Insurance Outsourcing Perspectives: Business Process Utilities Have Promise

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TowerGroup Take-Aways

- Insurance carriers have used external resources in a variety of tactical ways, primarily for cost reduction; the persistent driver is availability of low-cost, highly skilled workforces around the world.
- Third-party administrators represent approximately 60% of the business process outsourcing (BPO) market share and may be potential acquisition targets for enterprise service providers.
- Enterprise service providers are struggling to define their value proposition, and they face resistance from carriers on a number of grounds.
- If approached from a one-dimensional operational perspective or IT perspective, BPO will not enable fundamentally new ways of doing business.
- A business process utility (BPU) is a model for processing high-volume, standardized transactions in which speed and consistency of delivery are important and customization is limited.

Report Coverage

The business practice of outsourcing is no longer the center of public or private debate, and the media have turned their attention to other topics. Although many insurers continue to avoid press coverage of their outsourcing activities, utilization of external resources has become a mainstream element of strategic resource planning. The relocation of work to outsourced facilities, domestic and overseas, is routine. This TowerGroup Research Note examines changes in the nature of the work outsourced, explores barriers to business process outsourcing in the insurance industry, and looks at the emerging market of business process utilities serving insurers.

Definitions of Outsourcing

Any discussion about outsourcing in the insurance industry needs to be clear about which aspects of a carrier's operations are amenable to outsourcing. Each of the following definitions has a spectrum of execution that could be limited to specific operations, could cover a range of services, or could extend to as much as total control of a process or processes, including the assets and personnel to perform those functions. This TowerGroup Research Note refers to four main types of outsourcing: information technology outsourcing, business process outsourcing, business transformation outsourcing, and business process utility.

- **Information technology outsourcing (ITO).** Management and day-to-day operations of the IT infrastructure, including the data center, and application maintenance and development as well as the hosting of systems and other IT-related functions for core insurance services.

- **Business process outsourcing (BPO).** End-to-end outsourcing of a business process in its entirety. Always includes an application component and may also entail deconstructing and recombining business processes to eliminate wasteful steps and enable straight-through processing.
- **Business transformation outsourcing (BTO).** Employs rich and robust process models and technologies to enable process transformation with customers' operations running in separate environments.
- **Business process utility (BPU).** Employs a rich and robust common business process model and technologies to service several customers' operations all running on a single platform and in a distributed network of sourcing locations.

The geographic proximity of the outsourcer to the contracting carrier is no longer much of an issue, thanks to stability of providers' services and advancements in technology. Therefore, the focus in choosing a provider has turned to governance and decisioning concerning the risks in locale, domain competency, project management, and service-level agreements for the work performed. For additional information on governance structures, see TowerGroup Research Note V48:25BI, *Smart Sourcing Without Governance Is Like a Patchwork Quilt Without Stitching*.

Spending on Outsourcing

TowerGroup's projection of the total US insurance industry's 2006 spending at $38.2 billion (USD) may seem a bit aggressive but reflects moderate growth that is commensurate with market demands and past performance. We believe that insurers do not need to spend more but do need to spend more *effectively*. Further, we do not expect the insurance industry to see double-digit increases in annual IT spending any time soon, and it is likely that spending increases will moderate at less than 5% for the next five years. Eventually, spending should moderate further as the result of improved performance resulting from business and IT reengineering.

Exhibit 1 illustrates the distribution of budgeted dollars among hardware and internal and external spend. Excluded are voice communication hardware and software.

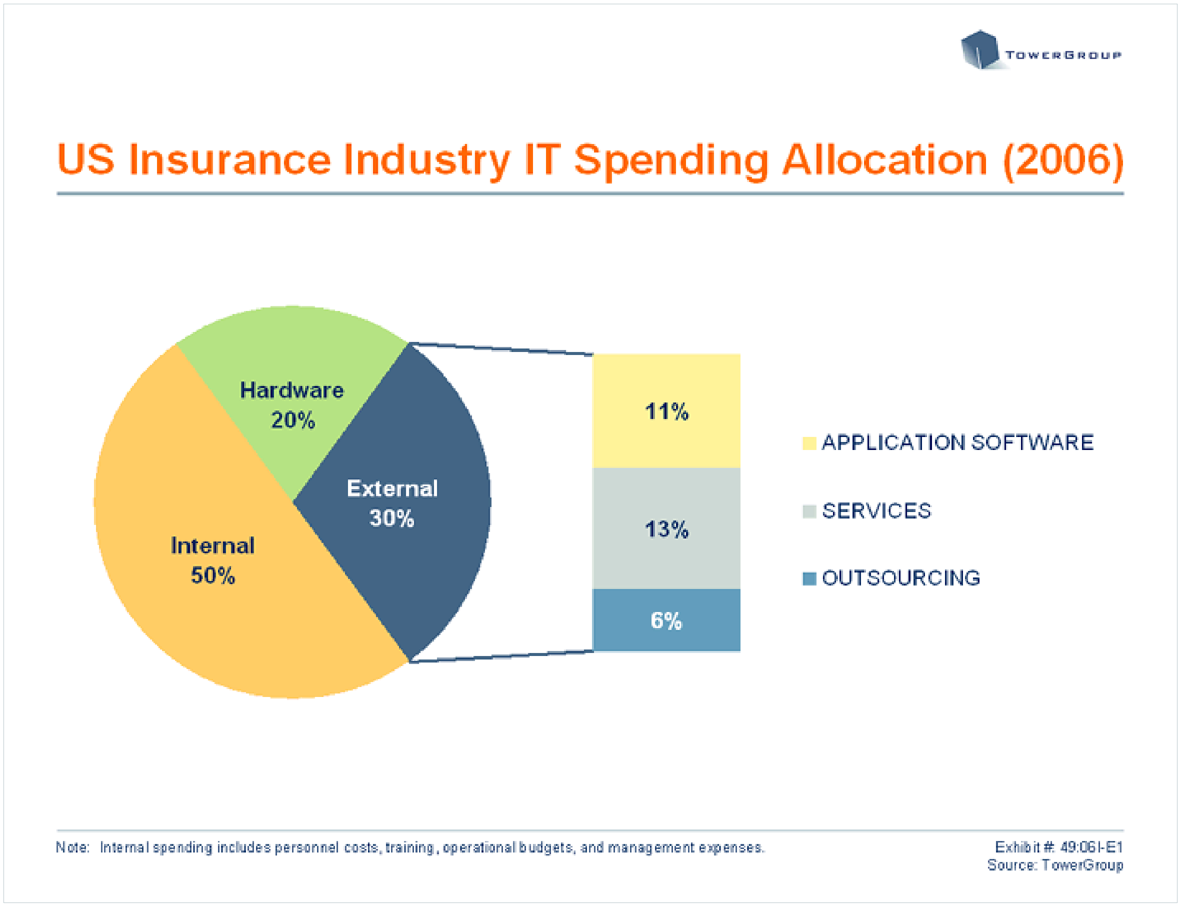

Exhibit 1
US Insurance Industry IT Spending Allocation (2006)
Source: TowerGroup

Hardware includes depreciated capital expenses or leases for computer equipment such as mainframe, servers, networking, storage, computers, the desktop, and printers as well as costs associated with operating systems and software.

There are three categories of external IT spending:

- Application software includes applications software licensing, maintenance fees, and maintenance costs associated with supporting the lines of business.
- Services include third-party services, consulting, and project-oriented ITO.
- Outsourcing includes ITO for the data center and application maintenance and development as well as the hosting of policy administration systems and other IT-related functions for BPO of core insurance services.

Carriers have used external resources in a variety of tactical ways for the past decade, but the primary driver continues to be the availability of low-cost, highly skilled workforces around the world. The availability of workers for ITO services has made the use of ITO by large US carriers commonplace. TowerGroup estimates that US carriers spent a $2.1 billion on ITO in 2005 and will spend $2.3 billion in 2008. BPO, while used regularly at many insurance companies for horizontal, standardized processes such as human resources and benefits administration, is used only sporadically for core operations such as underwriting, claims, and nonfinancial business transactions. TowerGroup believes that roughly 65% of BPO costs go to labor, 20% to technology, and 15% to facilities. Therefore, vertical BPO spending, which was at $2.4 billion in 2005, will increase slightly to $3.2 billion in 2008. It is too soon to determine spending in insurance on BTO and BPU services because they are not yet widely used by carriers. See Exhibit 2.

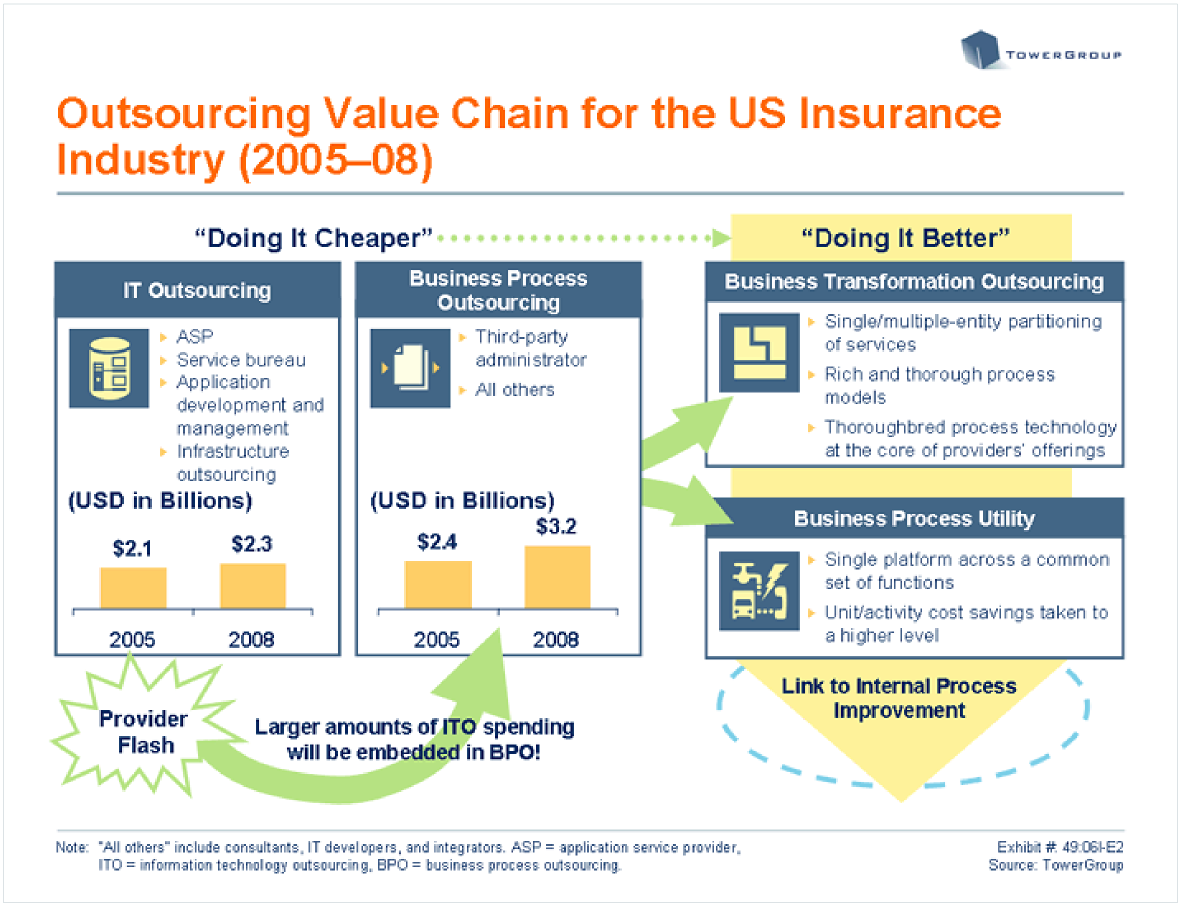

Exhibit 2
Outsourcing Value Chain for the US Insurance Industry (2005-08)
Source: TowerGroup

The Future of BPO

Is BPO a Dated Archetype?

Two basic groups of external BPO providers are having varying success in offering outsourcing services for core insurance services. The large group of hundreds of small third-party administrators (TPAs) continues to provide a range of services in areas such as wholesaling, teleunderwriting, new business processing, claims, billing, document handling, and nonfinancial transactions. These niche service providers have had decades of success providing specialized insurance services for specific business operations. TPAs offer a value proposition that aligns with insurance carriers' business needs by reducing headcount or increasing productivity for daily or overflow operational capacity needs. As a result, TPAs represent about 60% of the BPO market share in the insurance industry and may be acquisition targets for the enterprise group.

The next group of BPO providers is composed of professional and technology services companies that are expanding their core IT and professional services to offer enterprise core insurance processing. These enterprise providers are either acquiring companies or organically building capabilities to offer insurers low-cost core processing alternatives from their global centers. Areas of focus include closed books of business or discrete business processes that transition easily to outside providers. While most of these providers are trying to make the leap from ITO to BPO services, they are struggling to define their value proposition for enterprise services.

TowerGroup recognizes that these vendors are marketing to the business demand for lowering associated costs in core operations. This is typically the stated objective for meeting specific cost-reduction targets. It is apparent that to accomplish this objective, business is leveraging established ITO models that worked to reduce IT headcount and lower technology development and maintenance costs. Business lines are finding, however, that the borrowed IT approach does not work for them and is fostering considerable competition among the enterprise BPO vendors. The effect is threefold:

- Carriers have yet to exhibit any real interest in shifting the control of core operational processes to save a few dollars. Controlling the core business operations is an embedded cultural value, and insurers do not trust service providers to do it better than they themselves can. Adopting a strategic view of BPO for continuous process improvement requires a great deal of commitment from both the carrier and the provider. It is difficult to reach common ground where each institution can derive value from the relationship.
- Most insurance carriers are opting to go it alone and build worldwide captive sites. Exemplifying this trend are large carriers that are pursuing global expansion in emerging markets such as South and East Asia, Central and Eastern Europe, and Latin America. Carriers exercise this model to maintain control of operations, minimize risks, and take advantage of the financial incentives to operate in other countries. Another approach is simply relocating operations to regions where the wages are lower. Carriers are learning hard lessons here because they cannot realize economies of scale, facility and resource management costs escalate, and the financial incentives are lost.
- BPO services in core operations do not consistently demonstrate lasting value because labor arbitrage is proving to be a short-term fix. Labor costs and employee turnover rates in markets such as India, the major player in outsourcing services, are beginning to escalate. Moreover, the delivery proposition is weak (hand over your problem to me, and I can do it the same way, but cheaper). Outsourcers are struggling to offer reliable best practices BPO services that yield higher business value and enable new business models.

TowerGroup believes that the BPO archetype is not prevalent in the insurance industry because there is still too much emphasis on lowering operational costs. This emphasis is out of synch with most insurance companies' objectives of focusing on customer demands to foster deeper relationships ("customer intimacy") and revenue growth. The other issue is that insurance companies quickly reach a point of diminishing returns because they are approaching BPO from a one-dimensional operations perspective or IT perspective. The bottom line is that, in the insurance industry, BPO is not delivering on its promises to deconstruct and recombine business processes to eliminate wasteful steps. The economics do not work. It is cheaper to move the same processes and systems to another location than to transfer business onto new platforms and reach an agreement on how to deliver continuous process improvement.

Real value comes from business transformation services, which require both carriers and vendors to reconsider their point of view. Carriers need to fundamentally change their perspective on how to run their business operations, and outsourcing vendors need to dramatically upgrade their capabilities. This is why TowerGroup believes that not until the next stage of BPO, which can truly transform noncore insurance functions and consistently lower costs, will there be lasting value. For additional information on how life insurers can devise an alternative approach, refer to TowerGroup ViewPoint Issue 104, *Strategic Resource Management in Life & Annuity Operations*.

Doing It Better in Next-Generation BPO

As illustrated in Exhibit 2, shifting business strategy from "doing it cheaper" with ITO and BPO to "doing it better" with the models known as BTO and BPU causes complications. It is clearly more difficult to ensure continuity with the company's objectives when complex operational processes are outsourced. The next stage of BPO employs rich and robust process models and technologies to enable process transformation. In BTO, each customer runs its operations in a separate environment, but the core operational processes are consistent from one environment to the next. In BPU, all customers run their operations in the same environment and the core operational processes are all consistent on a single platform. In both of these approaches, business is driving the initiative.

BTO and SSCs

Business transformation outsourcing relies on what are commonly known as shared service centers (SSCs). SSCs are independent organizations offering services in specific business operations such as underwriting and claims handling. Scale can increase efficiency for repeatable functions and effectiveness for complex activities in centers of expertise, and there is less than 15% customization by the carrier. Quality BTO providers are scarce because of the risks and resources required to implement these services effectively. The closer the BTO processes come to core insurance operations, the more difficult the implementation becomes.

Carriers and providers in a BTO arrangement, however, achieve economies of scale by increasing the number of transactions processed or increasing the number of products managed. The sole objective cannot be cost reduction. It must be a fundamental transformation of the business model to focus internal resources on development and growth and leveraged use of external resources to enable the operating model. The classic analogy to trying to change a car's tires while traveling 65 miles an hour applies when companies embark on BTO initiatives. BTO is a long-term arrangement with multiple dimensions of cost, time, and quality, which therefore requires executive commitment to be successful. Insurers have yet to demonstrate, however, that they will leverage BTO for fully integrated processes beyond areas such as closed books of business or for very specific operational processes.

The Emerging BPU Model

A business process utility seems less risky than business transformation outsourcing. BPU service providers can deliver immediate economies of scale because their focus is on high-volume, routine transactions that are required and distant from core processing. The utility model is an emerging trend. In simple terms, BPU models service not just one company's process needs but those of several other firms as well, all on a single platform. BPU deliver common business process services to multiple entities in a distributed network of sourcing locations. TowerGroup first observed this option in the European financial services industry. For more information, see TowerGroup Research Note V43:04BI, *The Ascendancy of BPO in European Financial Services: Farewell to the Corporate Monolith*.

The BPU model represents an evolution of outsourcing. It extends outsourcing services to high-volume, standardized processes for which speed and consistency in delivery are important and there is limited customization. BPU providers typically offer a transaction-based solution that costs less than BPO because it does not have the human labor costs of BPO. Another benefit of BPU is that it creates a channel for transacting business between parties in a one-to-many model as opposed to needing separate channels for each party. BPU's success will require the industry to let go of the belief that services are differentiators. In fact, because services have become standardized, there is little distinction between the services of various carriers and therefore little competitive advantage for carriers in retaining control of the services. As a result, the BPU model is emerging in the insurance industry and has the potential to deliver real economies of scale from the aggregation of commoditized industry processing.

DTCC. The most prevalent use of BPU services in the US life insurance market is for processing of financial transactions. Depository Trust & Clearing Corporation (DTCC), which also serves the securities and investment industry, supports insurance transaction processing and links carriers with their distribution networks. The company was formed when the operations of The Depository Trust Company and National Securities Clearing Corporation and other firms were integrated. The suite of DTCC services for insurance includes the sale, servicing, and back-office processing of fixed and variable annuities and life insurance. According to DTCC, its automated, centralized, and standardized infrastructure enables insurance carriers and distributors to exchange information at various points throughout the annuity and life insurance processing cycle. DTCC connects more than 100 distributors and 50 insurance carriers, which represent a growing proportion of the $3 trillion in US financial industry transactions processed daily.

Two other emerging examples that TowerGroup would define as BPUs are described below. One is a utility for claims adjustment, in which the vendor connects carriers to independent adjusters; the other is a utility for insurance agency appointment and licensing, in which the vendor connects producers, brokers, carriers, and states.

Symbility Solutions. This vendor offers two solutions for property claims. One is Symbility.Net, a Web-based communications hub, data warehouse, and analytics engine. The other is a mobile claims application to help insurance adjusters review claims, gather information, and create and edit estimates in the field. According to Symbility Solutions, its services are available for use with any mobile, pen-based handheld platform, and the system allows adjusters and contractors to write and process claims on-site with greater accuracy and to settle claims more efficiently. As of September 27, 2006, the mobile claims solution supported 600 companies and 3,500 users, including insurance companies, independent adjusters, and restoration contractors in Canada and the United States. Symbility.Net has the potential to connect carriers with independent adjusters to allocate work, manage field activity, and efficiently receive claim data. This utility can dramatically speed the claims process, principally for residential and commercial property claims estimation.

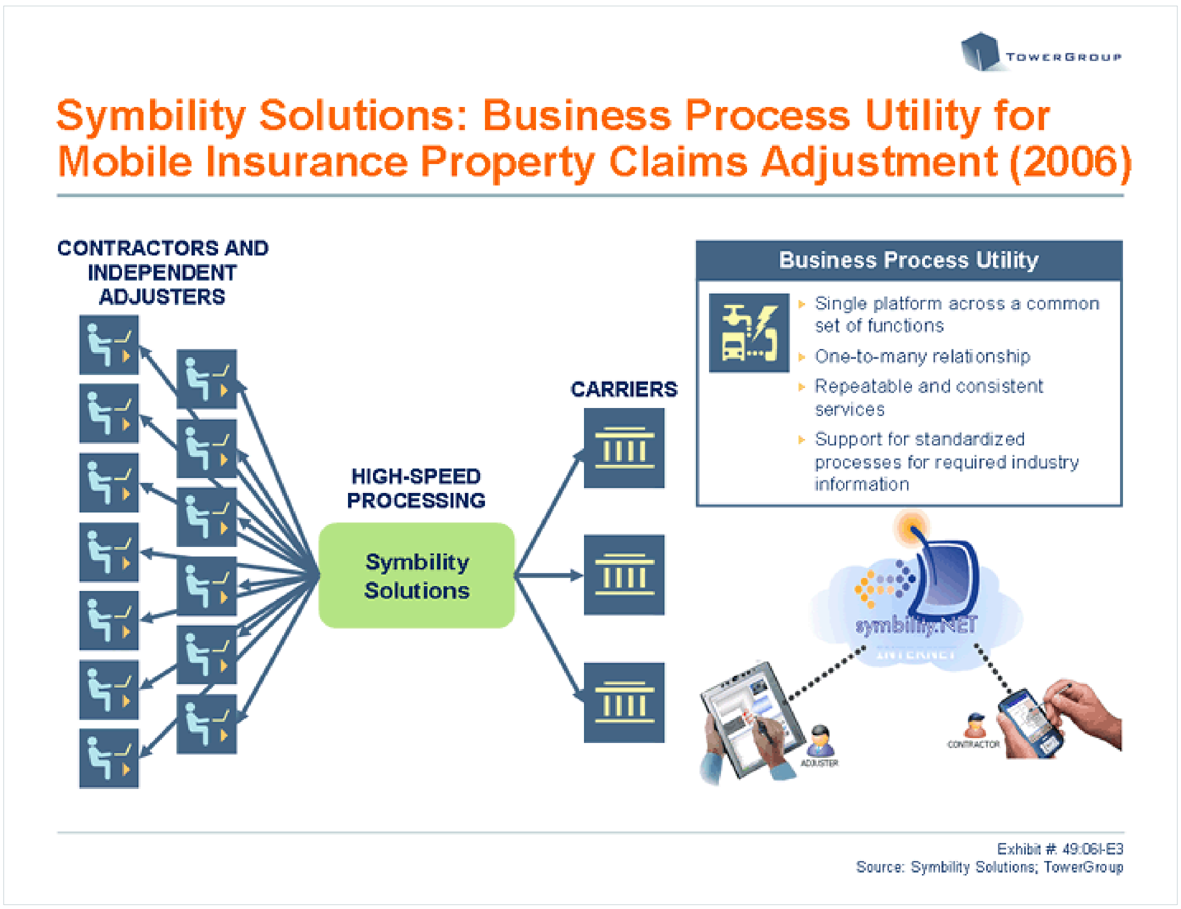

Exhibit 3
Symbility Solutions: Business Process Utility for Mobile Insurance Property Claims Adjustment (2006)
Source: Symbility Solutions; TowerGroup

Sircon. Sircon is a Web-based offering for agents, brokers, insurers, and state departments to streamline agency appointment and licensing. (See Exhibit 4.) This process is often totally manual, and it can take weeks to establish a new producer relationship. The premise is that a producer enters the required appointment and licensing information once, and the utility then submits it to multiple carriers and state regulators for approval. This approach could deliver on the elusive promise of a single-entry, multiple-company interface (SEMCI) for the appointment and licensing process and improve time to market for valuable revenue-generating activities. According to Sircon, instead of a carrier having to master 50 different states' Web sites, the carrier can access the utility's easy-to-use, Web-based services for all of these transactions in a single place. As Sircon increases the number of states, brokers, and agencies on its network, more carriers will participate.

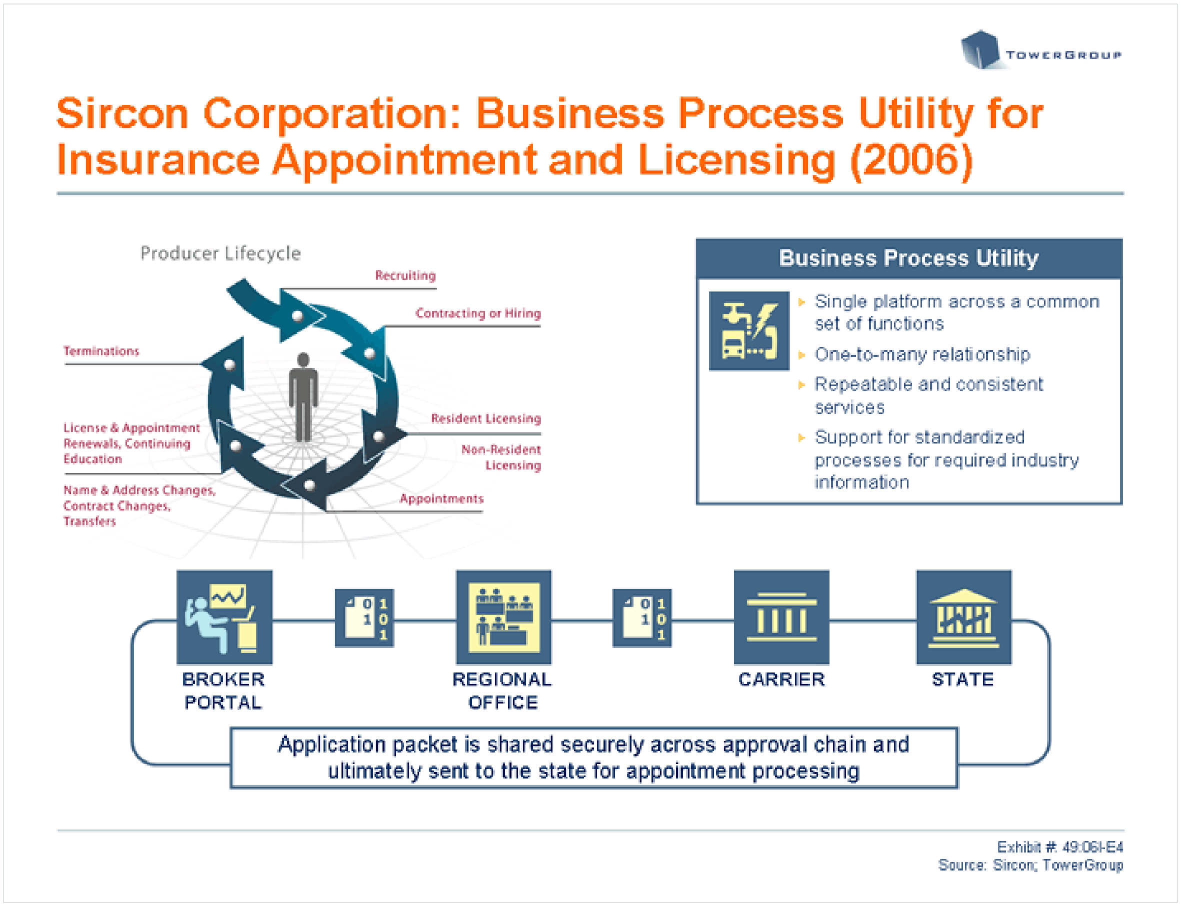

Exhibit 4
Sircon Corporation: Business Process Utility for Insurance Appointment and Licensing (2006)
Source: Sircon; TowerGroup

Automation of High-Volume Activities. Automation will have a major impact on the future of BPO and give rise to adoption of BPUs. Process automation at the utility level will make it clear that it is no longer necessary to customize processes and retain control of them. As the services offered by BPU vendors improve, insurers will eventually recognize that their core differentiation is not in routine, required services. In the future, it will be routine for carriers to hand over these high-volume activities to companies that can serve as their proxies performing services with speed and discipline that streamlines operations at lower cost and higher value.

Summary

In the insurance industry, outsourcing information technology is an accepted practice to lower costs and, in many instances, to deliver speed and quality that the insurer may not have accomplished otherwise. The key to successful outsourcing for these services is to match an outsourcing provider's services to the carrier's needs, employ strict governance of the outsourced activities, and monitor the activities to ensure that the stated objectives continue to align with the carrier's goals. This premise is no different for outsourcing business processes. However, the benefits that carriers expect to derive from adopting business process outsourcing (BPO) should be different. Carriers need new business strategies that ease pressure on their profit margins and enable them to create flexible operating models that not only lower costs but also create a more adaptable operating environment. Combinations of internal and external resources enable that type of performance and create consistent value for continued innovation.

TowerGroup recognizes that insurers have serious concerns about outsourcing services to third parties because of the perceived risks. The limited experiential data today about the extent to which carriers are outsourcing their business operations contributes to misperceptions about the risk of outsourcing. The perception of risk is heightened by media hype and becomes an unfounded barrier to sourcing strategies. In 2003, the perceived risk with regard to information technology outsourcing (ITO) concerned the threatened loss of American jobs to overseas workers; in 2006, the perceived risk concerns data privacy and security. Just as the concerns of three years ago subsided, we expect that today's issues will give way to new ones. Leading outsourcers meet stringent performance levels to attract and retain business, and they have experience in addressing carriers' concerns. In fact, many outsourcers may surpass individual carriers in their capability to control operations. Carriers must simply address their concerns head-on and deal realistically with each based on what is best for their respective company and circumstances.