INDUSTRY OPINION

Transformational outsourcing: does the new buzzword really work?

DAVID SKINNNER of law firm Morrison & Foerster examines the advantages of outsourcing for those looking to make technological progress

THE insurance industry in the UK faces many challenges. Margins have been squeezed, regulation has forced up costs and poor investment returns have put many traditional lines of business under threat, including life and endowment policies.

Insurance companies have faced these threats in a number of ways and have often looked to technology and outsourcing as potential saviours. Having closed their life books to new business, some companies have sold them to specialist investment companies to release capital — eg, Royal & SunAlliance. Others have outsourced their life business to a third-party outsourcer — eg, Abbey Life to Unisys. In fact, insurance companies have been heavy users of outsourcing, following both onshore and offshore models — Aviva and Royal & SunAlliance are good examples of this.

New wave

Outsourcing has not necessarily achieved the cost and efficiency savings that many in the industry require. A new wave, so-called "transformational sourcing", is now being pushed by a number of service providers, including IBM and Accenture.

So what is transformational sourcing? Is it something new or another passing fad? The theory behind transformational sourcing is clear. Traditional outsourcing involved transferring an existing function or process (such as applications maintenance, IT infrastructure or claims handling) to a third party who either used the current staff and assets to provide the service onshore, or its own staff and assets to provide the service offshore.

Whether the service was onshore or offshore, the end result was that the insurance company received a very similar service back from the provider. There might have been some cost savings and many companies also used outsourcing or offshoring to trim staff costs and unwanted assets.

However, the cost savings were not dramatic and there were rarely substantial service improvements. In addition, managing a third-party outsourcer was often time consuming and merely distracted management from dealing with the problems facing the industry.

The transformational model is different. It aims to re-engineer a process or function so that both the performance improves and the cost decreases. Transformational sourcing aims to change the traditional outsourcing paradigm that says if you outsource a problem you do not get rid of the problem.

For an insurance company, transformational sourcing offers opportunities to make rapid improvements, enabling the company to impress the market analysts and steal a march on its competitors. Service providers are offering to transform applications maintenance, claims handling and even underwriting, so that costs are reduced and the performance ratios are improved.

Transformational sourcing leverages third-party expertise in two ways. Under the first methodology, the insurance company outsources a function or process with a pre-agreed programme of process re-engineering to be carried out by the outsourcer during the initial phase of the contract.

The second approach uses a skills infusion. This is similar to the traditional consultancy model and involves using third-party expertise, often at a management level, to improve skills and management so that the insurance company's own staff are trained and managed to deliver the required transformation. This second model has been used before, not least with the Prutech joint venture between Prudential and Andersen Consulting in the 1990s.

Back-office jobs in insurance have been outsourced: are they as effective as they could be?

Jury out

Do these approaches work? The jury is still out but there is evidence that some of the recent projects in the insurance and financial services sectors are showing positive signs. In our experience, the key is setting up the project in the correct way.

Transformational sourcing needs upfront work to ensure that the cost savings and service improvements are delivererable. Firstly, the insurance company needs to decide which transformational sourcing model it wishes to follow.

It then needs to work on defining the functions or processes to be transformed and what are the measures for cost and improvements. If claims handling is being improved, you need to decide what is being measured.

The time spent in handling each claim? The cost of processing each claim? The amount paid out per claim? Client satisfaction? Performance scorecards need to be developed so that the insurance company and the service provider are clear on the objectives.

The contractual framework also needs a different approach. Outsourcing contracts differ from M&A contracts since a long-term relationship is different from a business sale. So a good outsourcing contract clearly specifies price, scope and performance levels.

However, since these are usually based on the customer's existing operations, it is easier to achieve this level of precision than with transformational sourcing. Transformational sourcing needs to be precise about the current state of the function or process and also set out a route map for how this function or process will be transformed.

There are fewer standard tools to measure this type of transformation than in many traditional IT and call centre service levels. In addition, relationship management is even more important, especially for the infusion approach. The inter-relationship between the insurance company and the service provider needs to be carefully mapped out.

Exit management has to be pre-planned with even more precision than with traditional outsourcing. In five or seven years there may not be a function to hand back to the insurance company or to transfer to a new service provider.

Self-sufficiency

Instead, the insurance company needs to have in place mechanisms to achieve self-sufficiency once the contract is over. The aim is that the skills infusion is not a permanent reliance on third-party expertise but rather an up-skilling of the in-house staff and a genuine knowledge transfer.

An added risk for the insurance company is how to comply with its regulatory obligations. If it follows the outsourcing route, it may have to make the service provider an appointed person. It will also need to ensure that the contract complies with Financial Services Authority guidance. An attraction for the infusion model is that less regulatory hurdles need to be crossed. There is also the added benefit that key staff and knowledge are not lost to a third party. Instead, the existing staff and knowledge are enhanced by using third-party expertise.

Risks and opportunities

For the service providers, transformational sourcing poses considerable risks and opportunities. The opportunities are to find new lines of business to supplement their existing consulting and outsourcing business. Delivering the cost savings and benefits is very difficult and many suppliers are now recruiting heavily to find people who have experience in service delivery.

For an insurance company, having aggressive targets and penalties may appear reassuring. But failure will impact their business more than the supplier's. Accordingly, some of the more sophisticated contracts have a complex risk and reward mechanism which encourages the supplier to meet and exceed certain targets rather than just relying on traditional service credits or penalties.

In our view, transformational sourcing is going to be one of the fastest-growing areas of the sourcing market, especially in the insurance and financial services industries. It will only succeed if companies spend the time and effort to construct and manage these projects effectively.

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