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How Insurance Cos. Can Benefit From Innovative Outsourcing

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Insurance companies have long benefited from innovation in outsourcing. In the 1990s, the industry understood and captured the benefits of outsourcing noncore functions to specialist suppliers. In the 2000s, insurers invested in new contracting approaches to gain benefits of offshore outsourcing, an innovation permitted by reductions in telecommunications costs and improvements in process design. Insurers secured the benefits of offshoring by extending traditional onshore outsourcing processes to engage new suppliers.

Now, cloud computing has spawned a burst of innovation opportunities for insurers. Insurers can benefit from innovations such as big data, cognitive computing, robotic process automation, the Internet of Things and “as a service” products. Many of the innovations spawned by cloud computing can be applied to improve outsourced functions in ways that reduce cost while holding steady or even improving service performance.

There are examples of innovation across the insurance value chain. In product design, for example, insurers are able to provide discounts to insurers who are willing to accept remote monitoring devices. In marketing, insurers digitally personalize insurer experience in real time and target superior risks. In underwriting, insurers capture more data and derive more insights using “big data” analytics. In claims and loss control, insurers are able to respond more quickly and spot fraud more effectively with these emerging technologies.

So, the question becomes, how can insurers secure the benefits of innovation in outsourcing arrangements? For this article, let’s use the example of an insurer that outsources claims handling to a supplier.

Traditional Outsourcing Models

Traditional outsourcing pricing models do not naturally drive the benefits of innovation to insurers. If the insurer pays for inputs such as time spent processing claims, the supplier may have an incentive to avoid innovations that would reduce the amount of time spent. If the insurer pays based on the number of claims processed, the supplier captures all reductions in its cost of performance such as the reduced time taken to perform operations. Thus, for example, a supplier who uses robotic process automation to reduce the cost of processing claims obtains all of the benefits.

In addition, the traditional outsourcing model tends to involve a promise to deliver services at standards that are being attained or are clearly attainable at the signing and the parties can price in the cost and benefit of these attainable improvements in the precontract negotiations — albeit, in all likelihood, in a rather opaque way. Thus, the supplier has the ability to win the lion's share of the benefit of any innovation by charging for improvements such as claims management through a mobile application. Some outsourcing agreements include glide paths or other automatic mechanisms, but those generally provide insurers only what was foreseeable in an earlier competitive bidding process, not what is delivered in the burst of emerging technologies coming to market today.

Suppliers often claim that market forces drive them to continuously innovate and improve. However, in the traditional outsourcing model, early termination fees create barriers to switching suppliers. This reduces the incentive for a supplier to provide innovations to existing insurers on the theory that doing so would cannibalize existing committed revenue (although the supplier might offer innovations to win new business from competing insurers).

General Innovation Covenants

Insurers have long obtained express commitments from outsourcing suppliers to deliver innovation. Similarly, insurers often have bargained for rights to "roadmap" briefings and to be offered a chance to be an early adopter of innovations. Frequently, an insurer will negotiate the right to participate in development forums and the like to help influence developments by the supplier that could benefit the insurer. Arguably, again, the net value transfer is to the supplier because the supplier learns from the insurer.

Quite often, the insurer makes further, specific investment to participate in the supplier's development process. The insurer's "benefit" is in getting a more tailored service, for example a claims handling process that fits its product design better or generates more data useful for underwriting. The insurer may also benefit from having supplier's investment in innovation being spread across its entire insurer base. In the absence of a gain-sharing methodology or facing the expense of rebidding the work, though, it is not easy to see how the insurer gets a direct financial benefit from the gains the supplier makes as a result of innovation reducing the cost of delivery of services in the traditional service level and input based changing model. These gains might well be material.

Somewhat paradoxically, insurers often seek a share of gains from innovation through covenants that prohibit innovation. For example, outsourcing arrangements commonly prohibit suppliers from subcontracting work without consent. While these covenants can reduce the risk that cost-reducing innovations for the supplier will increase the insurer's risk, they also allow the insurer to negotiate for some share of the benefits of approved innovations. In deals in the 2000s, insurers used this approach to prohibit offshoring to lower-wage countries without adequate cost reductions, and insurers are now doing the same with emerging technologies. The roundabout nature of the protection is unlikely to provide a full or fair share of the benefits to the insurer.

Bespoke Innovation

There are also difficulties in assessing whether the insurer gets a fair share of the gain that the supplier derives from bespoke innovation, that is, innovation made specifically for an individual insurer at that insurer's cost. Bespoke innovation reliably produces innovations that conform to agreed specifications, such as a new claims management system. The challenge, however, is that the insurer may share little or none of the value that the innovation brings to the supplier. Often, the insurer contributes not only funding but a great deal of market, technical and operational information.

Insurers often negotiate some exclusivity in bespoke innovations. While the insurer still may not receive much of the benefit that the supplier receives, the exclusivity can protect the insurer from having competitors benefit from the innovation. That protection is, of course, more important if the claims outsourcing provides a market benefit in terms of speed or customer experience than if it merely reduces an operating cost. Alternatively, the insurer might use the prohibition to bargain for royalties on later use of the developed innovations.

Thus, traditional outsourcing arrangements and covenants seem unlikely to allow the insurer to secure the benefits of innovation. Insurers need to look to alternative models that might reward each party more equitably for their respective investment in innovation. One such alternative model is outcome-based pricing.

Outcome-Based Pricing

In an outcome-based pricing model, the supplier is paid based on the benefit that the insurer derives from use of the supplier's services. For example, a claims management supplier might be paid based on factors such as minimizing total claims handling costs (including administration, investigation and payments made), claims handling speed and the claimants' willingness to recommend the insurer to friends following the claim. There could also be a "gain share" based payments avoided through innovative types of fraud detection. The supplier providing a mobile application as a bespoke innovation might be paid based on the number of downloads, the amount of use or the amount of additional premium revenue obtained through the mobile application.

These outcome-based pricing models work by aligning the interests of the insurer and the supplier. If the supplier is more efficient at delivering the outsourced service, then, in theory, the insurer's business would be more profitable. If structured well, this model can incentivize a supplier to drive gains through innovation over an extended period. In addition, if the incentives are well-aligned, the contract needs fewer restrictive covenants and requires less control-oriented governance.

Outcome-based pricing benefits greatly from an initial investment in deal structuring. The challenge is to define measurable outcomes that can be attributed to successful innovation. In doing so, the parties work to exclude the effects of factors outside of supplier's control. For example, an insurer might use end-to-end claims processing time compared to an industry average instead of the insurer's previous claims processing time so that the supplier's compensation is based on its efforts, not changes in legal requirements or improvement measured from an inefficient internal metric.

There are, of course, risks in outcome-based pricing. The supplier may impose unanticipated costs and risks on the insurer in pursuing the selected outcomes or may be compensated for lucky results instead of genuine effort. The insurer's strategies may shift, making the outcomes less valuable. The supplier's

scope might need to be expanded to give the supplier adequate control over an outcome. However, balanced against likely lack of fairness in the division of benefits from innovation in conventional input-based pricing, the rewards from a well-structured deal can greatly exceed risks in outcome-based pricing for elements of a deal that involves having innovation commitments.

Conclusion

Traditional outsourcing models are not well-suited to incentivizing suppliers to deliver the benefits of innovation in markets such as insurance, where rapid innovation has the capacity to transform the marketplace. Insurers who are willing to make the initial investment in structuring outcome-based pricing strategies may stand stronger prospects of securing more of the benefits of an increased flow of innovations in a heavily outsourced industry.

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