Factory and Firm

The Future of Claims Handling

McKinsey&Company

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Building a world-class claims organization remains one of the great challenges for management in financial services. Never "just right," with huge financial stakes, under regulatory scrutiny, bearing great HR challenges, at great cost – there is no greater balancing act for senior executives. If not optimized, claims can become a major barrier to profitable growth that can endure for years. We believe that to optimize claims, management will need to recognize that claims presents two very different (but interrelated) challenges: 1) building a world-class service factory and 2) creating a top flight professional services firm. To succeed, claims management must use the tools and incorporate the best ideas from these two very different disciplines.

WHERE WE HAVE BEEN

Over the decades, P&C executives have tried numerous solutions in their quest to perfect the claims balancing act.

In the 70s, claims was seen largely as an art – with senior claims managers as craftsmen deserving of great freedom and latitude. Some believed that this posed little risk, because the result was really determined by the underwriting decisions made months or years earlier.

By the 80s, with costs growing rapidly, claims' status as an art came increasingly under fire. Management began looking to claims for more cost efficiency and, while the indemnity result was still largely seen as set by underwriting choices, the focus shifted toward managing the loss adjustment expense more aggressively.

By the 90s, the pendulum began to swing back the other way. After years of squeezing the cost side, management recognized huge opportunities to rebalance and invested cautiously in LAE to capture indemnity savings. The concept of “leakage” or total economic opportunity came into vogue as firms, led by McKinsey, encouraged many in the industry to use closed file reviews (CFRs) to measure the trade-offs between LAE investments and indemnity accuracy. These projects frequently identified huge indemnity opportunities and, in some cases, under-resourced claims organizations. Many executives used CFR data to make new investments in claims and reaped substantial economic improvement as a result.

By the end of the 90s, the leakage story had grown more complicated. While many carriers continue to gain substantial benefits from measuring and using leakage to drive performance, others increasingly believe that it cannot be the sole measure around which to optimize claims. This belief emerged for a number of reasons. First, while focusing largely on indemnity, some carriers have seen expenses on the LAE side creep up. Additionally, leakage measurement itself can be costly and difficult to sustain - some carriers have been searching for ways to measure leakage in a more cost effective/rapid manner, while sustaining objectivity. Others have wanted to add measures that focus more on the customer service components of claims handling. Finally, some managers believe that while leakage measures are very useful for guiding an organization, they want additional operational metrics that are tied to near-term outcomes.

More recently, many have turned to other approaches, such as IT applications. These IT investments have been warranted in some cases, but the ROIs for these projects have often been disappointing. While they are certainly part of the answer, IT solutions can never address the broader challenge of claims – applying properly executed human judgment in every case.

So what will the future bring? And more importantly, how should claims management respond?

WHAT WE ARE FACING NEXT

The future environment will only bring greater challenges for claims management. While the old challenges remain, a number of other challenges will become more pronounced. For example:

- **A challenging tort environment.** Recent trends suggest that the tort environment is beginning to worsen. Perhaps as a result of more plaintiff-friendly judicial appointments over the last decade, this trend could continue for the foreseeable future. Increases in mega-awards will only raise the stakes for claims executives.

- **Hardening reinsurance markets.** In the wake of September 11, primary carriers will face much higher prices for reinsurance and will therefore choose to retain more risk, potentially in areas where they have limited experience. This will further challenge claims organizations, particularly on the commercial side.

- **New technologies.** The growth of more powerful decision support tools will provide a new arsenal for carriers, but IT decisions will remain expensive and capturing value increasingly complex.

- **Integrated business systems.** The claims business system will be increasingly integrated between vendors and carriers. While these will be marketed as value-added for consumers, they will add a further level of complexity for claims executives.

- **No relief from cat losses.** The difficult catastrophe environment and emerging new cat classes (e.g., mold) seem to be with us for the foreseeable future as well. These events put strain on every element of a claims operation.

- **Economies of scale effects.** We believe that scale will be an increasingly important factor for success in both personal and small commercial lines. Over the past decade, we've seen consistent share growth among the "Big 15"* as their investments in IT, brand, channel management, and multi-channel service have generated strong returns to scale. We believe that claims will be a growing part of this story as well. Carriers with scale will find ways to

* *"The Big 15": Personal Lines Consolidation in the United States and Implications for Management,* McKinsey & Company; for a copy contact Chris Gorman Wanfried in our New York office at (212)446-8421 or at chris_gorman_wanfried@mckinsey.com.

use claims to generate superior service for policyholders and superior returns for shareholders. This will also serve to increase pressure on claims management.

Given the experiences of the past and the growing challenge, what is the best way forward for claims management? What is the next evolution in thinking to enable us to better tackle the problem?

HOW TO MOVE FORWARD

Claims is so challenging because it is, in fact, a balancing act – between the competing needs of customer service, indemnity accuracy, and expense management. The challenge is made greater because no single approach or tool allows management to address all of these elements effectively. As a result, we believe that the way truly to optimize the claims challenge is to recognize that it is in fact two separate problems.

We used to joke that if a factory and a law firm had a child, it would be a claims organization. Its factory-like manners would ably handle the millions of individual claims that have low value and relatively straight-forward paths for resolution, while its lawyerly tendencies would be well equipped to handle the few extremely complex claims with high potential value. Clearly, a claims organization with these different sensibilities cannot be optimized by one set of tools and approaches. Any attempt to do so would compromise the factory and firm "halves" of the organ-ization. To optimize performance, management needs to recognize the distinct challenges within these two halves and address each with a distinct set of tools and best practices.

A factory model – for consistency, service, and LAE efficiency

The best way to handle some claims, or certain moments in a claim's life, is in a service factory. This might be at a particular point in time (e.g., file set-up, subrogation) or for certain types of claims (e.g., auto glass, first-party APD). In these instances, management will need to focus on three key measures: consistency (to ensure payment accuracy), customer service, and LAE efficiency. Like world-class call center operations, the best claims service factories will optimize performance against these measures by focusing relentlessly on making transactions consistent and error-free, by improving efficiency, reducing "waste" in the business system, and by using integrated business system management (with IT links to vendors' systems), "smart" support tools, and other tools that drive efficiency and consistency. In our experience, building an optimized service factory requires a specialized set of tools, including:

- **Lean manufacturing.** These tools (including Six Sigma, TQM, and TOP) are modifications of those applied in industrial operations settings. They seek to minimize waste in all its forms by reducing or eliminating low-value-added tasks, reducing cycle time, more accurately matching supply and demand, and minimizing errors.
- **Customer service diagnostic.** The best service operations use classic customer touch-point analysis to lower the number of customer complaints, most of which emerge from the factory part of a claims operation.
- **IT strategy and straight-through process design.** By employing modular IT applications, claims organizations can reduce manual work and errors.
- **Call center optimization.** These tools apply the learnings from world-class call center operations to improve phone-based claims resolution.

These tools help management maintain focus on the few key metrics that matter in a service factory environment and thus tend to simplify the claims challenge. We have found that companies that adopt a service factory model also have an edge when it comes to recruiting, training, and retaining top performers. This is because a focused organization can better address the needs of the type of people who do best in a service factory environment.

A firm model – leveraging knowledge and experience

For some claims, or at certain moments in a claim's life, the file is best handled in an operation that is more like a law firm. This might be for higher severity claims, for claims that require litigation, or for claims above a certain threshold of complexity. This type of professional services model would largely focus on optimizing indemnity accuracy through knowledge and experience. While the other claims measures are important, the focus in this type of claims environment will be on indemnity.

The claim firm of the future will borrow many practices from the best professional services firms of today. It will excel in talent management; processes designed to ensure a structured problem-solving approach as well as collaboration on critical decisions; close collaboration and targeted use of best-in-class vendor partners (e.g., law firms and outside experts); and knowledge capture, codification, and sharing as well as the technology tools that support knowledge efforts.

These practices demand a very different skill set than those deployed in the factory setting, which means that the people who are attracted to and thrive in the claims firm will be very different as well. When these two groups of people are managed in different ways, both can be optimized and can attain best-in-class performance levels. However, if they are managed to some sort of middle ground, both will continue to disappoint.

To build a world-class claims firm, a very different set of tools is needed. They are:

- **Talent management.** These types of claims environments will borrow from the talent management practices of world-class professional services firms. They will source talent in new ways, design career paths and value propositions tailored to this type of talent, and manage development and feedback appropriate for claims professionals.

- **eCFR.** Many claims organizations will continue to measure settlement accuracy, but the latest tools (e.g., e-CFR) focus on changing behavior at an individual claim rep level (via on-line learning, continuous feedback and skill building, and ongoing measurement and performance management) The objective is rigorous and consistent execution as the path to increasing settlement accuracy, not just measurement.

- **Knowledge management.** As with leading professional services firms, claims organizations have opportunities to better leverage their proprietary information and more effectively use existing knowledge sources across the organization. This may include expert databases, information about opposing counsel, settlement tracking, panel counsel management etc.

- **Litigation management.** The best claims organizations will manage litigation risk at both the individual case level and at the portfolio level to ensure that aggregate portfolio exposure is well understood. They will continue to refine their models for how they use staff and panel counsel and ensure case-level litigation outcomes are tightly managed to reduce variance in outcomes and unwelcome surprises.

MAKING THIS REAL

Separating the claims challenge into these elements will allow management to finally apply the right set of metrics and tools to the problem. It will allow both halves to be optimized and all organizational elements – structure, skills, shared values, etc. – to be aligned to the needs of either factory or firm, as the case may be.

We believe the precise outcome of this vision will vary depending on a carrier's business mix, starting point, and culture. However, a number of changes will be necessary in most claims organizations, even those that have already started down the path toward making this vision a reality:

- Some carriers will, over time, create separate factory and firm operations. Many, however, will manage the factory and the firm models as two aspects or subcultures within a singular claims organization.
- Whatever structural approach is taken, it will be critical to build separate cultures, vocabularies, approaches, and talent management processes for each model. Separate management practices that optimize on the discrete goals of the factory and the firm will also be critical.
- Ironically, this approach may lead to less specialization, as we know it today. Rather than lots of specialized units, factory and firm will become the primary axis for specialization – each handling a variety of claims.
- Technology is a very important part of the answer, helping drive consistency and efficiency in the factory and access knowledge and support decisions in the firm.

Only by handling claims with two separate approaches, each addressing specific challenges, can the industry achieve true excellence. The claims factory will improve settlement accuracy by focusing on consistency of process and customer service while managing ULAE to a minimum. Meanwhile, the claims firm will focus on attracting the right talent and using knowledge workers to apply the best judgment and experience to claims. The two components will be tied together by a simple segmentation methodology, some shared infrastructure, and common senior management – but each will have separate measures, culture, day-to-day management, people processes, and IT. The claims organization of the future will be factory and firm – together and separate.

McKinsey & Company is the leading strategic, organizational, and operations advisor to insurance carriers globally. For further information contact Chris Gorman Wanfried in our New York office at (212) 446-8421 or chris_gorman_wanfried@mckinsey.com.