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Hidden Costs of Administering Complex Products

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For the company to have the best chance to meet profitability goals, the company must select the administration solution that minimizes the combination of the explicit costs and the hidden costs.

Product innovation is one of the keys, if not *the* key, for sustaining a successful product manufacturing business. Without innovation, products are differentiated primarily by price, leading to intense competition and erosion of pricing margins. A new, innovative product may offer the potential to uniquely satisfy a market niche and produce greater returns.

Innovative products generally have complex features that make them uniquely different from other products—therein lies the potential. But companies that choose to pursue new designs also incur additional costs as a result of the complexity—research and development, additional state filing costs, agent training and education, etc. Likely the largest cost, however, is the cost to modify an existing administration system or purchase a new system to accommodate the new product features.

More Than Just the Price Tag

The cost associated with various administration solutions seems explicit and easily quantifiable—just look at the "price tag." This explicit cost is often where the cost-benefit analysis ends, but there may be other "hidden" costs associated with an administration solution that will have important implications for the success of the product and the company. For the company to have the best chance to meet profitability goals, the company must select the administration solution that minimizes the combination of the explicit costs and the hidden costs.

Hidden Administration Costs

Although it is more difficult to quantify the financial impact of these costs, they will impact profitability and need to be considered.

- **Product Design Constraints**
  In many cases the administration system simply can't accommodate all of the innovative features of the new product, so these features are removed from the final product specifications. As a result, the product that is brought to market may only have a limited ability to address the market's needs. This leaves room for competitors to respond to the unmet needs and ultimately the system limitations will cost the company money in the form of lost sales and reduced market share.

- **Inefficient Operations**
  When implementing a system to accommodate a new product, a typical goal is to meet the minimum functionality requirements while keeping the initial investment as low as possible. This often includes seemingly less expensive manual processes instead of systematic workflow designs. However, the true cost of this short-sighted approach is realized as the company loses money through increased operational costs for the life time of the system. Highly manual procedures cost the company money through additional staff, extra training and documentation, slower processing speed, etc. In addition, manual procedures introduce errors that are expensive to identify and fix and have many potential bad consequences (data reliability issues, customer service complaints, unrecoverable payments to unintended parties, etc.).

- **Increased Time-to-Market**
  The implementation of the solution could result in an extended time-to-market for the product. Even if the administration system is being implemented on a fixed-cost basis, an extended implementation will cost the company money in the form of lost sales.

- **Inability to Monitor Experience**
  If the data collected and stored by the system is incomplete, it may not be possible to monitor and value the emerging block of business. As products become more complicated, with more features, benefits, etc., the need for detailed data regarding the specific benefits and associated premiums and claims becomes more critical. The risk is that a given product feature or benefit was mispriced and is costing the company money. If there is not sufficient detail in the system to identify specific benefits, the aggregate claims and premium data might mask the emerging experience. This will prevent the company from identifying the problem and taking corrective action to prevent further loss.

- **Lost Cross-Selling Opportunities**
  Additional product complexity will allow a product to specifically meet the needs of the market. With each additional benefit, feature and option selected, the company is building a detailed profile of the policyholder or insured. This information, if captured and combined with other sources of customer information, can be used for future cross-selling and customer relationship management initiatives. However, if the system does not adequately capture this detail, or the system cannot link policyholders or insured across multiple products, the system is costing the company money from lost cross-selling opportunities.

- **Misleading Pricing Data**
  Product complexity is often added in the form of additional risk classifications. This allows the insured to be included in a cohort where the risk characteristics are increasingly homogeneous and the product pricing reflects the specific risk characteristics. In many cases, however, exceptions and "business decisions" are made where the insured gets a premium rate that is better than his risk characteristics would indicate. The effects of these business decisions are magnified as the number of risk classifications is increased and the size of the risk cohort is reduced. An administration system needs to be able to differentiate between the "true" risk classification and the "sold" risk classification. If this differentiation is not available, the experience that emerges from this block will not accurately reflect the underlying risks. The company will be affected financially through the skewed pricing assumptions that will be based on this experience.

- **Locked Into Old Technology**
  The company may not be able to upgrade to new technology because the administration system was "hardwired" to accommodate the unique product features. This is a common dilemma faced when the business rules defining the product are inextricably intertwined with the underlying technology. In this case, any custom modifications that were made when the product was implemented would again need to be made after the upgrade. The company, if it were to choose to pursue the upgrade, would again incur the customization costs to implement the unique product features.

- **Discounted Value of the Block**
  Unique products, by definition, are different from other products on the market. If the company chooses to sell the block of unique products, this complexity could impact the ability of the company to move the block. The acquiring company may find it difficult or impossible to achieve economies of scale by integrating with other blocks. If the block can't be integrated, acquiring companies may be hesitant to assume potentially costly administrative operations. The impact to the selling company is a limited market and likely a discounted selling price.

Conclusion

Administration systems directly impact a company's ability to innovate. Beyond the explicit costs of implementing an administration solution for a complex product, there are many other potential "hidden" costs. Both the explicit cost (i.e., the "price tag") and the "hidden" costs need to be considered when choosing an administration solution. The best solution may require a larger initial investment, but by reducing the ongoing maintenance costs and minimizing opportunity costs the company can save money over the life of the system. By minimizing the combination of the explicit costs and the hidden costs, the company will have the best chance to meet profitability goals for the current product and leverage the solution to continue to be an effective, profitable innovator. ☐

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