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Why Are Insurance Outsourcing Contracts So Bad?

Dennis Winkler

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COVID-19 Related Changes in Operations Are Not Getting Captured in Contracting

The insurance industry has changed dramatically over the past decade in response to increasingly stringent regulations, changing consumer preferences and falling interest rates. Over just the past 18 months, COVID-19 resulted in massive, high-speed changes to the insurance industry in technology, process automation, cybersecurity, and work-from-home delivery models. Yet the vast majority of insurance outsourcing contracts contain very little that reflect this new world. Insurance outsourcing contracts today look like they could be straight out of 2010.

Over the next three years, six billion dollars of insurance outsourcing contracts are up for renewal. Insurance companies have a huge opportunity to update their outsourcing contracts to reduce risk, save money and improve performance.

Many insurance carriers are sticking with incumbent providers and renewing typically provider-favorable, often overpriced and sometimes underperforming contracts. Others are failing to update contract terms and service levels or benchmarking prices to achieve today's best practices.

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Shifting Outsourcing Strategies

The past decade has brought tremendous change to enterprise outsourcing strategies. Insurance third-party administrator (TPA) contracts from the prior decade focused on offloading smaller closed blocks of business and, when necessary, the related computing platforms. Insurance business process outsourcing (BPO) and IT outsourcing (ITO) contracts were smaller and full-time equivalent (FTE)-based with benefits of labor arbitrage gained by moving work to India and other lower-cost locations.

Since then, the insurance customer base has changed rapidly. Many companies have narrowed their focus from a broad book of business to fewer, more profitable lines, and others have become specialty oriented. The insurance outsourcing providers in the TPA, BPO and ITO space have changed dramatically also. Outsourcing pricing has gone down significantly due to automation and the rupee devaluation.

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Insurance outsourcing – whether ITO, BPO or TPA – has evolved from being a labor arbitrage play and is now a technology/digital transformation play, with carriers and new venture capital players looking for end-to-end solutions that not only lower operating costs but also enable top-line growth.

Insurance outsourcing contract terms also have changed considerably. As outsourcing providers have matured their insurance-related processes, they are willing to bear more risk, commit to per-policy and other volume-based pricing models with guaranteed savings, and increase service level and customer satisfaction scores. Artificial intelligence (AI), robotic process automation (RPA) and other automations have improved the accuracy and speed of previously manual processes.

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Most insurance contracts contain a benchmarking clause that is always one of the most difficult to negotiate but is rarely leveraged in support of the ongoing cost savings and operational benefits insurers negotiated. If an insurance company has not invoked the benchmark clause, it is likely missing out on the innovation of new technology and losing 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 70 percent since a decade ago when the exchange was relatively stable at 44 to 1. As seen in Figure 1, today's exchange rate is 75 rupees to the U.S. dollar.

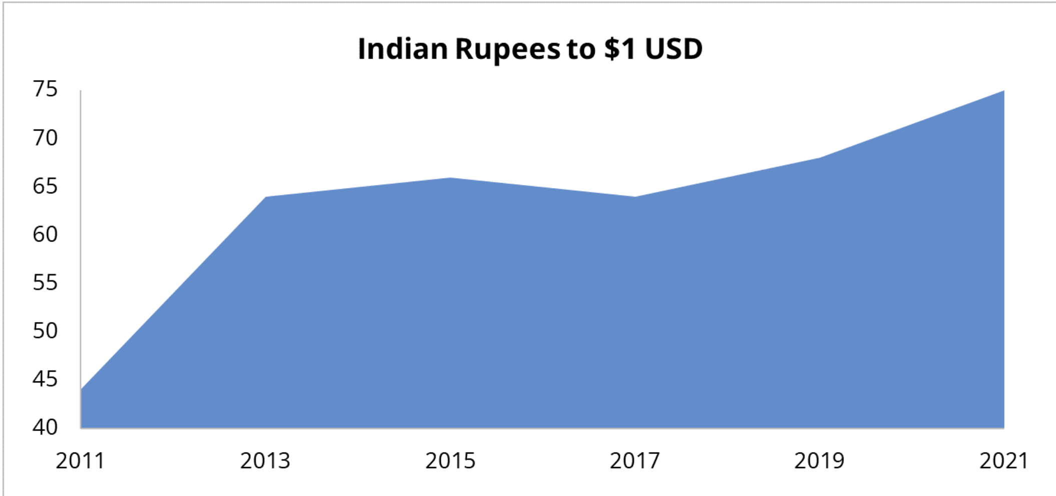

Figure 1: Indian Rupees to $1 USD

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Because most insurance outsourcing providers rely on an India-based workforce to deliver services, and because U.S. insurance contracts are paid 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 due to inflation, and we see contracts with COLA set well above U.S. averages. 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 below compares the typical provider cost breakdown for insurance outsourcing fees in 2011 compared to 2021. Because most of the provider's underlying costs are paid in rupees, the profit margin jumps from 25 percent to 56 percent – a sum of almost $1.6 Million more per year.

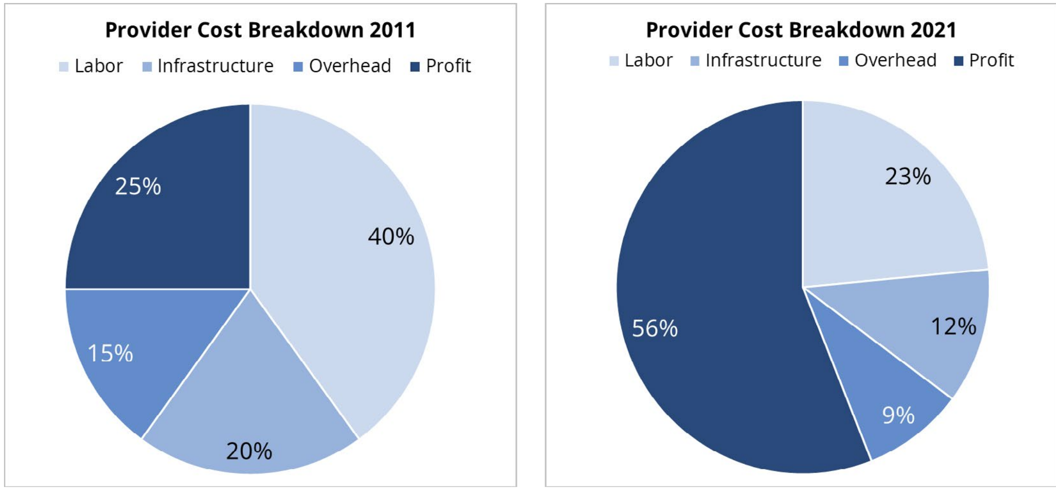

Figure 2: Provider Costs 2011 vs. 2021

Note that some of the effect of the rupee devaluation on provider profits is offset by the inflation of salaries in India. However, in most insurance contracts, the higher-than-actual U.S. COLA annual increase (we see bad contracts with 4% to 7% increases) built into the contract price more than offsets this salary increase. For example, just a 4% COLA increase on the $5 Million contract referred to above results in a $200,000 price increase, while a 7% increase on the underlying provider salaries results in only a $140,000 provider cost increase. This means the provider nets another $60,000 of profit annually.

The bigger, more recent reasons insurance provider costs have decreased are the advances in automation with AI, RPA, cloud-based infrastructure and process enabling ecosystems that sit on top of policy administration systems and allow work to flow across

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applications, including insurtech solutions. With COVID-19, the need to create work-from-home environments has also decreased the providers' operating costs. If an insurance company's outsourcing 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 Contracting

Insurance outsourcing contracts entered into just two years ago already differ significantly from today's market standard terms and conditions as they do not include the COVID-19 related changes in the marketplace.

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Older insurance contracts were often provider led, with the provider helping write the statements of work, the service-level agreement and the key terms and conditions. ISG's insurance contract benchmarking reveals that over 75% of these contracts are favorable to providers and that insurance companies bear an inappropriate amount of risk and are missing out on the full benefits of outsourcing. We also find that P&C contracts tend to fare worse than life and annuity contracts, and that ITO contracts tend to be better than BPO. TPA contracts are the most egregious as they focus more on the processing while having little-to-no meaningful platform requirements.

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. ISG analyzes and scores 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 3 shows the unfortunate results when we analyze typical insurance contracts (indicated by light blue dots) against 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 as it gets 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 favorable terms for these criteria, it should pay a market price with market pricing

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mechanisms, service levels and governance. Business terms and legal terms should be balanced and favor neither the provider nor the insurance company.

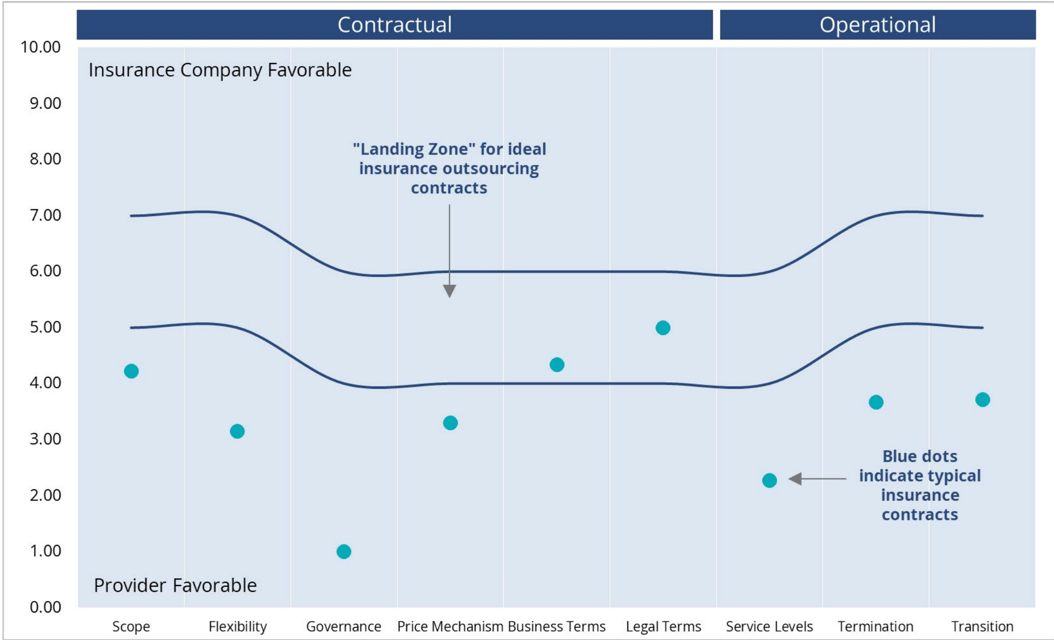

Figure 3: Typical Insurance TPA Contract Terms vs. Best Practices

While each component of the contract should result in a score that falls within the landing zone, the reality is that most insurance contracts favor the provider.

Common Challenges in Insurance Outsourcing Contracts

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, most contracts fail to document 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. Post-COVID-19 digital transformations with AI, insurtechs and the cloud have to be adequately addressed to give the insurance company control over provider-led automations and applications to ensure proper requirements for monitoring, testing, training, and cybersecurity protocols exist.

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2. **Flexibility:** Insurance contract terms tend to be longer than necessary, often seven to ten years vs. a new market standard of three to five years. This is a problem when the contract contains cost-of-living inflationary adjustments that exceed market standards, lack reasonable productivity requirements or incentives, and lack provisions for onboarding new work from new products and future acquisitions, or reduce costs when there is a decrease in volume from run-off or selling of old blocks. The contract needs to allow the technology ecosystem to evolve over the life of the contract as innovation generates new products, new technologies, more insurtechs and more advances in direct-to-consumer mobile apps, AI, drones, etc.

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 are rarely found in insurance contracts, so providers are not contractually obligated to introduce innovation. This gap in innovation and lack of controls for operational, financial, legal, regulatory and technology changes is especially troubling given the massive technology transformation that most insurance companies are/should be going through in our post-COVID-19 world.

4. **Pricing mechanisms:** Old insurance contracts with FTE-based pricing are out of market with today's contracts, which have variable pricing tied to policy counts (all in price per policy) or have a fixed base price that changes incrementally over time as volume increases or decreases. Insurance outsourcing providers often bring subrogation, underwriting and other tools that focus on increasing sales, reducing risks or increasing indemnity savings with some guaranteed performance improvements and savings, and some gain-share for performance over and above the guaranteed amounts. These savings are often larger than the total of the provider's outsourcing costs and are part of today's new insurance outsourcing provider marketplace. Another provision missing or underused in insurance contracts are errors and 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.

5. **Legal terms: T**hese tend to be in line with market standards because insurance companies' legal departments invest in third-party counsels to insure they are protected, so this contract area tends to align with best practices. Unfortunately, insurance company leaders too often do not invest in third-party advisors to insure they are getting the same protections from an operational perspective, so the rest of their contract areas fall outside market best practices.

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6. **Business terms:** Most insurance contracts cover the basic business terms as well as they do the legal terms, however today's digital initiatives bring new complexities. As providers' help insurance companies digitize their data and perform data analytics, there needs to be contract requirements that protect policyholder data and limit the provider's ability to use non-scrubbed and normalized data in provider data sets used for their own clients. Disaster recovery/business continuity planning (BCP) requirements need to be updated to address heightened cybersecurity needs with regular BCP tests, audit rights on testing, and requirements to implement actions based on test findings. COVID-19 has shown that not being prepared for business continuity can result in not being able to stay in business. Limitation of liability clauses should also be updated to include and or increase a super cap to cover the potential for breaches as insurance companies have been one of the primary targets of ransomware attacks. Also, pandemic-related language related to work-from-home, supplier site definitions, and force majeure needs to be reviewed and likely rewritten to add allowances and requirements for work-from-home, and exclude COVID-19 as a force majeure event. Key personnel requirements should also be tightened with succession planning to reduce the risk of loss of knowledge and skills when there is attrition.
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 much lower than market standards. When we do see quality service levels, there is not enough detail to ensure that the quality score is a correct reflection that the work has been done accurately. A typical contract uses service-level percentages that are lower than what today's world class providers are achieving with AI, RPA and other 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 our best practice's market standard and lack documented requirements related to termination assistance from the provider and maintaining of service levels during the termination period (which is typically much shorter than what is needed for a conversion and transition to a new provider).
9. **Transition:** Often we see a single, flat fee for transition and conversion, or at best a prorata fee each month during transition/conversion period. Instead, there should be a detailed transition plan with clearly identified roles and responsibilities, and transition is only paid for when the provider has achieved significant milestones.

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Older contracts are rarely in line with contemporary, post-COVID-19 market terms and conditions. Insurance companies that renew them without a detailed contract benchmarking review as they enter renegotiations put themselves at significant risk.

The Need to Benchmark Your Insurance Outsourcing Contracts

Insurance companies with existing outsourcing contracts are likely overpaying, are not getting the level of service they could be getting and are taking on more risk than required. Much has changed about the insurance outsourcing market over the last decade and especially since COVID-19, including the mix of insurance providers and old contracting methodology with the smaller, FTE-based deals being replaced by new, larger, digitally oriented transformation deals with guaranteed savings that adjust as volume changes.

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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.

Benchmarks can be extremely valuable if performed in a sophisticated manner. Simply benchmarking the FTE price or price of the technology will miss potentially massive (frequently eight-figure) costs associated with missing or deliberately obscure contractual and compliance terms. ISG is highly sophisticated in its approach to integrating the cost of the today's digital technology into our models. We have the most extensive data on insurance outsourcing contract terms and conditions in the world as ISG has successfully negotiated contract terms in line with the best practices detailed herein on more than half of all the large insurance outsourcing contracts in the last five years. Please reach out to discuss how we can help you achieve a lower-cost, sustainable contract that aligns with best practices.

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ABOUT THE AUTHOR

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