

ADDED VALUE OUTSOURCING



Outsourcing has been popular among insurers for decades, but in this post-Solvency II era, insurers must develop a deeper understanding of where third-party providers can create the greatest value for their business.

By Peter Davy

Solvency II didn't invent outsourcing. According to the federation Insurance Europe, the continent's insurers employ 1,000,000 people directly, but also an equivalent number as outsourced employees or independent intermediaries.

That reflects trends well beyond the insurance industry. Offshoring—just one, albeit large, element of outsourcing—is forecast by some analysts to account for a quarter of service jobs by 2017. In the finance sector, Deloitte, a leading US audit, consulting and tax advisory services firm, estimates that the global IT and business process outsourcing market was worth €150bn in 2015 and is growing at 7% compound annual growth rate. The UK leads the way, followed by France and Germany.

A range of factors have made it particularly attractive for insurers, and for life business in particular, according to Roy O'Neil, senior business development lead, Europe - Life Technology Solutions at Milliman. Competition, consolidation, low interest rates and regulatory pressures have all played a role since the early part of this century to popularise outsourcing.

On the one hand, outsourcing built its popularity as a solution to insurers' closed books of business.

"There are only so many ways you can strive for growth to fund running those legacy books, and if you can't grow the top line anymore, you have to look at where you can take costs out," says O'Neil.

Freed from the requirement to support staff and IT systems for legacy business, insurers have been able to not only save costs, but improve customer service and reduce capital requirements for those policies.

It has offered insurers more cost effective ways to deliver basic services, as well as efficiently deal with decreasing volumes of business.

On the other hand, it delivers significant benefits to open book and growing businesses. It offers not only similar cost-saving benefits, but also a solution to changing customer expectations in terms of technology, and a faster route to market for new businesses or product lines.

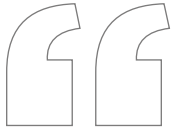
Consequently, the scope of outsourcing has continued to grow. Consultants Ernst & Young noted in a report last year that outsourcing in life insurance has expanded beyond simply hiring third-party administrators for billing, accounting and claims.

"Traditionally, larger insurers have viewed the actuarial function as a core competency and, for the most part, it has not been sourced to third-party providers. Today, however, market complexity, cost pressures and a shortage of talent are causing many insurers to rethink the best approach for all kinds of work and functions, including actuarial."

Outing the actuaries

A survey by the Economist Intelligence Unit in 2014 for the main US and Canadian actuarial societies found that 29% of small firms and 60% of large firms outsourced actuarial work. Similar trends are found in other developed markets, such as Australia, and markets that are themselves hubs for offshoring, such as India.

Outsourcing offers the function a wide range of benefits, says O'Neil: flexibility to deal with variable workloads; access to leading practices; freedom for senior management to focus on other business priorities. For established players, outsourcing presents



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move to principles-based reserving and increased complexity and workloads in terms of risk management, calculations and reporting. The UK Treasury, in its recent response to the EU Commission, stated that the new framework is already “raising issues around the impact of the framework on long-term investment and competitiveness of the European insurance industry”.

an avenue to carve out repeatable, non-core tasks; for new market entrants, it provides core actuarial back office support while the organisation grows.

It also frequently gives insurers access to better technology. Dr. Lars Michael Hoffmann, principal and co-practice leader of German life insurance at Milliman, says: “Many of the outsourcers can maintain huge and sophisticated systems because they are used all the time. That can mean quicker delivery for calculations and reports that are outsourced as well.”

The increasing opportunities presented by Cloud computing are likely to continue to expand both the opportunities and appetite for insurers to rely on outsourced providers. Regardless of regulatory pressures, the business case for outsourcing is as strong in actuarial services as anywhere.

Added impetus

Nevertheless, the requirements of the Solvency II framework will push insurers to review which functions they outsource and which they keep in-house.

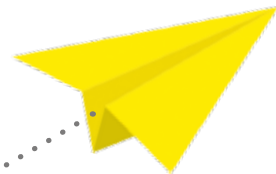
Increasing capital requirements threaten to sap insurers’ resources, just as they try to manage the

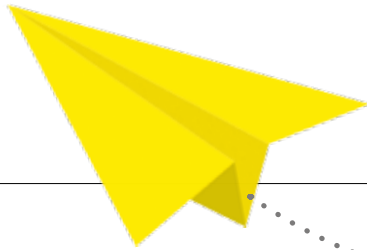
Pressure on actuarial departments responsible for assumptions informing firms’ reserving models is particularly acute. Many—and perhaps especially the smaller organisations less prone to outsource such functions in the past—will struggle to meet the new requirements on their own, argues Hoffmann.

“In Germany we have almost 100 insurance companies, and about 80 of them are pretty small. Of those it seems likely a large portion will move toward some sort of outsourcing,” he says.

“The additional work from Solvency II is considerable,” confirms Ulrich Starigk, senior counsel at Milliman. “It requires more people and training for staff on the new requirements. In many cases it’s going to be more efficient to buy these resources from outside.”

However, in recognition of this, Solvency II also imposes significant obligations on firms to ensure adequate supervision and oversight of outsourced arrangements. Under the Directive, EU member states





are charged with ensuring insurers “remain fully responsible for discharging all of their obligations under this Directive when they outsource functions”.

“They can outsource the function, but they can’t get away from the responsibility for it,” says Starigk. “They are ultimately answerable to the regulator and they have to monitor the outsourced provider.

Under the Directive, insurers must ensure a number of conditions when outsourcing ‘critical’ or important functions (which certainly includes the actuarial function, notes Starigk): no impairment of the quality of the system

of governance; no increase of the operational risk; no undermining of the quality of the service to policyholders; and capability to monitor the service provider.

These high-level requirements are elaborated in the Delegated Regulation that supplements the Directive, requiring a written outsourcing agreement and extensive due diligence to ensure the outsourcer has the ability, capacity and legal authorisation (such as required certifications) to undertake the functions. There must also be provisions in place for regular review and monitoring of the arrangements.

AVIVA'S ACTUARIAL SHARED SERVICES

Aviva's actuarial shared service centre in Warsaw, Poland, provides services to the insurer's business units throughout mainland Europe, for its UK life business, and for some of its Asian units.

Employing nearly 100 people, it has doubled in size in the last 18 months, and Paul Mylet, Aviva's group actuarial reporting director and head of business development and management of the centre, has ambitions for it to double again over the next couple of years.

As he explains, the centre provides a range of services for different business units. For some smaller, younger units, it covers the end-to-end reporting process, including all functions below the chief financial officer or chief actuary.

“For those units, Aviva wanted to get the actuarial teams to a particular level and the easiest way to do so—quickly—was to move the entire process to the shared service team.”

For bigger, more established units it provides perhaps half a dozen people to help with recurring processes (about three-quarters of its workload), such as period-end reporting, and one-off projects (about a quarter).

Finally, for the biggest units like the UK business it does specific pieces of work, such as experience analyses and, lately, some Solvency II validation work.

The sweet spot

Poland offers Aviva a balance between cost savings and a familiar financial culture. While some far-shoring

arrangements (Aviva also outsources work to third parties in Asia) are cheaper, the Polish staff can take on more complex tasks.

“They speak the same technical language,” Mylet explains. “They understand the process and the calculations being done, so when issues come up they have the ability to make intelligent judgements themselves.”

The Polish centre is best for work that falls between the repetitive tasks that can be outsourced more cheaply further abroad, and work that, from a regulatory or organisational perspective, must stay in the local unit.

“There's a definite sweet spot,” says Mylet.

In such cases, however, the centre doesn't just bring cost savings, but allows Aviva to increase the consistency of its reporting across the group, refine processes and adopt best practices across the different units.

Even so, the business units all retain close oversight and control. “We bring people out of Poland into the business units for a month or more as needed. They sit with the people they are transferring the work from, understand the process, ask questions and do the work in a supervised environment before taking it over to Poland. From that point forward, there are regular conversations – once or twice a week,” says Mylet.

“While they are running the process themselves, we are always keeping onshore owners of the processes updated and involved.”

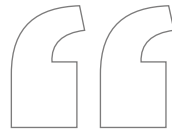
Solvency II adds to existing pressure on insurers. In January 2016, for example, the UK's Prudential Regulatory Authority published further guidance on outsourcing under the Senior Insurance Managers Regime, again making it clear that whether a function is outsourced or not, someone within the firm must still have responsibility for it. In the general insurance market, the Financial Conduct Authority (FCA) outlined in a review last year that it expected improvements in firms' approach to delegate authority arrangements.

As Linda Woodall, acting director of supervision at the FCA, put it: "All firms must ensure they have appropriate oversight of outsourced arrangements and meet their wider responsibilities to deliver fair customer outcomes."

Selection criteria

Even without regulatory drivers, there are significant incentives to carefully consider outsourcing arrangements. Solvency II is an opportunity, as much as an obligation to review outsourcing arrangements, says O'Neil.

First, that means looking at which tasks can be outsourced. Some core tasks that are more bespoke and subjective, such as product strategy and design or defining risk appetite, are unlikely to make good candidates. Others, however, that are repeatable, periodic, or objective, are scalable and can be developed into a systematic work process and handled by more junior workers. Even within actuarial work, there are a wide range of non-core tasks, including experience studies, in-force valuations, reconciliation and model valuation, that are repetitive and have clearly defined work requirements.



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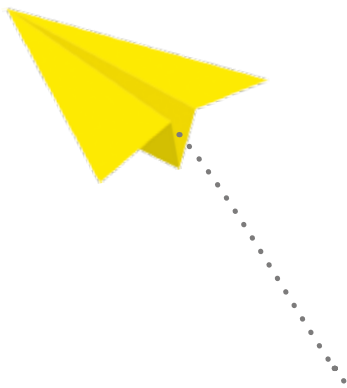


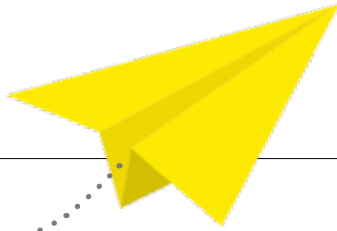
Dr. Lars Michael Hoffmann, principal and co-practice leader of German life insurance, Milliman

The extent to which organisations decide to outsource them will vary widely, however, and is likely to be significantly dependent on the size of the organisation (see table, page 6).

Even when arrangements are outsourced, the specific arrangements also vary widely. While simple offshoring—whether to an external outsourced provider or to a captive subsidiary—remains popular, managed services and business process outsourcing (BPO) have increased in importance over the last few years in the insurance industry, as they have elsewhere. Across the public and private sectors as a whole, the UK saw 39 BPO contracts with a combined value of £1.4bn in the first half of last year alone, according to outsourced services provider Arvato.

The distinctions between the three are not always clear, says O'Neil, but the move from offshoring to managed services, and finally BPO, largely reflects organisations moving “up the





| TYPE | APPLICABILITY OF OUTSOURCING | CANDIDATES |
|-------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|
| Large established | Used selectively to address non-core activities or release skilled resources to be available for more value-added analysis. | Model valuation and model risk management; Valuation support. |
| Medium sized | As above, but to focus on the increasing demands of the actuarial function. | Financial model maintenance; Valuation support; Process and control requirements. |
| Small-sized or new market entrants | Administer core functions with a possible move to recapture and bring these in-house when scale demands. | Full valuation support; Experience study analysis. |

technical spectrum” in terms of the tasks they are willing to outsource.

Offshoring has usually involved low-skilled work, and managed services handled more sophisticated tasks. But where control remains firmly with the client, the managed service provider may provide the IT infrastructure for a task (often now through the cloud), but those using it remain in-house. BPO takes this further, outsourcing processes that demand advanced research or analytical, technical and decision-making skills.

As such, outsourcing to a BPO provider will not be a decision based purely on cost. It is as likely to be driven by a recognition that the outsourcer has greater access to the specialist skills and capabilities the functions require, for example.

That means, however, that the requirements for oversight, monitoring and control are, if anything, even greater. A carefully managed transition to the outsourcer, ensuring a well-planned transfer and defined responsibilities, controls and communication requirements are essential, says O’Neil. It may also mean considerable work at the outset to ensure the quality of the processes and data being transferred.

Indeed, perhaps the greatest challenge for those outsourcing key functions such as reporting is not

external but inside the organisation itself. As Hoffman says, it is not just the outsourcer that needs to align with the culture of insurer, but the insurers’ own staff need to adapt to a new way of working.

“All of a sudden your actuarial staff are not the first to see their year-end number, for example. Instead it is calculated outside and in some cases then distributed throughout the whole group,” he explains. “That’s a very different approach for teams used to doing the calculation themselves, checking the numbers and then perhaps revising the calculation in light of targets and thresholds like the value of new business.

“It is a huge cultural challenge.”

If it is to be worth it, those on both sides of the outsourcing arrangement will need to be prepared to put in the work.

Find out more

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