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Insurance Outsourcing Contracts Are Changing – It's Time to Review Before You Renew

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ISG WHITE PAPER

INTRODUCTION

The insurance industry has changed dramatically over the past decade in response to increasingly stringent regulations, changing consumer preferences and falling interest rates. As the industry has been evolving, so has insurance third-party administration (TPA) and business process outsourcing (BPO). Insurance TPA/BPO pricing has gone down significantly due to rupee devaluation and robotic process automation (RPA), and insurance outsourcing contracts have become more favorable to insurance companies due to a more mature outsourcing provider market. Now is a compelling time for insurance companies to benchmark and renegotiate their existing TPA/BPO contracts.

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Shifting Outsourcing Strategies

The past decade has brought tremendous change for insurance companies and their outsourcing strategies. Insurance TPA contracts from just a few years ago focused on offloading smaller closed blocks of business and sometimes the related computing platform. Insurance BPO contracts were smaller and based on the benefits of labor arbitrage gained by moving work to India and other lower-cost locations. Since then, the pricing, contracting and players in the TPA/BPO space have changed dramatically.

The insurance customer base is also changing rapidly. Most companies are narrowing their focus from a broad book of business to a few niches, and others are becoming specialty oriented. Insurance companies are looking for more than simple labor arbitrage; they want a far more complex solution with RPA and other automation as part of a broader digital strategy that will positively impact their bottom- and top-line growth. Given the devaluation of the rupee and the advances in automation that can eliminate manual processes and their related staffing needs, long-term insurance BPO and TPA outsourcing contracts signed early this decade are now overpriced and underperforming when compared to today's insurance outsourcing market.

Insurance outsourcing contract terms also have changed considerably. As outsourcing providers have matured their insurance-related processes, they are willing to bear more risk and commit to the lower prices and higher service levels that automation can bring. RPA has improved the accuracy and timing of the manual service level metrics.

Most insurance contracts have a benchmarking clause that is one of the most difficult to negotiate, but only a few insurance companies actually use it to deliver the cost savings and other benefits they negotiated. If an insurance company is operating out of outsourcing deal that is more than three to five years old and has not invoked the benchmark clause, it is likely missing out on millions of dollars in savings.

A Decade of Change in the Economics of Insurance Outsourcing

The value of the Indian rupee to the U.S. dollar has decreased by 64 percent since 2010 and 2011, when the exchange was relatively stable at 44 to 1. As seen in Figure 1, today's exchange rate is 72 rupees to the U.S. dollar.

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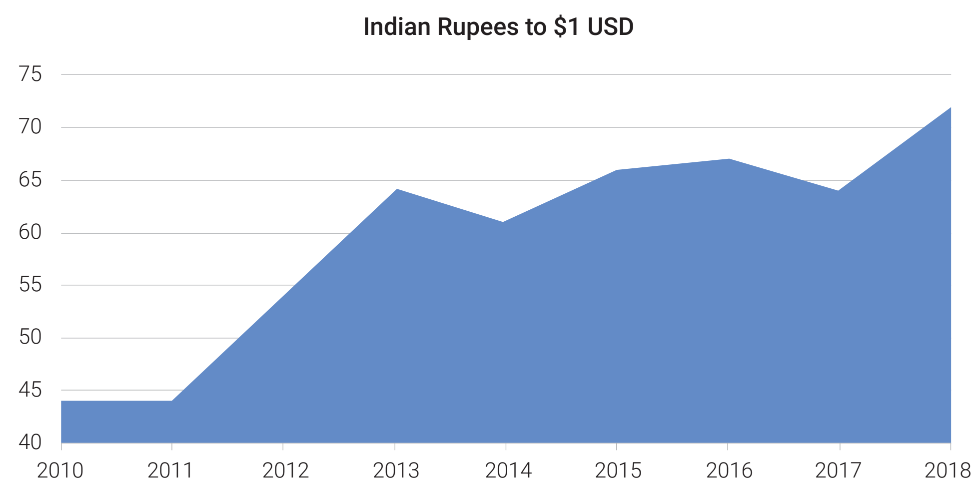
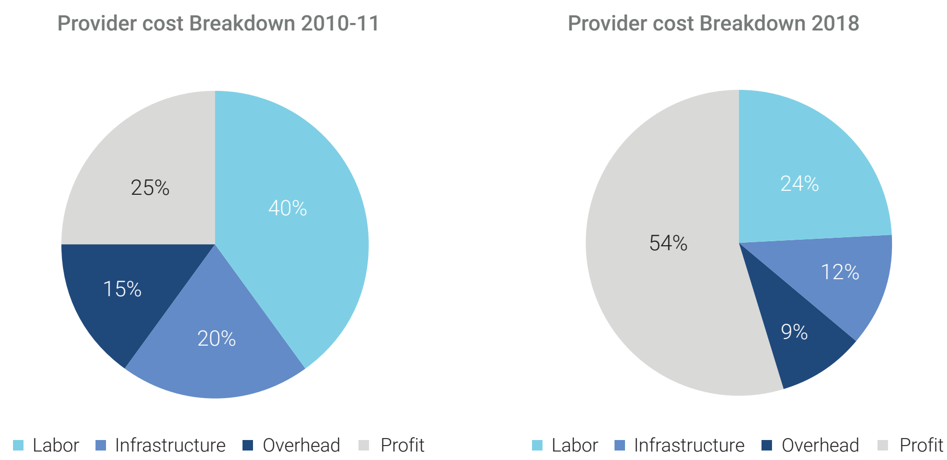
Figure 1: Indian Rupees to $1 USD



Because most insurance BPO/TPA providers rely on an India-based workforce to deliver services, and U.S. insurance BPO/TPA contracts provide for payment in U.S. dollars, the India-based providers are making a significant profit on the currency exchange. Their profit grows when outsourcing contracts allow providers to increase their fees annually two to five percent due to inflation. For example, a 200-FTE contract with average rates of $25,000 per FTE would amount to an annual fee of $5 million. Figure 2 next page shows the typical provider cost breakdown for insurance BPO/TPA fees in a 2010-11 deal and how those same U.S. dollars equate in 2018. Because most of the provider's underlying costs are paid in rupees, the profit margin jumps from 25 percent to more than 50 percent – a sum of almost $1.5 million more a year.

Figure 2: Provider Costs 2010 vs. 2018



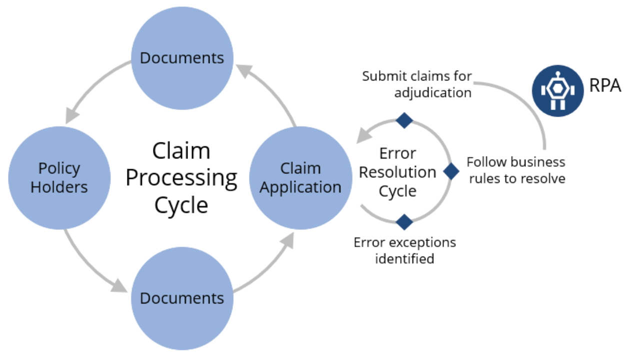
Note that some of the effect of the rupee devaluation on provider profits is offset by the considerable inflation of salaries in India. However, in most insurance contracts, the two-to-five percent annual increase built into the annual contract price mitigates this salary increase.

Insurance BPO/TPA provider costs have gone down since 2010 (with new deals having more of a market-level profit margin). If an insurance company's costs have not gone down accordingly, it is significantly overpaying. Benchmarking a contract to current market prices may save substantial cost.

Changes in Insurance Outsourcing Automation

Automation, especially RPA, has further driven down the cost of insurance BPO/TPA services. One of the biggest benefits of RPA is the elimination of manual "swivel chair" activities that cut and paste data from a screen in one system into a screen from another system. Insurance companies tend to have multiple IT systems with a different one for each product and process, with teams of people cross-checking systems and reentering data. Virtually all this manual work can be eliminated with RPA, which can automate almost any rules-based process. Figure 3 next page illustrates how RPA can automate multiple steps in the claim administration process.

Figure 3: How RPA Automates Claim Administration



RPA can be used to follow business rules and resolve and resubmit errors and exceptions into claims processing systems.

Examples for RPA

- Gather and accumulate policyholder information
- Determine validity of policyholder information and identify errors/exceptions
- Provide initial review of documentation to determine if all required documents have been submitted
- Send message to policyholder on any missing documents
- Resolve policyholder information errors/exceptions or escalate to human
- Submit claim package to adjudicator

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We have seen insurance companies replace 10 to 30 percent of their back-office staff with low-cost RPA software. However, insurance TPA/BPO providers that are enjoying the benefits of the rupee deflation in FTE-based deals are reluctant to cut their profits by eliminating FTEs. Insurance companies using service providers that have not implemented RPA are losing out on these 10 to 30 percent reductions.

The combination of the rupee devaluation and RPA has driven down the cost of new insurance BPO/TPA deals significantly – between 20 and 50 percent – so contracts today cost less than the same services earlier this decade. A company that does not benchmark or rebid its work is losing out.

Changes in Insurance Outsourcing Contracting

Many insurance BPO and TPA contracts entered into early in the decade differ significantly from today's market standard terms and conditions. Even contracts from two or three years ago may not include RPA and other automations. In addition to the significant financial benefits gained by RPA, automation can have positive effects on service levels – including timing and accuracy – and on customer and stakeholder experience.

Older insurance BPO and TPA contracts were often provider led, with the provider helping write the statements of work, the service-level agreement and the key terms and conditions. Benchmarking studies reveal that these insurance contracts are favorable to providers over 75 percent of the time and that insurance companies bear an inappropriate level of risk and miss out on the full benefits of outsourcing.

Based on our review of more than 500 successful outsourcing contracts, we have developed a framework of what a solid and sustainable contract should look like. When we benchmark, we analyze and score contracts over nine key areas: 1) scope of services; 2) flexibility to add, remove or change services; 3) governance of the contract and related operations; 4) pricing mechanisms; 5) legal terms; 6) business terms; 7) service level agreement; 8) termination; and 9) transition.

Figure 4 below shows the results when we analyze typical insurance contracts (indicated by light blue dots) vs. the best practices of a sustainable contract (found between the two lines in the ideal “landing zone”). An insurance company should have slightly favorable terms for scope, flexibility, termination and transition. And it should get to decide what it wants to buy (scope), when it wants to add, remove or change services as its business changes (flexibility), how fast it wants to make these changes (transition) and how it can get out of the contract when necessary (termination). For the insurance company to get these favorable terms, it should pay a market price with balanced business terms, legal terms, pricing mechanisms, service levels and governance that favor neither the provider nor the insurance company.

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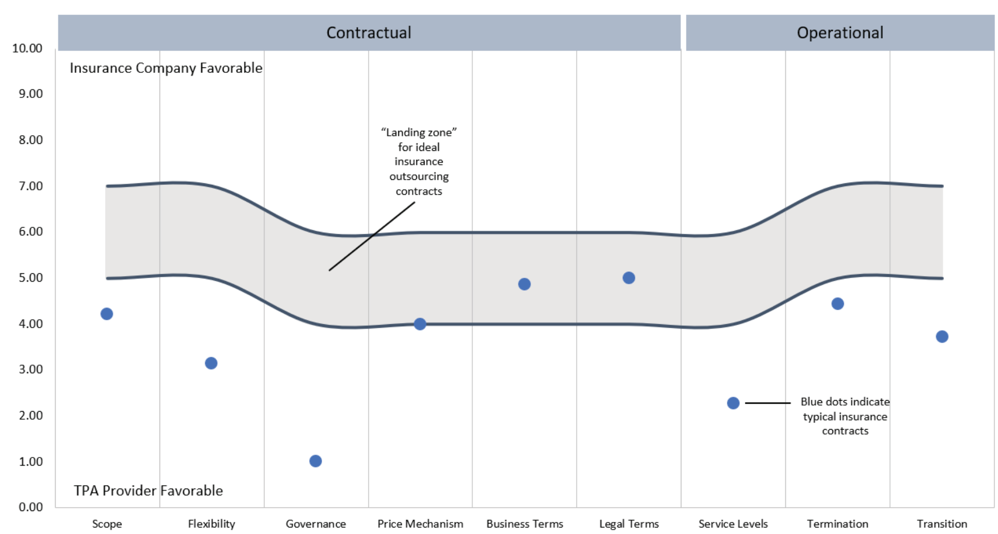
Figure 4: Typical Insurance TPA Contract Terms Vs. Best Practices



While each component of the contract should result in a score that falls within the landing zone, the reality is that most contracts favor the provider. Common challenges in the nine key areas include:

1. **Scope:** Provider responsibilities for the basic insurance processes are usually reasonably well documented, but contracts rarely document what happens when things go wrong, including communication, incident management and escalation rules. Also, when the provider is responsible for the insurance platform, it often does as poor job at documenting data feeds, testing, cyclical peaks, quality assurance, release management

and demand management. We rarely see well-designed provider requirements that would keep the platform current with such things as a hardware and software refresh policies, automation requirements, RPA and middleware support, agile vs. waterfall, etc.

2. **Flexibility:** Insurance contract terms tend to be longer than necessary (often seven to ten years vs. a market standard of three to five years), include cost-of-living or inflationary adjustments that are exceed market standards, lack productivity requirements or incentives, and lack provisions for onboarding new work relationships or offloading work (such as future acquisitions of new blocks or selling of old blocks).

3. **Governance:** The governance provisions typically lack defined roles and responsibilities of the governance team/steering committee members and fail to include meeting schedules and agendas to manage the strategic and operational aspects of the contract. Innovation provisions and controls for operational, financial, legal and regulatory changes often are also lacking or weak.

4. **Pricing mechanisms:** The main provisions missing or underused in insurance contracts are gain/loss provisions in which the provider takes responsibility for its errors that result in losses, late fees or regulatory fines above some reasonable baseline. Getting this right can save millions of dollars and prevent lawsuits. Also, old insurance contracts with semi-fixed FTE-based pricing are out of market with today's contracts, which have variable pricing tied to policy counts.

5. **Legal terms:** These tend to be in line with market standards because insurance companies' legal departments invest in third-party counsels to insure they are protected.

6. **Business terms:** Unfortunately, insurance company leaders do not always invest in third-party advisors to insure they are getting the same protections from an operational perspective.

7. **Service levels:** While timing-related service levels tend to be included, we rarely see quality or customer-satisfaction service levels, and at-risk amounts and allocation pool percentages too often are lower than market standards. A typical contract uses service-level percentages that are lower than what today's world class TPA/BPO providers are achieving with RPA and automation (and much higher than insurance trade association LOMA's benchmarks). Other areas frequently lacking are root cause analysis, continuous improvement and the ability to add, remove and change service levels over time as the business changes.

8. **Termination:** Often, termination fees are much higher than market standard and lack documented requirements related to termination assistance from the provider and maintaining service levels during the termination period.

9. **Transition:** Often we see flat fees for transition instead of a detailed transition plan with clearly identified milestones and payments tied to achieving them.

Older contracts are rarely in line with contemporary market terms and conditions. Insurance companies that renew them without a detailed contract benchmarking review as they enter renegotiations put themselves at significant risk.

CONCLUSION

Insurance companies with existing TPA/BPO contracts that date back to earlier this decade are likely overpaying and not be getting the level of service they could. Much has changed about the insurance outsourcing market, including the mix of insurance TPA/BPO providers with the old, small, FTE-based TPA/BPO providers being replaced by new, larger, digitally oriented ones. A benchmark of your existing contract before you renew or recompete with new providers can deliver current market terms, significantly better pricing and a service offering that takes advantage of the advances in digital technology.

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ABOUT THE AUTHOR

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Dennis Winkler is a director in ISG's business advisory services practice. He has 25-plus years of experience helping enterprises develop their business process sourcing strategy. He has worked with most large insurance companies on their BPO/TPA outsourcing strategies including advising on the two largest insurance TPA and BPO deals in U.S. history. Dennis is an author and regular speaker at conferences on the subjects of business process outsourcing, shared services, governance, RPA, innovation and business transformation.

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