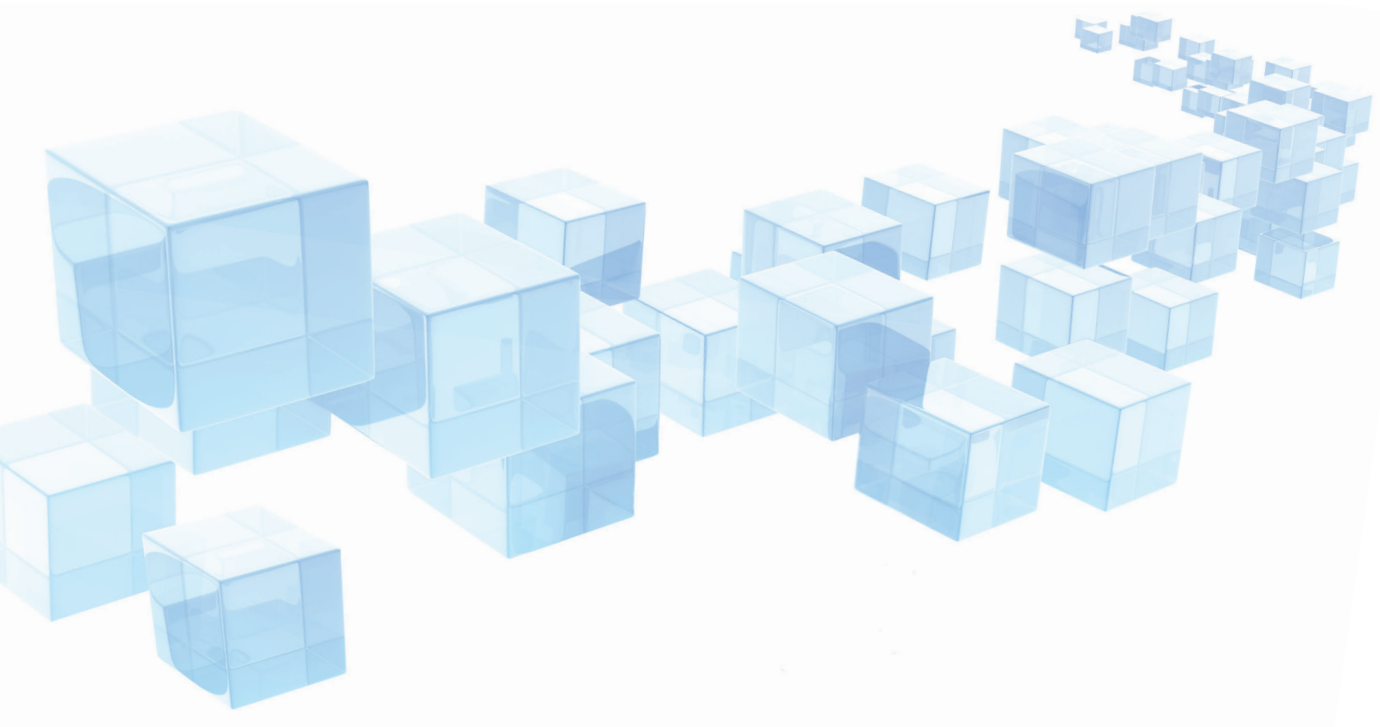


DRAFT: Scoring and Assessing Innovation

March 14, 2019



Scoring and Assessing Innovation

Outline

- A. The Importance of Innovation
- B. Defining Innovation
- C. Scoring Innovation
- D. Translating the Innovation Score into an Assessment
- E. Interpreting the Innovation Assessment in the Context of the Rating Process

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of AM Best's rating process.

A. The Importance of Innovation

Innovation is becoming increasingly critical to the long-term success of all insurers. With innovation, companies can develop sustainable competitive advantages and better respond to external challenges such as evolving consumer preferences, growing business complexity, shifting market dynamics, and ever-expanding technological advancements. Companies need innovation to outpace competitors, fend off potential external disruptors, and promote organizational longevity.

Insurers agree with AM Best that innovation is critical to their future success and that they must innovate to attract and retain customers. By improving efficiencies through innovation, insurers can gain a competitive advantage. Technological developments—such as advancements driven by machine learning, the Internet of Things (IoT), and blockchain—tend to be the innovations that receive the most fanfare. However, while technology plays a non-trivial role in providing tools for innovation, innovation is not all about technology. Many insurers have historically found nimble ways to adapt to an ever-changing market environment without having to become sophisticated technology players. To keep up with current innovation developments, insurance innovators rely on diverse sources, including employees, customers, and consultants and, when faced with challenges requiring innovations outside of their core competencies, are willing to make investments and form partnerships to get up to speed.

In the insurance industry, the importance of innovation is not segment-specific. Given the accelerating pace of innovation and magnitude of change, insurance companies that fail to innovate may find it difficult to sustain long-term success/profitability and may ultimately be subject to anti-selection and loss of relevance. Those insurers that successfully incorporate innovation will likely strengthen their organizations, increase their customer base, and improve efficiency, which will support their financial strength.

Historically, AM Best has captured innovation indirectly through the various building blocks of its rating process. AM Best now believes that the pace of innovation in the insurance industry is accelerating and that an insurer's ability to innovate is increasingly critical to its long-term financial strength. From a rating perspective AM Best's innovation initiative is two-pronged: (1) all rated

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companies will be scored and then assigned a published innovation assessment; and (2) within its business profile building block AM Best will explicitly consider whether a company's innovation efforts have had a demonstrable impact on its long-term financial strength.

B. Defining Innovation

AM Best defines innovation as a multi-stage process whereby an organization transforms ideas into new or significantly improved products, processes, services, or business models that have a measurable positive impact over time and enable the organization to remain relevant and successful. These products, processes, services, or business models can be created organically or adopted from external sources.

There are several key aspects to AM Best's definition of innovation. First, innovation can take many forms—it is not limited to a particular type of innovation or technological development. The definition also allows for flexibility regarding the source of innovation; for some organizations, innovation through adoption may prove to be the most appropriate path, as there may be inherent barriers to innovation within the organization.

Second, AM Best expects the output of the innovation process—those new or significantly improved products, process, services, or business models—to have a measurable impact. Some level of failure is an expected part of any innovation program, but companies receiving the highest innovation scores will have a demonstrable success in innovating. Without productive results, the resources consumed by the innovation process will be a financial drain rather than an aid.

Third, innovation is a dynamic and ongoing process, as well as a long-term commitment. Companies receiving high scores will be those that treat innovation as part of a continuous cycle of organizational growth and development, and that successfully integrate their “new-stream” innovations with their mainstream legacy operations.

C. Scoring Innovation

Components of the Innovation Score

AM Best's evaluation of a company's innovation level is based on two elements: (1) innovation inputs—or the components of a company's innovation process; and (2) innovation outputs—or the impact of the company's innovation efforts. The resulting innovation score is the sum of these two evaluations.

Exhibit C.1: Innovation Score Formula

$$\text{Innovation Score} = \text{Innovation Input Score} + \text{Innovation Output Score}$$

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Assessing the Components

Innovation Inputs

The evaluation of a company's innovation inputs entails an assessment of four sub-components: (1) leadership; (2) culture; (3) resources: allocation, strategy, and management; and (4) processes and structure. These sub-components capture both a company's innovation capacity—i.e., the resources the company has dedicated to innovation—and its potential innovation ability, or whether the structural elements of the innovation process are positioned in such a way that the company can leverage its available resources and create value. Each of the sub-components is scored from 1 to 4, with 1 corresponding to the most negative assessment and 4 the most positive. More detailed scoring considerations for the sub-components are outlined in the following sections.

Exhibit C.2: Innovation Input Score Formula

$$\begin{aligned} \text{Innovation Input Score} \\ &= \text{Leadership Score} + \text{Culture Score} + \text{Resources Score} \\ &+ \text{Processes and Structure Score} \end{aligned}$$

Leadership

Leadership can be a driver of innovation success or a cause of innovation failure and thus has a direct influence on the other sub-components in the innovation assessment. AM Best expects that industry leaders of innovation will have the sponsorship of top management and support throughout the organization—including board participation.

Companies that successfully innovate typically benefit from buy-in at the senior management level, evidence of which can be found when the concept of innovation dovetails with the corporate mission statement. Encouraging new ideas, fostering productive organizational evolution, and backing innovation with strategic actions are among the hallmarks of management at an innovative organization. Leadership is supportive of a mindset that supports cross-functional collaboration to identify, develop, and implement new innovative ideas. The clear enumeration of goals by leadership is essential, so that all parts of the organization understand what the result should be. By embracing and fostering a culture of innovation, leadership can generate a high level of interest/buy-in, so that all employees are empowered to be change agents.

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Exhibit C.3: Leadership Score Examples

Score	Example Description
1	Management does not recognize that innovation is critical to organizational success. Prioritization of innovation is not part of a longer-term strategy.
2	Management recognizes that innovation is a critical aspect of the organization's continued operations. However, converting that recognition into action tends to be irregular, and innovation goals do not appear to be prioritized.
3	Management demonstrates that innovation is a critical aspect of the organization's continued operations. Management's actions are generally organized and structured; however, the focus is typically still on immediate operational concerns, which appear to be prioritized over innovation goals.
4	Through deliberate actions, all levels of management have demonstrated the organization's commitment to the innovation process as articulated by its leadership. Companies operating at this level should be able to provide evidence that middle management understands leadership's innovation directives, is actively working to accomplish these goals, and addresses immediate operational concerns in conjunction with—rather than at the expense of—innovation goals.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Culture

Like leadership, culture can either stimulate or suppress innovation. Organizational cultures that inspire innovation allow for risk-taking as well as the possibility of failure. Companies receiving the most positive assessment approach the innovation process purposefully and systematically, and can demonstrate that their innovation initiatives are integrated throughout the organization. The culture of these companies fosters ownership and transparency, while also encouraging cross-functional knowledge-sharing, recognizing that innovation flourishes in a diverse environment.

For these companies, innovation is part of the enterprise mission statement and is embraced as a key element for long-term success. Tolerance for risk-taking is well defined, with failure an acceptable option but with a process in place to kill ineffective innovation ideas after an appropriate and timely review. There is openness to both internal and external innovative solutions as part of a regular assessment of customer needs, market conditions, and internal/external threats to the business model.

Because leadership often drives culture, an enterprise is unlikely to have a high culture assessment if it does not have strong leadership.

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Exhibit C.4: Culture Score Examples

Score	Example Description
1	Any innovation initiatives are approached from a limited, risk-averse perspective. Innovation is developed on an ad hoc basis.
2	Innovation initiatives are approached largely from a reactive perspective. Innovations may be developed on an ad hoc basis, but ownership of such initiatives is clear. However, these innovations tend to be group-specific and are not undertaken or conceptualized in conjunction with mainstream operations and the larger organization.
3	Innovation initiatives are approached largely from a proactive perspective. The company has fostered a structured approach to developing innovation initiatives that includes input from individuals outside designated innovation groups. However, the company has found it difficult to integrate innovation into its mainstream operations.
4	Innovation initiatives are approached from a proactive perspective. The company can show through specific examples that it successfully encourages innovation throughout the organization and that innovation is part of its vision and mission statement. The company has successfully integrated innovation into mainstream operations across multiple business lines and products. Culture is forward-looking and focused, and fosters a collaborative environment.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Resources: Allocation, Strategy, and Management

A company's ability to strategically allocate resources is critical to the success of an innovation initiative. For a company to receive a higher score for this sub-component, the resources it devotes to innovation must be appropriate relative to its operations and financial wherewithal. This requires that management be fully cognizant of the company's level of agility so that it can determine whether partnering makes good business sense. For instance, a company with limited personnel may find it more appropriate to outsource its innovation initiatives or incorporate innovation responsibilities into an established role than to create a Chief Innovation Officer position. This is not to say that companies with more limited resources do not need to be innovative, but that they need to be more focused in their allocation of resources to innovation, as they would in other areas of their operations. Thus, a smaller niche insurer may emphasize operational innovation or product design rather than harnessing the use of groundbreaking and expensive technology in its operations.

Moreover, having resources is not enough; a company also needs to be able use these resources efficiently and create value. For example, companies may invest significant capital in collecting and storing data, but without an effective data strategy and the ability to exploit what it has collected, its efforts and capital expenditures may not yield productive results.

The resources critical to a company's innovation strategy can generally be divided into one of three categories: technical, creative, and financial. Technical resources include systems and data allocation, with an eye towards the potential for harnessing new technological breakthroughs. Creative oversight encompasses not just the generation of ideas to develop new, practicable solutions, but also ensuring that the right people are assigned to the project. Thus, hiring practices that focus on a diversity of experience and backgrounds, as well as the ability to attract and retain high-level talent, are key. Finally,

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financial resources should focus on the appropriate allocation of budgetary resources: Is the process properly funded? Can the idea be monetized or implemented so that it results in improvement or growth in the top/bottom lines? Additionally, the financial process should include rewarding the organization's innovators. As a result, expenses may be temporarily elevated owing to innovation investments. AM Best expects that these expenses will be explained to the analytical team as part of the normal rating process. AM Best also expects that companies will be able to provide detailed analyses of the return on investment for their innovation initiatives. Partnering with, or purchasing solutions from, external providers is also incorporated into the Resources sub-component.

Exhibit C.5: Resources Score Examples

Score	Example Description
1	The company does not devote resources to innovation, or, if it does, the resources are not appropriate for its operations. Its strategy for managing these resources is not clearly defined.
2	The company devotes some resources to innovation, but its strategy for managing these resources is not linked to its critical operational goals and the use of these resources is not tracked effectively.
3	The company devotes resources to innovation, and its strategy for managing these resources is linked at least in part to its operational goals. However, there may be some inefficiencies that diminish the overall effectiveness of its resource allocation.
4	The company devotes resources to innovation, and actively hiring/retaining talent is a key priority. Its strategy for managing these resources is clearly linked to its operational goals, allowing for their efficient transformation and exploitation. Staff is rewarded for successful innovation ideas and implementation. Not only does the company exhibit effective resource allocation, its resource management strategy also includes opportunities for effective reallocation.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Processes and Structure

The organizations that optimize processes and structure promote organizational intelligence while avoiding innovation silos. Without a proper process and structure in place, implementing innovation process and initiatives will be difficult. Elements of an innovation program that may be evaluated include the company's data management, innovation strategy, and governance processes.

Proper data management is a building block for a successful innovation strategy, as good data is fundamental for innovation to succeed. Proper data management includes data governance that is well defined and clearly delineates (1) the parameters for the organization's investment for data initiatives; (2) the prioritization of these investments; (3) data standardization policies/procedures; and (4) the responsibility for data quality, data stewardship, and data ownership. Access to data and transparency are embraced as corporate-wide objectives. Effective data management processes and structure will ultimately lead to better innovation outputs.

A challenge for insurers is aligning the use of customer data with varying regulatory restrictions related to consumer privacy. The rules for mining of personal data are expected to fall within the confines of

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governance and encompass regulatory guidance. Governance also looks to manage innovation at a portfolio level.

The innovation strategy should incorporate an honest assessment of a company's capabilities and determine whether the strategy will have an inward or outward focus or an appropriate blend of both approaches. This could be project-dependent: some projects may be handled internally, while others may require external expertise or be wholly outsourced. When dealing with external partners—such as venture capital, government agencies, universities, or insurtech—a process for integrating them into the overall strategy is necessary. Companies should be able to articulate/quantify the benefits derived from these external relationships.

A company receiving higher scores in this sub-component has clearly linked its innovation strategy to specific business objectives, such as explicitly linking innovation-driven growth to business targets, with the goal of creating and sustaining a competitive advantage. The company's development plan for innovation is iterative, allowing for adjustment and refinement, and is replicable for processes that work.

Exhibit C.6: Processes and Structure Score Examples

Score	Example Description
1	The company does not have an innovation strategy. The processes and structure of its innovation initiatives are not linked to its goals or operations.
2	The company's innovation strategy is not clearly aligned with the company's long-term strategic objectives. The processes and structure of its innovation strategy are sometimes ineffective, given its business objectives.
3	The company's innovation strategy is aligned with long-term strategic objectives. The processes and structure of its innovation program are generally appropriate given its business objectives, but may have areas in need of further development.
4	The company's innovation strategy and the processes and structure that support it are clearly aligned with its long-term strategic and business objectives. Facilities are in place to explore emerging issues. Data is used to make better decisions, create solutions, and solve problems, and data governance is well defined and managed at a portfolio level. These processes and structure facilitate innovation-driven growth that supports business objectives.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Scoring Expectations

Based on survey results and observations of the insurance industry, AM Best would expect that most companies would generally score in the lower range in the components of the input score, with only the very strongest scoring at the higher ranges. This reflects challenges in process and structure, as well as the relatively recent acceptance of innovation by many industry participants as part of a company-wide corporate culture.

Innovation Output

To be identified as innovation leaders, companies need to establish that their innovation process is effective and creates value, which can take many forms. In the assessment, the output would have to

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be tangible and quantifiable. An example of measurable output would be a decline in expenses linked to a specific innovation process, project or event.

The Innovation Output Score is based on two components: (1) results and (2) level of transformation. When calculating an organization's innovation output score, AM Best uses the previous five years as its timeframe for the analysis.

Exhibit C.7: Innovation Output Score Formula

$$\text{Innovation Output Score} = 2 \times (\text{Results} + \text{Level of Transformation})$$

Results

Ultimately, innovation needs to lead to measurable results to make the investment of resources worthwhile. Companies that invest significantly in innovation infrastructure (systems, talent, and processes) but derive no tangible benefit will score poorly on this sub-assessment. The innovation output can include results such as a lower expense ratio; higher revenue growth; more robust, customer-centric, data-driven product design; better customer retention; greater brand recognition; or stronger data analytics.

Companies can sustain the competitive edge they gain from innovation only by continual evolution of their innovation strategies and initiatives. Therefore, companies receiving the highest scores in this sub-assessment will demonstrate the following:

- A well-balanced mix of operational and growth-oriented innovation
- The ability to respond quickly to both internal and external pressures
- An implementation strategy that appropriately balances short and long-term initiatives—for example, by encompassing a mixture of incremental and disruptive innovations with various time horizons

Exhibit C.8: Results Score Examples

Score	Example Description
1	The company has minimal, if any, measurable results from its innovation initiatives or has no initiatives in place.
2	The company has demonstrated a measurable impact on its results from its innovative process/initiatives. The company has been able to generate ad-hoc innovation results, but whether the results can continue into the foreseeable future is uncertain.
3	The company has demonstrated measurable results from its innovative process/initiatives in its financial results and can identify areas affected quantitatively, such as improved underwriting experience. The results are sustainable and very likely to continue over the near to medium term.
4	Innovation has resulted in a sustainable competitive advantage, with a measurable impact over a sustained period, and is replicable. The company has been proactive in using innovation to outmaneuver competitors and potential disruptors.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

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Level of Transformation

A company's innovation initiatives may be fruitful but may not be transformative or even allow the company to remain relevant or competitive. For example, a company may switch from manual policy filings to digitized storage. Although this process would result in lower expense ratios and would therefore have a positive impact on the results sub-assessment, the level of transformation involved is rather low relative to the industry and leaders outside the insurance industry. The transformation score would therefore be low.

Only those companies with best-in-class output will be eligible for a higher transformation sub-assessment. Transformation does not encompass splashy initiatives that do not create value; rather, it encompasses initiatives that create value, improve customer engagement and experience, lead to a superior business model, or significantly enhance growth opportunities.

Exhibit C.9: Level of Transformation Score Examples

Score	Example Description
1	The company's innovation output is primarily the result of replication of well-used or mature processes or technology.
2	The company's innovation output is not industry-leading. The company has adopted some emerging technologies.
3	The company's output indicates that it is an industry leader in innovation. Peers often replicate the output results. The company is viewed as a disruptor in the industry.
4	The company effectively uses cutting-edge processes and technology throughout the enterprise. The company's innovation is at levels comparable to leaders even outside the insurance industry.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

AM Best would expect that most companies would generally score in the lower end of the output categories. This reflects the challenges insurance companies face in terms of their customer experience relative to other industries. Thus, AM Best would expect that few if any companies would score highly in the level of transformation sub-assessment.

D. Translating the Innovation Score into an Assessment

AM Best translates its innovation scores into five assessment categories shown below.

1. Non-innovator: Companies receiving an innovation score of less than 12
2. Reactor: Companies receiving an innovation score between 12 and 17
3. Adopter: Companies receiving an innovation score between 18 and 22
4. Innovator: Companies receiving an innovation score between 23 and 27
5. Innovation Leader: Companies receiving an innovation score of 28 or higher

The assignment of an innovation assessment follows the summation of the Input and Output scores outlined in Section C. **Exhibit D.1** provides a detailed example of how the scoring system is applied.

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Exhibit D.1: Innovation Assessment Example

Company A is a medium-sized mutual motor writer in the Midwestern US. Company A's top management has recognized that innovation is critical to the organization. The process of communicating this message through company-wide town hall meetings is to ensure that all employees are on board and have an understanding of the company's innovation strategy. Innovation initiatives have focused primarily on expense saving initiatives that have been centralized and budgeted. Management also recognized the need to use data from telematics to track vehicle usage and driving behavior to improve product pricing and risk selection, and it has been ahead of the curve by implementing these innovative initiatives before its competitors have. Challenges for Company A have been effectively tracking the budget for this initiative.

As a result of the company's actions, annual expenses have decreased and net operating income has increased; however, next year's budget does not anticipate the same outcome given the challenges the company is experiencing with the transition to new software for expense tracking and budgeting, as well as unknown costs related to a new metadata initiative. In addition, the company recently lost some key talent in its IT area.

Input Score

Leadership Score = 3

Company A recognizes that innovation is a critical aspect of the organization's continued operations and its strategy is well messaged throughout the organization.

Culture Score = 3

Company A is proactive and has demonstrated that it has a systematic approach to its innovation process. The most recent initiatives had clearly identified owners and followed an assessment of changes in market conditions, with input from varied stakeholders.

Resources: Allocation, Strategy, and Management Score = 2

Company A has devoted some resources to innovation but did not have a formalized process in place until recently. The company has lost key talent to competitors, and system upgrades are behind schedule.

Processes and Structure Score = 2

Company A has a good data structure in place; however, it has not been exploited effectively to date and does not align with its long-term goals. There are concerns about consumer privacy that have prevented progress, and the governance around this is still emerging.

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Total Input Score = 10

The total input score adds up to 10, as shown below.

$$\begin{aligned} \text{Innovation Input Score (10)} \\ &= \text{Leadership Score (3)} + \text{Culture Score (3)} + \text{Resources Score (2)} \\ &+ \text{Processes and Structure Score (2)} \end{aligned}$$

Output Score

Results Score = 2

The company's innovation programs have focused primarily on expense savings and have proven to be effective. However, the ability to replicate these results in other areas is unproven and is not part of a comprehensive strategy.

Level of Transformation Score = 2

Company A has adopted some new technology, but relies on legacy systems and now recognizes that this could put them at a competitive disadvantage if newer entrants attempt to penetrate its niche market. The loss of talent may affect the company's ability to improve in this sub category.

Total Output Score = 8

The total output score adds up to 8 as shown below.

$$\text{Innovation Output Score (8)} = 2 \times (\text{Results (2)} + \text{Level of Transformation (2)})$$

Innovation Score

The final innovation score is 18 as shown below.

$$\text{Innovation Score (18)} = \text{Innovation Input Score (10)} + \text{Innovation Output Score (8)}$$

Innovation Assessment

Company A's innovation score of 18 translates to the innovation assessment category of Adopter.

Company A = Adopter

E. Interpreting the Innovation Assessment in the Context of the Rating Process

Published Innovation Assessment

AM Best considers the assignment of an innovation score to be an absolute assessment—that is, all insurance companies are subject to the same evaluation criteria regardless of their line of business, location, market position, or other segment-specific characteristics. Although there can be degrees of innovativeness (as demonstrated by AM Best's five assessment categories), the scoring of innovation is not contextual. A company either innovates (to some degree) or it does not. AM Best acknowledges that some companies are consciously choosing not to be Innovators or Innovation Leaders and that every company needs to tailor its innovation strategy to what it deems appropriate for its needs.

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Business Profile Impact

The published innovation assessment is not necessarily correlated with an insurer's issuer credit rating. There may be instances where lower rated companies score well on innovation and are assessed as Innovators or Innovation Leaders as well as cases where higher rated companies are assessed as Non-innovators or Reactors. The innovation score does not automatically translate into a rating positive or negative, as AM Best must also assess whether the company's innovativeness provides it with any long-term financial strength enhancement (or detriment), given the company's particular business profile assessment.

While innovation has previously been incorporated in the overall rating assessment, AM Best will now assess the impact of innovation specifically within the business profile building block when assigning a rating. The impact of innovation on an insurer's financial strength is a relative assessment, and does take into account the unique situational characteristics of a particular company. For instance, a line of business as a whole may not be particularly innovative, with most of the composite receiving an assessment of Reactor. A company in that composite receiving an assessment of Adopter that is able to translate its innovative advantage into a competitive one would receive credit for the positive impact innovation has had on its financial strength within the business profile assessment. AM Best anticipates that the importance of innovation will increase over time and that the cultivation of innovation will become a leading indicator of companies with defensible market positions.

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