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Outsourcing of Insurance Claims: A U.K. Case Study

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Contemporary business outsourcing has extended beyond manufacturing to include service sector industries, including insurance. There are developed theoretical arguments that both support and reject insurance claims handling as a service that should be determined by the market and outsourced where possible. Indeed, insurance has a tradition of using professional loss adjusters to negotiate the settlement of both commercial and personal lines claims. There appears, however, to be little empirical research to evidence either the success or failure of approaches to insurance outsourcing. This exploratory study adopts a case study methodology using a major U.K. insurer. Findings indicate a significant return to in-house claims handling but also point to advances in the professional exercise of bulk purchasing power in the provision of indemnity. Possible explanations for this behaviour are considered and an industry-wide survey is suggested.

1. Introduction

Fundamentally, decisions on outsourcing revolve around an organization considering the relative merits of carrying out a particular function themselves, i.e., in-house, or contracting out the function to another organization. This fundamental definition masks, however, the complexity of the outsourcing decision, and the concomitant dangers that wrong decisions can bring to an organization. Indeed, Lonsdale and Cox (1998) identify the important problem of concentrating on the short-term financial gains of outsourcing to the exclusion of more long-term strategic issues. McIvor (2000, p. 22) takes this one stage further by claiming that:

> "In fact, outsourcing decisions are made most frequently by default, with little consideration for the long-run competitiveness of the organization."

The traditional question which organizations asked themselves relating to outsourcing was one of "make or buy". This question implies that outsourcing is a concept more appropriate to manufacturing. This implication is supported by the experience of outsourcing success stories such as Nike, in the manufacture of sports footwear, and Apple, computer hardware (Quinn and Hilmer, 1994). Contemporary business outsourcing has, however, been extended well beyond manufacturing processes to incorporate such diverse operational areas as Information Technology (IT), payroll and marketing. It has been estimated that between 1996 and 2000 the growth in outsourcing would be 46 per cent (PA Group, 1996). Against this background of an expanding market, this paper will look at an area of outsourcing which has been largely ignored by the academic literature, that is the outsourcing of claims handling by insurance companies. The U.K. insurance industry journals suggest that this too is a growing market, but there appears to be no published empirical material relating to the rationale behind such outsourcing and evidence of its success or failure. On an *a priori* basis, it would

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be reasonable to assume that, given their close association with both risk assessment and broader risk management, insurers would be alive to both the positive and negative risk factors surrounding outsourcing. This is particularly so in the area of claims handling, given that as far as policyholders are concerned this is, perhaps, the key indicator of the insurer's service capability.

Our study will indicate that, at least in one major U.K. insurer, the attraction of outsourcing has not been as seductive as some of the literature would suggest.

2. Theoretical basis for outsourcing

The primary basis for outsourcing is very much related to the theory of the firm. This theory has been exhaustively covered in the economics literature, and it would not be appropriate to analyse it extensively in this paper. Crucially, however, the work of Coase (1937) has been cited as being central to the modern notion of the virtual organization, although Coase himself doubted whether this was economically efficient due to the existence of transaction costs. In his view, a fundamental consideration in make or buy decisions was the level of these transaction costs, and the fact that where they were high the operation should remain in-house. On the other hand, where transaction costs are low it may be economically efficient for the organization to outsource.

The important modern theoretical development in outsourcing can be firmly located with Williamson (1975, 1985). Again this has been extensively analysed in the literature (see Lonsdale and Cox, 2000), but the most relevant aspect for an application of it to the insurance industry is Williamson's marriage of economic and management theories, i.e., the debate was extended beyond simple costs. In the context of claims handling, insurers could find the basic transaction costs of contracting out this function to be relatively low, but, following Williamson's logic, it might not be appropriate to do so if external providers could not provide a level of service which was acceptable to both insurer and policyholder. The three main difficulties which Williamson (1985) identifies in respect of outsourcing transactions are:

- asset specificity;
- uncertainty;
- infrequency.

Outsourcing the vast majority of insurance claims does not appear to encounter these difficulties to any insurmountable extent. Asset specificity is low, i.e., there will be little or no need for bespoke equipment, uncertainty will be relatively low as claims handling firms will be working within the terms of policies and service standards and finally transactions, i.e., the number of claims, will be frequent. Theoretically, therefore, insurance claims handling would appear to be a service which should be determined by the market (McIvor, 2000).

Bray (2001, p. 2) alludes to the "received wisdom" which argues that business operations can be categorized under one of two headings:

> "core (the unique and commercial-advantage winning sort) and chore (the rest)".

Arguably, this is an over-simplification of the outsourcing dilemma for organizations, in that operations which are viewed as "chores", and theoretically lend themselves to outsourcing, may be so inextricably linked with core activities that not retaining them in-house could have a detrimental effect on the core activities. In practice, therefore, a much more detailed frame of reference is required to inform the outsourcing decision, a framework which recognizes the complexity of organizations and the subtle interdependencies which exist between functions.

A further aspect of the whole outsourcing debate, that of "core competencies" (Prahalad and Hamel, 1990), must also be considered. Bettis *et al.* (1992, p.19) succinctly summarize the significance to organizations of focusing on core competencies:

> "One important key to sustaining competitive advantage in today's world is focusing corporate resources on the development and enhancement of core competencies more effectively than competitors."

Given the centrality of claims handling to insurers' reputations and, ultimately, their market advantage and share, there appears to be a sustainable argument that this is one of their core competencies. *Prima facie*, therefore, the outsourcing of this function could be seen as a potentially flawed strategy. Research is therefore needed on why so many insurers appear to have gone down the outsourcing route. Specifically, two main research questions have to be answered:

1. Have insurers used a rigorous analytical approach in deciding whether, in principle, they should outsource?
2. If so, what operational framework have they used?

Cánez *et al.*, (2000) provide a comprehensive review on the literature relating to how questions such as these are addressed by the outsourcing decision-making process. Whilst recognizing the usefulness of a number of strategic approaches to outsourcing, Cánez *et al*. (p. 1316) identify the common omission of failing "... to address specific make-or-buy decisions by trading off relevant factors". In effect, they are claiming that whilst there are a number of extant theoretical approaches to outsourcing principles, there is a lack of practical advice on how organizations can weigh the costs and benefits of outsourcing. A logical extension of this view would be that companies are learning-by-doing. This approach clearly has potential dangers, and in an industry such as insurance, where competition is high and customer loyalty low, a wrong decision on outsourcing the claims function could lead to a loss of market share.

Whilst, therefore, there is a strong theoretical case for outsourcing in certain circumstances, the main focus of our research is on its practical implementation in insurance and the risks associated with that implementation.

3. Risk associated with outsourcing

The whole issue of outsourcing-related risks has been the subject of considerable analysis. Commentators such as Welch and Nayak (1992), Venkatesan (1992), and Probert (1997) have looked at various strategic risk aspects of outsourcing in a number of business environments. Perhaps the most comprehensive summary of the risks of outsourcing is, however, that supplied by Lonsdale and Cox (1998). Although recognizing that there may be some overlap, they categorize the risks (p. 25) as:

- loss of core activities;
- being leveraged by suppliers;
- loss of strategic flexibility;
- interruptions to supply;
- poor quality of supply;

- fall in employee morale;
- loss of internal coherence;
- confidentiality leaks;
- loss of intellectual property rights.

To these could be added such factors as differences in culture between the principal and the sub-contractor and the costs, both obvious and hidden, of monitoring performance.

Several of these risks seem particularly relevant to insurance claims outsourcing. The core nature of claims handling has already been discussed, but such aspects as loss of flexibility, supply interruptions/quality, and confidentiality leaks are all potentially troublesome for insurers. For all of these risks, insurers would be well advised to heed Compton (1999):

> "Rigorous risk management standards must be applied to outsourcing because badly managed outsourcing can deskill or even destroy an organization."

As suggested above, insurance can rightly be described as the "risk business", and the expertise gained over many years of underwriting and pricing should be a valuable tool in informing a whole range of business decisions. It is accurate to say, however, that many insurers have made questionable business decisions as a result of poor assessment of a number of risk factors. A pertinent example of this was the decision of many U.K. insurers in the 1980s to expand into the estate agency business. Large sums of money were paid for independent estate agents at a time of buoyant (and ultimately unsustainable) house prices. As the, not entirely unexpected, house-price recession followed, some insurers were left to regret this foray into estate agency. Whilst there appears to be little superficial connection between diversification into estate agency and outsourcing of claims, it is a connection which is worthy of further analysis. The decision to diversify into estate agency did have a clearly articulated business rationale, i.e., an opportunity for product cross-selling. With the benefit of hindsight, however, there is a sustainable case for saying that at least some insurers' decision-making was as much prompted by the fad for diversification as it was by systematic business-case analysis. In effect, diversification became a fashion. There is no doubt that outsourcing generally has grown and, for the foreseeable future, will continue to do so (Blumberg, 1998; Fitzsimmons *et al.,* 1998; Baldwin *et al*., 2001). Based on empirical research, Lonsdale and Cox (1998, 2000) and Lonsdale (1999) identify, however, that many organizations have not been entirely satisfied with the outcome of their outsourcing. This raises the question of whether they have rigorously evaluated outsourcing, or if they "... were simply following the latest fads" (Lonsdale and Cox, 2000, p. 450). The possible parallels between insurers' questionable, but at the time fashionable, business decisions over estate agency purchase, and their moves towards greater outsourcing are clear.

Another potential, and highly problematic, risk associated with the outsourcing of claims is that is may introduce de-skilling in the organization. Arguably this was evident in the Lloyd's market in the 1980s with the centralization of claims handling, i.e., what had been a core skill for syndicates was now removed. Clearly, this de-skilling leaves the insurers in a position whereby poorly-managed or unsatisfactory outsourcing experiences could not be resolved simply by bringing the function back in-house. In reality, in a very short time after the function is outsourced, the skill is unlikely to exist in-house.

4. The insurance industry experience

As discussed earlier, outsourcing within the U.K. insurance industry has not attracted a great deal of academic attention, although Willcocks and Lacity (1999) use an insurance related context to discuss IT outsourcing. The Chartered Insurance Institute (1998) does refer, however, to two non-U.K. studies which suggest that the claims function is not a core activity and that a large number of insurance companies were driven to outsourcing by competitive pressures. What is not clear, however, was the extent of analysis carried out by these organizations into the potential risks of outsourcing, i.e., was a very narrow analytical framework used when assessing these competitive pressures.

Trade and practitioner journals appear to confirm, however, the growth in the phenomenon across a number of areas of insurance company operation. The areas where there appears to be the greatest amount of activity are IT services and claims (Essen, 2001). The main focus of our empirical study is that of outsourcing of claims handling in the U.K.

An analysis of the available literature would suggest that there is a considerable diversity of approach by U.K. insurers. There is evidence (Gordon, 1998; Threadgold, 2000, 2001; Noble, 2000) that across the range of U.K. insurers, there are those who:

- do not outsource;
- outsource on an *ad hoc* basis, e.g., due to a large volume of weather-related claims;
- outsource all types of claims at all times, normally up to a predetermined value;
- outsource a particular type of claim at all times, e.g., household;
- outsource, but do not publicize the fact to clients or brokers. In effect, the company to whom the business is outsourced operate under the badge of the insurer;
- provide a service which most insurers have traditionally outsourced, e.g., those motor insurers who now own and operate vehicle repair centres;
- outsource the initial telephone notification of the claim only;
- have previously outsourced, but have now brought the function back in-house.

Even those insurers who vigorously outsource appear to regard claims handling as a core competency, but within this homogenous group there are some who see no problem in contracting out the function (Threadgold, 2000, p. 9):

> "All insurers state that they regard claims as a core competency, though some are more competent than others."

This quote may be no more than a casual, even throwaway, line but it encapsulates what may be the key problem in claims outsourcing. Claims handling is recognized as a core competency/activity, but, contrary to the best advice from a significant body of research, some insurers have decided to outsource it. Our empirical work will seek to address why this may be the case and what have been the consequences of outsourcing decisions.

5. Methodology

A challenge for the selection of an appropriate methodology is that (a) earlier studies have, as identified above, highlighted a wide range of variations of outsourcing practice, and (b) it is known that the insurance industry contains many member companies and is diverse in terms of scale and type of operation. In addition, the successful entry of many non-U.K. (particularly European) insurers into the U.K. (e.g. AXA and Zurich) has blurred any peculiar "Britishness" of the insurance industry in the U.K., suggesting that a study of the phenomenon of insurance outsourcing be investigated firmly in an international context. An extensive survey geared to quantitative analysis offers the greatest potential for generalizability of findings. In advance of such a study it is useful to explore the ground and a qualitative methodology may be ideal for this.

For our exploratory study we have adopted a single case study approach and examine what is happening to outsourcing of claims in one of the top five U.K. insurers and a world class player in their own right. Investigation of industry statements and published commentaries relating to the company's stance on claims issues is coupled with a semi-structured interview with a key informant in their claims management.

6. Case study results

6.1 Introduction

The findings of this case study would suggest that the notion of claims handling not being a core function for insurers, as suggested by non-U.K. studies referred to by the Chartered Insurance Institute (1998), is an oversimplification of the reality. The study indicates that the claims function is actually seen as a key differentiating factor in the marketplace, and that any marketing edge can only be maximized by retaining the function in-house.

The insurer under study had previously outsourced a large amount of its claims handling to loss adjusting companies. This would appear to have been a policy which developed more through custom and practice than through any analytical study of the costs and benefits. Beyond that, there has been no history of significant outsourcing of customer-interface services, although a number of "back office" IT functions have been outsourced.

Changes in management structure mean that commercial lines and personal lines are coming closer together, reversing a fashion that appeared around 20 years ago. In the case study company only the information technology systems "legacy" of these keeps them apart. They now acknowledge four core competencies: underwriting, sales, claims and accounts, and now have a single director for claims, underwriting, etc.

Whether it is selecting the best way to contact and negotiate with a client or to repair or replace property, they have adopted a philosophy of reviewing how things are done and who does them, neatly encapsulated in the expression "rightsourcing".

6.2 Claims as a differentiator

It was the firm opinion of the interviewee that, as regards household insurance business, there was very little to choose between the major providers in respect of both policy cover and cost. The interviewee described claims as the "proof of the pudding", in other words it represented the major, perhaps only, opportunity for any insurer to demonstrate that they were providing good value for money.

That being the case, the view was that if claims are the only way in which you can differentiate your product from those of your competitors, it is too valuable to leave in the hands of an outside organization. Any customer dissatisfaction with the service provided by external providers was going to be aimed at the insurer, not at the provider. In other words, the poor quality of supply risk identified by Lonsdale and Cox (1998) was considered to be a significant one. Loss of control over such a key function was also seen as significant.

Interestingly, the provision of a good, one-stop claims service is seen as a valuable marketing tool for the company, both in the retention of business and in the procurement of new business through word-of-mouth recommendation.

6.3 Claims as a core competency

It is axiomatic that in any type of insurance business, claims represent the biggest single outflow of funds. This being the case, the company under study was of the opinion that even low-percentage savings across high volume claims were likely to represent considerable financial savings. Essentially, therefore, a thorough, fair, efficient and effective claims service is at the core of their business.

The company has had a fairly lengthy history of carrying out customer satisfaction surveys. Over a period, these surveys were revealing a pattern of customer dissatisfaction with the services of loss adjusters. When this was combined with a rigorous financial analysis of the relative costs of in-house as opposed to loss adjuster handling of claims, a policy of maximizing in-house provision was pursued. This financial analysis involved an audit of a large number of individual files along with a benchmarking exercise. Both aspects pointed to the financial benefits of in-house provision. There was also a view that, for low cost/high volume claims the levels of expertise of staff employed by the major loss adjusting companies was questionable. In many respects it could be argued that, if this is the true position, the major insurers have significantly contributed to it. Since the late 1980s/early 1990s, insurers have taken a very firm line with loss adjusters' fees, with most operating a system of fixed fees. These fees have been set at much lower levels than previously prevailed. It is understandable, therefore, that the loss adjusting companies have had to make economies *vis-à-vis* recruitment and training in the face of such a reduction in fee income. The interviewee unequivocally accepted, however, that for the high cost/low volume claims the utilization of loss adjusters was still their preferred strategy.

Another area where traditionally many U.K. insurers would have employed the services of loss adjusters is in the investigation of suspected fraud. This is another aspect of claims handling which the case study company no longer outsource. They have employed their own specialist fraud investigators, mainly ex-police officers, who are utilized when claims-handling staff suspect that there may be fraudulent elements to a claim.

In addition to any quantifiable financial benefits, there was a general feeling in the company that direct employees were more likely to be in tune with the whole company ethos. This was more likely to result in increased customer satisfaction. Post-claim surveys carried out by the insurer now point to higher levels of customer satisfaction. Audits of settled claims also suggest that the introduction of increased in-house provision has increased levels of consistency of claims handling across different regions of the U.K.

6.4 Strategy and operation of increased in-house provision

Clearly if an insurer places such great store on its in-house claims service and decides to pursue this at the expense of outsourcing, it must have adequate resources in place. Increasingly for high-volume business this involves sophisticated IT systems, but primarily it requires adequate staffing both numerically and in terms of expertise. The case study organization has had a long tradition of recruitment and training in the claims area. Generally, however, the claims staff were employed for purely office-based functions. The reduction in usage of loss adjusters and the move to employees externally investigating claims required staff with different skills. The company addressed this skills gap initially by purchasing part of a national loss-adjusting firm and by re-employing, and retraining, the adjusters as their own employees. In time, they have trained their own staff to fulfil this role.

The interviewee admitted that, mainly due to the increasing use of technology, many aspects of the claims function had been de-skilled. Plainly, this could have implications for staff recruitment, retention, motivation and morale. Whilst there was no hard evidence from the company, it appeared that these potential problems had not become a major issue. There had been no staff opinion surveys to mirror the policyholder surveys which had been carried out. It was suggested that the prospect of becoming one of the company's claims investigators held open the possibility of some form of career structure.

6.5 The supplier market

That insurers should be interested in using their purchasing power (or the "supplier market") is not a new idea. Insurers large and small have for many years had arrangements with suppliers such as wholesale jewellers where their effective bulk-buying has earned them attractive discounts. However, at the case study company the concept is now greatly developed. It is worth looking at this aspect of our findings because it does have a bearing on our central theme of outsourcing. In the process of getting the best replacement deals and of shaving the claims costs, an element of policyholder contract is entrusted to particular suppliers, e.g. a large, national electrical retailing group. Perhaps most interestingly, such suppliers will to some extent try to validate a claim during their process of questioning to establish what has been lost or damaged so that they can propose a suitable replacement. Contrary to the risk of being leveraged by suppliers (Lonsdale and Cox, 1998), they have actually used their size, integrated claims-handling systems and national presence to negotiate maximum discounts for replacing items which form part of a claim.

The insurer has developed the supplier market for a number of types of loss, e.g., carpet replacement and specialist cleaning, jewellery, builders, electrical appliances, recommended car repairers and are now buying and running own garages (an attraction of the latter being the saving in Value Added Tax thus available to the insurer). A further incentive behind a slick car repair service is to deflect the new breed of credit hire company/law firm and car hire tie-ins that have been a source of concern for motor insurers. Rehabilitation of injury claimants is another variant of the supplier market, though certainly not an original idea and well developed in, for example, the U.S. Any health service ought to help its accident victims back to normality without undue delay but in reality health services vary: if the insurer can be proactive and provide expert help it can cut time and therefore reduce the claim. They concede that the supplier market is not without its problems. A strong audit regime is essential to prevent fraud on the part of suppliers. Constant monitoring is needed, and a penalty and reward element helps to reduce the dependence on policing measures. Again, the company bought in the expertise to initiate and manage this aspect of their claims service. Instead of merely allocating the task to, for example, a head office claims manager, the company have employed "purchasing managers" with in-depth experience of the wholesale and retail businesses.

These replacement schemes have attracted very few complaints, and customer surveys again appear to justify their adoption.

6.6 Monitoring and quality assurance

Commentators on outsourcing have identified poor quality provision as one of the main risks. As discussed, the case study organization had concluded that, for certain types of claim, they were concerned over the quality of the service being provided by loss adjusters. If, however, an organization concludes that it can provide a better quality of service through in-house provision, how should it monitor this provision?

The company have a number of methods of monitoring quality. As indicated above, post-claim surveys of policyholders have produced encouraging results. Also, the use of IT systems allows the company to monitor aspects of the claims investigators' performance, e.g. number of calls, response times and claims status. The main monitoring method, albeit a reactive one, is the auditing of closed files. This auditing covers indicators such as speed of response, methods used in settling the claim, amount paid and any comments/reactions from the policyholder. The interviewee suggested that the overall results were favourable.

Taking all of these measures into account the interviewee expressed the view that, in his opinion, the overall quality of in-house provision was better than when the same type of claims were handled by loss adjusters.

6.7 Plans for development of in-house provision

The interviewee was of the firm opinion that his organization's experience of bringing in-house what had previously been outsourced had been positive. In the light of that success, the company continues to explore opportunities to further reduce their reliance on external providers.

The major such initiative undertaken thus far is the purchase of vehicle repair centres. This decision was taken subsequent to a rigorous analysis of the costs and benefits of such a purchase. The analysis suggested that there were potential capacity risks for a large motor insurer in the future, i.e., many of the repairers which they used were likely to either simply cease trading or would be taken over by larger companies in the foreseeable future. The latter situation could potentially result in motor insurers being leveraged by a small number of very large, national vehicle repairers. In addition to this, financial analysis suggested that considerable savings could be made in repair costs, made up by simple reductions in repair bills and in savings in Value Added Tax.

Based on current plans, the company has no intention of outsourcing any of the claims functions which are currently undertaken by their own members of staff.

7. Conclusions

Attention to claims may be especially important when we consider the value of being able to retain a policyholder. New policy processing costs are high. Only once it is "on the books" and has been running for a few years will a policy be at its most profitable and it is difficult to make money out of a predominantly "churned" book of business. This prompts us to question what makes a policyholder renew with an insurer: price surely, inertia possibly, but also satisfaction with the insurer and fear of worse to be had elsewhere. The latter point is fuelled by everyday stories of poor service as dissatisfied policyholders make a point of spreading their view far and wide. Claims experience could possibly be the ultimate test of an insurer/insured relationship and the chance to embed the company in the customers' mind in the nicest possible way.

What are the reasons for the change in our case study company? Are we simply witnessing another change in fashion or are there sounder reasons, well thought out and based, for example on the customer surveys as mentioned above? Case study research is respectable but has its limitations. Our findings about the company prompt speculation about, but do not reveal what might be happening to, the rest of the sector or internationally. They do appear, however, to challenge the orthodox view on the rationale for and benefits of outsourcing, at least so far as the insurance industry is concerned. We have observed a number of interesting developments in the company: we see a significant change in organizational approach, one requiring commitment from the top and a major investment to put in place; we see significance of scale of operations being employed; we see an increased recognition of claims as a core competency; and we see staff attitude as something that cannot be bought. But do we see success as a result?

The purchasing aspect is surely easier to measure, but what about the cost/opportunity/ loyalty value of an improved claims service (i.e., by shifting the emphasis to in-house). This is a difficult notion to evaluate and a possibility for future research. Whatever we can say about the company it can only be a tentative pointer to the rest of the industry, but it seems that if we go looking we might find that generally in the insurance market there is: more collective control of policy from the top; more flexing of purchasing muscle; an awakening to the hitherto hidden disadvantages of outsourcing; and to the arrival of an important new insurance management role, that of the purchasing manager, to professionally monitor wherever part of claims supply chain contact is entrusted (outsourced) to another.

Behind it all must surely be the question: does it all make for more profit? That is where we come back to classical economic theory mentioned earlier in this paper. Ultimately, the new strategy must produce more satisfied customers prepared to pay premium levels (probably not the cheapest possible) that support a margin greater than that enjoyed by insurer competitors. If it does not work out that way and, as a consequence, the laws of supply and demand (and the peculiar conditions of the supply of insurance) result in the company facing a declining share of their markets, they may have to think again.

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