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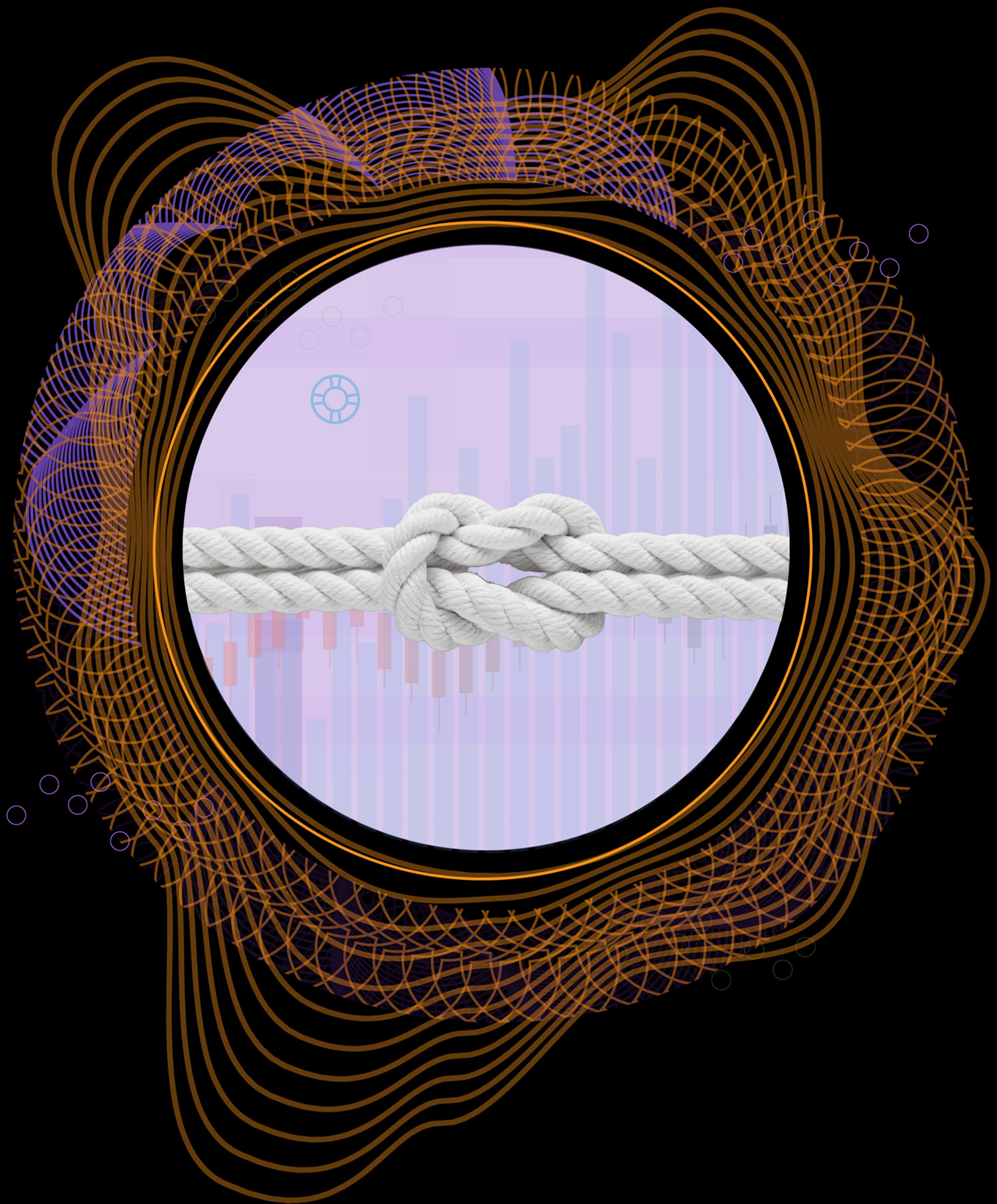

Managing allocations effectively in the insurance sector

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Executive summary

In the face of evolving macroeconomic conditions and stringent regulatory demands, CFOs in the insurance sector are tasked with the critical role of managing expenses amid organizational changes. Whether the goal is to reduce costs or to support growth, CFOs must navigate the complexities of expense allocations, facilitating transparency and the capability to conduct complex scenario analyses. The current landscape, marked by expense pressures and shifting market dynamics, places transformation at the forefront of strategic priorities, particularly in the realms of compliance and profitability management.

To effectively manage expenses within the insurance sector, CFOs should first illuminate the intricacies of cost allocations, bringing clarity to the underlying drivers of expenses. This foundational transparency sets the stage for accurate forecasting, enabling CFOs to anticipate and navigate financial challenges proactively. With a clear view of the present and future financial landscape, they can then pinpoint and capitalize on opportunities for strategic expense management, ensuring the organization's growth and adaptability in a dynamic market.

This paper outlines the challenges and leading practices for expense allocations within the insurance industry, emphasizing the need for CFOs to address issues such as intricate allocation processes, lack of transparency, and the necessity for robust IT infrastructure and talent. As insurers strive to explain cost changes, support expansion, and explore opportunities through mergers and acquisitions, the ability to manage allocations effectively becomes increasingly vital.

CFOs are increasingly asked to better manage expenses by capturing expense reduction opportunities and scaling efficiently as the organization grows

Challenges for the insurance industry

Insurers develop complex cost allocation models because of highly intermediated distribution models, as well as high regulatory granularity and transparency.

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 regulatory requirements for granularity and transparency drive insurers to develop complex cost allocation models. Due to these factors, managing 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 versus 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 [LDTIs] Pillars One and Two, 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 these dimensions need to be provided with granularity and traceability that satisfies both regulators and auditors.

These complexities can 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 with. 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. A key component of cash flow and fulfilling contracts is attributing expenses; therefore, continuous energy should be dedicated to defining the right amount of attributable overhead costs and expense recharges to present the most advantageous projections on financials. There is also a need to maintain and update extensive data sets and to upgrade existing actuarial and financial systems to reflect current assumptions and discount rates for LDTI regulatory requirements.

Regulators are keeping a keen eye on the rapid use of technology such as generative artificial intelligence (GenAI). The European Union has taken a lead in paving the way for regulators around the world for a global regulatory framework for technology use and development. However, insurers' responsibility lies in ensuring that its use and development should be driven not only by a profitability lens, but also with an emphasis on ethics and trust, governed by corporate values.

Granularity, transparency, and scenario analysis ("what if?") capabilities will help organizations face these challenges.

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.

With the increasing focus on a customer-centric model, there is a mounting need for more relevant and holistic product offerings and ease of doing business. Insurers offer customized and innovative insurance products tailored to emerging risks and customer needs, which helps in increasing customer retention rate and generating new revenue streams for the insurers. Insurance companies need advanced technologies for this innovation and to remain market competitive, which affects profitability of insurers.

Advanced data analytics and AI can enhance risk assessment and fraud detection capabilities. By identifying and mitigating risks more effectively, insurers can reduce claim payouts and improve their loss ratios, which directly enhances profitability.

However, the integration of new technologies often requires adherence to regulatory standards and compliance measures that can add to the overall cost, which is concerning for insurers.

Insurance leaders overwhelmingly consider information technology as the greatest cost and expense management challenge—far outpacing the challenge of regulatory and accounting compliance.

Focus on combined ratio: Combined ratio is a measure of profitability used by insurance companies to measure the performance of their daily operations. The trends dictate that combined ratio has been deteriorating over the past few years with an increase in incurred losses and loss adjustment expenses bringing down the net income to almost one-third for the non-life insurance market. In this scenario, effective expense management is crucial for maintaining a favorable combined ratio. This involves controlling underwriting expenses, claims handling costs, and administrative expenses. The main reasons behind a deteriorating combined ratio are soaring prices of single-home residential construction materials by 33.9% since the start of the pandemic and contractor services that have increased 27%.[1] Meanwhile, the United States has seen larger number of catastrophes for the eighth consecutive year causing more than US$1 billion in losses, driving up property catastrophe reinsurance costs for primary non-life carriers by 30.1% in 2023.[2] These losses have created the hardest market in a generation for non-life insurance companies.

The major reasons for an increased combined ratio for other types of insurers are a surge in catastrophic events such as hurricanes, wildfires, floods, and earthquakes that can lead to higher claim payouts. Rising inflation and lower interest rates could put more pressure on underwriting profitability.

To curb this loss, insurers are taking additional steps to lower combined ratio by maintaining higher average of premiums per policy, a smaller number of policies in force, favorable prior years' reserve development, and lower claim frequencies.

Both IFRS 17 and LDTI (Pillars One and Two) translate into requiring additional details and transparency of expenses

1 Nicole Mahrt-Ganley, "US P&C insurers facing hardest market in a generation," American Property Casualty Insurance Association, March 27, 2023.

2 Ibid.

Distinctive business challenges for insurance subsectors

As the insurance industry encounters unprecedented expense pressures and complex market dynamics, the imperative for transformation in cost allocation processes has never been more critical. This document delves into the intricate challenges that insurers may face, highlighting the dual trends of tightening margins and increased competition, alongside the complexities introduced by highly intermediated distribution models and stringent regulatory requirements. This section underscores the necessity for insurers to adapt and evolve their cost management strategies to maintain profitability and compliance in a rapidly shifting landscape.

Property and casualty (P&C) companies

The P&C sector is grappling with the dual challenge of increasing demand for insurance products and rising costs and losses, particularly from natural disasters and automobile claims. The sector is expected to see a surge in premiums due to growth in the population and commercial businesses, leading to higher demand for property, automobile, and specialty insurance. However, this growth is accompanied by an increase in loss levels due to factors such as distracted driving and the expensive aftermath of natural disasters. Thus P&C companies should consider focusing on cost-efficiency and investing in digitization to develop usage-based coverage models and enhance customer experience through user-friendly interfaces.

The complexity of expense reporting in P&C is further compounded by high transaction volumes, shorter contract durations, and specific workflows like subrogation. The goal for P&C companies is to effectively manage marketing expenses in relation to policy renewals and to support customer-centric policy acquisition and claims management processes. For P&C commercial lines, the challenge is to manage expense and cost allocations that vary year over year due to the nature of the business.

Life and annuities (L&A) companies

L&A companies are facing a challenging environment characterized by low interest rates and high costs of intermediation. Despite an anticipated increase in product sales, these companies are focused on profitability improvement. The need to invest in product simplification and streamline the policyholder application process has made 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 L&A companies' profitability levels.

Reinsurers

Reinsurers must navigate the cost structures of their insurance markets while managing their internal costs. Their business model often relies on profitability assumptions associated with strict cost-ratio targets, necessitating efficient cost models. A reinsurer's cost base can be significantly affected by policies targeting top-tier actuarial talent in attractive locations, resulting in high salary and housing costs. Additionally, the high volumes of data found in treaties and contracts require customized computation and analytics to derive insights, making information technology a significant expense.

Composite companies

Composite companies, which combine L&A, P&C, and/or reinsurance businesses, face the intricate task of aggregating diverse business specifics into a universal cost model. These companies typically have more organizational complexity and a greater need for coordination across corporate functions, shared services, and operations in multiple countries and jurisdictions. This can lead to higher levels of indirect costs and necessitates a consensus on allocation drivers, while also complying 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. Transparency and clarity of ownership are critical for effectively managing expenses, and both are drastically reduced by complex allocations. Added complexity also drives longer process cycles and the allocation preparation work (e.g., reaching across the organization for rates and rules) requires a significant amount of effort to coordinate. The result is allocations being the ultimate "black box" in most organizations. There is no transparency in the process—who is allocating to whom, and how, is a mystery for various customers of cost allocations.

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

Lack of a transparent cost allocation framework

- **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.
- **Nonlinear chargebacks:** When functional areas execute reciprocal chargebacks (i.e., corporate functions charge one another for their services before allocating to a business unit), receiving areas struggle to identify the true driver to indirect expense variances due to the cyclical nature of expenses moving throughout the organization.
- **Complexity and lack of proper systems:** Existing systems are old, inefficient, and have data-volume limitations that significantly disrupt the allocation process.
- **Inconsistent or nonstandard methodologies:** In the absence of clear guiding principles, like-expenses within various areas are allocated inconsistently under different drivers. This results in further confusion for the expense receiver to understand how their actions impact their indirect charges.

Inaccurate financial forecasting

- **Lack of reporting and decision support:** Post-allocated reports are at a level higher than the business requires, limiting the ability to conduct analytics.
- **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 governance processes:** Lack of governance results in unstructured hierarchies and unstructured drivers for allocation of costs.

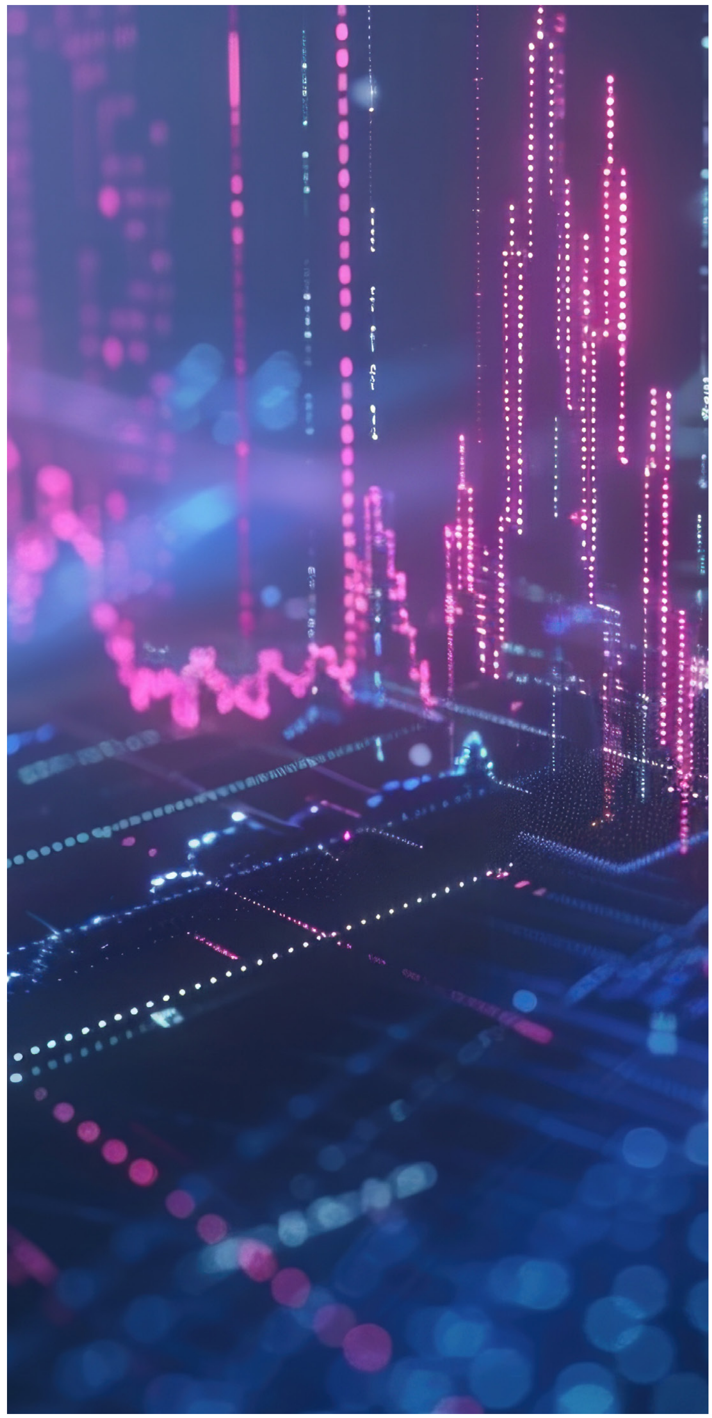
Inefficient expense management

- **Lack of expense ownership structure:** Cost center hierarchies are not defined with ownership in mind, resulting in multiple cost center owners to a single center. Expense accountability is limited in the absence of clear one-to-one mapping of expense results and ownership.
- **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.

The following are examples of how allocation model complexity is related to organizational practices.

- **Unstructured hierarchies and data model:** 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 can create 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 can unfortunately produce a strong temptation to use spreadsheets to create cost pools, drivers, and resulting allocations. The execution of allocation calculations within spreadsheets creates analytical challenges where users' ability to drill back is limited by the components built into a static offline document. This typically leads to driver and variance detail being provided by respective functions through review series rather than an avenue for end users to self-service.
- **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 designed with an expense management mindset. An expense management mindset prioritizes efficient distribution of expenses across departments, units, or projects within an organization to improve transparency into expense drivers, and provides the business with tools to understand, plan, and influence expenses throughout the year. When firms approach the allocation process, they should consider the following framework:

- **Philosophy:** The goal of the allocation framework should be to ensure transparency, fairness, and alignment with strategic objectives. In addition, management and optimization of costs should be key objectives for the organization.
- **Methodology:** The cost methods, pools, and level of granularity utilized to drive the overall process should be designed considering organizational goals, fairness, and efficiency. Emphasis needs to be placed on delivering timely expense reports backed by a well-understood chargeback and allocations methodology. Consistency and governance should be more important than trying to achieve precision for cost allocations.
- **Drivers:** The various measurable statistics and metrics used to push down expenses to various parts of the business should be clearly defined and reflect actual usage or the factors most strongly associated with expense generation.
- **Systems and tools:** The tools and technologies used to facilitate and operationalize the allocation process should be scalable and efficient. They need to automate the collection, classification, and allocation of expenses along with data analytics capabilities to provide on-demand clarity to the business.

Additionally, these tools and technologies must enable the business to conduct expense management. Responsibilities should be clearly defined, documented, and understood by all participants in the process. A successful framework will also assign feedback responsibilities to process stakeholders to enable continuous improvement across technology, methodology, and reporting and insights.

Allocation leading practices

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

Process

- **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. Simultaneously, it is critical to establish controls and compliance required to adhere to accounting standards and regulatory requirements. Additionally, recent technology advancements have made it possible to convert data into actionable insights in unprecedented ways, and this should be considered while designing the target solution.
- **Lay the foundation.** As a first step in overhauling the process, companies should start with the foundation—the hierarchies, structures, and code block elements that make up the process. They should 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 help 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. Lastly, it is essential to have a foundation that is not only effective today but also scalable and adaptable for future needs.

People

- **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 don't design governance processes may 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.
- **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, finance 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 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 should stop and ask, "Will the new method be any more accurate?" and "Will we be able to monitor performance and efficiency improvements?"

Technology

- **Reporting.** The reports and the output of the framework can enable easy understanding of how costs are allocated to help ensure stakeholders can assess the impact on their budgets and use the information to drive better decision-making. The emphasis needs to be on facilitating decision support for better decision-making versus purely reporting on the allocation of cost expenses.
- **Roles and responsibilities.** The ownership of various elements within the process, including governance, model management, and interactions between corporate and business units should be clearly established.
- **Data visualization tools help make the process more transparent.**Even the best redesigned allocation processes can 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.
- **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.
- **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.

Technology options

Performing cost allocations in the insurance sector requires more than just basic allocation features offered by general financial solutions. Only a few specialized solutions are designed specifically for cost allocations, enabling the creation of advanced models that provide high flexibility, traceability, and performance. These models are capable of handling the large volumes, complexity, and detailed requirements typical in the insurance industry.

The figure below highlights the most commonly considered solutions that support sophisticated cost allocation models in this sector, each offering unique strengths tailored to different business requirements.

Product category	Product	High-level description
Specialized allocation solutions	**Oracle Enterprise Profitability and Cost Management (EPCM)**	Oracle EPCM is a comprehensive solution designed to help organizations understand and manage their cost and profitability. It enables detailed cost and revenue allocations, profitability analysis, and scenario modeling across various dimensions such as products, customers, and regions.
	SAP Profitability and Performance Management (PaPM)	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, and more.
Standard finance platforms supporting allocations	**Anaplan**	Anaplan is a cloud-based planning software 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. In addition to employing the standard Anaplan product, Deloitte provides the ***iCost Allocation Engine***, a proprietary allocation solution developed on the Anaplan platform. This solution leverages industry-leading practices and frameworks to enable flexibility, scalability, and transparency in the expense allocation process and significantly accelerates the time to value.
	Workday Adaptive Planning	Workday Adaptive Planning is a cloud-based solution for budgeting, forecasting, and financial planning. It is powered by a robust in-memory modeling engine and offers real-time data, advanced analytics, and flexible modeling, enabling organizations to make informed decisions. Workday also offers packaged solutions or preconfigured accelerators providing allocation functionality to expedite time to value.

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 can enhance the need for a thoughtful approach, helping to ensure 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 is foundational.

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