Article from:

News Direct Newsletter

May 2004 – Issue No. 47

THUMBS UP ON OUTSOURCING

LIFE INSURERS ARE FINDING OUTSOURCING CAN INCREASE SHAREHOLDER VALUE BY CUTTING COSTS AND BOOSTING EFFICIENCY.

BY DOUG MCPHIE

A properly structured and managed outsourcing arrangement has a positive impact on shareholder value, according to a recent Ernst & Young study, while an improperly structured arrangement can have the opposite effect. This finding is corroborated by the conclusions reached in a Morgan Chambers study of 100 Financial Times Stock Exchange (FTSE) companies in the UK which showed that the announcement of a mega-outsourcing deal resulted in a 5 percent sustained increase in share value over companies that did not use outsourcing. Another study by U.S. analyst Stern Stewart produced similar results.

Despite the demonstrated linkage between outsourcing and shareholder value, life insurance companies historically have lagged banks and other sectors of the financial services industry in the extent to which they engage in outsourcing. Another UK study indicated that the banking industry accounted for 35 percent of the total value of outsourcing contracts for business processes in the UK, while the life industry represented only 5 percent of the total.

> **Over the past year, the trend toward outsourcing in the life industry has been growing, with major deals occurring in North America, Europe and Asia.**

PICKING UP SPEED

Now that may be about to change. Over the past year, the trend toward outsourcing in the life industry has been growing, with major deals occurring in North America, Europe and Asia. Since the beginning of this year, Manulife Financial, Canada's largest life insurer, has announced the outsourcing of its North American IT infrastructure management to IBM, and Sun Life of Canada has agreed to have Marlborough Stirling handle the policy administration of its 800,000-policy UK business. Last year, Abbey Life announced a similar deal with Unisys for its 1.5 million life policies.

John Mather, chief information officer of Manulife, cites four main reasons why the insurer has entered into its partnership with IBM: to provide IT depth and flexibility for future mergers and acquisitions, to provide resource flexibility that will allow the insurer to respond to the peaks and valleys of IT demand resulting from the rapid development of new products, to create a top-flight IT back office and to drive cost savings.

Outsourcing is often viewed as falling into two categories: the first category, information, communications and technology outsourcing, encompasses IT operations, development, infrastructure and networks. The second, business process outsourcing, can include back-office operations for group, individual, finance, investments, human resources and other operating areas. Providers such as Cap Gemini, CGI, EDS and IBM all offer solutions in both of these areas for many industries, while other companies specialize solely in the life industry.

Historically, North American life insurers have used outsourcing only for minor business processes, or for new processes that lack an existing administrative infrastructure. However, as the recent announcement by Manulife and other companies suggests, the trend is shifting. And while IT is often the first place where life companies outsource, the bigger opportunity may lie in the area of business-process outsourcing. The incremental gains that come from internal management of business processes may be neither big enough nor achievable quickly enough to produce the kind of dramatic process improvements that senior management is looking for today.

CORE VERSUS NONCORE PROCESSES

Our study found that financial services firms increasingly view outsourcing as an integral part of their strategy to save money and boost the bottom line. As a result, they are now willing to outsource activities once regarded as sacrosanct. Is policy administration one of those activities?

Most of the life companies we have spoken with say they have not given serious consideration to outsourcing some or all of their policy administration

Doug McPhie is a partner in Ernst & Young's Toronto office. He can be reached at 416.943.3800 or doug.mcphie@ca.eyi.com.

processes. They question whether outsourcing policy administration can reduce costs. They also maintain that insurance products, systems and interfaces are too complex for outsourcing providers to manage effectively and that policy administration should not be entrusted to a third party because it is a core business process. How valid are these concerns?

In the life insurance industry, we believe that product design, marketing and distribution, policyholder service, underwriting and risk management are the key areas where life companies compete through differentiation. While many life companies attempt to differentiate themselves through outstanding policy administration, the marketplace recognizes only a few. Policy administration does touch the customer, but for many companies the goal is to deliver service at the lowest cost while meeting a minimum baseline of quality. This makes policy administration a prime candidate for outsourcing.

Liberty Insurance Services, a U.S.-based, third-party administrator owned by Royal Bank, currently provides policy administration outsourcing services, from underwriting to claims adjudication, for more than four million policies issued by a number of life insurers. Among those companies is Fortis Family Life, which decided to outsource the administration of its more than one million policies years ago.

Doug Donivan, senior vice president, notes that Fortis uses Liberty for most of its policy administration activities, from initial application to claims payment. Other processes, including the product development, distribution, actuarial and corporate reporting, are still handled in-house. Essentially, the policy administration process has been changed from being a back-office operation at Fortis to being a front-office operation at Liberty.

Policy administration in its broadest sense covers all stages of a policy life cycle after the policy design, marketing and sale processes (see Figure 1, right).

Routine internal transactions are obvious candidates for outsourcing. More sensitive are those with a customer interface, such as the call center. Can a provider's call center deliver the depth of knowledge needed to handle for what can be a large portfolio of highly sophisticated products, and can the provider be given the right empowerment to resolve customer problems appropriately?

THE MANY FACETS OF POLICY ADMINISTRATION

PRIMARY PROCESSES	RELATED PROCESSES
ASSESS RISK AND ISSUE POLICY • Underwriting decisions • Operation and maintenance policy administration system and policy master file • Initial premium processing and deposit • Policy issuance • Bank account maintenance	• Commission calculations and payments • Reinsurance • Accounting
POLICYHOLDER SERVICES • Call center operation • Premium billing, collection and processing • Name and address changes • Receive initial claims/surrender notification and collect relevant documentation • Annual policy update	• Commission calculations and payments • Information systems enhancements and maintenance • Reinsurance • Accounting
PROCESS CLAIMS AND SURRENDERS • Receive initial claims/ surrender notification • Payment of claim/surrender value	• Claims adjudication • Commissions adjustments • Reinsurance • Accounting

FIGURE 1

PRODUCT COMPLEXITY AND INTERFACES

Policy administration involves complex products and systems, and complicated interfaces between these systems. Products can range from simple term policies to sophisticated variable universal life policies. Systems interfaces include linkages between underwriting, policy maintenance, commission, reinsurance, call center operations, cash management, claims adjudication, billings and collections, reserving and accounting.

Outside providers typically have the systems and processes to support the most complex products and can provide seamless interfaces back to the life company's in-house systems, supported by real-time, daily, weekly or monthly connections.

Fortis believes Liberty is successfully managing the complexities of its products, according to Donivan.

CONTINUED ON PAGE 8

| THUMBS UP ... CONTINUED FROM PAGE 7 |

Interfacing between systems is not an issue, he says, because there is a seamless interface back to the insurer's accounting, reserving and investment systems through extracts between Liberty's systems and those at the insurer.

However, multiple products and interfaces, together with the long life of policies, result in another major complication: system conversions. The applications supporting policy administration must support a range of products whose life cycle can exceed 50 years. Often, the systems applications are home grown or are modified versions of commercial applications. Given the life span of insurance products, it is inevitable that the products will need to go through several systems conversions throughout their life cycle—an expensive and risk-prone process.

Insurers often elect to maintain multiple applications rather than incur the costs of conversions.

Adding to the complexity is the acquisition of companies or blocks of business that can result in a life insurer's maintaining multiple systems' applications. Insurers often elect to maintain multiple applications rather than incur the costs of conversions. However, multiple applications mean multiple support processes, such as reprogramming each application for a change in tax law. Outsourcing removes these issues, and outside vendors claim that they often can complete conversions more quickly and at less cost than the company would incur in doing a conversion itself.

SUBSTANTIAL COST SAVINGS

There is some skepticism in the industry about an outsourcer's ability to provide services at a cost lower than the life company itself can achieve. However, Manulife's John Mather reports that the savings his company realized from its outsourcing deal with IBM exceeded what the company anticipated when it first began examining outsourcing opportunities. He estimates the seven-year deal will result in a 30 percent savings on the $1 billion CDN it would have cost Manulife to continue to manage ICT itself.

Sun Life of Canada reported a $50 million savings from outsourcing policy administration in one business unit. Abbey Life and Fortis also cited cost savings resulting from their policy administration outsourcing arrangements.

According to Bruce Powell, senior vice president of Liberty, its customers have realized an average of 25-30 percent savings in annual policy administration expenses, and a one-time system conversion typically costs between 30 percent and 50 percent of the initial annual cost. The savings result from economies of scale, process innovations and the provider's ability to spread its investment in new technologies—for example, new universal life systems applications, imaging, work-flow and call-center operations—across many companies, reducing the costs to each one.

Another benefit of outsourcing, says Donivan, is that previously hidden costs are now visible and are better managed. For example, when Fortis maintained its own policy administration information systems, program changes were not clearly defined, resulting in inefficiencies and rework. Now that Fortis receives explicit bills from its outsourcing provider for programming time, it has learned to better define exactly what is needed and why, before involving the provider in systems development.

A number of other less obvious factors, in our experience, can have a financial impact on the success of an outsourcing transaction:

- The opportunity to reflect expense savings in product-pricing decisions.
- The changing regulatory capital requirements that result from disposing of capital assets such as systems, facilities and call centers.
- The transfer of employee future benefit liabilities from the balance sheet of the life insurer to the provider.
- The potential commodity tax impact of convert ing internal salary and other expenses to external service fees.
- The conversion of internal fixed costs into variable external costs based on transaction volumes.
- The ability to smooth cash flows by avoiding the periodic capital expenditures required when in-house processes, systems and facilities are maintained.
- In some countries, such as Canada, there may be an actuarial liability impact.

- The insurer's willingness to take capital stock from the provider in lieu of cash. Typically, when a provider takes on a business process, it will acquire and pay for the assets underlying that process, such as call centers, technology and facilities. In some cases, the provider prefers to issue its own stock as consideration instead of paying cash to tie the customer to its success.

MAKING IT WORK

Our study found that, despite the good will that usually marks negotiations with a provider, the final wording in many contracts focuses only on cost cutting and includes numerous nonperformance penalties. This is not the right framework for fostering cooperation and joint problem solving.

Life insurers that have implemented or managed a major outsourcing arrangement agree that having the right attitude is a critical success factor. This issue starts with the leader of the business unit that is being outsourced, says Manulife's Mather. If that leader views outsourcing as amounting to selling off the business and a threat to his or her position, it is unlikely that an outsourcing arrangement can be worked out.

To Donivan of Fortis, maintaining an ongoing relationship after the deal is implemented is equally important. "To succeed, you have to approach the relationship with the provider as a partner, not a vendor," he says. "You need daily communications, you have to train your own people in the outsourcer's methods, and you must stay involved with the process." That means having an in-house structure to manage the relationship at a governance, relationship and process level.

One of the key techniques employed by Fortis is to use internal auditors to manage process control and quality. The insurer maintains one of its own auditors full-time on its provider's site doing daily audit procedures on applications, claims, call handling and the management of suspense accounts. It also uses its corporate auditors to conduct more formal semiannual reviews of processes such as underwriting and claims adjudication. Service-level agreements are important and should address both quantitative and qualitative performance measures, says Donivan. Quantitative measures include speed to process a policy, error rates and waiting time at call centers. Qualitative measures, such as customer satisfaction surveys, look at the intangibles that cannot be captured by traditional measurement systems.

While some argue that the consolidation and uncertainty prevalent in the industry today will delay outsourcing decisions, we believe the opposite will occur. The trend toward outsourcing of IT and business processes in the life industry will accelerate, because a well-structured, well-executed outsourcing arrangement can increase company value and facilitate future integrations with other life insurers. The promise of future cost savings is driving much of the consolidation now occurring in the industry. And based on the experience of the companies that have tried it, cost savings is exactly what outsourcing delivers.