

research

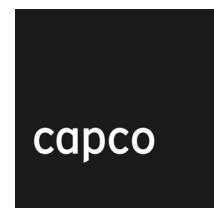
Services sourcing in the banking and financial services industries

Exploding myths and describing emerging best practice

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Executive summary

The financial services sector is the largest and most sophisticated market for IT and IT enabled services (ITES). This research, conducted jointly by a team drawn from Capco and London Business School, highlights current sourcing strategies, their rationales, and emerging trends among the world's top financial services organizations. A survey of sixty two senior (CXO level) respondents from the largest banking, financial services and insurance companies suggests the following:

- The Global Sourcing Model has finally arrived - companies no longer think about “whether to outsource” and “whether to offshore” decisions in isolation, but consider multiple mixed options simultaneously.
- As their level of sophistication has grown, companies have begun to outsource and offshore not just horizontal, generic processes, but also vertical, business specific processes.
- While cost savings continue to be the dominant motivation for global sourcing, quality improvements and flexibility are rapidly catching up as important drivers.
- Rather than hand-over the entire set of functions to a single vendor, companies are beginning to prefer managing a multiple-vendor, multiple-geography sourcing framework. This goes hand-in-hand with the development of global sourcing capabilities.
- Such decisions demonstrate a clear logic on how to match process characteristics to sourcing options along the dimensions of co-ordination and control, as well as competence at implementing sourcing arrangements.
- Experience confers sophistication; the more experienced among our respondents outsourced/offshored more challenging processes, experienced fewer hidden costs, managed multiple models more effectively, and had more effective collaboration with their suppliers.
- The most significant management challenges in global sourcing of services are often at the operational level. Good project management capabilities are cited as the single most important ingredient to an effective global sourcing capability.

Dr. Phanish Puranam of London Business School and Dr. Suresh Gupta of Capco, the co-directors of the research project, argue that the findings, dispel many of the myths surrounding both outsourcing and offshoring in the financial services industry today. They also provide unique and practical insights into the experiences and evolving models of the sourcing leaders, insights that all financial institutions, and not just the newcomers to global sourcing, can learn from.

1 Introduction

Continuing and intensifying pressure on margins coupled with the increasing complexity of client and product mix is driving fundamental change in the financial services sector. The effective use of alternative sourcing models - any means of sourcing services other than the traditional in-house/on-site model - is increasingly crucial to the successful transformation of all financial institutions today.

The range of sourcing options available today is far more complex than the “two extreme ends of a spectrum”: maintain full control via fully owned operating centers or fully outsource end-to-end back office or IT processes to a third-party. These models were inflexible, often poorly integrated and frequently poorly executed. The new models are flexible, provide a range of options to fit every process, and appear to be commercially sound. They derive their strength from providing a range of options in terms of degrees of co-ordination and control appropriate for different kinds of processes. Variously called “RightSourcing,” “SmartSourcing” or “Global Sourcing”, these models blend service sourcing strategies along a continuum; ranging from fully owned (“captive”) to fully outsourced centers, located in multiple locations around the globe, - on-shore, near-shore and offshore. These strategies are used for business processes as well as voice and IT support services.

Our research was designed to discover the rationale by which the pioneers in this strategic sourcing space are configuring their sourcing models and whether newcomers can learn from their collective wisdom. The study, conducted jointly by a team drawn from the London Business School and Capco, also aimed to identify the key attributes of a given process that drive the selection of a certain sourcing configuration.

Study objectives:

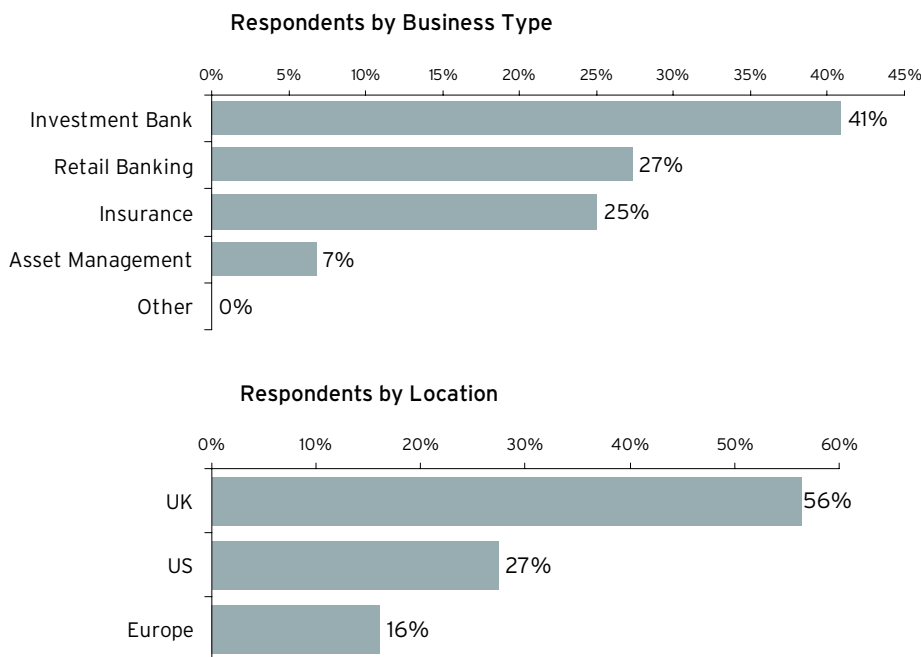
- How do experienced firms differ in their sourcing strategies from inexperienced players? What can the newcomers learn from them?
- What makes a process suitable for outsourcing? For off-shoring? Are the criteria different?
- What motivates firms in this sector to outsource/offshore?
- What do they see as primary constraints and management challenges?
- What are the key mitigating strategies that companies use to successfully deal with them?

The team conducted a survey of senior “C.XO” level executives in the banking and financial services sector familiar with the sourcing strategies of their companies.

The target sample included large global firms with wide experience in outsourcing and offshoring - two-thirds of the sixty-two respondents are from firms in the top fifteen in their sector in their region (Figure 1); the respondents include executives from seven of the top fifteen commercial banks, seven of the top ten investment banks, eight of the top ten diversified financials firms and five of the top thirty insurance firms.

The largest response group was from the UK, followed by the US, and Europe. The services sourced by these firms included IT application development, IT maintenance and service, horizontal processes (cross business unit), vertical processes (business unit specific) and voice based processes.

Figure 1: Survey respondents



2 Deconstructing the myths

The results of the study help to dispel some prevailing myths/fallacies about global services sourcing.

The first myth - a clear fallacy - is that offshoring always involves outsourcing. In fact, offshoring implies only the sourcing of work from offshore *locations* not necessarily from third-party *vendors* based offshore. In fact, our data indicates that in-house, so-called "captive" offshore centers are often preferred to third party outsourcing as a means of moving work offshore in the financial services industry today. Over half (53%) of our respondents who have offshored manage captive offshore operations, reinforcing the importance of distinguishing between the two terms.

The second myth that our research explodes is that only "non-core, horizontal processes" have been outsourced or offshored successfully. The view has been that the offshoring or outsourcing of core, vertical, end-to-end business processes has involved too much risk of losing control of core processes and unmanageable demands on a firm's co-ordination capabilities. However, our research suggests that experienced companies seem prepared to trade-off the incremental co-ordination effort and expense against the superior skills, quality and lower costs available offshore and from third parties.

Over half (58%) of our respondents are using some combination of outsourcing and offshoring for vertical processes - and many of these processes have traditionally been viewed as 'core.' Reluctance to outsource end-to-end business processes to external providers also seems to be dissipating as vendors are increasingly offering more sophisticated solutions and acquiring domain knowledge and experience to penetrate the vertical BPO segment.

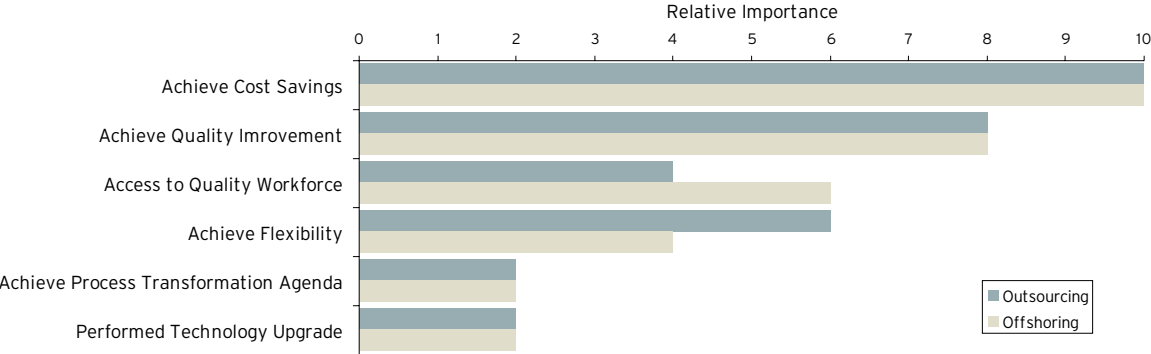
Our research also reveals that, contrary to the popular assumption that full service IT/BPO firms have an edge over the "best-of-breed" vendors, leading firms in fact tend to deploy a componentized model for sourcing. In preference to deploying a single vendor for IT and business processes, there is a clear trend towards picking a variety of vendors and locations for specific process needs. Almost 25% of the respondents in our research utilize in-house and outsourced, "multiple-vendors, multiple-locations" models for sourcing their IT and business process needs while over 60% view such models as among the key levers for mitigating sourcing pain points.

A final popular myth is that labor arbitrage is the only reason to offshore. The opportunity to benefit from labor arbitrage has been a key driver of global sourcing and will

continue to be so (Figure 2). However, our research indicates that savvy enterprises weigh many other variables, including improved agility, skills, quality, risk mitigation, etc. that a componentized

global sourcing model offers. Over 80% of our respondents cited “flexibility” as a significant/very significant criterion for success in alternative sourcing.

Figure 2: Criteria for sourcing success



3 The emergence of a global sourcing model

Surpassing the rhetoric, companies finally appear to be adopting what can truly be described as a Global Services Sourcing Model on the strength of a process of modularization of the services value chain. In migrating to a componentized operating model, the financial services sector has begun to emulate the manufacturing sector. Just as the manufacturing sector has for years leveraged suppliers around the globe as part of its supply chain, the financial service sector has begun to exploit the availability of new technologies (digital processing, increased bandwidth and internet) to break free of geographical and organizational boundaries. This has opened up a range of sourcing options (Figure 3).

Now it is possible for a North American or European firm to exploit the comparative advantages in cost, quality or skills offered by different locations around the globe: thus a U.S. bank may have Research performed in India, derivatives processed in Russia, reference data processed in Singapore, applications development handled by centers in North America, Europe and Asia, and customer service handled in Ireland, India and South Africa. Many of these “competency” centers may be “captive” while some others may be outsourced to third parties.

In our study, the majority of the respondents use several different sourcing options. 67% have outsourced to offshore vendors. A significant 52% have outsourced vertical business processes to an offshore location and 39% to an offshore captive. 49% of the European participants have established onsite/near shore shared services and 67% of European respondents manage captive centers offshore.

While third party outsourcing dominates, shared ownership and captive models are increasingly popular. In fact of the 89% that have used third party vendors - almost half (47%) have dabbled in shared ownership structures as well when sourcing key activities.

Figure 3: Sourcing options

	on-site	near-shore	offshore
complete ownership	Status quo (neither outsourced nor offshored)	In house, near shore (captive center in nearby location)	Captive offshore
shared ownership	JV onshore	JV near shore	JV offshore
no ownership	Onsite vendor	Offsite near shore vendor	Offshore vendor

4 The anatomy of a “global sourcing capability”

Sourcing is defined as seeking the right **competency** at the right **cost** from the right **source** from the right **shore**

The more sophisticated of our respondents are seeking to create a robust and dynamic operating model enabling them to respond to market forces with unusual agility and nimbleness. The “product-focus” characteristic of the financial services sector of the old days is giving way to a new “process-focus” and, as a result, to new global sourcing model.

The results from our research indicate an increased willingness to “flex” the sourcing model over time as a firm gains experience and confidence in managing componentized processes. There is also clear evidence of firms becoming more proficient over time at managing this network of distributed service delivery centers spread across geographic and ownership boundaries. For instance, the more experienced among our respondents:

- have more centralized vendor selection, transition and ongoing management processes (though, offshoring decisions seem to take place in a more decentralized manner than outsourcing decisions)
- have more effective collaboration practices with their suppliers

- manage “multiple vendor, multiple geography” models more effectively
- outsource/offshore more “challenging” processes- processes that are known to create control and co-ordination problems, and which the less experienced may write off as not suitable for outsourcing or offshoring
- experience fewer “hidden costs” in offshoring

Our research also shows that there is a robust and fairly widely shared logic around the match between process characteristics and sourcing options- given certain process attributes, some choices are perceived as being superior to others. These are summarised below (Figure 4).

Figure 4: Top reasons for choosing a particular sourcing model

	on-site	near-shore	offshore
complete ownership	<ul style="list-style-type: none"> ■ Process is world class ■ Direct customer contact ■ Process not mature ■ Brand impact 	<ul style="list-style-type: none"> ■ No one else offshored ■ Lack of scale ■ Frequent changes ■ complex/tight linkage 	<ul style="list-style-type: none"> ■ Familiar w offshore location ■ Long term viability ■ Risk of competitor access ■ Difficult to get back to SQ ■ Domain experience
shared ownership	<ul style="list-style-type: none"> ■ Difficult to get back to SQ ■ Complex/tight linkage ■ Business transformation ■ Less defined/unstable 	<ul style="list-style-type: none"> ■ Difficult to get back to SQ ■ Complex/tight linkage ■ Business transformation ■ Less defined/unstable 	<ul style="list-style-type: none"> ■ Familiarity w offshore location ■ Difficult to get back to SQ ■ Complex/tight linkage ■ Business transformation
no ownership	<ul style="list-style-type: none"> ■ Frequent changes ■ Complex/tight linkage ■ Business transformation 	<ul style="list-style-type: none"> ■ Frequent changes ■ Complex/tight linkage ■ Process not mature 	<ul style="list-style-type: none"> ■ Familiarity w offshore location ■ Long term viability ■ Lack of scale

4.1 When do firms prefer higher levels of ownership in their sourcing arrangements?

To a first approximation, the logic appears to be one of “if control needs are high, retain ownership; if co-ordination needs are high, keep onshore”.

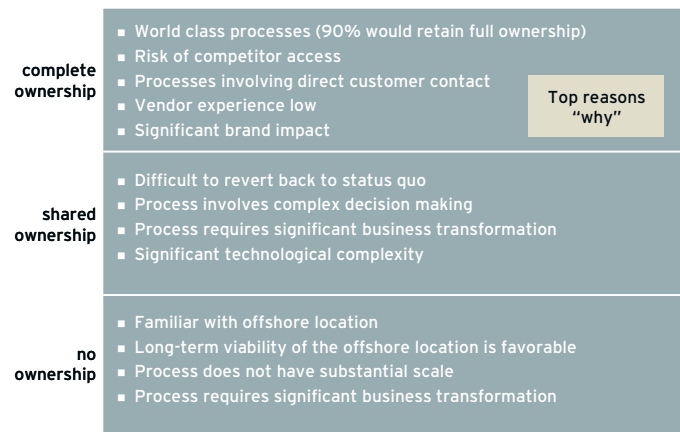
The most significant driver when opting for a “complete ownership” model is the firm’s perception that the process is world class. Considerations such as the possible impact of outsourcing or co-sourcing to their brand, the risk of competitor access to detailed knowledge of the process, and the requirement of direct involvement with the customer follow closely behind.

By contrast, respondents appear to have a greater receptivity to outsourcing when they have insufficient scale, when a vendor has domain experience or superior technology, and, when they are looking to offshore, where a vendor has greater familiarity with the offshore location.

Compared to the captive or fully outsourced models, shared ownership models are not yet mature; nevertheless, this model - where the outsourcer and vendor share ownership of the insourcing operation - is beginning to receive attention. Intuitively, the shared ownership appears to be a stop-gap measure for those firms who wish to enjoy the benefits provided by a vendor but are not convinced that the candidate process is the right one to out-source; the foremost reason given for opting for shared ownership rather than a full

outsourcing option was that the processes involved would be difficult to bring back in-house once outsourced. Presumably, this is seen as a lower risk, “easy-to-reverse” option. Processes requiring significant business transformation or those that involve complex decision making, and processes where contracting would be particularly difficult were also associated with a “shared ownership” model (Figure 5).

Figure 5: Reasons for opting for one or other ownership model in sourcing decisions

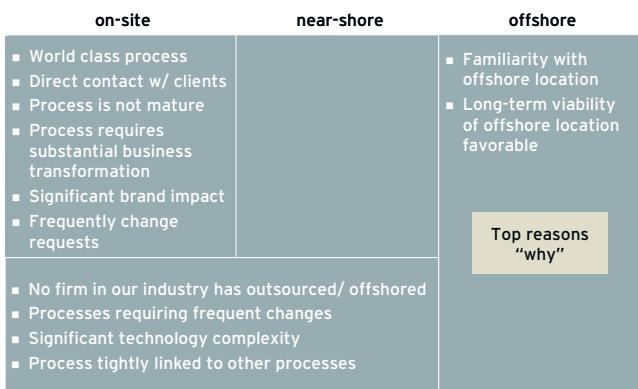


4.2 When do firms prefer on-shore, or near-shore locations for business processes?

When determining whether to offshore non-IT processes, respondents reported that they would not consider offshoring if no one else had done so before them or if the long-term viability of the offshore location was not favorable. They were also unlikely to offshore processes which are immature, which involve direct contact with customers, or have a high brand impact.

Where processes require frequent changes, have significant technology complexity or are tightly linked to other processes respondents would choose equally between an onsite and a near-shore model (Figure 6). This is particularly true of European firms and their propensity to source or establish regional service centers.

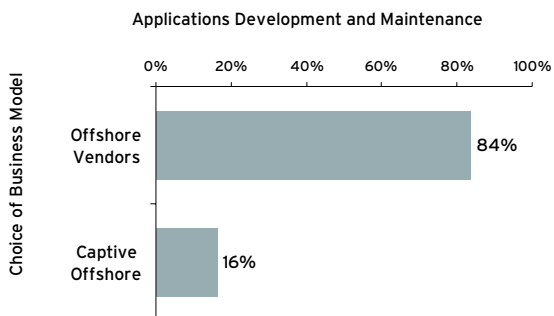
Figure 6: Reasons for opting for one or other ownership model in sourcing decisions



Interestingly, our respondents firms show a marked difference between the business models they would pick for IT versus the one for business processes (Figure 7).

Figure 7: Offshoring IT vs. business processes - Propensity to use offshore vendors to offshore

For IT, respondents are five times as likely to utilize offshore outsourcing as captive setups

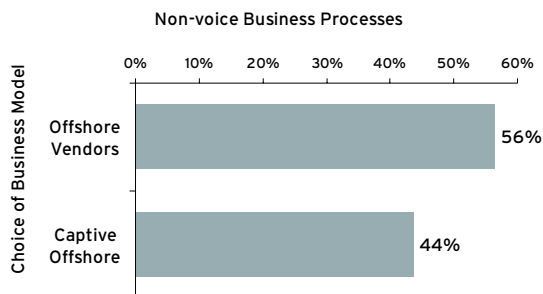


For IT, respondents would pick offshore outsourcing over "captive" set-ups by five to one. However, for non-voice, business processes captive set-ups were almost equal in popularity to offshore outsourcing. Perhaps a partial explanation for this behavior is the fact that IT outsourcing market is relatively mature both onshore as well as offshore. Outsourcing suitable IT processes to vendors is therefore a "no-brainer".

However, the outsourcing and offshoring market for non-voice business processes is relatively young, fragmented and immature. Few vendors can provide credible evidence of relevant domain knowledge or experience of vertical processes in the financial services sector. Hence, even firms who have had experience with, say, IT outsourcing find it preferable to retain these in-house or to establish captive centers when they offshore.

Captive offshore units confer the benefits of offshoring but not those of outsourcing. In our view, as vendor capabilities increase captives may give way to more reliance on third party vendors.

For non-voice business processes, offshore outsourcing is only marginally more popular than captive offshoring



4.3 Control versus co-ordination: the key dimensions of global sourcing decisions

Based on our findings, the willingness to outsource or offshore a process is typically a function of the perceived need to retain control of a process and the effort likely to be involved in co-ordinating with third parties.

Respondents cited a range of reasons for not offshoring or outsourcing processes (Figure 8). Key issues of control and co-ordination are prominent in both lists.

Figure 8: Reasons not to offshore/outsourcing

No offshoring

Coordination

- Users require frequent changes
- The process is currently not mature
- Process requires substantial business transformation
- There is a significant cultural distance to the offshore location/vendor

No outsourcing

Control

- Risk of competitor access to knowledge of our process is unacceptable
- Current process (cost, quality) is world class
- Contracting for this process is difficult
- It will be difficult to revert back to status quo

Key reasons cited for not offshoring included where the process was not mature or where substantial business transformation would be required to offshore successfully. In both cases, these are situations where close co-ordination with the onshore business is clearly key to process performance and is

achieved through greater interaction typically by co-location.

Key reasons cited for not outsourcing focus heavily on the loss of control: risk of competitor access to detailed knowledge of the process, the difficulties of setting up effective contractual relationships with a third party and the problems involved in unwinding outsourcing arrangements if they prove unsatisfactory.

The overall picture is clear: processes for which a firm is unwilling to give up control are best served by the “complete ownership” onshore and offshore models. Processes where close co-ordination is paramount are best served by onsite models even where outsourcing is considered. Any departure from these “pure” models calls for a trade-off between control and co-ordination.

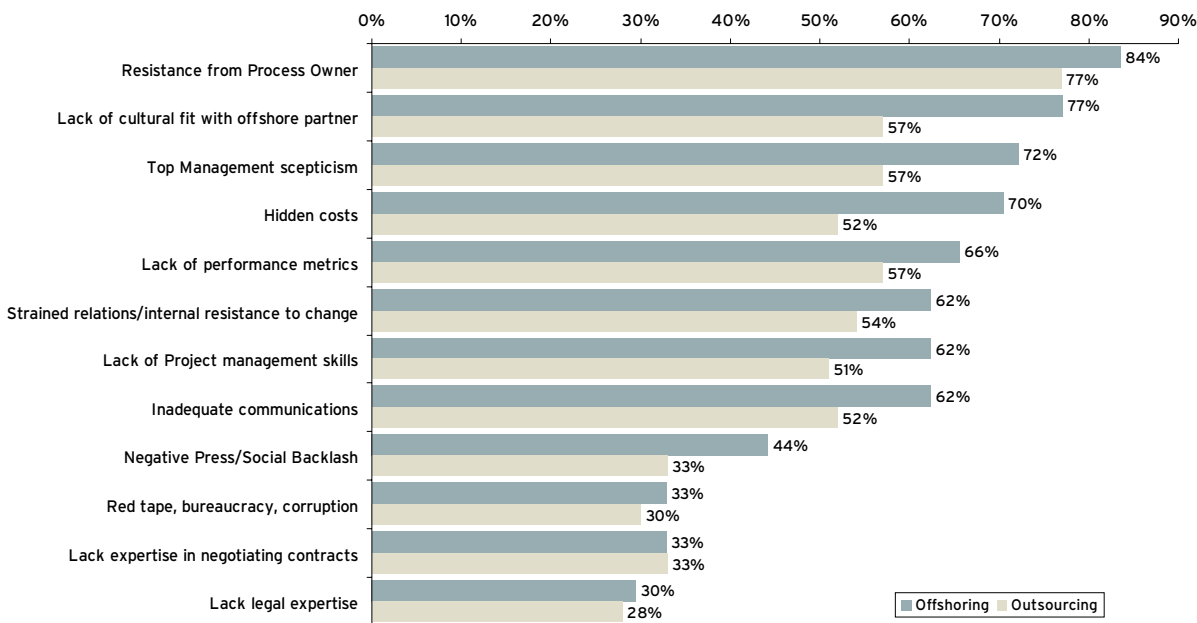
Two examples of processes where our respondents indicated willingness to trade-off control and co-ordination included those with tight linkage to other processes or which involve complex decision making: in each case the respondents were equally likely to choose between a captive offshore model and an onsite/near-shore outsourced model. Perhaps, in such cases the decision to establish a captive model versus outsourcing would not solely depend upon the process attributes; other considerations, e.g., organizational comfort level, stakeholders’ risk perceptions etc. might help determine the preferred outcome.

5 Key pain points in alternative sourcing

Firms cite 'resistance from process owners,' 'top management scepticism,' 'lack of cultural fit,' 'hidden costs,' and 'lack of performance metrics' as key pain points in attempts to outsource or offshore (Figure 9). Not unexpectedly, lack of cultural fit with vendors and hidden costs are significantly more pronounced with off-shoring than with outsourcing. Also lack of project management skills and inadequacy of communications posed much greater difficulty with offshoring.

Surprisingly, respondents do not appear to be overly deterred by the scepter of 'negative press' when offshoring - among the top ten potential obstacles to offshoring, this factor appeared as the 9th in the list; only 8% of the respondents cited negative press as a "very significant" factor in making offshoring decisions.

Figure 9: Key pain points in sourcing decisions

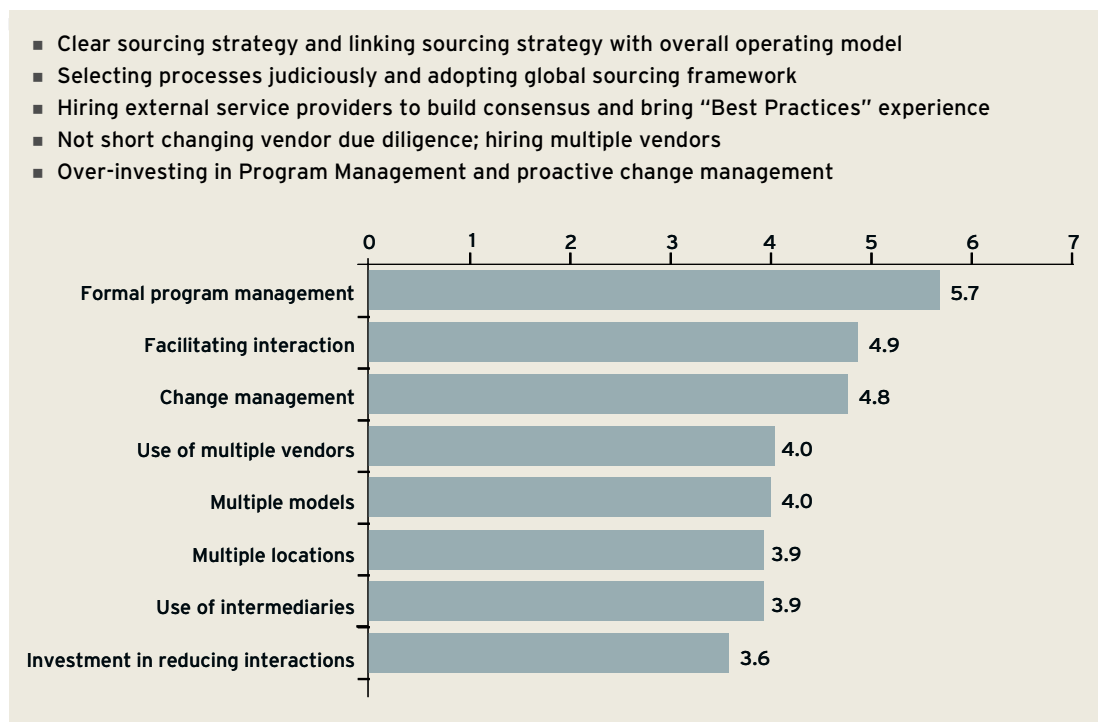


6 Managing the challenges of global sourcing

One of the key objectives of this report is to enable organizations with less experience in alternative sourcing to learn from the pioneers in this space. Our respondents highlighted the following key “mitigation strategies” to ensure optimum results from their sourcing strategy (Figure 10).

- Formal program management underpinned by heavy investment in proactive change management.
- Robust knowledge transfer and governance programs to promote close working relationship with vendors.
- Hiring intermediaries to build consensus, bring ‘best practices’ experience and facilitate implementation.
- Carry out a full and considered vendor due diligence, along with hiring multiple vendors.
- Adopt true global sourcing using componentized multi-vendor, multi-location models.

Figure 10: Mitigation strategies



7 The future

Financial services firms are moving to a modularized, agile and dynamic operating model. Global sourcing is considered the strategy of choice; offshoring has become a dated concept. Global sourcing will be characterized by its spread of sourcing partners, locations and its ability to remain dynamic and flexible. A corollary is that once a sourcing decision has been made, organizations must recognize that these are not set in stone. This is an ongoing process which should be supported by a proactive central change management team. As the operating model changes so too will the processes sourced and the nature and location of sourcing decisions.

As more complex processes are considered candidates for sourcing, the shared ownership model will become more prevalent than the captive or full 3rd party processing.

In the current environment, trail-blazers in financial services sector are proving that offsetting rising costs, tightening profit margins and increased competition through comprehensive global sourcing with strong program and change management elements will be a strong defense. Companies can only ignore these signs at their peril. ☐

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