

# COST STRATEGIES POSSIBLE TO IMPLEMENT IN INSURANCE COMPANY<sup>1</sup>

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## Abstract

*The purpose of the present paper is to present various kinds of cost strategies implementable in the insurance company in changing market conditions. In order to attain the main goal such research methods as literature analysis, cause and effect analysis and deduction method have been used. The determinants of the latter-day insurance market having the greatest influence on the insurance company costs are: a new system of insurance supervision, functioning of financial groups, new type of insurance risks, new distribution channels, financial markets and new financial instruments and the rest (services of indemnity chancellery, changes to social awareness and client requirements, increased competitiveness resulting in paying more attention to service quality on the part of the insurer).*

*Cost management process in the insurance company can be designed in various ways in accordance with the chief objective the process is to serve. Here are three most common situations: cost management is subordinated to finance management, cost management is correlated with implementation of kaizen (continuous improvement process) based on activity management, cost management is part of value-based management process. The choice of a strategy enables a precise definition what is objective achievement index of cost management whether a defined cost level, profitability or some other parameter whose achievement should guarantee achievement of the aims set by the insurer.*

*In the case of insurance companies it is easy to distinguish basic cost strategies depending on: cost reduction/cost optimization, profitability, pricing policy, insurance risk, financial liquidity and capital cost minimization. Characterization of the aforementioned cost strategies is presented by way of indicating purposes their implementation is to serve. As a result instruments are obtained, which are used to achieve these goals. Issues to do with cost management have been very popular for years. However, the presence of these questions in business activity of insurance companies is caused by the specific way in which they operate.*

**Keywords:** *Insurance company, cost management, cost strategy*

*JEL codes: G22, M41*

## Introduction

Insurance companies belong to this group of financial institutions which offer their clients financial products. These institutions operate on a robustly developing market. Accordingly, all the operations regarding their management require constant modifications and adjustment to the current market needs. The purpose of the present paper is to present various kinds of cost strategies implementable in the insurance company in changing market conditions. In order to attain the main goal such research methods as literature analysis, cause and effect analysis and deduction method have been used.

The current insurance market is conditioned by various factors. They can be divided into two areas. The first one is concerned with the investment area in which the most important factors are: changes to financial markets, appearance of new financial instruments, rapid cash flow and relations with other business entities. All these factors are interdependent for the development of financial markets not only creates the possibility for investing in new

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instruments, but also contributes towards still more rapid cash flow and this in turn results in yet more complex network of capital relations between various business entities.

The other group of factors is connected with the social-economic area. To these factors belong: the creation of a uniform European insurance market, changes in European and world economy as well all social and demographic changes. The uniformity of the European insurance market results in the standardization of operating principles of various character. One of the most important changes is the appearance of new supervision systems over this market. In the initial phase, the process of implementation of these systems usually causes administration cost increase in the insurance company. Changes in the world economy also bring about the appearance of new legislative regulations, and – at the same time – contribute towards arising of new types of insurance risks, e.g. the risk connected with terrorist attacks. The last group of factors are social and demographic changes. They include first and foremost changes to demographic structure of a given society, changes to social awareness and new information technologies (fast information flow and new opportunities of canvassing and client service).

These changes result in the appearance of new types of insurance risks, which creates both a new opportunity and menace for insurers. For this reason the situation may contribute to the increase in acquisition costs because insurance companies have to incur additional expenses for preparing new products. The increase in acquisition costs can, however, be compensated for by growing sales revenues.

Apart from new products the insurers will be able to use new distribution channels, which will, no doubt, influence the cost structure, just as will the remaining factors. What comes into play is not the change in the cost structure as such, for the basic items of costs of the insurer will remain on the same level, but the change to the percentage share of specific items in the whole structure, as well as changes in the structure of specific cost items e.g. acquisition costs or administrative expenses, which will involve somewhat different factors.

On the basis of the aforementioned factors and the chances and risks accompanying them, it is possible to designate determinants of the latter-day insurance market having the greatest influence on the insurance company costs. And they are as follows:

- a new system of insurance supervision,
- functioning of financial groups,
- new type of insurance risks,
- new distribution channels,
- financial markets and new financial instruments,
- and the rest (services of indemnity chancellery, changes to social awareness and client requirements, increased competitiveness resulting in paying more attention to service quality on the part of the insurer).

The market determinants mentioned above decide about the choice of cost strategies and the way they are designed by insurance companies.

#### **The process of cost management in the insurance company.**

The relevant literature offers various definitions of cost management. The term signifies activities undertaken by managers in the form of constant scrutiny and systematic cost reduction with a view to client satisfaction (Horngren, Bhimani, Foster, Datar, 1999, p. 6). The name of the game in cost management is undertaking such activities that are to lead to reduction in incurred costs mainly through perfecting economic processes, especially by increasing efficacy of action and efficient use of the company's resources (Nowak, 2006, p. 15).

Another definition indicates that cost management consists in elaboration and implementation of an adequate management policy and code of practice as well as building of an information inflow system based on substantial costs (Jarugowa, Nowak, Szychta, 2000, p. 22). According to T. Wnuk (2002, p. 6) cost management is to help in cost optimization and raising the profitability of the company, both particular responsibility centers and the entire company.

At the present time, the world over there are three approaches to cost management: German, Anglo-American and Japanese (Zyznarska-Dworczyk, 2012, pp. 21–22). German and Anglo-American approaches do not differ significantly, whereas the Japanese approach, which was developed earlier concentrates on long-term efforts directed

toward consistent pursuance of target level results via common effort in which decision-makers at various levels participate.

The cost management process in the insurance company involves the following stages:

1. designation of common elements for the strategy adopted by the insurance company and cost areas,
2. division of strategic tasks into basic areas of activity of insurance companies,
3. choice and preparation of an adequate system or systems of cost accounting,
4. developing cost budgeting system,
5. preparing reports on cost accounting in line with previously adopted premises,
6. monitoring the procedures and activities,
7. scrutiny including a detailed cost variance analysis,
8. impact evaluation of the implemented cost management process.

Cost management process in the insurance company can be designed in various ways in accordance with the chief objective the process is to serve. Here are three most common situations:

1. cost management is subordinated to finance management,
2. cost management is correlated with implementation of kaizen (continuous improvement process) based on activity management,
3. cost management is part of value-based management process.

Separated areas connected with costs and including three aforementioned concepts are presented in Table 1.

**Table 1. Operational areas of insurance companies in relation to cost management approach**

Concept	Operational areas of insurance companies
Cost management is subordinated to finance management	<ul style="list-style-type: none"> <li>– insurance risk</li> <li>– reinsurance</li> <li>– investments</li> <li>– insurance technical reserves</li> <li>– cash flows</li> <li>– value creation</li> </ul>
Cost management is correlated with implementation of continuous improvement process based on activity management	<ul style="list-style-type: none"> <li>– product design and sale</li> <li>– loss adjustment</li> <li>– administration</li> <li>– investment management</li> </ul>
Cost management is part of value-based management process	<ul style="list-style-type: none"> <li>– products</li> <li>– distribution</li> <li>– tariff policy</li> <li>– underwriting</li> <li>– business system administration</li> <li>– loss adjustment system</li> <li>– investments</li> </ul>

Source: own elaboration.

The concepts presented here do not vary considerably for some of the issues are of a very similar nature. They are only different in approach and underlying assumptions. In cost management concept based on finance management indicated areas refer to typical notions, which are important for the financial economy of the insurer. In the case of the concept connected with implementation of continuous improvement process (kaizen) based on activity management, the assumption focuses on reduction of redundant operations and thus elimination of unnecessary expenses in order to achieve better results. The last approach based on value management is connected with value creation areas. These concepts, despite appearances, are not mutually exclusive. It is possible to implement value creation process in the insurance company and concentrate one's operations on continuous improvement on the assumption that cost management is part of finance management. However, it is also possible, for instance, not to implement value management nor use the continuous improvement process kaizen, but manage the costs as part of finance management.

#### **Cost strategies in the insurance company.**

If an insurance company makes a decision to implement a cost management strategy, it should work it out on the basis of one of the adopted cost strategies. The choice of a strategy enables a precise definition what is objective achievement index of cost management whether a defined cost level, profitability or some other parameter whose achievement should guarantee achievement of the aims set by the insurer.

In the case of insurance companies it is easy to distinguish basic cost strategies depending on:

- cost reduction/cost optimization,
- profitability,
- pricing policy,
- insurance risk,
- financial liquidity,
- capital cost minimization.

Each strategy is based on a different objective, even though instruments employed by them can be similar or even identical. In the course of strategy implementation there appear slightly different problems. Table 2 presents cost strategy characteristics that the insurance company can adopt as part of cost management.

Cost strategies dependent on cost reduction or optimization are the least complex from the standpoint of objective implementation, for the determinant of such a strategy is a defined cost level. The strategies do not take account of other factors and parameters, such as income, profit or profitability. The aim of implementation of such a strategy is to cause the insurance company to have a definite cost level, often referred to as target cost level. Such a strategy can comprise various cost items, differently classified and subsumed under different categories.

**Table 2. Cost strategy characteristics in the insurance company**

Cost strategy	Basic objective	Instruments used	Main problem areas
Reduction-based cost strategy/cost optimization	target cost level	<ul style="list-style-type: none"> <li>✓ cost budgeting</li> <li>✓ activity-based management</li> <li>✓ responsibility accounting</li> </ul>	<ul style="list-style-type: none"> <li>– acquisition costs</li> <li>– loss adjustment expenses</li> <li>– administrative costs</li> <li>– activity-based costs</li> <li>– internal units cost</li> <li>– investment management costs</li> </ul>
Profitability-based cost strategy	target profitability level	<ul style="list-style-type: none"> <li>✓ product life cycle costing</li> <li>✓ kaizen costing</li> <li>✓ client's cost accounting</li> </ul>	<ul style="list-style-type: none"> <li>– product profitability</li> <li>– client profitability</li> <li>– distribution channels profitability</li> <li>– profitability of reinsurance technical activities</li> <li>– investment profitability</li> </ul>
Cost strategy based on pricing policy	target premium rate	<ul style="list-style-type: none"> <li>✓ budgeting and control of claims incurred costs</li> </ul>	<ul style="list-style-type: none"> <li>– claims incurred</li> </ul>
Insurance risk-based cost strategy	target level of insured risk	<ul style="list-style-type: none"> <li>✓ budgeting and control of claims incurred costs coordinated with a defined solvency level</li> </ul>	<ul style="list-style-type: none"> <li>– claims incurred</li> <li>– solvency</li> <li>– own funds</li> <li>– capital</li> <li>– cost volatility</li> </ul>
Cost strategy based on financial liquidity	target financial liquidity level	<ul style="list-style-type: none"> <li>✓ cash flow statement</li> <li>✓ cost budgeting coordinated with cash flow budgeting</li> <li>✓ value creation chain</li> </ul>	<ul style="list-style-type: none"> <li>– costs expenses relation</li> <li>– cash flow</li> <li>– defining the relation between cost raising and cash flow generating</li> <li>– value creation in the insurance company</li> </ul>
Cost strategy based on cost of capital minimization	minimum weighted average cost of capital	<ul style="list-style-type: none"> <li>✓ capital budgeting</li> <li>✓ financial leverage</li> </ul>	<ul style="list-style-type: none"> <li>– capital structure</li> <li>– cost of capital</li> </ul>

Source: own elaboration

In the case of implementation of the cost strategy based on cost reduction or cost optimization there are three approaches possible. The first one is a traditional approach basing on reporting cost classification. Its aim will be, then, attainment of, for instance, target acquisition level or loss adjustment costs. The second approach is based on cost classification as per activities, and its aim will focus on attaining target cost level of particular activities. This approach makes use of assumptions of the concept of activity-based management in which a definite cost level is attained through selecting these activities that can or should be eliminated. The third approach hinges on liability costing, whose objective is to attain a definite target cost level in the internal unit, which can be a section, branch, agency or department. The main instrument which should be used when pursuing this strategy is budgeting concentrated, first of all, on planning and cost control and also include a deviation analysis.

With cost strategies based on cost reduction/optimization two problems deserve particular attention. These are:

- a cost drivers analysis,
- defining the way in which data is collected.

A proper cost drivers analysis, especially internal, enables reasonable cost reduction. According to G. Gieschen (2009, p. 154–155) there are 16 basic areas where to look for sources of cost reduction, e.g. electronic equipment purchased for managerial staff, outsourcing, purchase of fixed assets etc.

In the group of cost strategies, based on profitability, indicator of achievement of objectives are not only costs, but also a definite level of target profitability. The choice of such a strategy may be part of activities connected with the results management process. This is the situation where costs become a key element, because cost management is quite naturally connected with results management or profitability, for decisions about a definite cost-bearing level are correlated with objectives relating to results and any activities in the cost area without taking account of the profitability level are anything but complete. A comprehensive profitability management system covers a whole range of tasks and activities, but most of them concern costs. (Wnuk-Pel, 2006, p. 9)

The cost strategy based on profitability can be implemented in the following three situations:

1. the insurance company is considering an offer of a new product,
2. the insurance company relies on kaizen concept (continuous improvements concept),
3. the insurance company strives to maximize sales by targeting specific client groups or developing distribution channels.

Another group of cost strategies are strategies relating to pricing policy. Determinant of activities as far as costs are concerned is here pricing policy adopted by the insurance company. The insurer aims at maintaining sales at the same level or increasing them by offering products at stated competitive prices. The target cost level is thereby determined by the price, i.e. by the premium rate. The underlying idea behind the strategy is similar to that of the profitability-based strategy, with the proviso that the difference consists in the fact that with the previous strategy the determinant was the profitability level and with the strategy in question it is the price level. Profitability in this case is not of primary importance.

Target sales volume and premium rate determine the cost level of claims incurred. Accordingly, the main operations with respect to costs will concentrate on planning and control of incurred claims costs. The key instrument in this strategy is therefore budgeting of incurred claims costs. Such a cost strategy does not concentrate on activities, aiming to find causes of costs formation and possibility of their partial elimination, but on their control. If, therefore, the insurance company wants to adopt such a strategy, it requires adjusting it to a given pricing policy pursued by that company.

The next cost strategy that can be adopted is the one based on insurance risk. It is of a somewhat similar character to the previous one, though in that case its indicator is a definite insurance risk level. What does matter, then, is not the size of the portfolio of insurances offered but its quality. The starting point is therefore the insurance company's potential in the form of its own resources, capital, sales, territorial scope, or client group. These factors determine the maximum risk that can be covered. The outcome of pursuing this strategy in the form of having to bear clearly defined costs is similar to the result, which was pointed out while discussing the previous strategy. The key cost item here are also incurred claims, whose rate is consequential upon previously made decisions with regard to sale of specific products. Therefore an important role is played here by the cost budgeting of incurred claims.

The penultimate of the cost categories mentioned on which the insurance company can depend for cost management is a strategy based on financial liquidity. It differs from the previous ones in that it takes account of cash flow, which the former failed to consider. It is therefore an approach that combines the question of costs as a category of financial result and profitability ratio with cash flows which create financial liquidity. This approach has a far wider scope, but also plays a different role. When a cost strategy is adopted, which is based on financial liquidity, the insurers' aim is to maintain an adequate level of financial liquidity due to their knowledge of costs which generate expenses. The key role in this strategy is therefore played by relation costs-expenses and the ability to plan expenses as a result of a prior decision taken about costs. Comprehensive financial liquidity management in the insurance company does not depend solely on this strategy. It is only an auxiliary element.

The last cost strategy, which can be adopted by the insurance company is based on capital cost minimization. This is a strategy that differs from the rest in that it regards only the area of capital cost. As with the previous ones, it does not offer, then, a comprehensive approach to cost management, but concentrates on one element only, which are capital costs financing economic activity. Its main objective are activities which should result in planning capital structure in such a way that the insurance company bears minimum weighted average cost of capital. The scope of the strategy will include capital costs.

### Conclusions

Characterization of the aforementioned cost strategies was presented by way of indicating purposes their implementation is to serve. As a result instruments are obtained, which are used to achieve these goals. It should, however, be remembered that whatever strategies adopted as part of cost management, they do not guarantee success automatically. Results management process has, first of all, the task to provide information which is subsequently used in decision making and assigning definite tasks to be completed. Whether such activities will be viewed in the insurance company as unnecessary red tape, or as a way to execute commitment to achieving goals set for the staff, depends largely on the ability to motivate the employees (Bourne, Bourne, 2013, p. 28). It is also worth noting that none of the strategies discussed above is perfect, for its choice is conditioned by many factors such as: current financial results, value of the insured risk, amount of own funds, or investment structure. That is why the choice of a cost strategy depends on the insurance company.

Issues to do with cost management have been very popular for years. However, the presence of these questions in business activity of insurance companies is caused by the specific way in which they operate. Solutions in the form of employing various instruments have been used in the entities carrying out productive, service or commercial activities, however, in the case of insurers they require modification and adjustment to specific conditions of financial institutions. At the same time an important role for insurance companies doing business in Poland is played by the character of the home market and internal legal regulations affecting it, local economy, client expectations and market history arising from past experience. It is impossible to transfer cost management instruments used by other business entities directly to insurers.

It is also difficult to directly implement the solutions found in other countries in insurance companies operating in Poland. This does not mean that the use of solutions from other countries is not possible, but they require modification before application in Polish insurance companies. The reasons for this are as follows:

1. In Poland, first of all, there are national regulations in the field of accounting, which impose rules concerning, for example, classification and calculation of cost positions;
2. In Poland, there is a specific market structure (in particular in non-life insurance companies), which is a remnant of the communist system. Although many years have passed, in the case of such long-term products as insurance, changes do not happen so quickly. In practice, this means that the two largest insurers on the Polish market are insurance companies that had a market monopoly in the communist times (it is manifested in better distribution network, customer habits and trust, better known brand, etc.). Therefore, it is difficult to break the remaining market by other new insurers;
3. In Poland, there is still low awareness and the need to buy insurance, which is the result of low income of people and limited saving opportunities. Therefore, the best-selling insurance is compulsory and motor vehicle insurance, which limits the ability of insurance companies in application of cost strategies;
4. Finally, in Poland there is a lack of stability regarding certain solutions that condition the functioning of financial instruments (e.g. concerning the pension system, which is related to life insurance

products). This situation causes a lot of uncertainty and limits for the possibilities of insurance companies to sell products.

Differences between the solutions in the implementation of cost strategies used by insurance companies in Poland and other European countries may be an interesting topic, which however needs to be developed in another paper.

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