

## **Mass Customized Risk Products**

**By  
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### ***Abstract***

*The financial services industry is proficient at devising solutions for individual risks and for homogeneous exposures. Now it must conquer the gap between these two extremes. As the number, size, and relatedness of exposures change overtime, the mechanisms needed to finance these risks must also change. Mass customized risk products are needed to fill the void between one-off transactions and those transactions that are largely generic.*

The 1990's was the decade of derivatives. Many people felt that it was only a matter of time before the financial markets would deconstruct every risk, incorporate them into new types of securities, and trade these issues over the Internet. The Glass-Steagall Act of 1933 that separated banking, investment and insurance activities was repealed, and it seemed that convergence was just around the corner. The insurance industry seemed somewhat old fashioned and dull by comparison.

What a difference a decade makes. Now, the capital markets are in turmoil, with fault lines showing between their component businesses, and it is not clear that the atomization of risk is all that appealing to buyers or sellers. The property/casualty insurance industry, which was in a drawn-out price war during much of the late 1990's, is now in the midst of a very hard market, struggling to find adequate capacity to meet its customers' needs.

Despite the individual players' changing fortunes, it is clear that the financial service industry still needs a makeover. Insurers should be thinking about what will happen to their financial strength and attractiveness when price competition heats up and the soft market begins. Investment banks and brokerages should pursue opportunities that will help them expand their product and distribution capabilities.

The ultimate convergence will take place when the financial service industry's product and transaction people start to think and act more like each other. To take fullest advantage of new growth possibilities, the industry will need to combine the innovation and customization of investment bankers with the product and process orientation of banking and insurance professionals. In short, the financial services industry must apply the principles of mass customization to risk transfer.

### **Mass Customization**

While one size does not fit all, it is equally evident that all sizes do not fit one. Mass customization is that happy middle between giving a customer a product that is unique and one that is indistinguishable from every other product of its kind. Unlike mass production, where products are essentially the same for all customers, mass

customization attempts to fill unique customer needs by building customized products off of a standardized product platform.

In some circumstances, off-the-self products work just fine. In other cases, products must conform to more exacting specifications. For example, the individual who is interested in general home computing can easily walk into an office supply store and pick out a machine that will meet his needs. Alternatively, the person who wants to produce a web-based investment advisory show would have some very particular demands and would want to go to Dell Computer or another OEM.

In recent years, mass customization has been a huge force in the manufacturing industry as companies have sought to increase customer demand by differentiating their products. In the process, they have increased their revenues and their profitability. Nowadays, one can customize: the names, clothing and looks of Barbie dolls; eye-wear; clothing; cars; CDs so that they contain particular selections of music; vitamin pills; and many other consumer items.

### **Application to Risk**

In the sense that customers have a wider range of choices, one might say that many financial products are already somewhat mass customized. People can shop for mortgages, investment products, and insurance and choose the terms and conditions that best fit their needs. While modular, build-it-yourself risk products are still some years away, the Internet is giving this trend traction and slowly making this concept a reality.

Nevertheless, customer knowledge is a critical ingredient of success since buyers must feel confident that they have enough knowledge to select the right product characteristics. For this trend to accelerate in the risk transfer business, there will have to be much more communication and knowledge sharing between buyers and sellers. Applying the concept of mass customization to risk transfer products will require companies to educate their clients about the pros and cons of the different options that they offer.

However, mass customization is about more than just offering customer choices. It is also about using the existing production and distribution infrastructure to satisfy unmet customer needs. This concept is particularly attractive in mature industries where real growth is stagnant and companies have a difficult time differentiating their products from those offered by their competitors. Let's examine some of the reasons why the financial services industry should be considering mass customized risk transfer products.

### **Customer Appeal**

Successful products satisfy customer needs. These needs may be viewed as real or perceptual, depending on people's differing value systems. Business people often disregard new products that have the potential for success simply because they are not appealing to them personally. Thus, if you do not take numerous pills on a daily basis you may overlook the appeal of customized multi-vitamins.

Similarly, there are large pockets of corporate risk issues that are overlooked or under-served by the insurance industry. Executives in many large corporations are currently bedeviled by the possibility that new drugs and technologies will have an adverse impact. They are also concerned about terrorism, information theft, and professional liability. The solutions to these issues lie somewhere between a generic general liability policy and a customized catastrophe derivative.

Over the years, the character and quality of these risk issues has changed dramatically, and the insurance industry's standard solutions no longer work for these issues. Risks that were previously considered homogenous are now recognized to be quite different from each other. Risks that were previously thought to be independent and insignificant are now of great consequence and directly related. Both the exposures and the potential for loss have changed.

Although the insurance industry's immediate reaction to these changes may be to limit coverage or stop coverage altogether, longer-term it must attempt to gain a better understanding of the unique factors that drive these risks. With this knowledge, companies can then help their customers develop best practices and finance these risks more efficiently. In short, financial service companies must leverage their knowledge and expertise as well as their capital.

**The Benefits Of  
Mass Customized Risk Products**

<p><b><i>Customer Appeal</i></b>          Products fit unique customer needs          No direct substitutes or alternatives</p>
<p><b><i>Value</i></b>          More efficient form of risk financing</p>
<p><b><i>Profit Potential</i></b>          High margins          New source of growth          No cannibalization of existing revenues          Informational barriers to competition</p>
<p><b><i>Development Costs</i></b>          Low marginal costs          Little downside risk</p>

## **Value**

Cost effectiveness is another issue to consider. In some instances, companies pay for more coverage than they need. In other cases, the coverage they receive is not nearly enough. For many risk issues, there may be no discrete financing options, which means that the risks are ultimately financed via debt and equity. Unfortunately, this is a very inefficient form of risk financing because the holders of these securities cannot readily evaluate these exposures or help manage them in any way.

Without detailed exposure and loss information, it is difficult to know what price to charge or to demonstrate the value of the various risk transfer alternatives. As long as risk transfer prices are perceived as being very low, demonstrating this value may not be a high priority for buyer or seller. However, as loss experience begins to increase, it becomes critically important for both parties to gather information that will help them understand and control the potential for loss.

Using the principles underlying mass customization, these inadequacies would be resolved by inviting customers into a more interactive relationship that extends from the product design phase through the lifecycle of the product. Feedback from customers is critically important in any business, but in the risk transfer business it is equally important to feed information back to customers.

By creating better feedback mechanisms, customers would receive information about the product options that might suit them best as well as routine feedback about best risk management practices. Insurers would get information that would help them react faster to changing risk conditions. Mass customization is about establishing a direct link to customers that allows companies to shorten information cycle times, deepen their market penetration, and improve customer loyalty.

## **Profit Potential**

One common argument against mass customization is that the size of the market for these products is smaller than for traditional products. While this is true, it is important to consider how much larger the margin can be on mass customized products as well as the extent to which the new offerings might overlap existing products. Ultimately it is the profit potential that matters. In the commercial markets, where risk solutions for many issues are either inadequate or non-existent, the development of mass customized risk transfer products would offer new sources of profits.

To understand an institution's ability to capture profit from a new product, one must also gauge the potential for competition. Many potential barriers to entry are obvious such as capital requirements, regulation, economies of scale, etc. Other barriers are more difficult to understand and include such things as the adequacy of intellectual property rights, the name-brand advantage that can accrue to the first market entrant or the extent of the informational advantage that it may have over its rivals.

The close relationship that develops between buyers and sellers of mass customized products can serve as an effective barrier to competition. Also, the fact that a particular product offering would be seen as a niche business would make it much less desirable in the eyes of competitors. Assuming that no competitor loses any of their existing business as a result of a new product, they may not be galvanized into competition until it is too late.

### **Low Development Costs**

Another attractive feature of mass customized products is that the marginal development costs are small since the infrastructure necessary to support these products already exists. The financial services industry already has the licenses, distribution systems and administrative structures to support mass customized risk products.

Successful efforts will be determined less by a given company's product delivery infrastructure and more by their flexibility, knowledge, and creativity. To realize the benefits of mass customization, financial service companies must be able to identify their customers' most pressing problems and to use the industries existing structures creatively to satisfy those needs.

Given their low marginal costs, the risk characteristics of these new business initiatives should be very appealing since the downside is minimal and the upside is significant.

### **Summary**

Mass customized risk products offer intriguing possibilities for new growth and increased profitability in the financial services industry. While the Internet has given this concept momentum in the area of personal finance, it will take much more focused efforts for this trend to gain traction for large commercial risks. In this area, the exposures are too heterogeneous, the issues are too complicated, and the prospects for loss are too great for the standard solutions to be very useful.

To capture this opportunity, financial service companies will need to develop capabilities to identify and solve their clients' intractable risk issues using the industry's existing infrastructure. New opportunities do not just happen. Dedicated and resourceful people are needed to make them happen. This work involves taking calculated risks and requires corporate cultures and incentive systems that foster innovation, but the effort is well worth it.

### ***Author's Note:***

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