BEST'S REVIEW
May 2007

3 Reasons To Replace Legacy Systems

Legacy replacement is achievable without massive enterprise risk.

by Marcus Ryu

Every insurance carrier aspires to grow and enhance profitability, but achieving those goals is getting steadily harder. Insurance executives today are trying to achieve growth in a softening, commoditized market while reducing costs, and dealing with an aging work force. Moreover, virtually all carriers are laboring under the constraints of a legacy technology environment.

No single decision will affect the long-term profitability and growth of a carrier as much as the timing and approach in migrating its core systems (underwriting, policy administration, billing, claims and policyholder management) to a new technology platform. Carriers that approach this decision strategically—recognizing the multiyear commitment and investments that are required—can achieve structural competitive advantage over their peers. Carriers that seek tactical fixes and quick paybacks may find their long-term survival in jeopardy.

For well over a decade, carriers have been asking for the next generation of core applications that will replace the mainframe and deliver the right combination of automation and human-decision support that insurance processes need. Yet innumerable examples of failed projects can attest to the degree that the software industry has underserved insurance. Many carriers understandably have reacted with defensive information-technology strategies that layer additional complexity on aging mainframe assets and impose extreme hurdles that need to be overcome before new projects will even be considered.

Key Points

- No single decision will affect the long-term profitability and growth of a carrier as much as the timing and approach in migrating its core systems to a new technology platform.
- Mature, modern, Web-based core systems truly can enhance insurer operations, and legacy replacement is achievable without massive enterprise risk.
- As prices drop and flexibility to make income from investments decreases, carriers are turning to increased operational efficiency as a competitive lever.

Mature, modern, Web-based core systems truly can enhance insurer operations, and legacy replacement is achievable without massive enterprise risk. Indeed, the far greater risk is borne by those carriers that do not see the need to develop a strategy for core system replacement.

Three Strategic Drivers

Let's consider how modern core systems directly support the pursuit of the three strategic goals:

1. GROWING MARKET SHARE. The property/casualty market remains soft due to increased commoditization, increased competition, falling prices and a reduction in customer loyalty.

Regardless of hard or soft market conditions, the leaders in gaining market share will be those carriers that can develop and adapt insurance products more rapidly and precisely than the incumbents. Thirty-eight percent of insurance company chief information officers interviewed by Celent rank the acceleration of product development and adaptation among their top three business needs. In its September 2004 *Rising Importance of Product Development* report, Gartner reported that 68 U.S.-based property/casualty insurers and 48 P/C insurers in Europe, the

Contributor Marcus Ryu is vice president of strategy and new products at Guidewire Software. He can be reached at mryu@guidewire.com.

Middle East and Africa assert that new product development and delivery is a universal concern. In other surveys, carriers estimated it takes 12 to 24 months (excluding regulatory approval) to get a new insurance product to market, with more than half the time taken up by system issues. Reducing that interval to two to four months will be the source of dramatic and sustainable competitive advantage for those carriers that can achieve it.

Another key driver of market share growth is ease of doing business. The delays, frustrations and busywork experienced by carriers' producers (and insureds) as they initiate business, make policy changes or seek information from the carrier all inhibit the capture and retention of premium. Ease of doing business is an important evaluator for independent agents, just as important as carrier rating and sometimes even more important than price. Carriers that are harder to deal with often find themselves having to compete or "buy" their way into the market by offering lower prices, higher commissions or higher risk products which may land them in the unenviable category of carrier-of-last-resort.

Last, but not least, maintaining high levels of customer satisfaction is vital to maintaining profitable retention and is a key differentiator when attempting to win new business. According to the recent 2006 National Auto Insurance Study from J.D. Power and Associates, "carriers achieving high levels of satisfaction retain 90% of their customers compared to those carriers with the lowest satisfaction levels who retain an average of only 78% of customers." Much of this satisfaction derives from the perception of efficient and responsive services. In the same report, J.D. Power & Associates writes that, "Satisfaction with claim handling drives 44% of the overall impression of their insurer for customers who filed a recent auto claim."

2. BRAIN DRAIN. While a carrier's most obvious asset is its policyholder base, its knowledge base is actually its most precious.

The Financial Impact of Replacing Legacy Systems

Replacing legacy systems is perhaps the key enabler for achieving sustainable improvement in financial performance. The following chart, published in 2005 by the Insurance Information Institute with data from McKinsey and Accenture, highlights a combination of improvements across the income statement of a property/casualty carrier. It is important to realize that incremental improvements in market share and operational efficiency in underwriting and claims management can drive dramatic improvements in operating income.

Aggregate US P&C Carrier Income Statement (2004)

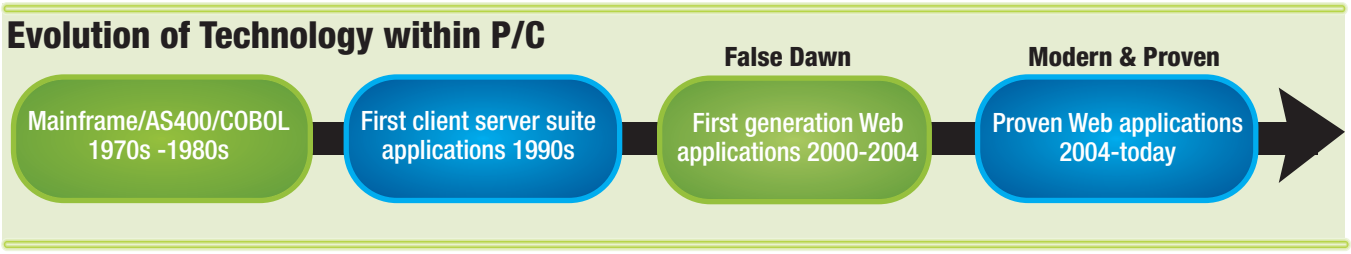
($ Per $100 of Premiums)

	Legacy IT	Modern IT	Change	Areas Supported by Technology
Net Premium	100.00	103.00	3.0%	Supported by factors such as ease of doing business and cross selling
Investment Income	9.60	9.90	3.1%	Supported by investment income boosted by top line growth
Expenses				
Underwriting Expenses	-22.60	-21.10	-6.6%	Underwriting expense reduced by better talent utilization and streamlined workflow and channel integration
Losses				
Claims	-52.70	-50.70	-3.8%	Claims reduced by better and faster service
Leakage	-7.00	-5.00	-28.6%	Leakage reduced by better coverage verification, fraud control, payment and recovery
LAE	-12.90	-11.90	-7.8%	LAE improved by better handling and evaluation
IT Expenses	-3.20	-2.50	-21.9%	IT expenses improved by lower maintenance and faster time to market
Operating Income	11.20	21.70	93.8%	

Source: Insurance Information Institute, 2005; McKinsey; Accenture

The often discussed brain drain of insurance talent to retirement and other industries has emerged as one of the most severe challenges to the P/C industry. As the baby boomer generation retires, so does the knowledge of experienced claims adjusters, underwriters, customer service personnel, managers and IT staff. A recent detailed study by Deloitte Consulting, *How Insurance Companies Can Beat The Talent Crisis*, said the need is especially critical in the underwriting and claims areas. The Deloitte study also observed 84% of chartered P/C underwriters and 70% of company adjusters are more than 40 years old, strongly suggesting that diminishing numbers of younger college graduates are pursuing insurance careers.

Because pay scales and job prestige in insurance have lagged behind other industries, it's vital to make core operational work more efficient and more rewarding. Activity-based costing analyses consistently show adjusters and underwriters spend between one third and one half of their time on noncore activities such as rekeying data, completing forms, rerouting work assignments and interacting with inefficient systems. The burden of these noncore activities has actually increased over the years, as system environments and regulatory requirements have become more complex. Automating these tasks is vital to both leveraging and motivating scarce human capital, which is turning over at rates of 10% to 15% for many carriers. Equally important is to transfer best practices from the habits and instincts of the most experienced personnel to the business rules of the system environment. Not only does



this drive greater consistency, it reduces dependency on a small number of top performers.

As both systems and expert IT handlers age, carriers confront a huge new enterprise risk: the loss of understanding how their own processing environments function. Because of the highly proprietary and customized nature of mainframe environments, only a handful of individuals in a company understand the deep intricacies of system logic. Many carriers are finding that requests for system enhancements must be routed through a dwindling number of experts, and every project must first excavate layers of insufficiently documented work. Carriers should therefore wean themselves off this dangerous dependency and migrate to a newer generation of standards-based, truly upgradable, vendor-supported solutions.

3. THE BOTTOM LINE. As prices drop and flexibility to make income from investments decreases, carriers are turning to increased operational efficiency as a competitive lever.

Reducing losses and loss adjustment expenses are key levers, given the potential savings achievable by streamlined claims management. Celent's *Technology Enabled Claims Performance Improvement* report estimated combined ratio improvement at between four and five points from the appropriate application of new claims technologies. In light of medical inflation, high litigation rates and the persistent challenge of fraud, achieving this improvement is a matter of necessity.

Many legacy systems were never intended to be applications. They started off as "point" financial transaction systems (such as reserve establishment or claim payment), essentially statistical programs intended to replace a single, multistep manual process. These systems evolved into poorly configured multitasking systems that were not thoughtfully designed with the entire business process—or the need to support adaptation—in mind. The systems, therefore, have become high-touch, multistep, paper-based and time-inefficient.

Well-designed modern systems, in contrast, leverage business rules to automate work where possible or segment and assign work when human involvement is required. For example, if a claim doesn't need an advanced adjuster for review, it could be processed in a straight-through manner with either no need or low need for human intervention.

Similarly, if a quote requires approval by a supervisor, a modern system could automatically escalate the request to the appropriate manager in the approval chain. The work would then be handled using exception-based techniques, and employees could focus on the most value-added tasks rather than shuffling paper. Managers could track performance and make informed decisions on fact-based metrics rather than gut feelings.

Time to Act is Now

The average age of a policy, claim and billing system is 24 years, according to a 2004 ACORD/LOMA study. Clearly the P/C industry has been slow to embrace new technology, while historically the software industry has been slow to build technology and systems able to handle the unique requirements of this industry. However, the past several years have witnessed the maturation of a host of new technologies relevant to the construction of highly flexible, upgradable, intuitive and maintainable core systems for insurance.

These developments include the emergence of the Java programming language as an enterprise software standard, the standardization of application servers to speed development, the maturation of XML (extensible markup language) as a rich standard for text-based configuration, and of course, the evolution of the Internet from an academic or consumer novelty to a vital infrastructure for mission-critical systems.

Insurance companies don't make physical products. They provide a service to insureds and differentiate on dimensions such as customer satisfaction, price, variety and flexibility of their products. As service organizations, the processes they use and the people they employ are vital. So too are the systems carriers use to support their core operations.

For decades the insurance industry has been asking for and in many cases building its own systems to run core processes such as claims management, policy administration and billing. Before the emergence of Web-enabled applications, many millions were spent and wasted on immature technologies or do-it-yourself projects that never saw the light of day. Now there is a new chapter in insurance technology where carriers are successfully deploying modern applications from trusted software companies.

In this light, carriers taking the cautious route of inaction actually expose themselves to the greatest risks: obsolescence and inability to compete in the market for premiums and talent. Core system replacement never will be easy or without significant investment of effort and capital. That realization only underscores the importance of starting serious strategic evaluations of options. BR