the organization so they are aware and understand where breakage will exist in the new process.
- **Governance, governance, governance.** When designing a new allocation solution, companies should account for the method that they will use to maintain the process and solution. Companies that do not design governance processes run the risk of reverting back to old processes. Defining a process by which allocation rules and rates are updated and cost centers and expense accounts are added should be a key output of the project. The governance process should be viewed as a companywide effort—not one that is owned by corporate only.
- **Transparency is not the desired end state.** While transparency into the allocation process will realize specific wins, it should not be the desired end state. Rather, transparency should be viewed as a mechanism to achieve more effective conversations between the "buyers" and "suppliers" in the organization.
- **Trying to build and launch a new allocation solution for the entire organization all at once is not always the right answer.** An effective approach may be to choose a specific business issue, preferably one that will yield significant value once addressed. Next, use the prototype as a pilot to receive buy-in from key stakeholders for a broader rollout.

Technology options

Performing cost allocations in the insurance sector and financial solutions support basic allocation features. However only some solutions are purpose-built for allocations and enable the design of advanced models with a high level of flexibility, traceability, and performance for the required volumes, complexity, and level of details observed in the insurance sector. Figure 2 notes the most commonly considered solutions to support cost allocation models.

Figure 2.

Product	High-level description
Anaplan for Finance	Anaplan is a platform powered by proprietary HyperBlock technology. The cloud-based solution provides a customizable modeling engine to support a variety of modeling needs, including purpose-built applications for activity-based costing, expense allocations, etc.
Profitability and Cost Management Cloud Service (PCMCS)	Oracle PCMCS is a performance management application that is part of Oracle's enterprise performance management system and helps to manage the cost and revenue allocation necessary to compute profitability by business parameters such as product, customer, and region.
SAP Profitability and Performance Management	SAP Profitability and Performance Management (PaPM) is an SAP HANA-based solution to develop and execute complex allocation models to support enhanced costing and profitability analysis. The tool also supports the models for intercompany price-setting, driver-based planning, risk, capital and solvency calculations, etc.
SAS Cost and Profitability Management	SAS Cost and Profitability Management is an analytic application that determines cost and profitability by modeling business processes as cost flows among accounts. With this solution, organizations can make informed decisions that streamline processes, deliver revenue growth, and reduce costs across the organization.

Key takeaways

The complexity in expense allocations for the insurance industry is expected to increase, given the importance of indirect costs, the diversity of insurance products, the high level of intermediation in the distribution process, and the regulatory push for granularity and transparency.

These imposed constraints enhance the need for a "design-thought" approach, ensuring that allocation models deliver visual and transparent insights to their customers with standardized, structured, and technology-enabled processes and data management.

The time to get started is today!

Having timely, relevant, and actionable information about cost and profitability is a cornerstone for more effective decision-making. Insurance companies should take a fresh look at their allocations processes and systems through a dedicated assessment project and evaluate if updated capabilities and practices would be right for them. In today's insurance industry, managing allocations effectively and efficiently is no longer simply a "nice-to-have" capability—it's essential for survival.

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