

Closed blocks
outsourcing —
How life insurers
can reduce cost and
improve focus



Introduction



Life insurance is a business in which customers are serviced long after the sale. Servicing includes policy administration, claims processing, queries, complaints and other important activities. Most insurers offer a variety of products and develop and market variants of those products frequently. As a result, insurers spend a significant portion of their capacity servicing products that are discontinued, but which still have active policyholders. Such products are collectively known as a “closed block”. Dedicating capacity to servicing closed blocks is not only inefficient from a cost perspective, but it also distracts focus from current and future strategic products. This paper looks at the problem of servicing closed blocks, and analyzes the suitability of outsourcing the servicing of closed blocks of business.

The concept of outsourcing closed blocks is not new. However, it is important to revisit this option in light of recent improvements in service providers’ ability to migrate closed blocks from insurers’ systems to the providers’ own systems. Multiple service providers have gained significant experience in executing such complex migrations. According to Neal Baumann, Deloitte Consulting LLP’s Insurance Leader, “outsourcing of closed blocks drives cost efficiencies and allows the insurer to focus its resources on new products that are aligned to its overall strategy”.

Yet it must be recognized that outsourcing closed blocks may not be the right solution in every situation. Thus, the paper also discusses an approach to evaluate the applicability of outsourcing to a particular insurer’s situation. The considerations presented can provide IT and operations executives with an overall basis for further exploring the outsourcing opportunity.

Finally, there are other outsourcing opportunities, adjacent to closed blocks outsourcing that an insurer should also consider. While it is not the primary focus of this paper, we conclude with a brief discussion on these other opportunities which may be considered as an insurer develops a systematic sourcing strategy.

Business realities facing life insurers

To better understand the problem of servicing closed blocks, we need to first understand the historic context in which the industry has evolved. Three important business realities have had a critical impact.

Greater need for new and customized products:

Until recently, access to customers has largely been through sales teams or partners, a highly personalized but expensive way of serving customers. In some sense, customers' loyalty and preferences were molded by their relationships with agents. Today, customers have greater access to information and can make far more informed decisions. Consequently, customers are looking for

however, insurers did not maintain the level of investment in newer technologies such as open systems, multi-tier architectures and data management tools. This was due partly to the need for processing speed (thus, staying with mainframes) and partly to the industry's conservatism. Even today, many of the admin systems in use are on mainframe technologies. The result is a set of extremely efficient systems, measured by unit cost per policy, but ones that lack the agility and flexibility to meet dynamic market conditions.

Industry consolidation leading to multiple IT systems:

In the more recent past, the industry has consolidated itself significantly through mergers and acquisitions. Insurance companies gained demand-side efficiencies (in customer base and market channels, for example), but find themselves saddled with multiple, incompatible IT systems, many of which require specialized knowledge to maintain. This has led to an excess of IT capacity (both hardware and software), multiple teams running IT & Operations and a consequent suboptimal cost structure. Further, as some IT systems today service only closed blocks of business, which by definition run off over time, servicing cost per policy for closed blocks is continually increasing.

In summary:

1. The market-driven need to discontinue old products and release newer products at an accelerating pace is leading to a greater proportion of the portfolio moving to the closed block.
2. Inflexible IT systems cannot support the market demand for an increasing number and variety of innovative products.
3. The runoff of closed blocks of business in disparate incompatible systems is increasing the servicing cost per policy.

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increasingly customized products to meet their specific needs. In response, insurers develop and market new products at a faster rate than before. This means that a greater proportion of the product portfolio moves to the closed block as insurers stop selling old products and move to newer products.

Cost-efficient but inflexible IT systems: All products, whether current or part of the closed block, need to be serviced on a policy administration system. Insurers today find themselves with a number of admin systems that are efficient but not particularly agile or flexible in servicing their customers. In large part, this is due to the uneven pace of technology adoption in the industry. Life insurers were fairly early adopters of IT, due to the importance of data processing for their core business. Over the years, most insurers developed IT environments largely based on mainframe technology, which was efficient and dependable. After the initial phase of early adoption,

Overview of outsourcing

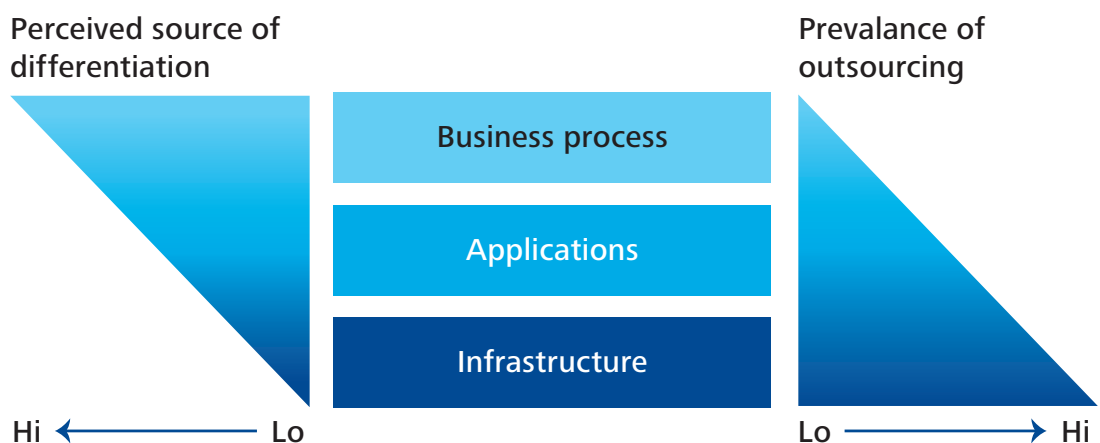
In the past twenty years, the term “outsourcing” has come to have a very specific meaning: the carving out of business or IT processes to an third party service provider. In this context there are three main categories of outsourcing:

IT Infrastructure Outsourcing: This relates to the outsourcing of IT infrastructure services, including data centers, help desk and end-user support. This type of outsourcing is well established, the supplier market is mature, and there is a high degree of standardization. Moreover, the types of services that comprise IT Infrastructure Outsourcing are generally not “core” to a company’s operations. The insurance industry, like others, has actively sought to improve their IT productivity through this type of outsourcing.

Application Management Outsourcing (AMO): This relates to the outsourcing of applications services such as minor enhancements, bug-fix, and L1 support of off-the-shelf, customized or legacy applications. The supplier market for this category has also matured significantly, and the India-based outsourcing service

providers have pioneered the low-cost, offshore delivery model. Some companies view the applications layer as being a source of some differentiation, hence AMO, while popular, is not as ubiquitous as IT Infrastructure Outsourcing.

Business Process Outsourcing (BPO): This type of outsourcing relates to the transfer of business processes to an external service provider. In general, business processes are seen to provide greater differentiation than either infrastructure or applications, and hence companies are sometimes hesitant to outsource this layer. That too is changing however, as companies are sensibly identifying “non-core” processes as candidates for BPO. Of the diverse set of processes currently being outsourced, there is maturity in “horizontal” processes (not specific to an industry) such as Finance & Accounting and Payroll. Less common, however, is the outsourcing of industry-specific processes, such as insurance policy administration and claims. This paper focuses largely on opportunities to outsource this process layer judiciously.



Outsourcing the closed block

Outsourcing of closed blocks of business, a model in which a third party services the insurer's closed block policies, is a solution that has the potential to address the aforementioned issues. The insurer's responsibility shifts to managing the quality of overall processing, managing customer escalations and managing the service provider's performance.



There are at least three different models for outsourcing closed blocks:

1. **FTE-based outsourcing:** In this model, the insurer retains the IT assets (software and hardware) while the outsourcer provides the staff required to service the portfolio. This approach enables the insurer to reduce its use of niche talent required to service the closed blocks. The insurer can eliminate staff, or re-deploy staff to service current and future products. The limitation of this approach is that the insurer still needs to maintain its IT systems, many of which have low levels of utilization. This approach is favored by insurers who do not want to undertake a complex migration, or as a stop-gap or interim approach until the block of business is ready to be migrated.
2. **Platform and FTE-based outsourcing:** Here, the insurer migrates its block of business to an outsourcer's platform, and retires all IT assets, and releases, redeploys or transitions its people. This approach enables the insurer to both reduce its use of niche talent, and to decommission IT systems. This requires a migration of the target closed block policies from the insurer's (multiple) admin systems, to one run by the outsourcer. This approach can create greater value as compared to the first approach, as the insurer no longer needs to run under-utilized IT systems, nor does it have to continue to deploy its niche talent onto closed blocks. The biggest challenge of this approach is the need to execute the migration of policies to the outsourcer's system, which can be complex and risky. Many source systems are antiquated and make use of proprietary data structures and protocols. Migration projects, therefore, require project management expertise. However, once a migration is executed, this approach can yield increasing benefits over a long period of time.
3. **Platform-based outsourcing:** And finally, in this variant the insurer migrates its block of business to an outsourcer's platform, but retains its staff and service responsibilities. Like Option 2 above, this also requires a migration of policies to the outsourcer's platform. However, by retaining the staff and the servicing responsibility, the insurer maintains greater control over the administration of the policies, including the overall quality of servicing. This approach delivers savings through retirement of hardware and software, while mitigating the risk of transferring service responsibility to a third-party. On the other hand, the insurer's staff is still engaged in the administration of closed book policies, rather than being re-deployed to current and future products.

How is value created through outsourcing of closed blocks?

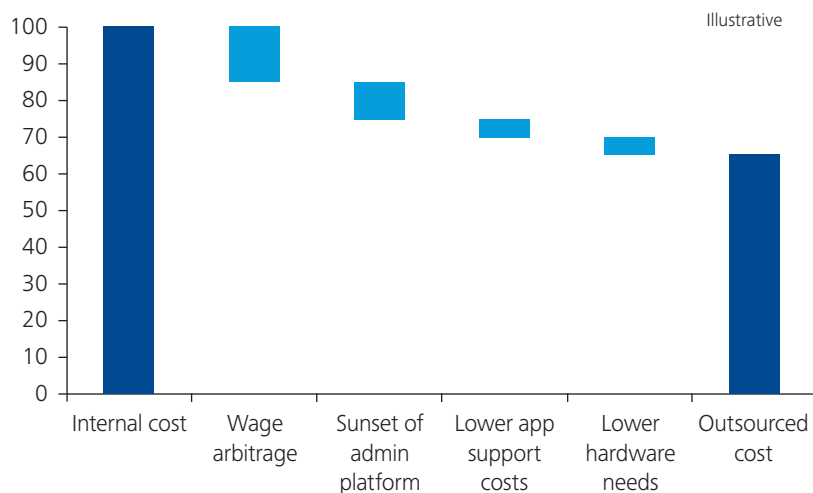
1. **Reducing operating costs:** The main incentive to outsource closed blocks of business is an economic one. The biggest driver of savings through outsourcing is the ability to sunset an admin platform and its related hardware. Because many insurance companies' systems were acquired with business acquisitions and mergers, systems have proliferated. Certain admin platforms run only to support a single closed block of business. Such platforms, along with the related hardware, can be retired and decommissioned if the closed block is outsourced. The comparable admin and hardware costs for outsourcing vendors tend to be lower, as vendors typically share platforms across multiple clients. For the same reason, the outsourcing vendor can support its application more efficiently, reducing application support costs. Finally, the wage arbitrage is another powerful driver of cost savings. Wage arbitrage, or the replacement of labor with lower cost labor in other geographic locations, can be achieved in a number of

ways, for example, by shifting labor to low-cost locations in the US, or moving labor overseas. Figure 4 illustrates these drivers.

2. **Enabling sale of closed book:** If an insurer would like to divest its closed book, such a transaction could be more attractive to a potential buyer if the servicing of the closed block is already outsourced. The buyer of the closed book can then focus only on managing the asset, and leave the day-to-day servicing to the outsourcing service provider. Thus, outsourcing of closed blocks could also be used as a first step in selling off the portfolio and releasing capital to deploy towards other business priorities.
3. **Focus on strategic, forward-looking products:** Outsourcing of closed blocks can enable an insurer to focus on new products which they are currently marketing, or will market in the future. Organizational capacity across the value chain — from Marketing, Sales, Product Development, Operations and IT — can then be dedicated to the engines of business growth for the company.

Figure 4. Economic drivers of savings

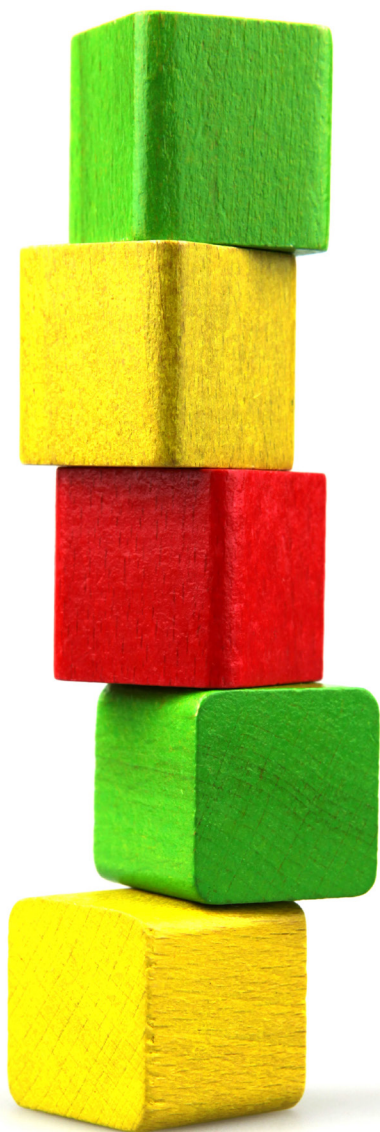
There is an opportunity for insurers to outsource closed blocks of business and realize its various benefits, including cost reduction.



Source: Deloitte analysis

2. **Re-deployment of scarce talent:** The talent pool related to policy processing and IT services is getting scarcer, in part due to the retiring workforce, and an inadequate backfill. This is particularly relevant for mainframe technologies such as COBOL and for insurance-specific domain knowledge. Rather than continuing to expend this scarce capacity on closed-blocks, an insurer can outsource the close block and re-deploy this talent to more strategic product groups.
3. **Superior service levels:** Structured correctly, contracts with external service providers can result in comparable or superior service levels. This is related mainly to the behavioral differences between internal and external service providers, as well as formal mechanisms (SLAs, penalties etc.).

Assessing the suitability of outsourcing closed blocks



There is a compelling case for insurers to consider outsourcing closed blocks. However, despite the potential, several large insurers are hesitant to move along this path. According to Gartner¹, many insurers are concerned with the cost of shifting the book to a third party, as well as the business impact on labor, processing, brand and products. Depending on the situation, the cost of migration to an outsourcer's systems may be prohibitively high. There are costs associated with integrating the outsourcer's platform with the insurer's internal systems such as finance, commissions, valuation and reporting. These integration costs could be quite significant and could affect the overall business case. There is also an element of risk in such a conversion. If a conversion fails, or is delayed, it can not only erode the savings expected from the transfer, it can also result in a degradation in customer service causing noise in the marketplace.

Thus, the costs, benefits and risks of such an approach need to be considered systematically. Below are some considerations that should be part of such a systematic analysis.

- What should be the scope of the outsourcing transaction?
- Why should the above scope be outsourced? What is the business case? Does the business case result in cost reduction? Are there other benefits?
- How should the scope be outsourced? Through migration to a different platform, or simply through a change of processing team? Should a vendor's processing team be onshore, near-shore, or offshore?
- To whom should the scope be outsourced?
- What are the risks associated with a migration, and can they be effectively mitigated?

A systematic assessment of the opportunity, inclusive of the above considerations, can lead to a more sound approach to execution.

¹ Hype Cycle for Life Insurance 2013, Gartner, July 31, 2013.

Adjacent opportunities

An insurer contemplating the outsourcing of closed blocks may also wish to assess the appropriateness of the following two adjacent opportunities.

New Product Development: While the closed block opportunity relates to retiring products, there is an equally interesting opportunity related to new products. As insurers develop new products to be released in the market, two important components are the configuration of the new product in the IT systems, and the readiness of the internal teams to take on the processing of policies related to the new products. These components can add several weeks or months to the product development cycle time. Increasingly, outsourcing vendors have the capability to stand up new products more quickly, allowing an insurer to test the new product by launching it off an outsourced platform. This can reduce the go-to-market

cycle time significantly and can empower the insurer to be more nimble in its market approach. Depending on the success of the product, the insurer can then choose to bring the admin processing and IT capability back in-house. This has strategic implications and can directly contribute to improving agility and responsiveness. According to Gartner², a number of Tier 1 life insurers, faced with legacy systems' inability to support new product varieties, are exploring alternatives to support new product launches including the use of Third Party Administrators (TPAs).

Managing cyclical demand patterns: Finally, an insurer can leverage outsourcing options to manage cyclical demand patterns. Due to nature of insurance operations, there are mandatory cycles within an operating year: tax reporting, month end, quarter end and year end. Insurers struggle to find short-term capacity to manage these cyclical peaks. Several outsourcers now have mature delivery models which allow an insurer to buy a predetermined amount of capacity at specific times in the year. This model is scalable, cost-efficient and simple to manage.

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² Life Insurers Adopt BPO for Product Innovation and Faster Speed to Market, Gartner, October 23, 2013.

Conclusion

In summary, the life insurance industry has a unique opportunity to outsource its closed blocks of business to enable a more efficient cost structure to service the portfolio, to better manage its talent and to enable focus on current and future products. Executing such a transaction can be risky and needs to be tightly managed. Outsourcing closed blocks may not be right for every insurer, or for every product, and it is important to conduct an objective and thorough assessment of the opportunity. Additionally, an insurer should consider adjacent areas where outsourcing may be leveraged, such as in new product development and managing cyclical demand patterns.

For more than 15 years, Deloitte has been actively involved in outsourcing strategic assessment, transaction management, program management, regulatory guidance and portfolio migration. Our knowledge of this particular opportunity and our strength in outsourcing advisory services can support an insurer that is embarking on such an important program.



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