Outsourcing Information Technology Processes 13 January 2007

Introduction:

I have been seeking ways to improve information technology (IT) services to both our internal and external customers, to reduce costs, and to enhance shareholder value. In collaboration with the financial, IT and HR department heads, an assessment was made of the readiness of our financial, human, information and organization capital resources needed to fund, staff and manage our information technology needs - both for the present and for the future.

This memo will discuss the present and forecasted IT situation, describe the major challenges, propose solutions and provide information in support of the recommendations.

Situation Summary:

The readiness assessment conducted by the inter-departmental team demonstrated that, at its current rate of expansion, Triad will need either to outsource the majority of its IT processing tasks to outside vendor(s), or to fund a major upgrade of its internal IT infrastructure and to implement a human capital development program. Included in the latter alternative would be installation of new hardware servers, software upgrades, hiring of additional IT programmers, database architects, developers, modelers and project managers, as well as institution of new training programs for current employees.

A robust, up-to-date IT network, together with a fully-trained staff are vital toward accomplishing Triad's strategic objective of improving shareholder value. According to the company's Balanced Scorecard, IT's role in the strategic value chain will be to support the following perspectives:

Financial Perspective: IT resources must support the improvement of sustained shareholder value through the attainment of two core strategies:

1. Productivity initiatives
   a. Improve customer and affiliate communications
   b. Reduce policy and claims processing time
   c. Eliminate difficulties of handling orders in call centers due to widely varying state regulations and form requirements for financial services and insurance industries.
2. Revenue Growth initiatives:

<u>Customer Perspective</u>:

1. Service Attributes
    a. Implement Web-based services: policy applications and payments; claims submissions.
    b. Instant messaging to service rep' and client phones.

<u>Internal Process Perspective</u>:

1. Service Attributes
    a. Common user requirements among all branches
    b. Accommodate future changes in business requirements and processes, which may differ between demographic & geographic areas.
    c. Improve competitive positioning.
    d. Reduce process redundancies and costs.
    e. Improve process performance.

<u>Learning and Growth Perspective</u>:

1. Information Capital Resource initiatives:
    a. Consolidate and standardize or outsource the proliferation of IT tasks resulting from rapid growth and geographic dispersion, including many policy conversions, daily operations and data center operations.
    b. Complete within six months (Phased approach)
    c. Meet competitive threat, including CRM, policy origination and credit management
    d. Eliminate low IT project completion rate, due to inability to attract, train and retain the necessary skilled personnel in all locations

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1. <u>Funding</u> - As documented in Figure 1, below, without significantly elevated funds allocations during each of the next three years for infrastructure, personnel and training, there would be insufficient funding to support the entire IT mission. Such additional funding for IT would severely impact other departments, as well as

degrade both net revenues and shareholder value. Significant upgrades would be required to support the company's growth. Included would be installation of new hardware servers, and software & database upgrades. Although a previous cost analysis determined that, at the current level of sales, consolidating and retaining all IT processes in-house would be equivalent to outsourcing, the level of growth projected to occur during the next three years indicates that keeping all in-house processing would be significantly more expensive than outsourcing. The cost and expense comparisons between keeping all IT processing in-house versus outsourcing a significant portion of the tasks to a vendor are shown in Figures 1 and 2, respectively.

Fig 1 - Consolidate In-house FISCAL YEAR:	2001	2002	2003	2004	2005	2006	2007	2008	% Delta 2005 to 2008
Employees	2	148	293	439	584	730	875	1021	75%
Revenue per employee	131	30	60	106	102	101	103	104	2%
Gross Profit per employee	-200	11	23	43	42	39	40	40	-4%
Expenses per employee	843	16	16	14	14	14	15	15	10%
Net Pre-Tax Income per employee	-1043	-5	8	29	29	25	25	25	-11%
BALANCE SHEET									
CURRENT ASSETS:									
TOTAL CURR ASSETS	244	3226	1589	1029	7059	6059	7203	8346	18%
Net Fixed Assets	98	229	455	763	1166	1343	1610	1877	61%
TOTAL ASSETS	342	3455	2044	1792	8225	7403	8813	10223	24%
TOTAL LIABILITIES	342	3455	2044	1792	8225	7403	8813	10223	24%
STOCKHOLDERS' EQUITY:									
Retained Earnings	-2085	-2816	-533	7338	17390	18590	23500	28411	63%
TOTAL EQUITY	-2085	-2816	-533	7338	17390	18590	23500	28411	63%
TOT LIAB + EQUITY	-1743	639	1511	9130	25615	25993	32313	38634	51%
INCOME STATEMENT									
Net Sales	262	4390	17580	46600	59520	73888	89961	106033	78%
Cost of Goods Sold	662	2722	10732	27720	34780	45242	54985	64728	86%
GROSS PROFIT	-400	1668	6848	18880	24740	28647	34976	41306	67%
TOTAL OPER EXP	1685	2398	4565	6117	7986	10108	13125	15308	92%
OPERATING INCOME	-2085	-730	2283	12763	16754	18539	21851	25998	55%
PRETAX INCOME	-2085	-730	2283	12763	16754	18539	21851	25998	55%
TOTAL TAXES	0	0	0	4892	6702	8512	10322	12132	81%
NET INCOME	-2085	-730	2283	7871	10052	10027	11529	13866	38%

AVAIL FOR COMMON	-2085	-730	2283	7871	10052	10027	11529	13866	38%
Net Working Capital	244	3226	1589	1029	7059	6059	7203	8346	18%

Notes:

- Figures are historical through 2005 & extrapolated for succeeding years.
- Assumption: Cost of Goods Sold, including Direct labor + burden costs, plus anticipated capital expenditures for new equipment and software, maintenance and training costs will rise at an annual inflation rate of 4.5% (http://www.compensation-online.com/cxgonl.html).
- Although revenues per employee are expected to increase by 2%, should IT processing remain in-house, gross profit per employee will decline by 4%, primarily due to the increase of non-revenue-generating clerical employees required to support the additional data processing requirements. As well, expenses per employee would rise by 10%, due to the increase in operating expenses necessitated by IT hardware and software upgrades, maintenance and training, resulting in a decline in pre-tax income of 11%.

Fig 2 - Outsource Scenario FISCAL YEAR:	2001	2002	2003	2004	2005	2006	2007	2008	% Delta 2005 to 2008
Employees	2	148	293	439	584	730	788	918	57%
Revenue per employee	131	30	60	106	102	101	114	115	13%
Gross Profit per employee	-200	11	23	43	42	42	47	48	13%
Expenses per employee	843	16	16	14	14	13	14	14	1%
Net Pre-Tax Income per employee	-1043	-5	8	29	29	29	33	34	19%
BALANCE SHEET									
CURRENT ASSETS:									
TOTAL CURR ASSETS	244	3226	1589	1029	7059	6059	7203	8346	18%
Net Fixed Assets	98	229	455	763	1166	1343	1610	1877	61%
TOTAL ASSETS	342	3455	2044	1792	8225	7403	8813	10223	24%
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TOT LIAB + EQUITY	-1743	639	1511	9130	25615	25993	32313	38634	51%
INCOME STATEMENT									
Net Sales	262	4390	17580	46600	59520	73888	89961	106033	78%
Cost of Goods Sold	662	2722	10732	27720	34780	43293	52617	61940	78%
GROSS PROFIT	-400	1668	6848	18880	24740	30595	37344	44093	78%
TOTAL OPER EXP	1685	2398	4565	6117	7986	9447	11079	12711	59%
OPERATING INCOME	-2085	-730	2283	12763	16754	21148	26265	31383	87%
PRETAX INCOME	-2085	-730	2283	12763	16754	21148	26265	31383	87%
TOTAL TAXES	0	0	0	4892	6702	8512	10322	12132	81%
NET INCOME	-2085	-730	2283	7871	10052	12636	15943	19251	92%
AVAIL FOR COMMON	-2085	-730	2283	7871	10052	12636	15943	19251	92%
Net Working Capital	244	3226	1589	1029	7059	6059	7203	8346	18%

Notes:

- Figures contained herein are based on transaction cost estimates supplied by US-based vendors of outsourcing services to the insurance industry.
- The calculations in Figure 2 include the direct costs of outsourcing (which is on a sliding

scale, based on the number of annual transactions that would be processed by the vendor).

- In the Outsourcing scenario, 50% fewer IT employees would need to be hired during fiscal years 2007 and 2008, the processing time for new policies would be reduced, and volume of throughput per day would increase resulting in an increase in pre-tax revenues from 2005 of 19%.

Issues (cont.):

2. Inadequate Resources - Even with adequate funding, it is problematic that fully-trained personnel would be available at all locations to sustain either our branch locations, our centralized operations, or even our customers, in conducting both our core business processes, as well as all ancillary support functions. Keeping all IT processing functions in-house will require hiring additional IT programmers, database architects, developers, modelers and project managers, as well as instituting training programs for current employees. Current development projects that were estimated to require 3 months are requiring 6-9 months.
3. Slow processing time - The company is experiencing a significant growth in the number of monthly bookings from its underwriting activity and the opening of multiple new territories. While the current analytical software is insufficient to provide precise figures, it is estimated that the average current time needed to process a new policy, from booking through distribution and mailing, is 4.7 person-days and is increasing exponentially in proportion to the company's growth.
4. Customer dissatisfaction - Customer complaints have risen by 35% during the past 12 months.
5. Unreliable financial data - As documented by the Accounting Division Chief, key financial data are not being provisioned to headquarters from regional offices in a complete and timely fashion.

Problem Causes:

1. The present information capital resources, including hardware networks, software applications and database structures are insufficient to adequately capture, process and provision the levels of data anticipated to be generated as the company grows. Even at present levels, processing time has degraded during the past year and is now well-below industry standards. For example, Triad's expense-to-premium ratio is 65 percent; the industry norm is 15-20 percent.
2. Current employees are not adequately skilled nor properly trained to design and implement the software applications and databases that are required to provide operational, regulatory and managerial reports necessary to perform analysis and for decision support.
3. Current IT systems and personnel are unable to keep up with the ever-increasing level of data processing requirements, especially with regard to policy and claims processing, document distribution and communications.
4. The lack of both a Web-based customer interface, as well as slow processing of claims make up the majority of customer complaints.
5. Financial data is currently tracked at the 4 regional offices on different sets of Excel spreadsheets, using non-standardized functions and commands, then is aggregated into an Access database at headquarters, after which it is manually keyed into Quickbooks by temporary help subcontracted by the Finance and Accounting department. Because of the multi-step process and the lack of standardization, the final reports lack both timeliness and accuracy.

Issue Summary: In order to perform to the levels of productivity, timeliness and efficiency necessary to sustain IT's value chain proposition, we face a "build or buy" decision in how to serve our present and future customers, both internal and external.

Proposed Solution:

In conjunction with process re-engineering specialists from McKinsey Consulting, members of the IT, HR and Finance departments who are experienced in negotiating and managing outsourcing relationships formed a team to study the issues and to make recommendations. The team first gathered and analyzed intelligence from the company's ESS, MIS, DSS, then solicited input and preliminary cost estimates from a number of the largest U.S. vendors of outsourcing, Web-development and telecommunications services for the insurance industry, including Accenture, IBM, and Everest, whose cost estimates were used to develop the calculations contained in Fig 2.

The team evaluated the following options:

- Keep all IT processing in-house. Consolidate and standardize systems and procedures.
- Outsource all or a portion of the IT processes to one or several domestic or foreign vendors.

Results of the study indicate that satisfactorily eliminating the probable IT shortfalls, improving Triad's financial perspective, and meeting the objectives contained in the Balanced Scorecard, can best be accomplished by outsourcing a portfolio of technology-driven job families to a single domestic vendor. Specific recommendations are:

1. Contract for Outsourcing Services - Based on the cost analysis presented above, and with regard to reducing processing time, the outsourcing of IT functions is deemed a highly cost- and process-effective solution. As well, outsourcing would enhance accuracy and timely financial reporting, leading to shareholder value. Quicker cycle times would also enable Triad to compete much more aggressively on price and performance. Communication with customers and field staff, both via the Internet and the use of portable devices could also be effectively outsourced.

2. Use a single, US-based vendor - Bundling requirements into a sole-source contract addresses the challenge of managing multiple providers and contacts and is easier to measure and evaluate because it creates standardized, repeatable processes under one integrated governance structure that ensures maximum performance at lower sustained costs. Keeping the contract domestic reduces or eliminates potential geographic, legal, cultural and linguistic difficulties.
3. Internal resources will oversee the engagement.
4. Retain all of our present staff - Anticipated growth will require that the level of present staffing will need to increase, regardless whether our IT services remain in-house or are outsourced, although outsourcing would reduce the need for additional hiring by approximately 50%.
5. IT's strategic job families would be consolidated into two major categories: Critical Core Processes and Non-Critical Support Processes, to be outsourced in two phases, beginning with the Non-Critical Support Processes, which are "extractable"—that is, easily definable, removable, including the following:

Digital Mailroom
- Dedicated PO Box
- Mail Receipt
- Mail Preparation
- Direct Connect to Policy Scan

Policy Scan
- Clerical Processing
- Scanning & Indexing
- Audit & Reconciliation
- Microfilm Scanning

Policy Workflow
- Approval & Exception Routing
- Business Rules
- Coding
- Work Load Balancing
- Reporting
- Transaction Audit Trail
- Existing Workflow Integration

Customer & Agent Communications
- Benefit & Policyholder Booklets
- Statements and Payment Slips
- Applications/Quotes
- Bills, Notices, Renewals and Endorsements

Document Distribution with Web Access
- Policy Documents
- Claims Documents
- Policyholder Records
- Transaction Audit Trail

Claims Processing
- Keying
- OCR
- Database Validation
- Auto Adjudication
- Electronic Reconciliation

Policy Loss Payment Disbursement
- Print & Mail Checks
- Audit & Reconciliation
- Online Check Proofing

Web Development
- Company Intranet
- Customer portal
- Merchant Services (payment of premiums)
- Banking Service

Dependent on the successful accomplishment of performance metrics during Phase One, the second phase of job families to be outsourced would consist of those Critical Core Processes that are deemed most cost-effective and appropriate for vendor processing. The phase II processes might include:

- Monetary Collections and Disbursements Services
- Life & Annuity Policy Services
- Pension Services
- Property & Casualty Claims Approvals/Disapprovals
- Property & Casualty Policy Services
- Specialized Insurance Business Processing Units

Action Plan

The outsourcing study team developed complete, consistent and well-defined descriptions of the criteria to be used to determine Triad's readiness to engage in an outsourcing relationship, and for evaluating risk factors, along with vendor selection and the expected level of service and performance to be provided by the application package vendor. The critical success factors to successfully implementing the outsourcing recommendations are:

- o Making and testing the decision
- o Involving end-users and measuring their satisfaction levels
- o Management support
- o Mitigating complexities and risks
- o Guarding against communication breakdowns with employees and vendor
- o Measuring vendor service performance against agreements
- o Measuring outcomes against the objectives of the Balanced Scorecard

The Action Plan for implementation of the recommendations consists of the following 5 steps:

1. Determine Triad's Ability to Successfully Engage in an Outsourcing Relationship:

Strategic Drivers: (does outsourcing fit with Triad's strategic business values?)	**Transition Readiness:** (does Triad have the aptitude and ability to outsource?)	**Technology Environment:** (stability, security & quality of existing systems**)**	**Operational Impact:** (refers to process documentation)	**Automation & Re-Engineering:** (Can outsourcing add value other than wage arbitrage?)

Fit to business processes	Change Readiness	Processing Platforms (hardware & software - MIS, ESS, DSS, GDSS,	Compliance (especially customer privacy - HIPAA)	PM Tools
ROI/Cost Savings	Program & Project Resources	Knowledge Mgt, Data Mining, OLAP - On-line Analytical Processing)	Standardized & Integrated Processes	High Volume of Paper
Near-Term Process Changes		Technical Ownership & Flexibility	Clarity of Key Metrics	Dated Technology
Growth Projections		Customization and Integration Needs	Policies & Procedures	High Repetitiveness

2. Evaluate Risks:

Financial Factors	Organizational Factors	Stability Factors	Experience Factors
Project Cost	Workforce Morale	Clear Requirements	Project Type
Duration	Efficiency of Operations	Identified Sponsor	Technology
Resources	Inter-departmental cooperation	Management Support	Makeup of Team
Project Interfaces	Diverse geographic locations	Project Priority	Customers
Stakeholders	Security of systems and data (HIPAA)	Stable Technology	Vendor Personnel

3. Select Vendor - The table below contains a set of vendor selection measures:

Reputation (vision and innovation, support, responsiveness, quality and delivery on commitments)	**Stability** (marketplace, customer base, financials and business/product maturity)	**Services** (locations, help desk, consulting, training, newsletters, user groups and third party support)	**Policie**s (licensing, upgrades, maintenance, warranties and costs)
Vision & Innovation	Market Base	Locations	Licensing
Account Management	Customer Base	Help Desk	Upgrades
Responsiveness	Financials	Consulting	Maintenance
Quality	Business Maturity	Training	Warranties
Delivery		Data Migration Plan	Costs

4. Develop Performance Criteria and Monitor Vendor Performance - A complete description of the expected level of service and performance will be developed jointly by the Triad team and the selected vendor, containing a set of requirements and evaluation against the service level agreement (SLA) criteria for each service

or performance need. The relationship with the vendor will be monitored and evaluated using a monthly scorecard, composed of the following:

Process Improvement	**Service Continuity**	**Networks**	**Training**
• Throughput of forms processed • Cycle time of forms processing • Cost of forms processing • Accuracy of forms processing • Accuracy of financial data	• Outages numbers • Business and financial exposure • Number of Customers, Branch Offices Affected • Response and resolution Time • On-call support management	• Usage, maintenance and upgrades of hardware and software adequate to support Triad's growth	• Level of user proficiency on use of Web-based applications and portable telecommunications

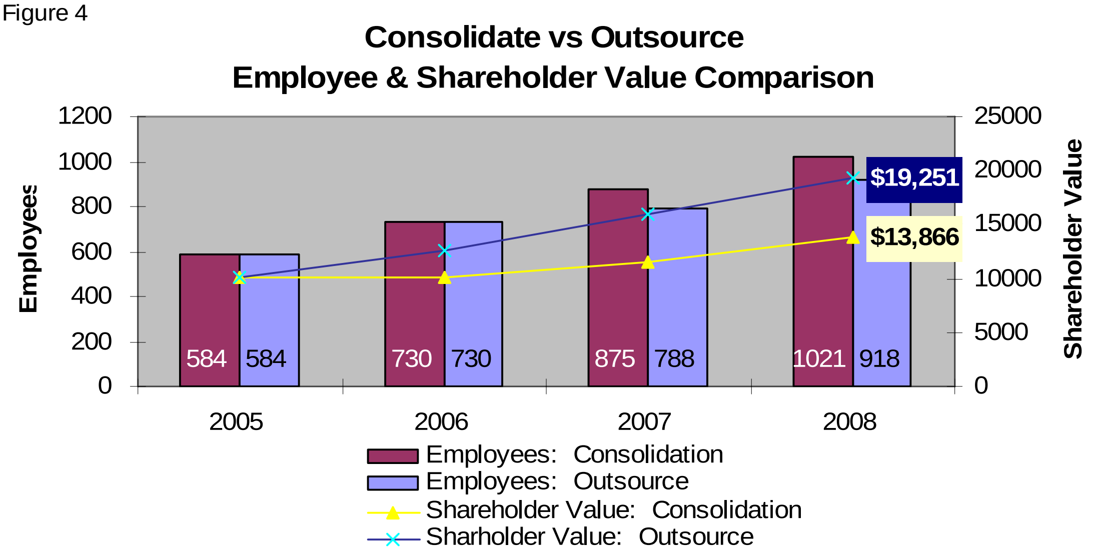
Business Impact:

As shown in Figure 3, the total three year cost savings which would be realized by outsourcing totals $12,408, by eliminating the costs of procuring new hardware, software, maintenance and training, as well as by reducing by 25% the time required to process new policies. The savings is calculated as the differential between doing the direct costs for labor + burden and staff training, plus capital expenditures for new equipment and operating costs which would be incurred by keeping the IT functions in-house, less anticipated outsourcing costs.

Figure 3 **COST SAVINGS BY OUTSOURCING**	2006	2007	2008	Totals
Net Sales	73888	89961	106033	$ 269,882
Pretax Income: Consolidate in-house	18539	21851	25998	$ 66,388
Pretax Income: Outsource	21148	26265	31383	$ 78,796
Total Direct & Fixed Costs: Consolidated	55349	68110	80035	$ 203,494
Total Direct & Fixed Costs: Outsource	52740	63695	74651	$ 191,086
			Total Cost Savings	**$ 12,408**

As demonstrated in Figure 4, with regard to shareholder value, keeping all IT processes in-house would result in an increase from 2005 in funds available for distribution to common stock holders during 2008 of $13,866 (+38%) whereas, outsourcing the non-core IT functions would result in an increase of $19,251 (+92%), as a result of eliminating the need to upgrade hardware infrastructure and hiring 50% fewer IT employees.

Figure 4



Conclusion:

This memo has presented information in support of recommendations for outsourcing many of Triad's IT processes. Cost reduction is central to Triad's outsourcing strategy, but outsourcing has the power to do much more than simply lower costs. Implementing the outsourcing plan outlined in this memo can deliver strategic value by enhancing service, improving organizational effectiveness, creating more adaptable business systems, speeding up business processes and enabling greater focus on the strategic objectives outlined in the Balanced Scorecard. To deliver this additional value, the outsourcing relationship we enter into will be engineered and managed by Triad's IT staff to ensure its ongoing adaptation to the company's changing business needs.