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New Swiss Re *sigma* study explores product innovation in non-life insurance

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Zurich, 6 December 2011 – There is much more to innovation in non-life insurance than people think. Although a changing environment continuously forces the industry to rethink its covers, insurers are often perceived as slow to embrace product innovation. This is because the nature of innovation in insurance is usually incremental and transaction-led. Insurers are constantly trying to discover new classes of risk protection, but they always need to be cautious not to overstep the boundaries of insurability.

A key finding of Swiss Re's latest *sigma* research publication, "Product innovation in non-life insurance, is that product innovation in non-life insurance is actually more widespread than many people think. However, it usually happens incrementally and is transaction-led. That is, it is more little 'i' than big 'I'.

Innovation means developing ideas into marketable products or improving processes

Innovation is a term that is widely used but can mean many things to many people. Darren Pain, Swiss Re economist and author of the study, says: "Innovation refers to the introduction of something new that improves on the *status quo*." It doesn't have to involve anything especially novel or inventive. Innovation involves developing ideas into marketable products (product innovation) or changing processes (process innovation). Core to innovation is that it creates value.

Innovations vary according to how far they change the existing product or service or the way it is delivered. At one extreme, incremental innovations involve modest improvements. At the other, transformational innovations may radically alter the product or competitive landscape.

Product innovation in insurance tends to be more little "i" than big "I"

"According to survey evidence, many insurers report that they have introduced new or improved products, although most innovations tend to be new to the firm rather than genuinely new to the market," highlights Pain. "Insurance has a poor image of being not innovative, but often people don't appreciate the range and degree of risks that insurers routinely take on. New risk classes such as cyber insurance and supply chain disruption cover, as well as alternative risk transfer techniques are all important innovations."

Nevertheless, most product innovation in traditional insurance markets tends be of the incremental or evolutionary type, building on existing knowledge and infrastructure. Among the most prominent incremental innovations in insurance, three broad classes stand out: amendments to terms and conditions of the cover, bundling or unbundling of risk protections, and policies based on parametric triggers.

Incremental innovation benefits insurers and customers alike

Some might describe this transaction-led innovation as product flexibility rather than innovation *per se*. But it is easy to undersell its significance. Pain says: "On the client side, such policy refinements – sometimes called 'deal-by-deal innovations' — can be extremely important for shaping existing risks to make them or keep them insurable. Innovations also help by saving on unnecessary cover and by using re/insurers' risk-absorbing capacity to reduce the overall costs of insurance." For insurers, incremental innovation is absolutely essential. However, to step up to the challenges of the market a certain dosage of radical innovation may be required.

There is scope to promote more radical product innovation

The range of insurable risks is small compared with the full set of risks facing individuals and firms. There is plenty of room to extend the boundaries of insurable risk and contribute to more efficient risk-sharing in the economy. "Insurance is socially useful. Without it, a society is often deprived of goods or services that were not produced simply because the risks were too great," explains Pain.

However, a mixture of technical, organisational and market factors naturally constrain how expansive insurers can or should be in terms of developing new products. Most obviously, missing information can give rise to adverse selection or moral hazards and lead to amplified losses. Insurers might easily find their capital exhausted if claims turn out to be unusually large. So caution always needs to be exercised when taking on new or changing risk exposures. Additionally, there is sometimes limited demand for highly innovative products, even if insurers are prepared to offer them. Instead, 'big' innovations tend to occur only when an exogenous driving force, such as new legislations or tax changes, stimulates demand.

Especially if the barriers to innovation in some areas are severe, governments and insurers can cooperate to spur on big "I" innovation, for example by designing new insurance vehicles or by partaking in risk sharing. Micro-insurance is an example of collaboration amongst insurers, governments, and non-profit organizations to give access to insurance to millions of otherwise unprotected people. Natural catastrophes are also more insurable than ever, especially because risk can be transferred in part to capital markets.

Cooperation with governments or between companies can however, lead to unintended consequences. Subsidised insurance, for example, can distort incentives and collaboration can potentially lead to reduced competition.

The key is to aim for a balanced innovation portfolio

Even if the constraints on insurers to promote more radical innovation are significant, insurers may recognise the potential drawbacks of too narrow an innovation focus. For one, turning a blind eye leaves insurers vulnerable to future innovations that could disrupt the marketplace and displace existing products. Also, certain strategic radical innovations may ultimately be needed to secure continued increases in business growth in insurance.

Pain points out that "in mature markets like insurance, firms naturally shift their innovation activities from product, at the beginning of the life cycle, to process innovations in the latter phases. The diffusion of existing ideas to new markets or regions is very important for supporting premiums. But ultimately more radical innovation may be needed to shift performance onto to a new, higher growth trajectory."

Insurers are beginning to recognize that business success typically requires a balanced innovation approach, combining both incremental and more radical innovations across the whole value chain. Looking ahead, process and marketing innovation will probably remain in the spotlight– for example, the development of electronic distribution and marketing channels will no doubt grow in significance. However, despite the maturity of the insurance market, there is still scope for product innovation either to cope with changes in existing risks or to respond to completely new, often complex, emerging risks.

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How to order this *sigma* study:

The English, German, French and Spanish versions of the *sigma* study No 4/2011, "Product innovation in non-life insurance: where little 'i' meets big 'I'", are available electronically on Swiss Re's website: www.swissre.com/sigma. The versions in Chinese and Japanese will appear in the near future.

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