

How Much Should IT Cost?

By Marek Jakubik

Among IT issues that occupy executive agendas the cost of IT is one of the all-time favorites. Curiously, all these years of asking and telling haven't seemed to produce a credible reply.

Perhaps the reason is its one of those interesting problems that not so much begs for an answer but rather provokes and stimulates. Sort of like when mathematician Benoit Mandelbrot famously asked: "How long is the coast of England?" He delivered no answer, but it did lead him to the discovery of fractal geometry.

And so today I will try to engage you in a bit of an idea journey to provoke and stimulate. Consequently, I'll be less prescriptive (although I would not be myself if I didn't offer an opinion or two) and instead offer a collection of hopefully inciting thoughts and observations.

Some Think It's Simple

I still remember one of my old bosses who had very little doubt about how much to spend on IT. "Less than it costs now" was his standard line. Of course, this drove me bananas, especially since in being frugal to the extreme he would, for example, never agree to spend money on a single benchmarking study. I suspect he thought of it as some kind of voodoo science.

To those who think like my old boss, I apologize. This piece definitely is not for you.

From my contacts with industry CIOs, I know many are in a situation similar to my former experience. "The boss" is more interested in pushing the IT costs down than any other discussion related to IT spending. Yet, while glaringly simple and apparently effective (for the boss), this kind of strategy obviously lacks depth. More important, it deprives the organization of an opportunity to explore and discuss how IT spending is (or is not) related to the achievement of strategic objectives and to the company's competitiveness.

IT Investment, Business Performance

Are they, or aren't they related? Surprisingly, the body of systematic research on this topic is very limited. By and large, however, the collective results can be summarized in three key points:

- When normalized for size, firms considered as "IT leaders" by their peers show better financial results (e.g., ROE, ROA) than non-leading companies.
- Expense ratios of "IT leaders" (e.g., General Expenses) are in line with the rest of the industry.
- Investment in IT, by itself, does not create superior results. What matters is the ability to use IT as an enabler by integrating it with strategies and processes.

The last point carries a perhaps obvious yet important message. Since every firm in the industry has access to the same IT resources, the ability to develop a competitive differentiation depends on the management's capabilities rather than technology itself. This, incidentally, is exactly what Nicholas Carr argues in his rather miss titled Harvard Business Review article "IT Does Not Matter," which together with its sequels provoked such hot debate and intense attacks from the leaders and luminaries of the IT industry.

As to the first two points, I do have a recent practical corollary. A senior executive of one of the best-performing P&C carriers offered this short description of the company's strategic approach: "Keep IT (and general) expenses at benchmark; win on underwriting and pricing." And winning it has been.

Leaders vs. Dinosaurs

P&C insurance companies generally spend a low proportion of revenues on IT as compared with other financial services firms: three to four percent vs. five to eight percent, respectively. It is primarily a function of a P&C industry business model characterized by a low level of transaction rates and limited pressure (at least historically) for business innovation.

Nonetheless, these low levels of IT spending generally do deliver good business value, with insurance companies scoring well on technology contributions to the strategic goals of reducing operating costs, acquiring customers, and improving both quality and employee efficiency. A study

by software company ITCentrix showed the productivity ratio of P&C carriers (measured by revenue per employee over employee cost) is more than two times higher than that of other financial institutions. And so, while insurance companies often lag behind financial services firms in investing in leading-edge technologies, they are quite adept in making effective investments especially as technology matures.

This should be a comforting thought to many of the mid-tier carriers that, quite correctly, use a fast-follower IT strategy. Please note “fast” here is relative to their large and aggressive cousins that, nevertheless, still lag behind the banks and investment firms.

All in all, and with the notable exception of business analytics where, in my opinion, many carriers (especially small and mid-size) still are seriously underinvested, P&C companies get a technology-dinosaur rap rather unfairly. Part of the reason is the industry’s heavy reliance on agents, who are not generally known for technological prowess.

As my friend Hugh once remarked: “Agent’s idea of innovation is to try a new driver.”

Get Ready for a Change

Will this picture change? Of course it will. New, younger agency and brokerage owners already show a much different attitude toward use of IT. A younger generation of consumers is much more comfortable with the use of direct channels. The change is creeping up on the industry. Consequently, P&C CIOs must not only learn how to be good at fast following but also prepare their organizations to be led through a major change.

To fulfill this aspiration, CIOs will have to go way beyond mastering management of IT costs. They will need to develop a new critical capacity: an effective system of converting the dollars allocated to IT into a true economic value for the business.

How well do you convert? This is where things get much more complicated. For one, effectiveness always is difficult to measure. And to make such a measurement a useful management tool, a CIO needs a process that answers at least the following

three questions:

- What financial return does IT investment generate?
- What solutions deliver what portion of that value?
- How best to optimize the value delivered?

Developing such methodology is a non-trivial but very worthwhile task. In return, the CIO will gain not only a solid measuring stick but also a tool to guide the corporate-wide investment-selection decisions. That will include the very important ability to optimize a balance between large strategic initiatives and smaller enhancements.

Far too often CIOs fail to ask: “Are we fully leveraging our investments in IT?” As a result, the existing IT infrastructures and systems are underleveraged. Simple but “unsexy” and hence overlooked issues such as proper training often prevent unleashing the full potential of existing IT assets.

By the way, I do notice sometimes people confuse the concept of measuring IT business value with TCO (total cost of ownership). Let’s be clear and state while TCO is a good way to measure systems costs, it does not measure overall business value. Do not allow TCO to substitute solid business-value analysis as input into IT investment prioritization decisions.

Never Forget the Basics

The last element of converting IT budget into business value is good execution, that is:

- bringing IT projects in on time, on budget, and to business specs (project management);
- managing business unit, corporate and IT strategies, responsibilities, and accountabilities (IT governance); and
- innovating in a timely, risk-controlled manner.

I have to tell you whenever I think of the first two points I see a picture of an orchard full of low-hanging fruit. I cannot help but wonder why it’s not harvested.

I’ll use only two simple but telling examples. A UK study reported 66 percent of project managers are dropped into their role without any training. A 2003 Robert E. Nolan study of the insurance industry re-

ported only 39 percent of respondents agreed, “Actual business results from technology projects are formally measured and compared to projected results”; moreover, only five percent of IT executives and 20 percent of business leaders strongly agreed with that statement. Did you, too, notice an interesting disconnect here? Does this perhaps remind you what is happening within your company?

If I harp so much on the subjects of project management and IT governance, it is for two reasons: a) neither one is a rocket science, b) major and almost immediate rewards await those who do it right. I cannot resist a call—just do it!

A Word on Benchmarking

I’m rather ambivalent on benchmarking. First because it is too often treated in isolation from any notion of strategy; Second, too frequently benchmarking focuses only on things that are easily measurable e.g. IT-budget-as-percentage-of-DPW. To that I say: Interesting, perhaps, but so what? I never have heard of a CIO who was either demoted or advanced just because IT expense ratio looked comparatively bad or good. On the other hand, if you benchmark and consequently have the ability to fine-tune what really matters to your company’s competitive position, I’m all for it.

Being a modern-day CIO and an equal partner with your company’s business leaders is not a matter of saving a dollar here, amortizing an investment there, or even making IT look good on the balance sheet and in the annual report. It is all about understanding how to enhance the value of the enterprise.

Marek Jakubik, a former CIO of Zurich Financial Services and Pitney Bowes, is a co-founder and CEO of the Insurance Technology Group (www.insurancetg.com). He can be reached at marek.jakubik@insurancetg.com or by phone at 416-214-3445.

The CIO Chronicles is a recurring column published every two months in Technology Decisions magazine, a publication of the National Underwriter Company.