

**RISK AND THE OUTSOURCING OF RISK MANAGEMENT SERVICES:  
THE CASE OF CLAIMS MANAGEMENT**

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**Abstract**

Outsourcing of risk management activities is a well-established practice, involving a range of services from actuarial audits to loss control training to risk financing management to claims administration services. Surprisingly, little work has been done to examine the risks associated with outsourcing risk management activities. This article examines the outsourcing of claims management services by reviewing the research on outsourcing risks and by interviewing leading practitioners. In doing so, the authors draw some provisional observations about risks and risk costs associated with outsourcing claims management services—observations that seem generalizable to all risk management outsourcing.

## **Risk and the Outsourcing of Risk Management Services: The Case of Claims Management**

### **Introduction**

Historically, risk management has been viewed as a technical function—one mainly focused on insurance-buying and the management of insurable risks. Various aspects of this range of responsibilities have proven to require specialized knowledge: insurance and insurance markets, safety engineering, the law, actuarial science, and finance. For this reason, and for others related to historical developments, risk management has long relied on outside vendors and experts to provide technical support.

In recent years, risk management has undergone a significant change and has expanded well beyond its insurance roots. Today, risk management is seen as a general management function engaged in assessing and addressing all risks that a governmental entity faces.<sup>1</sup> Perhaps not surprisingly, as the typical risk manager's brief has broadened, there has been a corresponding growth in the reliance on outside service providers. New risk managers tend to be generalists, so the need for technical advice is higher than ever.

One area of outsourcing that is undertaken commonly in (mainly larger) governmental entities is claims management services. Governments that self-insure or participate in pools desire to acquire the technical services of a claims administration firm (often called a TPA—Third Party Administrator) to manage and resolve self-insured or pooled claims. Claims administration requires technical knowledge of coverage documents, insurance

law, accident and claim investigation, litigation and dispute resolution, and claims financing. Unless a risk manager has had prior experience working in claims, it is unlikely that any self-insuring governmental entity would have the in-house capability to manage claims—even if it possessed the financial capacity to retain risks.

The potential benefits derived from outsourcing are rather well-known and discussed: access to high levels of technical expertise and the possibility that—owing to their expertise—outside vendors can deliver services at lower unit costs. And, certainly this argument seems strong in the case of claims management services. Most claims TPAs have technically competent staff and deal in high volumes of claims, both of which tend to reduce average per-claim costs.

Oddly, little has been done to understand the specific risks associated with outsourcing claims management services. To be sure, there is both practitioner and academic research on outsourcing and contracting, and certainly the issue of contracting costs is understood. However, within the field of risk management, no attempts have been made to consider systematically the risks associated with outsourcing claims management services.

In order to establish an understanding of the risks of risk management outsourcing, it is first necessary to consider briefly the literature on contracting and outsourcing and to evaluate the implications for public entities. From this analysis will arise a set of observations that provide a basis for considering the risks associated with outsourced risk

management services. Claims services are the specific vehicle by which this issue is discussed, but it seems likely that the observations are generalizable to all risk management services (in fact, to all outsourcing—though generalization to this level is not an intent of this article).

In an effort to contextualize the literature on outsourcing, ten large-entity risk managers were interviewed about their entities' claims management practices. The risk managers provided detailed information and their discussions serve to 1) describe their perceptions of risks associated with claims services outsourcing, and 2) to reflect on the connection between outsourcing claims services and general knowledge about contracting and outsourcing. Five risk managers were interviewed in Minnesota and five in Scotland. The reasons for doing so certainly were driven by logistical considerations but each of the risk managers is respected within the field and all represent similar large local governments.

### **What generally is understood about outsourcing?**

The primary private sector argument for outsourcing is very much related to the theory of the firm. As suggested by Watt, this theoretical framework could be relevant to local governmental entities.<sup>2</sup> Watt argues that decisions to contract can be considered in light of the prospect of adding value and economic efficiency to the government's services. Others, such as Coase,<sup>3</sup> cast doubts on whether contracting is economically efficient due to the existence of transaction costs. Thematically, this controversy is rooted in the fact

that economic models do not capture easily the frictional and indirect costs of contracting.

Williamson is recognized as having extended Coase's thinking beyond purely economic considerations.<sup>4</sup> Notably, he identifies three factors that shape contracting transactions.<sup>5</sup>

They are:

- Asset specificity (does the nature of the activity require a high degree of customization?)
- Uncertainty (are all variables and potential factors of the arrangement known and understood?)
- Infrequency (is the function under consideration characterized by high volumes or frequencies of work?)

Williamson's contribution to the subject of outsourcing can be summarized as a belief that the merits of outsourcing are very specific to the activity under consideration.

Management research focusing on core competences sees the contracting and outsourcing decision as being driven by the activity's role and position with respect to an organization's core assets/attributes/abilities.<sup>6</sup> Thus, contracting is a less attractive choice when the activity in question is central to an organization's distinctive identity and when it is entwined with other competencies.

When the question of contracting or outsourcing is placed in a distinct public sector setting, other issues become important. For example, time horizons influence the analysis of such decisions. Contracting implies a long-term consideration of costs, benefits, and other impacts, and that long term issues can be difference for public entities (continuity of services vs. quick returns, election cycles, financing burdens). Lonsdale and Cox offer one view on this issue by identifying the important problem of concentrating on the short-term financial gains of contracting and outsourcing to the exclusion of more long-term strategic issues.<sup>7</sup> McIvor 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."<sup>8</sup>

What emerges from the wide-ranging literature on outsourcing are four broad themes that inform this investigation of claims services risks:

1. Transactional and frictional costs of outsourcing frequently are ignored in considering outsourcing, but are suspected to be important.
2. Outsourcing seems best suited to situations where the activity can be characterized as a) undifferentiated, b) involving well-understood factors and c) a high frequency of activity.
3. The most compelling case for outsourcing is found in non-core activities.
4. Long-term costs and benefits are difficult to determine, often ignored, and—perhaps—susceptible to political and other influences.

**What are the risk management issues that arise from our understanding of contracting and outsourcing?**

To be fair, the question of outsourcing-related risks has not been completely ignored by researchers. Commentators such as Welch and Nayak, Venkatesan, and Probert have looked at various strategic risk aspects of outsourcing in non-public sector environments.<sup>9</sup> Sclar also addresses some of the key risk factors that organizations, both public and private, have to consider in deciding whether to outsource or internally expand.<sup>10</sup> Perhaps, however, the most comprehensive treatment of risks and outsourcing is supplied by Lonsdale and Cox.<sup>11</sup> Although addressing a slightly different subject, they indirectly categorize outsourcing risks 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

It is important not to draw a hasty conclusion about the merits of outsourcing given the apparent weight of these risks. Hood, writing on outsourcing and occupational safety and health, found that it was not possible to decisively state that outsourcing invariably leads to a worse risk situation for local governments.<sup>12</sup> And in particular, Hood found that those who tended to make general claims for public sector supremacy in managing risks appeared to be misguided, though he observed that the whole UK experience suggests that outsourcing can have negative risk effects. Particularly problematic issues arise when:

- The private sector provider lacks experience in the particular sphere
- Training and supervision within the provider are poor
- The monitoring of the provider by the local government is inadequate
- Outsourcing leads to the fragmentation of a long-established and effective system

Thus, the limited literature on risks and outsourcing produces two general themes. First, a number of problems emerge from outsourcing that stem from a loss of direct control over that activity. Second, loss of control produces risks that seem not to be accounted for when the outsourcing decision is under consideration.

## **The case of claims management services**

Does any of the preceding discussion shed light on the specific issue of risk management outsourcing, and particularly claims management outsourcing? And, is it possible to detail the risks associated with that practice?

Curiously, we know only a little about the actual process of evaluating risks related to outsourcing risk management services. The Association of Local Authority Risk Managers (ALARM) in the UK and the Public Risk Management Association (PRIMA) in the US both have produced general information on contracting issues, including some benchmarking data and “how-to” guides. However, the information that does exist is very general and does not offer many insights into the rationale for methods nor does it provide much scope in terms of the risks that may be present.

Since such information is not widely available, the authors endeavored to undertake an exploratory analysis of claims management outsourcing risks. The intent was to develop a better understanding of the applicability of existing research on risk management service outsourcing and to develop a provisional view on risks specific to claims management outsourcing. Owing to the exploratory nature of this work, it was decided to interview a panel of experts. Although the format adopted for this was not a Delphi panel (that is, a formalized “panel of experts” research method) *per se*, such was the spirit of the undertaking.

Risk managers were identified by reputation, by size of entity, and by geographic proximity. Five local governments were selected in Minnesota and five in Scotland. There were significant similarities among the ten entities—especially with respect to populations, urban/rural balance, entity sizes and scope of services). The interviewees chose to remain anonymous, but all represent large, mainly urban, state and local governments.

### **Risk management's role in contracting and outsourcing**

As a starting point for looking at outsourcing risks, the risk managers were asked to discuss their general involvement in outsourcing of all types.

All the risk managers indicated that they had some responsibility for contract review and formation. Typically, however, that responsibility was limited to 1) a review of insurance contracts, and 2) review of the insurance aspects of all contracts. Nearly all the risk managers reported some *ad hoc* reviewing on non-insurance issues.

There was one notable exception. A US risk manager (who, significantly, also is the deputy county administrator) has quite successfully inserted risk management into the front end of contract formation. He noted:

*Risk Management is responsible for the design of all indemnification, insurance and bonding language in County contracts. We are also responsible for the review and authorization of all contracts from a risk and insurance perspective. All contracts must be authorized by myself and the County Attorney's office. Risk Management has co-ownership responsibilities with the County Attorney's office for oversight and management of all County contracts, bids, and grant applications. We recently revised our Bid, Grant, and Contracting policies and are finishing the development of an on-line integrated Contract management system and database.*

In discussing the question of risk assessment as a part of general contracting, the risk managers agreed that the degree to which risk management became involved in contract review was down to, more or less, four things:

- The relationship risk management has with the department involved in the contract
- A referral to risk management from the legal department
- The profile of risk management within the organization
- The contracting department's past experience with contract related risks

In other words, the placement of the risk manager (or, whoever has responsibility for identifying and addressing risks) matters greatly in terms of the local government's ability to manage contracting risks. Assessing and addressing outsourcing risks is problematic if there is not a broad awareness of the need to identify the risks in the first place.

A notable innovation was reported by two US risk managers. They had developed a training program for procurement officers so those officers could understand risk management issues both in the front end of a contract and during its life. In those two instances, expanding an awareness of risk management among other managers was seen to be an effective means of introducing risk analysis into the contracting process.

When the questioning turned to the specific issue of outsourcing contracts, most of the risk managers reported little proactive involvement, except to the extent that specific insurance matters arose (certificates of insurance, surety bonds, coverage extensions). The single exception was the above-mentioned US county risk manager, who noted that he:

*...review(s) all contracts and (is) involved in decision-making processes at all levels regarding services changes within the organization. I sit on the County Board Agenda Review Committee with the County Administrator, division directors, and County Attorney and review each departmental request as it is prepared for the Board to review.*

In Scotland, two of the risk managers indicated that central government's "Best Value" (a competitive bidding requirement), "Public Private Partnerships" (a new framework for capital project undertakings), and "Corporate Governance" reforms (new requirements for reporting to governmental auditors) initiatives were likely to improve risk management's involvement in contracting and outsourcing. These observations raise the possibility that external expectations and requirements may be useful/necessary in motivating risk identification.

Risk managers, logically, have responsibility for risk management services like claims management, and so the interviewee's comments were more expansive on the task of outsourcing claims management services. It appears that the decision to outsource claims services commonly is based upon a formal evaluation process. In general, the process entails some type of request for proposal (RFP); a process that includes the internal development of the RFP, a public posting, hosting an RFP question and answer session, establishing criteria for evaluation, accepting and reviewing applications, selecting and interviewing finalists, and the ultimate awarding of the contract.

The risk managers noted that political forces play a major role in the outsourcing decision. Ordinary rules of bidding require the selection of the low cost bidder unless extenuating circumstances are compelling. Even though that rule appears straightforward, several participants thought that the current political environment of local government (both in the US and Scotland) created pressure to outsource no matter what the relative costs. *It is difficult to get approvals for new hires, but not quite so difficult to get approval to contract for services*, is how one risk manager put it. In other words, it appears that while the process to select an outside vendor is well established, consideration of whether to outsource in the first place is not so well understood, but is reckoned to be highly political.

Finally, though few of the entities actually managed claims in-house, it generally was held that a decision to do so would have to be driven by control issues. This was

interpreted as meaning non-economic issues sometimes raised the importance of direct and immediate control of a process. One illustration provided by a US risk manager was workers' compensation. He noted that, *a local government might have a compelling reason to manage claims in-house as it would signal the local government was a compassionate employer and that it took worker safety and welfare seriously.*

### **Risks arising from contracting and outsourcing**

*Success depends on the quality of the people who are assigned to you.*

This statement, more than any other, captures the main thrust of the risk managers' comments. They argued that the success of the claims management outsourcing experience is predicated on numerous intangible factors—personalities, “fit” with the entity and its objectives, management styles, and so on. The RFP process can isolate and measure tangible factors, but those factors end up being necessary-but-not-sufficient ingredients to success.

On this particular point, the US risk managers uniformly voiced the concern that turnover was high in claims management vendors and that produced uneven service. This raised the monitoring costs for the risk manager. In one instance, a risk manager indicated that he believed he was—effectively—running the vendor's claims unit.

While the intangible factors were cited as paramount, it was not clear that there were obvious ways to control them. Such factors are difficult to see before they occur. Unfortunately, the market for claims management services is not fluid or efficient, which means that it is difficult to rectify quickly intangible factor problems. Firing a poorly performing vendor is not easy and certainly the transition to a new vendor is fraught with difficulties and hidden costs. And, as has been noted earlier, the option of in-house services poses numerous difficulties for risk managers—most notably that the political culture may limit the public sector risk manager’s ability to bring in-house formerly outsourced services.

The Scottish risk managers all raised the issue of the rigor of any cost/benefit analysis that informs the decision making process. Both the local governments that did outsource and those that did not expressed a common concern about the quality of analysis. Questions remained as to whether, in the long run, outsourcing represented the best value. Notwithstanding that concern, the majority of the Scottish risk managers noted that there was a knowledge gap in their own local government and that, irrespective of cost/benefit analysis, they often did not have the expertise to handle certain categories of claims. This is a double-edged sword because while they did not have the expertise to handle claims in-house neither did they necessarily have the expertise to judge the competency of an outsider vendor in some technical areas of claims handling.

Another issue raised was the question of control. Outsourcing was seen as a way of losing hands-on control of claims. Given that only the actual handling of claims was

being outsourced, and not the financial, legal, political and social risks associated with the claim, this was acknowledged to be a problematic issue. As one risk manager put it:

*Ultimately the money and reputation are ours. Apart from the contract itself, the providers of the service have little to lose.*

What seems to arise from this discussion is an identifiable array of risks that attach to the outsourcing of claims services. Those risks might be categorized as follows:

- Cost/benefit risks (how confident can we be about the ultimate costs and benefits?)
- Relationship risks (can we work with the TPA's staff?)
- Goal risks (does the TPA understand the local government's goals and objectives with respect to claims management?)
- Expertise risks (does the TPA have the specific technical expertise on hand and, if not, what are the possible costs?)
- Scale/scope risks (does the TPA) have necessary size and scope to deliver against its promises?)
- Compliance risks (does the TPA comply with government rules—affirmative action, for example?)
- Capacity risk (does the TPA have the risk bearing capacity to assume contractual risks?)
- Reputational risks (how is the TPA viewed with respect to ethical practices, best practices, and reasonable expectations of the field?)

Underlying this list of risks is the fundamental issue of control. Put simply, measures need to exist to assure that the local government can monitor and exert appropriate control over its exposure to the above risks.

Finally, in light of the identified array of outsourcing risks, the risk managers were asked to comment on measures of success. How would they know that they have effectively managed such risks? Although there was not unanimity of response, the participants generally supported five measures of success:

1. The demonstrated ability to recover damages/costs under required insurance or performance mechanisms from defaulting TPAs.
2. The ability to demonstrate that no financial losses to the entity resulted from TPA activities.
3. The ability to successfully defend against claims made by third parties attempting to hold the entity accountable for the actions of the TPA.
4. The ability to record the satisfaction of contract managers, reflecting the reduced degree of difficulty they face in managing contracts and contract relationships.
5. The ability to demonstrate a reduction in insurance costs (or to control the increase of costs).

## **Final Observations**

The authors undertook this project with a concern that interviews with practicing risk managers might prove to be disappointing in the sense that they might reveal a narrow view of the risk management function and therefore might not be able to articulate the bigger issues related to outsourcing and risk management. And, it is true that almost none of the risk managers operated in a local government that took a broader view of risk management. Nevertheless, it was evident that the risk managers had thought a great deal about the issue of risk management and outsourcing, and indeed, it proved interesting to observe how closely their comments matched the findings of researchers.

In not always expected ways the subject of claims management services highlighted key topics raised by researchers. For example, Williamson establishes the principle that the decision to outsource is based on asset specificity, uncertainty, and frequency. Claims services would seem to be an ideal candidate for outsourcing in that asset specificity is low, uncertainty tends to be low and frequency is high (high, that is, from the standpoint of the TPA). Further, core competence research might suggest that claims services is not a core activity of a local government and therefore is not likely to be entwined with other core competencies.

However, the difficulties risk managers cited in managing claims services underscore Coase's concern about frictional or transactional costs. The cost of outsourcing is more

complicated than the purely direct economic costs of hiring a vendor. Those costs include monitoring costs, day-to-day administrative costs, training and development costs, political costs, and exit and switching costs. Further, the principally non-economic costs of interpersonal relationships, trust, reputation, and purpose can be significant. Thus, the Coase admonition might be to assure that all costs—direct, indirect, tangible and intangible—are counted when outsourcing is considered.

Thematically, loss of control seems to be a specific risk management cost issue for contracting and outsourcing in general and claims management services in particular, and this is an observation very much in alignment with the research. Another consistency, however, also should be mentioned. Lonsdale and Cox identified a set of risks that seem related to one another: loss of core activities, loss of strategic flexibility, interruptions in supply, fall in employee morale, and loss of internal coherence. All of these risks suggest that interdependency is a factor that must be reflected in the analysis of outsourcing options. That is, many activities undertaken by a governmental entity are interconnected with other activities and functions, and the indirect costs of outsourcing can be significant.

By the Williamson test, claims management services exhibit characteristics that make it a strong candidate for outsourcing, and so it might seem that “interdependency issues” would not be important. However, the previously cited example of the decision to keep workers’ compensation claims management in-house suggests that even non-core activities may have important linkages to core activities.

Finally, and importantly, there is evidence that political considerations frame many situations where outsourcing is taken under consideration. This is, perhaps, not a shocking revelation inasmuch as most all government activities are heavily influenced by political considerations. However, it does seem to need to be restated as a factor because political concerns can directly affect the basic mathematics of cost/benefit analysis (what is counted and what is not), and as such present a systemic risk that must be acknowledged.

## Footnotes

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