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Outsourcing, Vendor Relationships, and the Insurance Industry- Article 1-06

KATIE SCHOOL OF INSURANCE AND FINANCIAL SERVICES
ILLINOIS STATE UNIVERSITY
Adding Value to Industry

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Outsourcing, Vendor Relationships, and the Insurance Industry

Table of Contents

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Executive Summary

The following white paper presents the results of a qualitative study of insurance industry executives' perceptions of outsourcing and 3rd party vendor relationships. The results are based upon in-depth telephone interviews of 24 insurance executives across small to large insurance firms (see Appendix A).

Findings:

1. *There is no agreed upon understanding of the term "outsourcing" and "partnerships." The definition of "outsourcing" and "3rd party vendor partnerships" appears to depend on the size of the company of the person being interviewed.* Most respondents across firm sizes agreed that the terms "vendor partnerships" and "outsourcing" represent different concepts. However, with small to medium-sized firms there tended to be agreement that 3rd party vendor relationships represent a stronger commitment than outsourcing. Alternatively, larger firms appear to have the opposite view wherein outsourcing is viewed as involving greater shared commitment and responsibility.

2. *Outsourcing and 3rd party vendor partnerships are here to stay*. Most of the insurance executives who participated in the study perceive that outsourcing and other forms of 3rd party vendor partnerships will continue to impact insurance companies' practices for the foreseeable future. However, the practice is largely viewed as a "necessary to business competitiveness", and not something that they are eagerly embracing. For all except the largest firms, reservations exist with respect to service quality, especially related to offshore partners.

3. *There is agreement in the need for better performance measurement related to 3rd party vendor partnerships*. There appears to be relative consensus among those insurance executives participating in this study supporting the need to develop commensurable definitions and ways to measure "successful performance" by 3rd party vendor partners. Such definitions and measures would also serve the more general purpose of providing standards to gauge "good" versus "bad" 3rd party vendor performance.

4. *Insurers often feel that tools to better communicate expectations related to 3rd party vendor performance are desirable*. The development of such commensurable definitions and ways to measure "successful performance" by 3rd party vendor partners could further serve as a foundation for articulated vendor strategies to help all relevant stakeholders form appropriate expectations.

5. *"Value" in the Insurance industry is about (financial benefits + expertise + performance) relative to control.* "Value" is generally defined in business contexts as the perception of the ratio of "Get/Give Up" in exchange relationships. In terms of 3rd party vendor relationships, insurers of all sizes generally perceive that they "get" financial benefits, expertise, and performance by engaging in 3rd party vendor partnerships. Interestingly, executives from smaller insurance companies were more likely to discuss relationship

marketing and customer service considerations when forming value judgments than executives from larger insurance firms. In terms of what insurers feel that they are "giving up," the single biggest concern by far with 3rd party partnerships relates to perceptions of loss of control, and an associated lack of confidence in activities performed by others that are difficult to measure and control managerially.

6. *Relationships appear a stronger top-of-mind concern for small to medium-sized insurers than for larger firms.* What this means is that 3rd party vendor relationships are the most prevalent form of partnership for small to medium-sized insurers. Firms of theses sizes are highly concerned with maintaining relationships with customers. The idea of wholesale outsourcing is of greater concern. (Which is one reason they tend to use the term less.) The idea of "offshoring" (outsourcing to a foreign country) appears to be almost nonexistent for these firms. However, executives at larger firms, tend to use the term outsourcing for readily and see that wholesale outsourcing appears to be a more viable alternative to 3rd party vendor relationships. This is especially true for areas like payroll and functions that are highly transactional, and less customer relationship-based.

7. *Relationships also appear a stronger top-of-mind concern for operational versus strategic decision-makers.* What this means is the closer the level of management is to the customer, the more they tend to emphasize relationship considerations top-of-mind. That is, strategic managers (i.e. CFO's) tended to focus more strongly on financial measures of "success" than their operational subordinates (i.e. Claims Managers), who tended to focused more strongly on relationship indices.

8. *Insurers do not expect that service quality from 3rd party vendors will be better than service from their own employees*. The expectations of insurance executives associated with 3rd party vendor performance could best be described as trying to maintain the service standards as those provided by the insurers' own employees. Thus, there appears room for improvement in the industry image of 3rd party vendors generally.

9. *Gift-giving policies vary by company*, but overall there is a discomfort on the part of insurers with "pure" gifts that are given, but an acceptance, and even an expectation among some companies, that employees will seek to establish rapport and build relationships through social interactions. Thus a $25 bottle of wine mailed to an employee might be considered inappropriate but a dinner or golf outing, of equal or greater value, with a vendor might be considered acceptable.

Key Issues Requiring Further Development

Based on information gathered from this study, two areas surfaced that seem to hold the greatest potential for understanding and improving outsourcing and vendor partnerships. These two areas relate to:

1. Better defining and identifying value in these relationships, and
2. Better defining, and identifying performance measures that help quantify the value.

Recommendations:

- Identify a relevant governing body credible to both insurers and 3rd party vendors that can help coordinate discussions and movement toward commensurable acceptance of some version of the model presented as Figure 2. Alternatives include involving organizations such as NASP and the Katie insurance School of Insurance, among others, which could represent all relevant stakeholders. There would be two major phases for such an initiative:

Phase 1: Develop a reliable and valid set of measures based upon the commensurable version of the model presented as Figure 2 derived from recommendation #1.

Phase 2: Develop a working group to help frame a draft general vendor strategy that can generally be used to appropriately communicate expectations related to 3rd party vendor relationships.

Key Issues of Study

As stated above, the two areas that have the greatest potential for understanding and improving outsourcing and vendor partnerships are related to:

1. Defining and identifying Value, and
2. Defining, and identifying Performance Measures that help quantify value.

The following discussion relates to these two areas.

The Quest for Achieving Perceived Value in 3rd Party Vendor Relationships

In order to enhance value, it is necessary to first define what value means in the context of outsourcing and vendor partnerships. We will refer to these collectively as Vendor Relationships. In short, insurance decision-makers' perceptions of "value" involve some ratio of what they perceive they "get" relative to what they perceive is "given up." Thus, in order to increase value to the insurer, the numerator (what you get) must increase, or the denominator (what you give up) must decrease.

In the context of the current discussion, the numerator of this ratio is what insurers "get" in a successful 3rd party vendor performance. The denominator is what is "given up" in this relationship. What insurance executives at all levels mentioned as the main thing given up was "managerial control". Figure 1 describes how "value" perceptions form in the context of vendor relationships.

Figure 1: Deriving "Value" from Successful 3rd Party Vendor Partnerships

$$\text{Perceived Value} = \frac{\text{Perceived “Get”}}{\text{Perceived “Give Up”}} = \frac{\text{“Successful” Vendor Performance}}{\text{Control}}$$

So, "perceived value" can be enhanced by either:

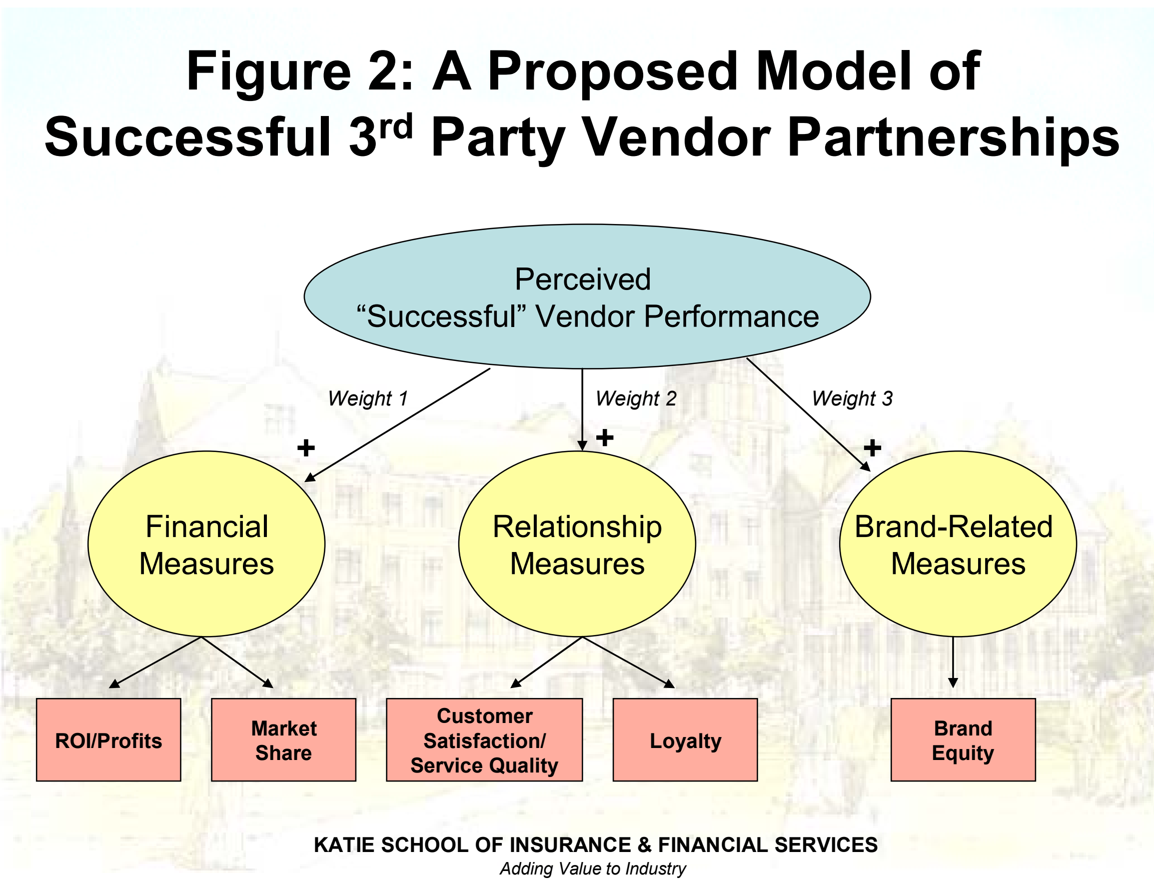
↑ perceptions of "successful vendor performance"
OR
↓ perceptions of loss of control

So, if insurance companies wish to receive (and 3rd party vendors wish to provide) maximum perceived "value", then this can be achieved by either (1) increasing perceptions of vendor relationship performance, and/or (2) reducing perceptions of loss of managerial control in such relationships. The following discussion examines these two parts of the relational value ratio in more detail.

Perhaps the most important and immediately actionable issue identified by this study concerns the need for commensurable (i.e., agreed upon) 3rd party vendor performance definitions and measurement.

Need for Better Performance Measures

Perhaps the most important and immediately actionable issue identified by this study concerns the need for commensurable (i.e., agreed upon) 3rd party vendor performance definitions and measurement. This addresses the numerator of the value equation discussed earlier. Figure 2 illustrates a model to help begin to understand how to better define and measure "successful performance" in 3rd party vendor relationships.



This model is based on current research which suggests that long-term "success" in insurance-based B2B relationships involves more than simply making a profit: brand- and customer relationship-related consequences are also important. This is supported by the notion that business customers are looking for "Customer Equity" defined as "…the total of the discounted lifetime values summed over the firm's current and potential customers." The three components of Customer Equity are:

1. Value equity (financial considerations for purposes herein),
2. Brand equity (the power of the brand), and
3. Relationship equity (the tendency of the customer to stick with the brand, above and beyond the customer's assessment of the brand).

"Successful" 3rd party vendor performance should be considered a function of performance perceived to be acceptable in three major areas: financial performance, relationship building and maintenance performance, and brand-building/protection performance.

Figure 2 presents a simplified model of how this Customer Equity perspective could be applied to insurers and 3rd party vendors and help provide a framework for defining and measuring "successful" 3rd party vendor performance. In this model "successful" vendor relationship performance should evaluated in three major areas:

- Financial performance,
- Relationship building and maintenance performance, and
- Brand-building/protection performance.

Financial Measures: One aspect of successful vendor relationship performance involves achievement of cost/ ROI objectives associated with the vendor relationship. Insurance companies tend to be comfortable with such measures, therefore, the following discussion concentrates on the "softer," often more difficult, measures (e.g., customer satisfaction, service quality, brand image, brand equity).

Relationship Measures: The three primary measures of marketing relationships are:
- Service quality,
- Customer satisfaction, and
- Loyalty.

Service quality captures impression of service "excellence." It tends to be a cognitive (intellectual, not emotional) judgment that people make that may or may not be based on personal experience.

Customer satisfaction is based on personal experience and refers to the level of fulfillment a customer perceives with a service encounter and/or their overall experience with a service provider. Satisfaction judgments tend to be both cognitive and emotional in nature and require personal experience.

Loyalty is defined as a deeply held commitment to rebuy or repatronize a preferred product/service consistently despite all the other influences and marketing efforts designed to cause them to switch to a competing product or service.

Brand-Related Measures: The measurement and strategic management of brand-related considerations also presents a significant challenge for marketers. We suggest the brand equity and management system recommended by Keller (2003). Keller's system calls for the measurement of (1) brand awareness and usage (e.g., Who is your favorite insurer?), (2) brand judgments (e.g., How favorable is your attitude toward XYZ?), (3) brand performance (e.g., XYZ insurer is convenient to use?), (4) brand imagery (e.g., To what extend do you admire people who use XYZ insurance?), (5) brand feelings (e.g., XYZ insurer gives you a feeling of … security?, and (6) brand resonance (e.g., I consider myself loyal to XYZ insurance).

The model does not require that each area of emphasis be equally weighted. In fact, the decision to weigh one more heavily than the other is a strategic marketing decision that customers and vendor partners will vary according to needs and the competitive environment.

For purposes of the current discussion, there is also a great deal of evidence supporting the following relationships:

Service Quality → Satisfaction → Loyalty

So, what does all this mean for insurers and 3rd party vendors?

It means that ideally, all three of these areas should be measured. However, it remains a strategic managerial decision of how many resources to devote to this activity. Therefore, if one were to choose, a focus on *loyalty* is probably preferable since it is most closely associated with the concept of life-time value.

Conclusion: Without question the main conclusion of this study is that there is a need to help better define expectations and value in the insurer/vendor relationship. The following comments from insurance executives illustrate the frustration that currently exists and supports the need for better measures of value and more uniform methods for selecting and managing vendor relationships in the claims area.

"Some things we need to have are: some clear metrics, whether it be customer service expectations, ROI, loss reduction, efficiencies around contacts and time periods. These need to be built into the full structure."

We had difficulty initially explaining the value proposition. It was viewed as simply a cost cutting exercise versus something larger.

"We do not have a vendor strategy. I think it would be a good idea because it provides the framework of the expectations, maybe establishes metrics, a good way to measure the effectiveness.

"You have to make sure as you move into more vendor relationships that you have rigorous methods in place for selecting and managing those relationships."

A significant pragmatic challenge facing the insurance industry and potential 3rd party vendor partners in moving toward better accountability and managerial control involves the development of a commensurable set of measures that both parties are comfortable relying upon for this purpose. This is difficult to do unilaterally and in isolation as a "one-off" for each relationship. This raises the interesting question of how to accomplish this goal considering the challenges faced in setting these measures.

For example, there are complex measurement issues that must be navigated requiring specialized skills and experiences. Outside of large organizations that have research units, the skills to capture and statistically analyze the appropriate measures may not exist.

Second, there is a need for uniform interpretation and setting of standards. This probably requires an independent external party which is positioned to ensure commensurability between relevant stakeholders. Most people are familiar with the J.D. Powers & Associates measurements on customer service. The Ward reports. A.M. Best and some rating agencies are other examples of other organizations used in the insurance industry to help make performance comparisons on an overall basis. The RIMS organization has been used to establish service standards between risk managers, brokers, and insurers. With respect to outsourcing in the insurance claims space, there may be a number of organizations which could weigh in on helping to establish standards and measurements. To move this forward, it is important to consider which organizations may be best positioned to perform this function to the satisfaction of all involved stakeholders? An independent organization with the necessary skills, that is capable of working with industry in the development of reliable and valid measurement instruments, is critical to moving the industry forward in enhancing the value of these vendor relationships.

Recommendations:

Identify a relevant governing body credible to both insurers and 3rd party vendors that can help coordinate discussions and movement toward commensurable acceptance of some version of the model presented as Figure 2. With respect to claims outsourcing, organizations such as PLRB, NASP, the American Institute for CPCU, the Katie insurance School of Insurance, among others, could play a role in helping to represent all relevant stakeholders and broker commensurate performance standards and measures. Such an initiative would likely involve two major phases:

Phase 1: Develop a reliable and valid set of measures based upon the commensurable version of the model presented as Figure 2 .

Phase 2: Develop a working group to help frame a draft general vendor strategy that can generally be used to appropriately communicate expectations related to 3rd party vendor relationships.

Without the development of commensurate standards and measures, outsourcing value is going to continue to be highly subjective and based on the "eye of the beholder" where one contingent group (i.e. CFOs) says that there is huge value based on what they get versus what they give up, and another group (i.e. operational managers) question the value because they believe too much control is given up. Commensurate standards and measures could help assess the value that outsourcing and vendor partnering adds and to what extent these relationships affect a client's own customer service, customer loyalty, brand image, and other key drivers of long term profitability.
Note: For more detail on the specific questions, responses, ideas, and conclusions, please see the following Appendix items.

Order of Appendix A- Questions and Responses

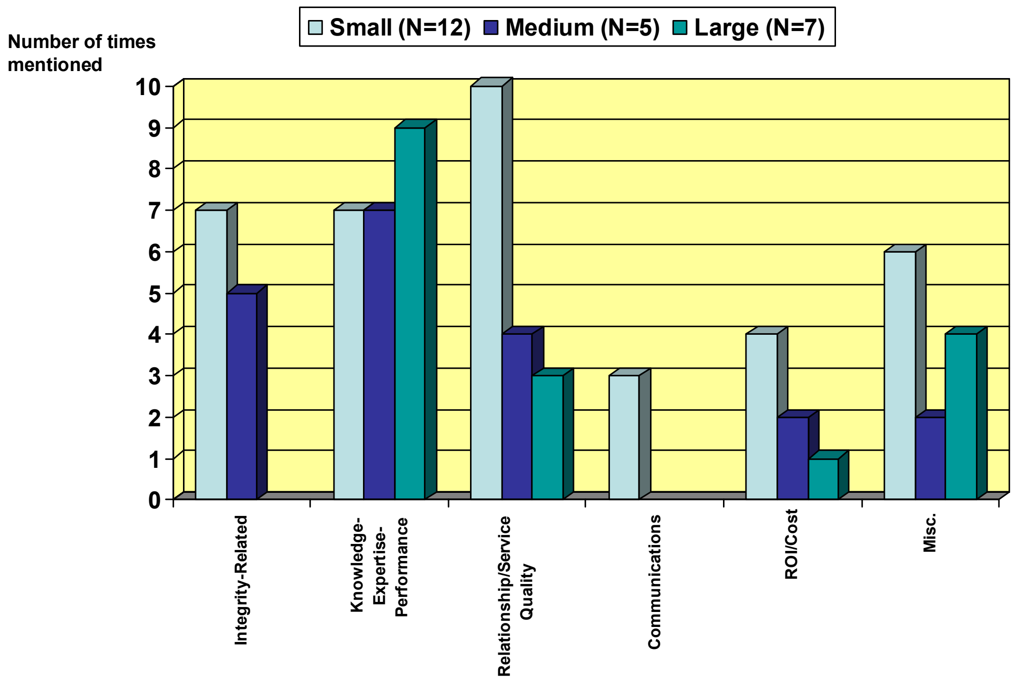
The following include a list of interview questions and responses. The responses are categorized by size of insurance company of interviewees.

Appendix A: Summary of the Qualitative Inquiry

Question: In your mind, do you see a difference between "vendor partnerships" and "outsourcing"?			
Small Companies **(≤ $750 Million)**	**Medium-Sized Companies** **($750 Million - $7.5 Billion)**	**Large Companies** **(≤ $7.5 Billion)**	**Overall Conclusion**
Six respondents stated that they did not perceive major differences between these terms. Six respondents stated that they perceived a difference, with most considering "vendor partnerships" the stronger of the two in terms of organizational relationships. **Illustrative Comments**: *"Yes. Vender partnerships would be more attractive to us than outsourcing. We do a little bit of both, but with the vendor partnership both parties seem to have a stake in the outcome. You want to have the party you're working with to have some skin in the game."*	Four of the five respondents stated that they perceive a difference between the terms similar to that voiced by respondents from smaller companies. **Illustrative Comments**: *"Yes, I think they are different. Typically, when we think about outsourcing activities, they are less of a partnership activity. Something that we can separate out from the business and hopefully an activity that is of lesser value to the organization."*	All seven respondents agreed that the terms are different in that outsourcing tends to involve wholesale transfer of functions to a 3rd party, wherein vendor partnerships tend to involve less ongoing and shared commitment and responsibilities. **Illustrative Comment**: *"We've had many conversations here about the term partner as it relates to suppliers and typically partnerships mean that there are shared risks on both sides. A lot of our vendor or supplier relationships don't really exist at that level so rather than being heavily involved in supplier relationship management or partnering, we're more about supplier performance management. It is a buyer/seller relationship. When we get into the term of outsourcing it comes closer to partnering than the typical buyer/seller relationship in that you are entrusting that supplier to perform activities or services on your behalf, many times, for your customers, so there's the curve or continuum of trust, but we still manage those suppliers on a performance basis rather than a partner basis."*	For all sized insurers most respondents stated that they preferred to keep operations in-house whenever possible. However, when necessary to use outside 3rd parties, there appears to be a clear tendency to prefer vendor partnerships over outsourcing. Further, there appears to be very little consideration and use of offshore outsourcing *at this time* except for very large insurance firms. The results suggest that "outsourcing," and particularly offshore outsourcing, will more likely to be first considered by the larger insurers, and over time potentially become more attractive to medium-sized and smaller insurers.

Question: Would you characterize your experience with 3rd part partners to date to be generally "good" or "bad"?			
Small Companies (≤ $750 Million)	**Medium-Sized Companies** ($750 Million - $7.5 Billion)	**Large Companies** (≤ $7.5 Billion)	**Overall Conclusion**
The vast majority of respondents stated generally "good" experiences. However, there appeared more a sense of "acceptable" 3rd party performance in the discussions rather than impressive performance results. **Illustrative Comments**: *"I'd say it's mixed. In the claims function, we have a strong preference for handling claims ourselves because we can control quality of what we a re getting. When we outsource claim investigation, we don't always know what individual is being assigned to the claim, how they are going about it, etc. We have a lot less control over the quality of it or the nature of how we are interacting with the public. Sometimes you can damage your reputation through a 3rd party and not even know it."*	The results were more mixed with these respondents, with the same sense of "acceptable" 3rd party performance, with more examples of "poor" experiences. **Illustrative Comments**: *"Generally good. It's been good when we knew exactly what our objective was."* *"With outsourcing, not that good. In my experience it would be specifically after-hour assistance in answering phone, taking loss reports; they fill the void we one time had, but the feedback on the quality was probably less than what we'd like to have or far less than what we're getting by doing it ourselves."* *"I guess what I'm saying is, looking at the front end of the claim adjustment process, touching the customer, the experience hasn't been that great. In the middle or back end of the process, they fill the void."*	The results for the larger companies tended to be viewed more positively, perhaps due to a greater emphasis on stronger managerial controls associated with such relationships. **Illustrative Comments**: *"Generally, where we have outsourced, we are satisfied with our choices we've made, both with the choices we've made on the services we've outsourced and with suppliers we've chosen ."* *"We would consider it good at this point in time. How so? In the past it hasn't always been. Due diligence is an area that needs attention. We would prefer exclusivity, service level agreements included in contract for level of performance.* *We've have very bad experiences, but I've also had excellent ones. It isn't one you can just let go; it has to be continually managed relationship-wise. Vendors have business cycles like anyone else. When things are great they're great; when they're bad, you have to watch it.*	For all sized insurers most respondents stated that there experiences to date have been "good" to "mixed." There seems to be a growing recognition of the potential brand implications of 3rd party performance for insurers, with "better" results tending to be associated with stronger managerial controls.

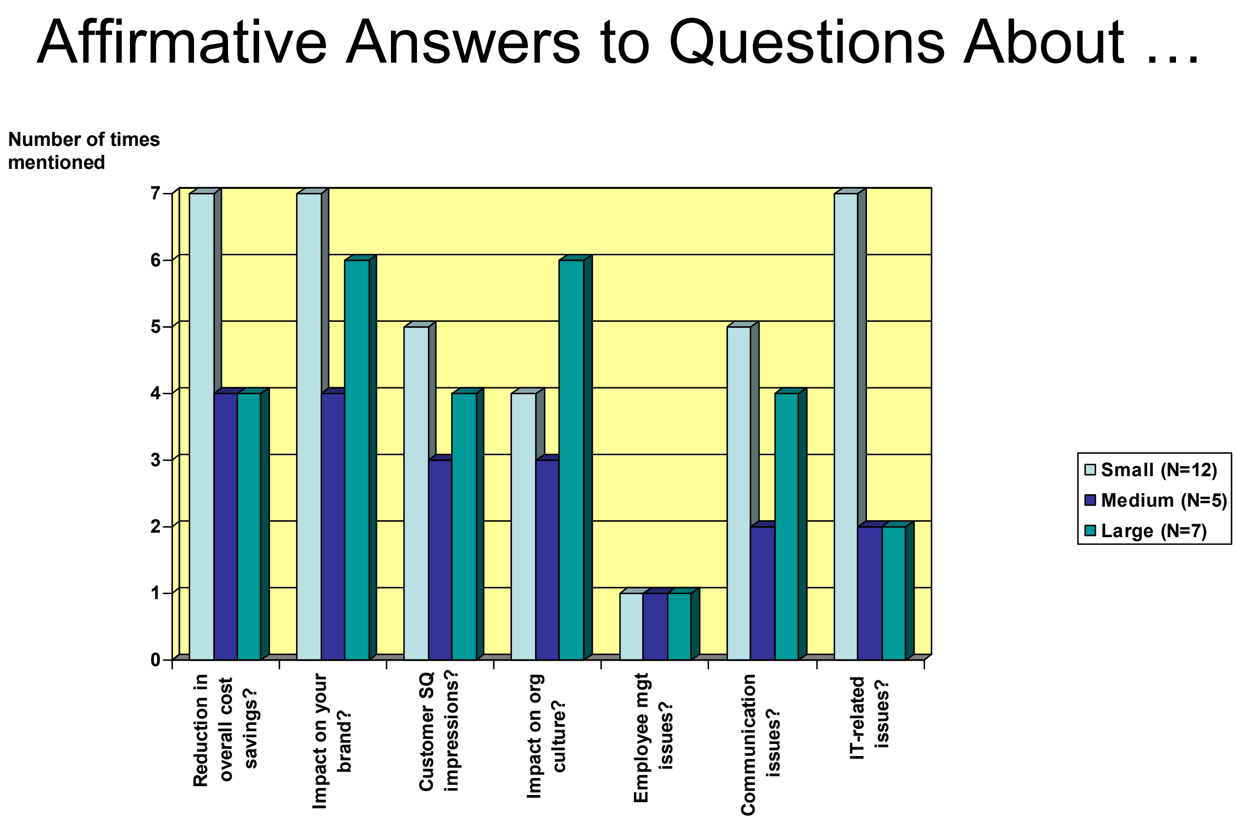
Question: "What are the important characteristics that you look for in a *vendor partnership* and/or *outsourcing*?"



The Misc category included:
Smaller: Items related to culture/fit and resources, technology, and value-added services.
Medium: Items related to culture/fit , financial stability, and previous experience with the firm.
Large: Items related to financial stability, process controls, technology, and transparency.

Overall Conclusion: For the smaller to medium-sized firms, there appears a clear emphasis on integrity-related-, knowledge/performance-, and relationship-related considerations. Other items that appeared top-of-mind included ROI/Cost-, cultural fit- and technology related issues. However, there appears less emphasis on integrity-related issues with the managers of the larger insurance firms. This does not suggest that integrity-related issues are less important for larger firms, as such issues may lie within the domain of managers other than those in the sample for larger firms, but does suggest the emphasis on performance-related and strategic consideration indices for the larger firms. Readers are again cautioned to remember that this study is a qualitative study with a small sample size, so care must be taken to not over-generalize the results reported herein.

Question: What are some of the important management issues that could be impacted by vendor partnerships or outsourcing?



Overall Conclusion: This question asked if the respondent had experienced or believed that their organizations could be impacted (positively or negatively) by 3rd party relationships. For the smaller firms, the results suggest that managers generally perceive influences related to a reduction in overall costs through such relationships, with potential impacts on the brand, IT, service quality impressions and communication issues. In terms of medium-sized companies, we see a similar perception of influence on reduced costs and brand image influences. However, for larger companies, we see greater potential perceived impacts on the brand, organizational culture, customer service quality impressions, and communication issues. Together, these results suggest that there seems a measure of commensurability in recognizing the potential impact of 3rd party relationships on brand considerations, customer service quality impressions, and the organizational culture. Further, the additional comments below suggest the powerful influence of perceived "losing control" as well as the growing recognition of the need for defining and measuring "**success**" related to 3rd party relationships.

Illustrative Comments:

" I would say that it (cost) isn't the motivating factor in using an outside party to get something done for you. It's more of a factor of not getting it done ourselves because we don't have the resources or expertise. Or it isn't cost effective because of something, but we don't look at taking a core insurance function because it is cheaper. We don't operate that way. Our philosophy as a company is based on executing at a high level and not being satisfied as being average. We want to do what we do better than others. If you look at it as just saving money, you're going to be providing the service at a level at or below another company that's outsourcing it. Cost isn't the driving issue."

"The things we outsource are things that won't affect our brand."

"The vendor isn't touching our insured. Most times the insured isn't aware of what happens behind the scenes."

We also added an additional query related to additional **managerial points-of-pain** respondents would like to discuss. Representative responses to this query included:

"Generally speaking – dealing with renewing contracts, vendor selections, etc. Can sometime be a battle."

"Going through the process of evaluating outsourcing is a learning experience. I think you learn from it whether or not you decide to do it."

"*We spend a great deal of time in the selection phase. Many companies will not outsource core competency processes. We have determined that it's more of a matter of the competitive advantage to the process than whether or not a process is a core competency. If we feel that a process is a core competency and not a competitive advantage, we'll outsource it... Also can we document that process sufficiently enough so that when we hand it off to a supplier, they can understand it and actually do it."*

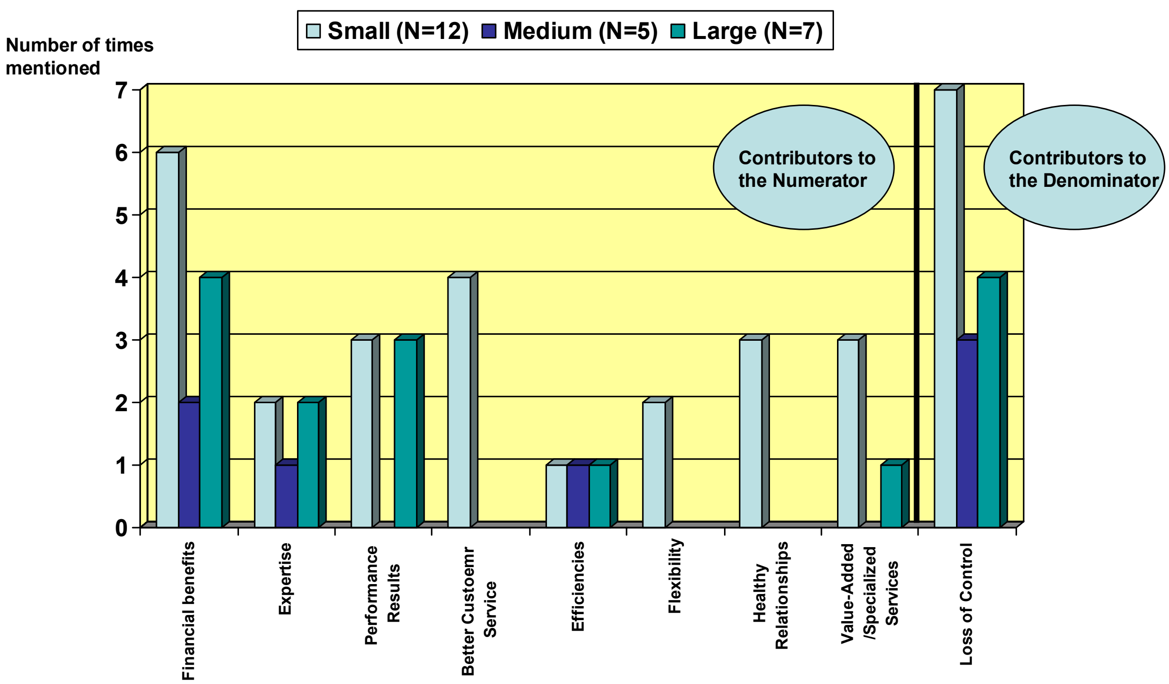
"The biggest thing for us is the gap between the performance and the potential. We need them to be proactive and deal with things on their own as opposed to us or the client having to make suggestions or recommendations in getting things done."

Other Points of Pain:
"The biggest single point-of-pain is the emotional perceived release of control and accountability. "

"From our outsourced after hours work, we received reports on what they did, but had no information on calls that may have been abandoned. After we handled these ourselves we gained a much better idea of our customers and what they needed.

Question: Let's define "value" as generally being the ratio of what your firm "gets" for what they "give up." How would you characterize the general value proposition of potential partners?

Overall Conclusion: The results suggest that all sized firms value financial benefits, expertise, and performance results from relationships with 3rd parties. Interestingly, however, only managers from smaller firms mentioned customer–service or B2B relationship related contributors to the value equation. These results do not imply that managers of medium to large sized insurance concerns do not care about customer service or health B2B relationships. Rather, the results imply that how value is defined may differ according to firm size.



The Misc category included:
Smaller: Items related to contingency rate/opportunity costs and the time and effort necessary to build healthy B2B relationships..
Medium: Items related to loss of institutional memory when relationships end and potential impacts on organizational culture.
Large: Items related to loss of institutional memory when relationships end and contingency rate/opportunity costs .

Exemplary definitions of "Value" from Managers of Smaller Firms:
"*The value comes into play with their willingness to work with us, whether or not we are of a comparable size, the personalities of our internal organization need to match up with our partnering organization, is there a level of trust in the relationship. Can we put forth our expectations and expect those to be met. They must be willing to look at our processes and make suggestions on what else we can do."*

"*We had difficulty initially explaining the value proposition. It was viewed as simply a cost cutting exercise versus something larger. For example, in the IT world, rather than just pricing, it was the* *availability of talent, finding certain skill sets that were hard to find in the US. Explaining the value in BPO is a little more difficult because it isn't just a matter of throwing the work over and having someone do it at a lower cost, you have to build in a mechanism where they feel it's an option. Call center work was the same because there was a resistance to put customer sensitive, customer facing processes overseas quickly so we went to the more simple customer service, answering the phone, taking payments kind of things versus the high-value, customer satisfaction programs. Explaining the value chain was difficult."*

Question: What do you and your firm potentially gain or lose in vendor partnering decisions?

Overall Conclusion:
Across all size firms, improvements in business performance are perceived, as well as contributions to the managers own personal professional satisfaction. This suggests that means-end models may be in operation in these competitive settings from the perspective of insurance managers. Specifically, the value of such relationships may lie in demonstrable improvements in business performance, and by extension, professional satisfaction for these managers.

Small Companies

(≤ \$750 Million):
Similar to many of the results above, managers in smaller insurance concerns perceive 3rd party relationships as contributing to more than simply business results. Specifically, there seems to also be a greater perception of positive influence on customer satisfaction, employee satisfaction, and organizational culture. Perhaps most surprising was the vast majority of respondents stated that such relationships contribute to their own personal professional satisfaction.

Illustrative Comments:

Our partnering with high quality defense attorney enhances our performance and we get very good results. We changed investment advisors a few years ago and our investment portfolio improved. (But) we don't see outsourcing our claims as an enhancement to our service; we see it as a necessity when we don't have all the resources in-house. "

"When we find experts in a certain field that definitely adds to our performance. For instance if we find someone with expertise in the medical field, they can handle a case for us that we couldn't do as well."

"In our environment, our employees understand why we use someone outside. I think they appreciate working with experts in some areas and they can have the advantage of their knowledge."

If we get a long term vendor, you develop personal relationships."

"The ones we've elected to do have performed effectively. We have been able to capture the benefits that we thought we were going to. The largest, most seamless one that comes to mind is ADP processing of payroll. It has definitely made my life easier."

Medium-Sized Companies

(\$750 Million - \$7.5 Billion):
Managers of medium-sized firms identified the importance of 3rd party relationships to overall business performance, and like their colleagues in smaller firms personal professional satisfaction. To a lesser degree, the influence of these partnerships on employee and customer satisfaction appear recognized.

Illustrative Comments:

"Most of what we have done is more of a support function, so it wouldn't have a direct impact. We are in the process of something that will have direct customer impact. We started with an objective and worked with outside vendors to develop the strategy. Now we're in the process of building out the strategy and we'll be involved in implementation. The vendor in the first phase in building the strategy has tremendous value to our end-user customer once implemented. Once this is implemented, it will have a positive impact on customer satisfaction."

"There's an opportunity for me personally and for other professionals in our organization as you bring in new

folks that are experts in their own area, it's a learning opportunity."

To the degree that employees' jobs are made better, easier, and more fulfilling, because you've entered into a relationship with a vendor that helps them perform better, you've improved their level of satisfaction."

"At my level you are held accountable for producing results. If I'm able to enter into a vendor relationship that enables me to produce better results, then I'm enriched by it."

Large Companies
(≤ $7.5 Billion):
Managers of larger insurance concerns appear similar to managers of medium-sized firms in terms of the results identified above.

Illustrative Comments:
When the partnerships I manage on behalf of our clients do well, it's pretty gratifying. Most of our programs are outperforming the industry and we feel like we're part of that success."

"Initially it gets worse, but over time it gets better. We might originally try to over-manage it because productivity will take a hit. There is always customer disruption whether real or perceived in that transition."

One of the things we do is to keep a constant screen out there to determine the capability of the general supply base and what work we perform that might be performed by others. If a process can be done as well or better than we can do it, it's our responsibility to bring it to the attention of the corporation."

"I do see the world differently, more globally, because of my background of living in several different countries. It isn't a matter of taking work out of the US and moving it offshore; it's about taking high cost locations and relocating to low cost locations."

Question: What do you think is the future of outsourcing, offshoring, and related trends?
Overall Conclusion While recognized challenges exist, interestingly, across all firm sizes there seems to be the belief that outsourcing practices will continue to influence the insurance industry, and subrogation/claims specifically.

Small Companies
(≤ $750 Million):
Eight of the twelve managers articulated arguments that could be summarized as suggesting that "outsourcing is here to stay." Three of the managers were unsure as to the future of outsourcing, particularly for smaller insurance concerns.

Illustrative Comments:

"*We're in the middle of trying to determine the future of outsourcing. We're seeing some carriers beginning to outsource their catastrophe claims handling to balance out their staffing for normal claims. We're seeing more outsourcing for subrogation so I would have to say that I do see the industry, for certain functions outside the normal claims handling process, having a tendency for increased outsourcing. I think it can be a good thing. Not all carriers are the size of State Farm, Allstate, or Farmers. For those carriers where there is a cost of building the competencies, processes, and systems to perform a function at a high level, outsourcing provides a focused high-level performing opportunity to maximize whatever you're trying to do. I think outsourcing is here to stay. We just went through a year and a half process to outsource our property subrogation. The decisions behind it was that our product is so unique that we didn't know what the potential was. We built a relationship to outsource and they're willing to take the financial risk that there's more potential there than we think. We've built a partnership behind it so we'll see where that goes. I don't see why offshore partnerships would be any different than US based partnering. We're seeing outsourcing of customer service functions more and more. We don't do that yet, but as long as organizations can get the same quality for less money and where the employee market is better, we'll see more of it. I don't think there is much of a limit to it. If it works for other things, why couldn't claims be done that way."*

"I don't see outsourcing diminishing. I think if companies figure out how to outsource and keep their costs down internally (staff, current resources, rent, etc.) they'll continue to do it. However, I think most folks would like to have all that work for them on their payroll from a customer service angle. I think most American consumers would prefer their service being within their company rather than being outsourced."

"*I think it's here to stay. I don't think it's a good thing, but a necessary evil. I dealt with a large insurance company where the claims adjuster, that was outsourced, wasn't competent. He processed a claim on our building where the settlement was totally too high. I would be surprised if offshoring turns out to be a growing trend in the insurance industry."*

"*I think it will go up because the margins are really tight in the insurance industry and I think anything that you can do to reduce your operational expenses, will drive more outsourcing. I don't really see much difference in relation to offshoring and don't think I would have a problem with doing it."*

"Fewer individuals are getting in this industry overall. We're in a drought here in for students or experienced individuals coming into this industry. As we continue to see a need for experienced, talented employees, you will

see a need to outsource different parts of the organization."

"My feeling is that there's always a certain segment of the industry that's going to outsource a lot of stuff. I serve on the board of the XYZ. We see companies become insolvent, for instance ABC. One of the thing we found out was they were being serviced by multiple administrators throughout the country. They had outsourced all of the claim functions to these vendors. They didn't know what was going on. I don't feel that they are much of an insurance company when they turn everything over to others to do, claims, underwriting, computer operations, etc. I don't think companies should outsource key functions of their business. There are things smart to outsource, but core insurance functions are not part of that. I don't think a call center in another country is going to work that well for a company where the contact with a consumer is through a local agency in the community where the customer lives in. I think insurance is a relationship business and it is still highly driven by relationships. You can't run an insurance company strictly through outsourcing."

"Subrogation is something that isn't talked about a lot. It's hard to find information about it. I think it's going to continue to grow. Autos have increased in value so there is more money involved. I don't know about offshoring because of the language barrier. I think customers get frustrated talking to someone that they have trouble understanding."

"I think the industry is going to improve on the technology side. I think we're behind in technology and there is a number of opportunities there. I think it's more a case of certain pieces that have the most potential rather than a whole process."

Medium-Sized Companies
($750 Million - $7.5 Billion):
Four of the five managers articulated arguments that could be summarized as suggesting that "outsourcing is here to stay." One respondent did not answer the question.
Illustrative Comments:

"*I think outsourcing in general is going to play a big role in the future in the insurance industry because technology is improving rapidly and becoming ever competitive and somewhat commoditized. This opportunity to tap into outside intellectual resources, best practices, will be important to strategic success. I don't see the price advantage of off-shoring will be sustained long term. My concern would be that in making that the significant investment required for off-shoring, those doors would close rather quickly and there may not be ample time to recoup that investment and return. I think whether it's US based or offshore, in the call center types of activities that are typically staffed at the lower income level, I don't see a long-term future or benefit of outsourcing those kinds of activities specific to the difference in costs. There may be some geographic issues relative to that. I would be more in favor to vendor relationships that bring some type of intellectual knowledge and strategic value to the organization not just outsourcing to reduce cost."*

"I think it's going to grow as outsourcers understand the needs of companies and it makes sense economically."

"I think it's going to be a growing industry. Everybody in our industry is going to be looking at how they can effectively utilize outsourcing to improve their claims results. I think the insurance industry will begin to embrace outsourcing, including offshoring."

"In subrogation, I think you'll see companies saying that they're going to keep what they can do as well and cheaper, but they will look to them to develop programs for their units. Once the adjusters make the referrals, we

take a second look at the closed files internally for missed referrals. We send them out to the outsource company to review. Anything they find and recover, they can collect a fee on. Also, files over $5,000 closed without recovery, we have them take a second look at to see if they can settle them before they're sent to a collection agency. Also only certain commercial vehicles are subject to subrogation, and in New York there are a lot of cabs that look like private vehicles on the police report, which would be subro, but turn out to be commercial. Vendors have methods for finding out information that we don't have. I think in subro the outsourcer's future is not the "whole banana", but finding where they can add value without threatening to steal the whole department. The mistake they make is not finding a high enough person in the company. They talk to the person that feels threatened by their existence."

Large Companies
(≤ $7.5 Billion):
Five of the seven managers articulated arguments that could be summarized as suggesting that "outsourcing is here to stay." Two respondents felt outsourcing would diminish for reasons of data mining and lack-of-success to date.
Illustrative Comments:
"*I think it's only going to grow. We outsource a great deal more every year. We get more continually comfortable culturally with the idea of working through others and being more of a virtual company. As companies begin to understand capital management they start to make decisions about whether or not they want to invest their capital in equipment, buildings, resources, etc. in order to do the work themselves or invest it in growing the insurance business and allowing others to have their capital invested in order to provide the kind of services you need to get."*

"I think offshore's were rapidly developed and people were quick to jump on the cost element of it. If we minimize the language barriers it could improve, however, I think with Voice Rec it could mostly be automated and offshore not needed."

"I think it's going to be reduced in the next couple years as Technology improves. For instance data mining."

"Subrogation-Yes, I think it has a place. I think it's one of the pieces that's missing from the equation. The results in the subrogation area with companies are dismal. You're asking a claims adjuster to do adjusting, be the medical manager, litigation manager, subrogation person and none of them are getting the results that they should. Subrogation vendors that we have dealt with give us a good feeling about their capabilities of recoveries. We will be using subrogation vendors going forward. We've challenged some of the claims management to do a better job on subrogation or we would hire a subro vendor to come in. They definitely have a place in this business."

"Internally there seems to be a big IT push and it can be done anywhere. Call center operations in offshoring doesn't seem to work. Customer Service seems to suffer."

"Hopefully, outsourcing is going to be first and foremost within XYZ and the establishment of these low-cost processing organizations around the globe; technology allows us to do that. We recognize that there's always need in both local and corporate jurisdictions that some outlet for volume is required. I'm sure there are reservations with some regarding offshoring, but there are many large companies that are utilizing offshoring. It's still a matter of moving from high-cost to low-cost locations. Our company was born in _____. Over 55% of our workforce is overseas already."

“In offshoring, I think it will be impacted by world affairs and the economy. There’s going to be an opinion on that whether it’s going to be acceptable or very unacceptable. Of course, that’s way out of our control. The question will be “How will the customer view that?” I think outsourcing is going to accelerate and improve because of technology in services and so forth. I think most industries are going to become very high service out of ability because of what the customers of the future are going to require and because of what the technology of the present and future is going to give us in order to satisfy those customers.”

<table>
<tr><th colspan="4">Question: Assuming you were asked by your Board of Directors to develop a vendor relationship strategy with a US-based service provider, would there be any challenges you would expect to have to overcome that are not identified in your previous answer?</th></tr>
<tr><th>Small Companies
(≤ $750 Million)</th><th>Medium-Sized Companies
($750 Million - $7.5 Billion)</th><th>Large Companies
(≤ $7.5 Billion)</th><th>Overall Conclusion</th></tr>
<tr>
<td>Only one in ten respondents stated that they had an articulated vendor strategy in place (two did not answer the question). Respondents were divided as to whether or not having one was a good idea.

Illustrative Comments:

“We have none (vendor strategy). It probably would be a good thing. We’ve experienced some “lessons learned” and have some understanding around that. Some things we need to have are: some clear metrics, whether it be customer service expectations, ROI, loss reduction, efficiencies around contacts and time periods. These need to be built into the full structure.”

“Only if your organization is large enough and you have the need for enough people that you require a coherent strategy. Our company is small enough, we talk with each other, we don’t need a written strategy for it; we just talk about how we feel about the issues by interacting with each other. A large organization may be a different situation.”</td>
<td>Only one in four respondents stated that they had an articulated vendor strategy in place (one did not answer the question). Respondents were divided as to whether or not having one was a good idea.

Illustrative Comments:

“We do not have one. I think it is a good idea because it provides the framework of the expectations, maybe establishes metrics, a good way to measure the effectiveness.”

“I think you’ll find that there are different needs between companies. I would recommend that vendors do their own studies in those areas. I do refer our partner vendors to other companies by telling them what I like to see and hear. Also, everyone is so protective of their own ideas; there’s a great competition.</td>
<td>Three out of four respondents stated that they indeed had had an articulated vendor strategy in place (one did not answer the question). All but one respondent in this group viewed having one as good idea.
Illustrative Comments:

“We do have an articulated vendor strategy. We veer away from the word relationship and toward the word performance. We measure with a highly sophisticated supplier performance management program, starting with the segmentation of suppliers based on the mission criticality to the company. We manage them differently if they’re a new supplier.”

You get (with a strategy) consistent buying power. Some vendors split companies looking for smaller units to penetrate, which is natural, but it can create issues and difficulties. A detailed and well-known strategy can short-cut through a lot of that.”</td>
<td>For small to medium-sized companies, most respondents stated that they do not have an articulated vendor policy, many chose to instead discuss whether having one was a good idea or not. The results were mixed with some suggesting skepticism in formal planning processes in general, while others feeling that the articulation of expectations would benefit any B2B relationships.

For larger firms, not unexpectedly we found that formal strategic planning and managerial control processes were viewed with much less skepticism,

One finding suggests that one impediment to the general use of stronger managerial controls to measure 3rd party vendors by small and medium-sized insurers is the argument that vendor partnerships should not be formalized because it has to be flexible.</td>
</tr>
</table>

Question: Does the subrogation function or other claims-related functions raise any unique opportunities or challenges in terms of 3rd party relationships?			
Small Companies (≤ $750 Million)	**Medium-Sized Companies ($750 Million - $7.5 Billion)**	**Large Companies (≤ $7.5 Billion)**	**Overall Conclusion**
There was general agreement that subrogation and/or claims functions do indeed raise unique challenges, including quality control, and finding 3rd parties knowledgeable in these specific business niches. **Illustrative Comments**: *"The quality of the work becomes very hard to control."* "*We're a niche carrier so the subrogation vendor that we work with now is primarily doing home and auto claims. We have unique terminology, exposure, causes of loss not seen in the normal P&C market, so there is a learning curve for a vendor to work with."* "*Yes, there aren't that many vendors interested in subrogation that do it very well. We get brochures daily from companies that want to do our subrogation work, but our experience is that there isn't much return there. To get the good law firms to handle subrogation is difficult because it isn't a huge money maker for them."* *"It can be challenging because since you aren't connected to them, what they do for your customers could be a reflection on us if they aren't doing things properly. There is risk. You do give up control and you're taking for granted that they're doing what they said they're going to do. It is important to know what is going on with the vendor."*	There was general agreement that subrogation and/or claims functions do indeed raise unique challenges, mostly related to the risks/costs associate with developing, maintaining, and dissolving B2B relationships. **Illustrative Comments**: *"Subrogation is a tremendous opportunity. We are very sensitive about claims handling so, those forefront points of contact with our clients, sales process, claims, and maybe even customer service, we're very concerned about the quality of that kind of contact. Subrogation is less about a policyholder relationship. It's more of a relationship between us and other insurance companies or people outside of our organization. We're much more comfortable in that arena and we have started to look at some outside assistance."* *You have to determine what the opportunities are and how to leverage those opportunities. The outsourcing industry is an expanding industry. The experience has been spotty. You have to make sure as you move into more vendor relationships that you have rigorous methods in place for selecting and managing those relationships. Undoing those relationships is very painful."*	There was general agreement that subrogation and/or claims functions do indeed raise unique challenges, mostly related to data management and legal considerations. **Illustrative Comments**: *"Subrogation exists under the umbrella of our claims department so they manage the subrogation activity...There are aspects of subrogation that we do outsource, but it's usually later in the process after internal resources have exhausted their efforts to recover the dollars."* "*Subrogation is working with IT on predictive modeling. Exciting challenges. … Challenges are to understand the data to improve performance."* *"Subrogation tends to be somewhat jurisdiction driven, claims maybe even more so. You have to be aware of the jurisdictional issues. I don't feel that the technology is at a point yet where a lot of the work flows easily off to another country. I guess the jury's still out on to what extent you move true claims functions away from the jurisdictions.*	There is general agreement across all firm sizes that subrogation and/or claims functions do indeed do present unique challenges in terms of 3rd party relationships. While different size firms perceive different challenges, they all share a general need for clear understanding of potential 3rd party vendors of their competitive situations.

Question: Does your firm have a position on gift giving in support of these relationships?

This question was added to the interviews in response to a previous exploratory investigation wherein the issue of gift-giving spontaneously emerged during a focus group.

The results suggest that firms of all sizes have relatively strong, well-communicated policies limiting the practice of gift-giving in support of 3rd party vendor relationships.

That said, there was apparent in the discussions some ambiguity concerning the appropriate level of incentive appropriate to support relationship building of 3rd party relationships (e.g., dinners, sports tickets, golf outings, etc.) as opposed to simple "gift giving."

Small Companies
(≤ $750 Million):
The vast majority of respondents were keenly aware of their firms' code of conduct and position statements of gift-giving associated with 3rd party relationships.

Illustrative Comments:

"Yes, less than $50. Vendors taking someone to games, for instance, would be different. In a social situation this develops a relationship; I don't think this is a bad thing."

"*We do discourage that. We try not to get ridiculous about it. What have roughly a $25 rule. However, we think good relationships with vendors are healthy and it helps to have some rapport building going on. We are okay with vendors and employees getting together in social gatherings to get to know each other. We have kind of a common sense policy. "*

"*We do have a policy; generally, we do not want individuals receiving gifts that may be perceived as favoritism or that results in the adjuster losing their objectivity. If we were to receive something, generally Christmas, we do make them available to the masses. We're just as happy if a firm were to provide a donation to an acceptable charity on our behalf.***"**

"*I don't like it. The Christmas food baskets, for instance, you just set out for everyone to share. I would distinguish this from crystal I received several years in a row. I finally just sent it back and said this isn't necessary. Gift giving is something that we don't do and frankly, I don't appreciate it."*

Medium-Sized Companies
($750 Million - $7.5 Billion):
The vast majority of respondents were keenly aware of their firms' code of conduct and position statements of gift-giving associated with organizational 3rd party relationships.
Illustrative Comments:

"*Yes, the policy is that you are officially able to accept a gift up to $25 - $50. Otherwise you have to report it. Unofficially, people should not be accepting gifts. It puts someone in the company in an uncomfortable position. I think it is avoided now as compared to say twenty years ago when it was common practice. At Christmastime, for instance, we receive various things that go out on the floor to share and nobody takes anything home or anything. Also, occasionally if the company is in town they take one or two people to lunch, I guess that's okay because it strengthens the personal relationship."*

"Yes, I don't believe we accept gifts at all. There may be a monetary amount, but I'm not sure what it is, maybe $25. Typically, we don't even let vendors take us out to eat."

"Yes, in claims, we do not accept any gifts. "

"We have a policy about gifts overall, from any source. There's a diminimus limit on gifts. We're very careful in setting that limit; we make sure it isn't at a level that would influence decision making."

Large Companies
(≤ $7.5 Billion):
The vast majority of respondents were keenly aware of their firms' code of conduct and position statements of gift-giving associated with organizational 3rd party relationships.
Illustrative Comments:

"Yes – we don't expect anything and we don't give anything – good thing in my mind."

"We have a strong policy that states our employees are not allowed to receive anything of monetary value, down to a pen, pencil, or pad."

"We pretty much stay away from that."

"Yes, we do. We don't accept gifts over a certain value."

"Yes, we do. We do have a $150 limit and must be explained and proved. Dinners are very restrictive."

Question: Re. (Enterprise Risk Management – managing the risk exposure of the enterprise of the entire firm.) There may be more of an emphasis coming over the horizon on that. Do you think, if that's true, that it could put a limit on outsourcing because there's more potential for risks if there are more "cooks in the kitchen" so to speak? **Note**: This was not originally a question in the interviews but based on what some interviewees volunteered early during the interviewing process. Thus we asked this question of subsequent respondents. The gist of the question was to determine if newly focused efforts to manage enterprise risk might provide a limit of future outsourcing practices. Interesting, however, there seems little evidence at this time that Enterprise Management initiatives will limit future outsourcing practices, although there was still some concern. See comments below:
Small Companies **(≤ $750 Million):** **Illustrative Comments**: *"Enterprise risk management is a hot button right now. A.M. Best for instance is asking insurance companies what does this mean for each company. Certainly if you outsource a lot of stuff managing these risks is more difficult because you're turning over control to so many third parties. How do you manage the enterprise risk? How do you keep tabs on it, etc.? I can see that being a factor that companies have to think about. How do you deal with outsourcing when you are turning over so much data, especially offshore, without there being risk involved? I can see that as something that companies have to think about."* *"Not the way we do it."*
Medium-Sized Companies **($750 Million - $7.5 Billion):** **Illustrative Comments**: *"You could build the theory that it leads to risk. Internally, you can do audits and such."* **"***I think it will always be a governor because if you're engaged in enterprise risk management you have to be cognizant to the fact that if you outsource, you could be increasing your enterprise risk. However, in some ways, you could be actually improving it. If you have business continuity issues and you have outsourcing functions, those functions could continue to go on because they've been outsourced."*
Large Companies **(≤ $7.5 Billion):** **Illustrative Comments**: **"***One of the barriers to outsourcing, especially offshore outsourcing, that more defensive areas of the company will throw up is issues around risk. We know that those risks can't be quantified and mitigated so you have to go the next level of questions about those risks before you dismiss the idea of outsourcing. We look at everything, people, brand, geopolitical, security and privacy, infrastructure, economic realization, country risk, knowledge transfer risks, cultural risk, etc. When we do that work, we do a very detailed look at how we might mitigate those risks. "* **"***Absolutely not. I think Enterprise Risk Management, when you think of it from our perspective, is a recognition that we're a heavily regulated industry. We look at operational risks in a lot of ways and whether you do the process in California or Tijuana the process isn't the issue; the issue is the client making sure you follow the rules appropriate for the jurisdiction that you're serving."*

Appendix B: Study Methods

The Research Question: This study was exploratory in nature, relying on qualitative research techniques to gain a better understanding of insurance executives' perceptions of outsourcing and other forms of 3rd party vendor relationships. Particular emphasis was placed on subrogation and claims functions.

The Sample: Respondents were selected based on a mix of listing with A.M. Best and referrals from industry participants knowledgeable of outsourcing practices. Potential respondents were first sent a letter inviting them to participate, followed by a phone call to solicit participation and schedule an appointment upon obtaining agreement to participate. The final obtained sample for the study involved 24 managers from 20 unique insurance firms, all of which having extensive experience with insurance claims and/or subrogation practices. Ten of the companies represented smaller insurance entities with net premiums written of less than $1 billion. Two of the firms represented mid-sized insurers with net premiums written in the range of $1 billion to $9 billion. The final eight firms represented larger insurers with net premiums written of greater than $9 billion.

Method: The data were collected using structured phone interviews, personally conducted by Professors Steve Taylor and Jim Jones. Care was taken to ensure the confidentiality of respondent's individual and company names.

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In addition to regularly serving as an ad hoc reviewer for numerous major marketing journals, Dr. Taylor also serves as Co-Editor of the *Journal of Consumer Satisfaction, Dissatisfaction & Complaining Behavior*, and has been a long-term member of the Editorial Review Boards of the *Journal of Service Research* and the *International Journal of Service Industry Management.* Most recently, Dr. Taylor was invited to be a founding member of the SPSS Academic Advisory Board (2004), and was named a University Statistical Fellow at ISU (2003). He has consulted across a wide variety of industries, including recent projects for insurance, health care, and manufacturing concerns.

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Prior to coming to Illinois State University, Mr. Jones held the position of Director of Center for Performance Improvement at the American Institute for CPCU at Malvern, PA. where he conducted research and reported on best practices of insurance organizations. He also served as Director of Claims Education where he was responsible for working with insurance industry in developing and maintaining curriculum for claims adjusters. The program (called Associates in Claims) has about 12,000 students nationally. The four course program includes courses in claims practices for auto and premises liability, commercial and homeowners property, and workers compensation. In his capacity at the Institutes he wrote textbooks, developed audiotapes, course guides, course instructor handbooks, and exams.

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- Conducted research on business ethics, especially with respect to the insurance industry.
- Research on outsourcing best practices in the insurance industry
- Research on economic implications of contingent commissions for insurance brokers and agents

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