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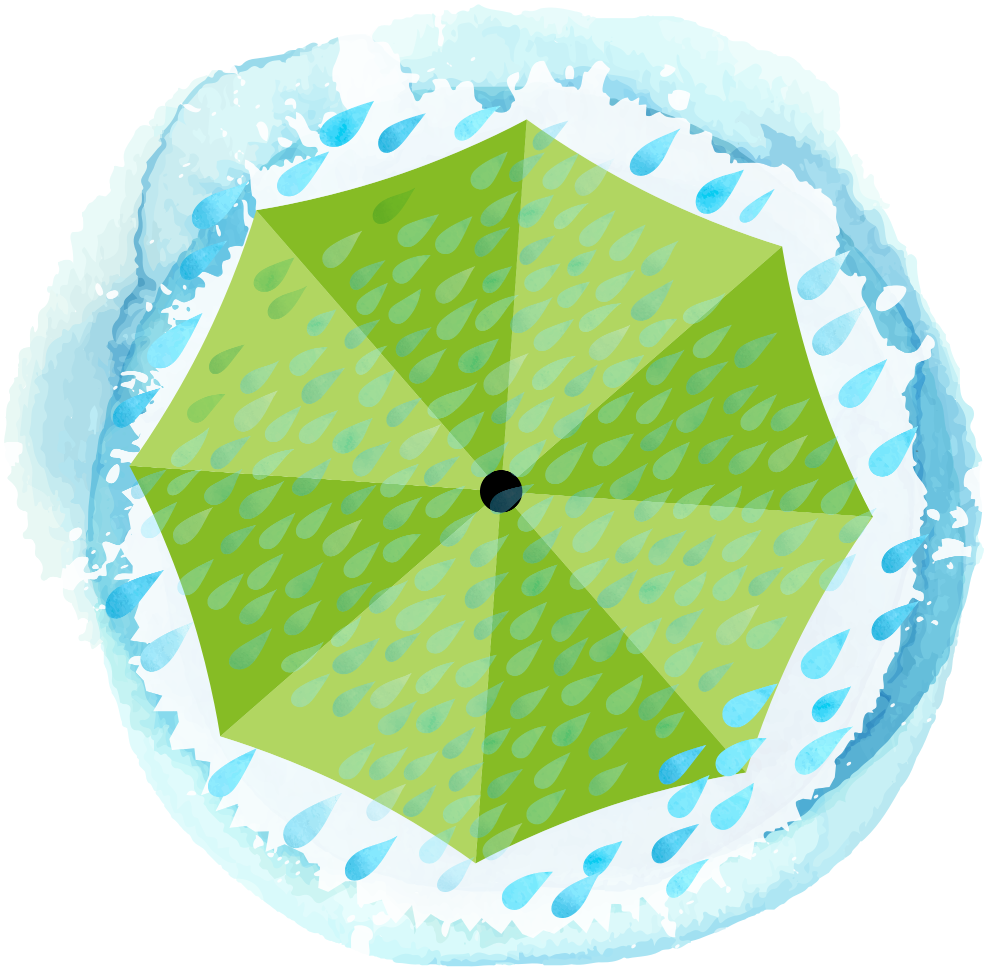

Providing shelter from the storm
How should insurers respond in inflationary times?

Introduction

Ireland like most western economies is facing into the third year of a macro-economic storm. The inflation rate may be falling from eye-watering highs but is still projected to remain higher than the European Central Bank (ECB) 2% target in 2023 and 2024[1]. The spectre of further increasing interest rates and the potential for recession within the EU compound the challenge. The net effect is a once in a generation cost of living crisis for consumers, many of whom, particularly those on lower incomes, are caught between higher prices and higher loan repayments. In this paper, we pose the question: How should insurers respond? How should they consider their response to the crisis within the role they want to play in society, their purpose, and what are the considerations on customers, employees, partners, and other stakeholders.

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What does this report do for you?

01

We begin by summarising the **underlying drivers of inflation** in Ireland and the European Union (EU) and lay out some of the possible scenarios as to **how this might play out over the next 2 years.**

02

We outline the key **considerations for tackling this challenge** from the perspective of critical stakeholder groups namely: **customers, regulators, and insurers.**

03

We highlight the responsibility and contribution that each of the **executive members** can make towards what should be viewed as a shared challenge and not solely an issue for the Chief Financial Officer (CFO) in terms of managing expenses.

04

Finally, based on our experience and market research we explain why cost transformation programmes typically fail to fully achieve their targets and **share the key criteria to increase the likelihood of a successful and sustainable business outcome.**

The CEO must ensure that the inflationary response is consistent with the Insurers 'purpose' and takes into account the needs of all stakeholder groups, balancing tactical and strategic actions in a coherent and sustainable enterprise response.

John Kilbride
Director, Consulting

What is driving inflation?

Inflation in Ireland began to accelerate in 2021 as pandemic-related shocks pushed prices higher. Throughout that year, COVID-19 continued in waves across the world, disrupting supply chains and creating labour shortages. As a result, the cost of imported goods and shipping surged worldwide. While supply was constrained, demand picked up as excess savings were quickly spent after lockdown restrictions eased, and vaccines became widely available.

In early 2022, as much of the world was still grappling with these COVID-19-related inflation shocks, Russia launched a full-scale invasion of Ukraine. The invasion threatened the supply of numerous critical materials such as oil, natural gas, fertiliser, and grain, sending food and energy prices soaring. For example, by May 2022, home heating fuel prices in Ireland had jumped more than 100% from a year earlier[2]. Given the substantial rise in the prices of critical materials, inflation spread to other goods and services. Even after excluding energy and unprocessed food, Irish prices were up 5.8% year over year in July, the highest level in more than 20 years[2].

Inflation barely eased in the second half of 2022. Irish prices excluding energy and unprocessed food, were still running at a lofty 5.5% come November. Energy inflation may have eased since summer, but it is still running 43.1% year over year. Meanwhile food and housing costs have continued to accelerate[2].

Where inflation goes from here will depend on several variables, including central bank policy, exchange rates, inflation expectations, wage growth, and energy supplies. The effect these factors will have on each economy will vary depending on broader economic circumstances.

> Monitoring these variables will allow business leaders to better anticipate the inflationary environment moving forward and make changes faster than competitors.
>
> **Michael Wolf, Global Economist, Deloitte Global**

How might this play out?

Soft landing: The adverse effects of the energy and food price shock abate relatively quickly, which reduces headline inflation across the euro zone. As a result, the ECB takes a more measured approach to monetary policy and can reduce rates sooner than currently anticipated. With headline inflation easing, inflation expectations come down as well, resulting in workers demanding smaller wage hikes. Other major central banks take a more dovish stance, raising the value of the euro and weakening import price inflation.

Recession with elevated rates: Rapidly rising prices for consumer staples weakens demand elsewhere in the economy. At the same time, the ECB continues to raise rates in an effort to keep inflation expectations contained. The combination of events pushes Ireland into recession. Unlike previous recessions, the ECB maintains elevated interest rates as the ongoing effects of the energy shock keep inflation running above the ECB's 2% target. Recession throughout Europe ultimately brings inflation back toward 2% as unemployment rises and demand for goods and services falls in line with limited supplies. As inflation moves toward 2%, the ECB begins to lower rates again to provide more support to the economy[2].

Stagflation: Despite inflation running well above target, the ECB pauses its rate hikes to prevent a more severe recession throughout the euro zone. Such inaction causes the ECB to lose credibility and inflation expectations to become unanchored. Some hoarding behaviour occurs, and workers increasingly demand to be compensated for rises in the cost of living. Relatively low interest rates weaken the euro further, increasing import prices. To make matters worse, fuel price inflation picks up again as OPEC+ makes additional production cuts and European countries rush to refill depleted gas stocks. Higher inflation causes real economic activity to fall in Ireland as well as in much of the euro zone. The ECB belatedly takes a more hawkish stance as inflation continues to accelerate. Rates rise much higher than the ECB had previously planned, which causes a more severe recession to force a correction in price growth.

What are the key considerations for each of the key stakeholder groups?

Consumers: The *talking point* du jour for all consumers, particularly hard on those on lower incomes. Purchasing power is being reduced as inflation rises faster than wages, (and erodes COVID-19 era personal savings), coupled with the expectation that loan repayments will continue to rise in 2023[3, 4]. Consumers and small businesses will be forced to make tough decisions resulting in lapsed policies, under insurance, vulnerability[5,6]. Customers will be looking for insurers who don't exploit the situation and who can simplify and expedite the claims process to minimise the time out of pocket. Depending on how deep and prolonged the crisis is Insurers might also expect to see an increase in claims fraud.

Insurers: The temptation is to define this challenge in narrow terms, look to the CFO and hope that the favourable interest rates will offset the need for deep cuts to the expense base. Instead, insurers need to consider their response to the crisis in the context of the role they want to play in society, their purpose, and that includes the impact on customers, employees, supply-chain partners, and other stakeholders. Key choices include their willingness to transfer rising third-party and staff costs to consumers in the form of premium increases (with the risk of the perception of price gouging), product changes, and support put in place for vulnerable customers (and staff). There's also a question of whether the advice provided to customers should change as a result of the current environment. Of course, uncoupling cost-income ratios is always sensible, and insurers should activate a coherent strategy to address the different drivers of inflation including claims indemnity, broader 3rd party expenses, staff costs and interest rates across timeframes that address short-term revenue erosion as well as longer term value impacts.

Regulators: Similar to the approach adopted during the COVID-19 pandemic, regulators will look at the actions taken by insurers in terms of addressing customer hardship and affordability challenges. It's an interesting one for regulators as they also must 'tow the party line' in terms of inflation expectations to align with the ECB[7].

How should Insurers position themselves to respond?

Regulators will expect safeguarding customer outcomes to be at the heart of insurers response to inflation.

Stuart Redmond
Director, Actuarial, Rewards and Analytics

At Deloitte we believe that each member of the executive leadership team has a specific role to play, however, what is essential is that this is a co-ordinated approach, that appeals to consumers, colleagues, and the market[8].

Chief Executive Officer

Setting the strategy

The role of the CEO here is to set the direction and tone and to ensure that this topic is given airtime at the top of the executive agenda. The CEO must ensure that the inflationary response is consistent with the Insurers 'purpose' and takes into account the needs of all stakeholder groups, balancing tactical and strategic actions in a coherent and sustainable enterprise response[8].

Chief Underwriting Officer

Managing customer needs

The CUO needs to ensure premium rates keep pace with insurance costs. The uncertainty around the future levels and duration of claims inflation means that the CUO needs to monitor granular, and perhaps new Key Performance Indicators (KPI's), such as inflation indices, to react quickly to developing inflationary trends. In addition to ensuring premium rates maintain pace with inflation there is a more strategic role to play through safeguarding protection levels and offering consumers products that help reduce cost-of-living expenses:

- Consumers often cut costs and save money by cancelling non-mandatory insurance or reducing coverage. CUOs can help avoid poor customer outcomes in the event of an under insured claim by putting in place processes to proactively review coverage with customers to ensure adequate coverage is provided[4, 9].
- Insurers that offer innovative self-controlled, adjustable, connected, preventative product features can gain an advantage over their competitors[10].

Chief Financial Officer

Managing expense efficiency

The CFO needs to balance short-term cost reduction with more durable 'save to grow' strategies which are more likely to land with leaders and staff alike[11]. Critical strategies include:

- Assessing upside potential for investments, balance sheet efficiency and exploiting interest rate rises to offset erosion in premium income.
- Position procurement as a Centre of Excellence to the business that promotes long-term value creation through strategic sourcing and not as an administrative centre. Ensure executive accountability for enterprise cost category management (e.g., Human Resources, Technology & Data, Legal, Consulting), controls and cost reduction tactics such as demand reduction, preferred supplier lists and supplier aggregation.
- When mobilising cost reduction initiatives to balance tactical cost reduction plays (spending controls, recruitment freezes) with more sustainable save to grow initiatives (digitalisation and simplification) that target both revenue generating and internal support functions alike[11].

Chief Claims Officer

Managing Claims Costs

Non-life claim costs are massively impacted by both inflation on a time and materials basis and the post COVID-19 supply-chain crunch. Factors driving claim cost inflation will differ across lines of business and while the ultimate impact remains uncertain, injury inflation may be somewhat mitigated by the 2021 adoption of the Personal Injury Guidelines[12]. CCOs can respond to inflation challenges by focusing on the customer experience and adopting a fusion of digital, analytics and traditional operational excellence techniques in strive to[11,13]:

- Eliminate, simplify, digitise & automate the end-to-end claims customer journey and experience
- Generate process efficiencies, unlock capacity, and reduce internal and external spend
- Optimise supply-chains for speed and resilience and leverage 3rd party pricing re-negotiation[14].

Chief Human Resources Officer

Managing wage Inflation

CHRO's need to consider how to differentiate the employee proposition and support employees through the cost-of-living crisis. Wage inflation in Ireland is running lower than core inflation for now but the threat of a wage spiral remains[15]. Insurers can support their workforce by:

- Sponsoring initiatives that encourage staff retention[8] and ensuring stringent controls over hiring policies are actively enforced.
- Taking a front and centre role in the design and decision making on emotive topics that may be of high impact to staff and unions/workers councils and carry brand/ public relations risk e.g., sourcing, location, and process automation[8].
- Strengthening workforce resilience by recruiting from alternative talent pools, promoting cross training, and designing novel hybrid working practices that appeal to colleagues and management alike.

Chief Operating Officer

Managing supply-chain resilience

COO's need to have a laser focus on the P&L contribution from operations and seek to unlock value from cross functional initiatives through:

- Systemic approach to eliminate, simplify, digitise, and automate end to end value chains that balances customer needs, resilience, and cost efficiency[8, 11].
- Improved transparency over the operational resilience and need to optimise end to end supply chains especially Business/IT Process outsourcing (BPO/ITO) and 3rd party relationships.

Chief Transformation Officer

Maximising the ROI on precious discretionary spend

Over the next few years, we can expect a reduction in discretionary budgets. Irish insurers who are owned by European or United States parents may find that these budgets are even further out of local control. CTO and CIOs need to work on change effectiveness to maximise return on investment from non-mandatory change budgets, working closely with finance to ensure equal transparency is in place over both budgets and benefits realisation. Our experience is that the latter is often neglected in the focus on projects, implementation budgets and deliverables.

Lessons learnt on making cost transformation both successful and sustainable

We have made the case for a rounded and balanced approach to managing inflation, however it would be naive to suggest that managing expenses is not going to be a critical part of the strategy. Just prior to the COVID-19, Deloitte commissioned a survey of over 1200 executives with responsibility for cost transformation[16]. Over 256 respondents were representing firms in the financial services industry. The results are consistent with previous surveys and are common across geographies and industry sectors. The evidence is that Cost Out initiatives whilst essential, are often set up to fail. For example, 72% of respondents said that cost to save was the primary driver of cost transformation initiatives, bearing in mind that this reflects the growth mindset prevalent at the time. Furthermore, the level of ambition was impressive with 31% of firms aiming for material cost transformation targets, measured at savings >20% of the cost base, however a stunning 81% reported that they failed to fully meet their targets[16]. The reasons cited are all too familiar and included implementation challenges, unrealistic expectations set top-down with no engagement and buy-in from local senior management, ERP, and data limitations.

The bottom line is that industry leaders, including insurers, need to re-think how we design and execute on cost transformation if we want to achieve strategic and sustainable targets.

This survey data is backed up by our experiential insight. Across our cost transformation client engagements, at some stage in the strategy and business case phase, we are struck by an almost universal truth; whilst most executive leadership teams know what to do, where they struggle is how to do it. From this experience we have outlined below some of the critical lessons learnt and design principles that will set up a cost transformation programme for success.

Principle	Away from....	...and towards...
Sponsorship	Cost transformation viewed as the exclusive remit of the CFO/ Finance	Cross c-suite active collaborative sponsorship grounded and anchored by the firm's purpose and environmental, social and governance commitments
Leadership	Side of desk mentality to the allocation of transformation leaders and subject matter experts	Extract and assign top-talent from line responsibilities to lead the change from day 1
Ambition	Overly aggressive, ungrounded targets, imposed onto the business from top-down	Cross executive consensus on appropriate level of ambition that is challenging but realistic
Approach	Predictable but demoralising 'we need to cut costs' narrative based solely on tactical measures (spend controls, hiring freeze, investments put on hold)	Capability led approach that aims to build and embed capability to ensure the change and benefits are material and sustainable
Investment decision criteria	Blind trust in multi-year payback models	Investments prioritised on self-funding principles, where early wins are used to generate confidence to release additional tranches of funding
Measures of success	Focus on short-term project delivery and outputs 'on time, on budget'	Priority given to longer-term business outcomes. Laser focus on tracking and attribution of benefits across the lifecycle.

Conclusions

Insurers, like their consumers, face tough choices in 2023. Persistent inflation and an uncertain economic outlook will force strategic choices over where to play and how to win. To survive and thrive in this economic cycle we recommend that insurance leaders frame their response to the crisis in rounded terms that consider the impact on consumer, expenses, and ecosystem partners equally. Favourable interest rates may soften the impact on profitability nevertheless Insurers should look at tactical and strategic initiatives to reduce management expense and create capacity for future growth. In planning these initiatives insurers should pause and consider if they have the right success criteria in place to ensure that they maximise the return on previous discretionary investment capital.

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We hope our Insurance Inflation paper is of benefit to you as we enter this year ahead. To view our full range of services, or if you have any queries, meet the full insurance team.

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