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IMPROVING A LIFE INSURANCE COMPANY'S PERFORMANCE THROUGH OUTSOURCING

BY GREIG WOODRING

Today's life insurance companies feel increasing pressures to deliver performance, at the same time contending with an environment characterized by growing competition and rapid change.

Gone are the days when a company can survive with long-term average performance. How does a company in this increasingly competitive world achieve the earnings required to satisfy its share and debt holders? The answer often requires the ability to partner through outsourcing with organizations that improve the company's performance, an approach evidenced by the growing use and acceptance of outsourcing.

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A COMPETITIVE AND UNCERTAIN ENVIRONMENT

There is no doubt about it, the life insurance industry on a worldwide basis has become a much more competitive place over the last 15 to 20 years and most signs would seem to indicate that even greater competitiveness can be expected in the future.

The composition of the industry has been changing. Greater globalization has meant that large, well-capitalized financial service organizations continue to expand their worldwide reach. At the same time mergers and acquisitions weed out underperforming life insurance companies as stronger companies search for ways to drive down their own costs and build critical mass.

Demutualizations bring former mutual companies into competition for capital growth and expansion and change the competitive landscape. New players have entered the industry, such as banks, securities brokers, mutual fund companies and even non-financial service companies such as brand name retailers, like Marks & Spencer, that have power via their access to the consumer.

On the consumer front, demographics and psychographics lead customers to expect higher performance and greater value from their life insurance provider. At the same time, as populations mature and life spans increase, needs shift from protection products to income products. In addition, intergenerational wealth transfer creates a need for investment advice, financial planning and estate planning. What's more, consumers today have greater access to financial information than ever before and more ways to buy financial and insurance products.

Regulatory changes also have a major impact on the industry. Deregulation worldwide encourages insurers to enter new markets and also encourages the emergence of large-scale financial services organizations, replacing standalone banks, insurers and brokerage firms.

Regulatory changes also focus greater attention to market conduct issues; they concern themselves less with what an institution sells and more with how they sell it.

Technology, of course, exerts huge effects on all industries and insurance is by no means immune. It affects how things can be done and raises expectations with respect to speed and efficiency. Technology improves operational efficiency for most insurance functions. It facilitates medical breakthroughs, which promise to improve treatment and early detection for various diseases, as well as improve mortality. In addition, the Internet can increasingly be used as a distribution channel, especially for simple products, as well as a tool to complement existing sales channels.

Finally, all of these activities directly take place against the backdrop of economic uncertainty and concerns over global terrorism.

ACHIEVING PERFORMANCE

How does a company overcome the challenges of this competitive environment and achieve high performance?

Many companies with the resources to do so go on the acquisition trail, looking to get bigger and

Greig Woodring is President and CEO of Reinsurance Group of America, Incorporated.

"squeeze out" redundant expenses. Any under-performing company can find itself in an acquirer's sight as shareholders have less patience than in the past. High performing companies with attractive assets, which do not possess the size to fend off acquirers, can also become targets.

However, while this approach can increase ROE and has the added benefit of reducing the competition, a strategy dependent only on acquisition strategy is difficult to sustain. An acquisition strategy takes focus capital and, with the right people, the ability to integrate effectively. An acquisition strategy also may require even larger acquisitions to sustain the momentum, a difficult task. Many mergers and acquisitions have failed to meet their original financial and strategic objectives.

Other approaches, more sustainable for most companies, often involve the use of outsourcing. In this competitive environment a company needs to focus on results and performance across its entire business. However, companies find it difficult to be the best at everything. To improve overall performance many companies turn to outsourcing certain functions that a company can't or doesn't choose to do as well as others. Within the outsourcing approach, successful companies choose to follow one of two models, i) the manager model and ii) the specialist model.

Companies that follow the manager model often operate successfully across a number of functions or businesses and succeed through good management policies and procedures that bring standardization and efficiency. Such companies can manage diverse businesses through process and brand leveraging. However, these companies also recognize that to achieve the optimum results means using third parties for certain functions. Manager model companies succeed at doing this, because their core competency—management—gives them the skills to manage both internally and externally. They make internal/external decisions rationally based on core competencies and transaction costs.

Companies that follow the specialist model focus on a particular function or business and develop deep skill in their area of expertise. They incessantly use outsourced providers to broaden their operations and, given their distinct focus, may often extend themselves as outsourcing providers as well.

One key to successful use of the manager model or specialist model involves the ability of companies to outsource effectively.

OUTSOURCING

Outsourcing for any company can potentially yield a number of benefits, including faster new product introduction, lower costs, access to professional expertise for a function not possessed in-house, improved quality and an opportunity to focus more resources on core activities.

However, outsourcing is a partnership and, as we all know, partnerships can be difficult. To get the most out of outsourcing requires a company to i) be clear as to why it is seeking to outsource, ii) select the right provider and iii) dedicate effort to managing the relationship.

An organization must understand why it is seeking to outsource. A company that outsources wants to become more competitive, but it must appreciate exactly how outsourcing can make it more competitive. Is the company outsourcing a function because primarily it is looking for improved speed, cost, technical expertise or something else? Lack of clarity with respect to the basic motivation can lead to the wrong outcome.

Finding the right provider is paramount. A provider may have, for example, the attributes to provide speed, but not cost savings or leading edge solutions. Transaction costs also need to be considered, they include the cost of services provided, as well as the costs to manage the process.

It should be recognized that resources are required to manage the function provided and the relationship with the provider. Outsourcing a function does not mean you can forget about it. A well-managed relationship will minimize potential problems and benefit both parties.

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What can be outsourced? Most of the functions, that together comprise the value chain of a life insurer, can be outsourced to various providers. However, life insurers, until fairly recently, have traditionally performed most of their functions in-house; this has been changing quickly. Today there are many examples of life insurers outsourcing key functions, such as distribution to banks, brokers and the Internet, underwriting to reinsurers, administration to third-party specialists and fund management to third-party fund managers. In fact, we have even seen, facilitated by technology, the emergence of virtual insurance companies, where most functions are outsourced.

A better question should be, what should be outsourced? This will, of course, vary from insurer to insurer, depending on their core competencies. However, there are some activities that, by and large, on an industry-wide basis make more sense for insurers to outsource, simply because it is an area where a higher level of expertise exists externally. One of those areas is in the pricing and management of mortality, the logic of which, given the recent growth of this activity, is being better and better understood.

OUTSOURCING MORTALITY RISK ACCEPTANCE

Outsourcing mortality risk to reinsurers has become one of the most common outsourcing activities by insurers and a practice that is on the rise in many countries around the world. It is particularly prevalent in the United States and Canada, where statistics for the year 2000 revealed that the percent of ordinary new business that was reinsured had grown to over 60 percent. On an in-force basis, an estimated one quarter of total in-force sum assured has been reinsured in North America.

Why does it make sense for insurers to outsource mortality? Outsourcing mortality allows insurers to free tied up capital for other purposes. The reinsurance market is efficient and on a risk-adjusted basis, counting the cost of capital, reinsuring mortality risk changes a variable profit stream to a fixed-profit stream at no significant risk adjusted cost. Mortality is a reinsurer's core business; consequently they focus on mortality pricing and management. Outsourcing mortality allows insurers to take advantage of reinsurers' expertise and offer better prices on their new business.

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When properly done, outsourcing any activity will help make an insurer's whole value chain more effective. With respect to the outsourcing of mortality specifically, its wide use and growing adoption by insurers is arguably making the whole industry more effective.

CONCLUSION

Insurers that focus on their core competencies and astutely outsource the other functions of their life insurance value chain will become more competitive and improve their performance.

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