Business Process Outsourcing & Offshoring

First published by *Euromoney*, August 2003. Excerpted from *Making Overhead Outperform: Next-Generation G&A Performance*, published as a *strategy+business* Reader by Booz Allen Hamilton, September 2003.

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It is more challenging than ever to improve business performance. The global economic downturn, diminishing returns on capital, internal business constraints, and new security and governance requirements all conspire to depress companies' results.

Faced with these mounting pressures, most major corporations have already assessed their internal services and employed a series of cost reduction strategies. Starting with corporate standard setting and consolidation of services like information technology, procurement, and other shared services, companies have since turned to reengineering internal processes, outsourcing, and, most recently, improving demand management for internal services.

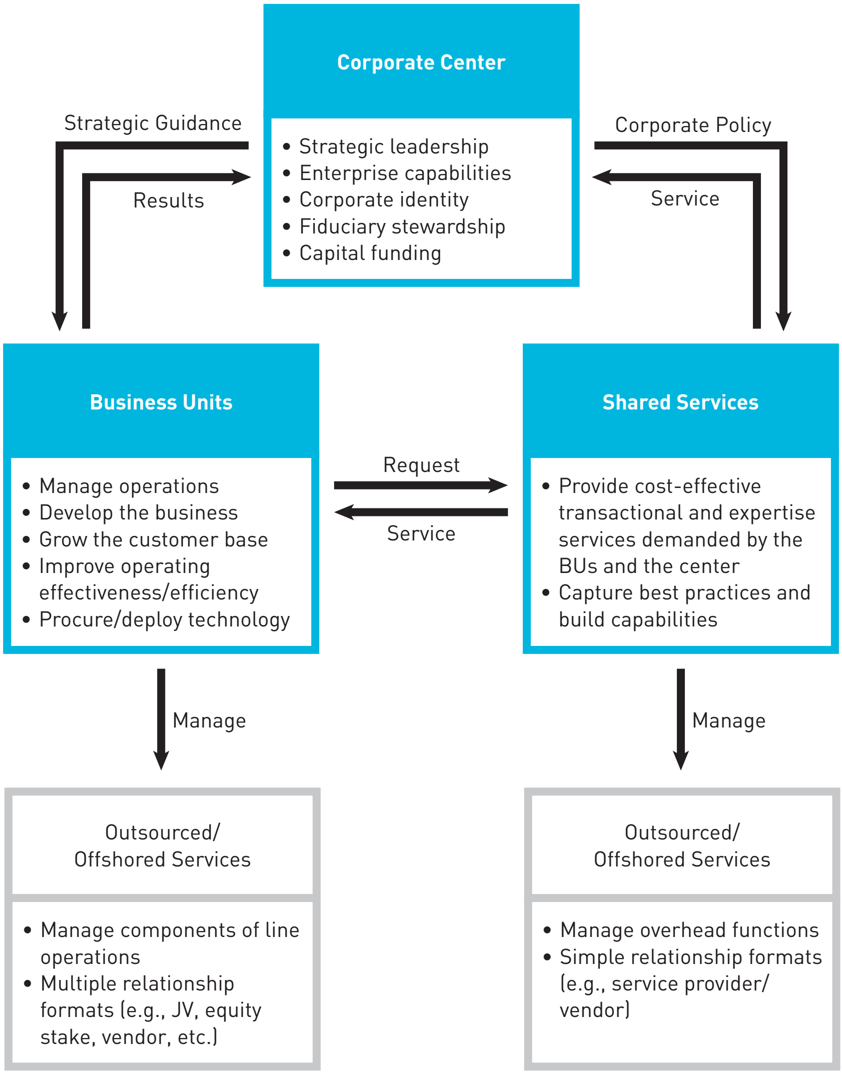
Having exploited most of the first-generation cost savings available, leading companies are now focusing on business model transformation. They are looking beyond IT and G&A services and outsourcing processes closer to the core — including line operations — often using offshore resources. Moreover, many are exploring ways to commercialize their own world-class internal services through spin-offs and joint ventures.

Traditional outsourcing has increased in scope and impact with the inclusion of business process outsourcing (BPO) and offshoring as new instruments. Business process outsourcing, which encompasses not only overhead functions (e.g., accounting, human resources), but also line operations (e.g., call centers), is an increasingly popular and effective tool to reduce internal costs and achieve strategic objectives. When implemented effectively, BPO enables a company to leverage industry-wide scale, harness superior factor costs, speed technological advances, and enhance business flexibility, so resources can be focused even more intensely on mission-critical competencies.

As the BPO service provider value proposition evolves from cost-based to valuebased (e.g., enhanced service revenue realization), companies are restructuring their operating models to accommodate these new service delivery options (see Exhibit 1).

In fact, in nearly every industry, new operating models are emerging that extend the traditional boundaries of the organization and encompass new-form alliances and business arrangements. Financial services organizations have been pioneers in outsourcing certain areas of their value chain, along with the airlines, telecom, and energy sectors. In fact, recent deals in these industries have exceeded $1 billion in value.

Exhibit 1: **New Operating Models Explicitly Include Outsourced Services**



Source: Booz Allen Hamilton

Exhibit 2: **Financial Services Firms Have Innovated the Outsourcing Arena**

Snapshot of Recent Deals
J.P. Morgan Chase & Co. When J.P. Morgan made the decision to outsource a large part of the back office, it ushered in a wave of significant outsourcing deals in the financial services industry.
Prudential Prudential Securities has outsourced its entire back office and realized a 20 percent reduction in expenses (guaranteed in SLA).
Westpac Australia's First Bank Westpac Banking Corp. outsourced the processing and servicing of its mortgage portfolio to EDS. In so doing, it was able to shift approximately 1,300 back-office employees off its payroll and onto EDS's.
First Financial Bancorp. First Financial Bancorp. has been able to access the expertise required to enter the mutual funds market by outsourcing a comprehensive suite of services, including fund administration, accounting, transfer agency, and distribution to BISYS.
Abbey National Abbey National PLC has credit card giant MBNA managing its credit card portfolio.
Cendant Small financial services concerns have outsourced their entire loan origination process to leading outsourcers such as Cendant, Equizz, MortgageSelect.com, and Nextar, who can offer better service levels.
Prudential Focused on improving its customer service, Prudential Insurance (U.K.) has outsourced its call center functions to ICICI OneSource.

Source: Company press releases and Web sites

Evolution of the Marketplace

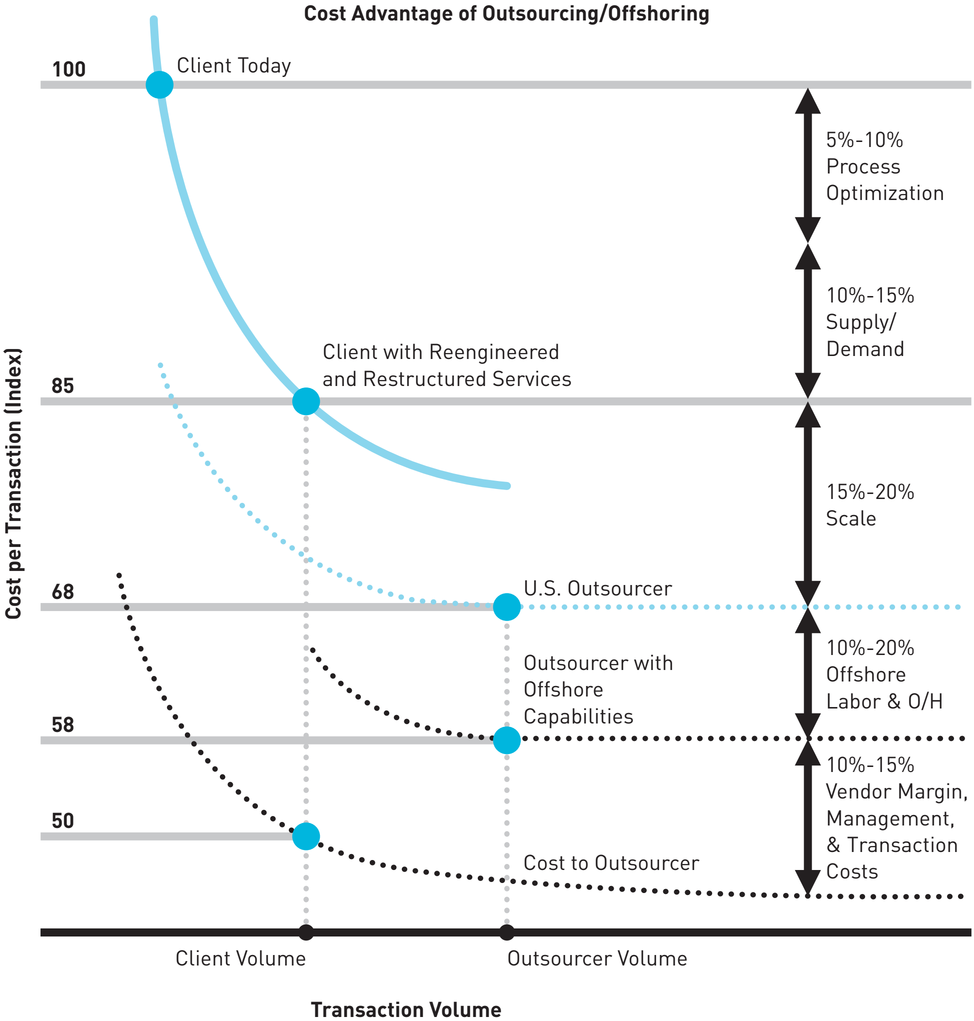
Now a market that totals hundreds of billions of dollars, business process outsourcing has evolved dramatically since the 1980s, when distressed firms looking to raise cash "sold and leased back" their internal services (e.g., IT services) or midtier banks engaged in correspondent banking to capture scale. Outsourcing has since achieved maturity across industries and various parts of the value chain from functional services such as payroll to line operations such as call centers. Managers in both the United States and Europe now have long experience with outsourcing as a way to reengineer internal processes and improve service levels. Indeed, in the financial services community alone, outsourcing has emerged as a critical mechanism for delivering services to existing customers, as well as for growing new markets. Exhibit 2 captures just a few of these innovative deals and models.

The latest frontier in outsourcing for many financial services companies lies offshore in places such as India, China, Malaysia, Singapore, even South Africa and Australia. Select transnational companies have already achieved cost reductions in excess of 25 percent as a result of offshoring, primarily because of lower factor costs. In making the decision to offshore, companies can choose to either own the assets (captive) or access them through an external provider (noncaptive). Either way, moving processes offshore allows companies to achieve greater savings than they could through traditional business process outsourcing alone (see Exhibit 3).

• By outsourcing operations to its 2,500 employees in India, Citigroup realized an estimated $75 million in 2001.
• GE Capital now has more than 15,000 employees in India.
• Prudential Insurance U.K. outsourced its call centers to ICICI OneSource in India and has achieved savings of 30 to 40 percent.
• American Express has reported savings of 50+ percent on its Indian-based operations.

Offshoring is growing at double-digit annual rates in both the U.S. (11 percent)

Exhibit 3: **Offshoring Enables Greater Savings Than Traditional Outsourcing Alone**



Source: Booz Allen Hamilton Client Experience and Europe (12 percent) and is steadily migrating beyond IT applications development and transactional HR services (e.g., payroll processing, benefits administration, employee records) to finance functions (e.g., accounts payable, credit card processing), knowledge-based customer care (e.g., call centers, e-mail response), and advanced information technology services (e.g., customer software development, application maintenance).

Offshoring takes the outsourcing concept to the next level, covering greater chunks of core operations. It can be explored independently or as part of a wider outsourcing agenda. Still in its nascent stages, offshoring is a phenomenon with real value yet to be tapped. In fact, we believe that all BPO discussions in the future should include offshoring as an option.

The Pitfalls Behind the Promise

In a survey Booz Allen Hamilton conducted last year with 100 U.S. companies, 80 percent of those companies that outsourced were satisfied with their outsourcing arrangements, and 94 percent indicated they would outsource again … so outsourcing is clearly here to stay. That said, outsourcing is no "silver bullet," and it comes with its own challenges and risks.

Given the impressive economic arguments in its favor and the growing size of the market, business process outsourcing should be driving major improvements in overhead efficiencies, but that is not always the case. In fact, only a select few companies, including Procter & Gamble, General Motors, General Electric, and Hewlett Packard, have been able to fundamentally shift their internal cost structures and realize savings of as much as 30 percent.

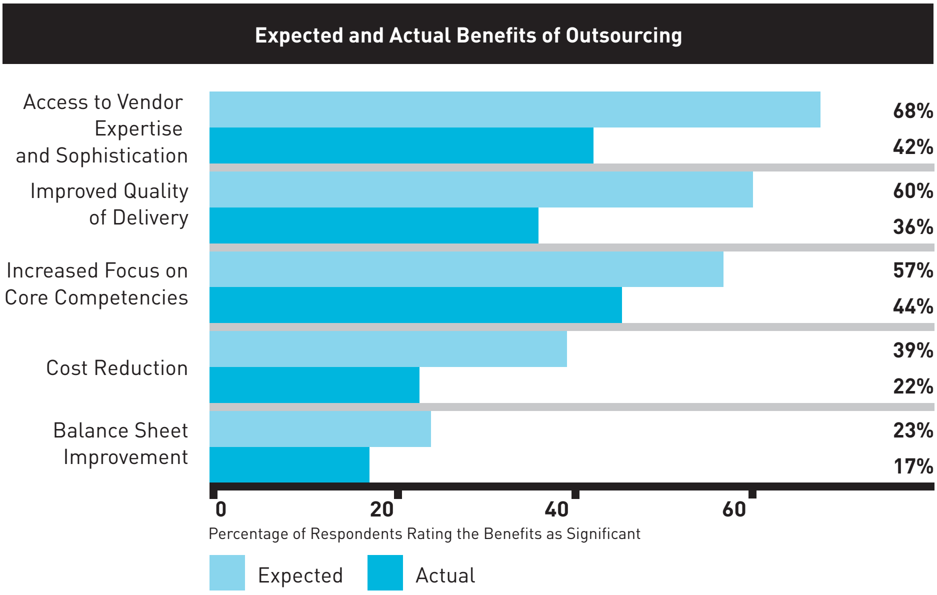
Many companies remain frustrated that outsourcing has not delivered on its full potential. Our survey respondents cited weak cost controls, excessive standardization, and insufficient responsiveness to changing business needs as some of the significant challenges that remain (see Exhibit 4).

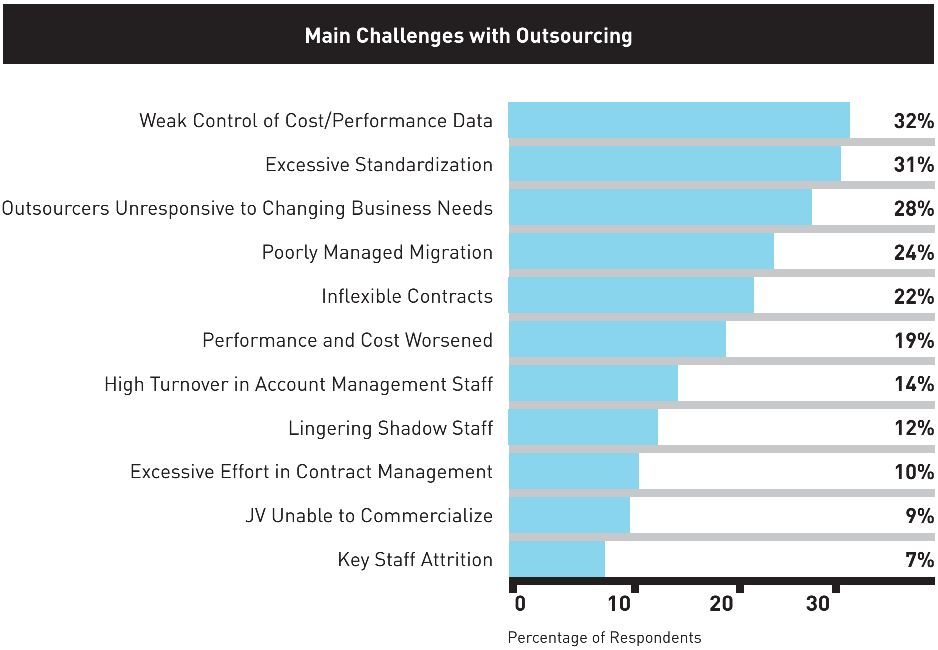
When offshoring is added to the mix, additional political, economic, social, technological, and operational risks emerge. Some of the factors that need to be weighed include:

- Political (homeland) — loss of white-collar jobs; resistance from labor unions, local government, and professional associations
- Political (offshore) — government stability, tax laws, legal system, educational system
- Economic — exchange rates, repatriation of profits
- Social — size and competition for talent pool, cultural differences
- Technological — infrastructure requirements

• Operational — reaction of customer to voice-facing activities; reaction of unions to all activities; ability to manage interfaces, service levels, loss of competencies, data security, loss of customer contact

Exhibit 4: **Outsourcing Is Failing to Reach Its Full Potential**





Source: *Top* GartnerGroup; *Bottom* Booz Allen Hamilton BPO Survey of 100 U.S. Companies, 2002

Key Outsourcing Lessons

Clearly, business process outsourcing has the potential to deliver real value, but capturing the value is another story. Our work helping clients outsource both information technology and business processes has offered a few key lessons for those moving forward in this dynamic market.

1. Understand Your True Objectives — Outsource for the right reasons
2. Don't Outsource a Mess — Eliminate the complexity first
3. Maturity Matters — Assess market maturity in developing strategy
4. Know Yourself and Marry Well — Understand what you and the vendor *really* bring to the table
5. Exercise Good Governance and Relationship Management — Actively manage the ongoing relationship

1. Understand Your True Objectives. Financial services firms, as a group, are contending with margin compression, mounting customer expectations, and increasing technology costs. These trends contribute to a set of strategic imperatives that lend themselves well to an outsourcing agenda.

While the precise objectives for outsourcing will vary by company and by service, it is imperative that these objectives support a company's strategic goals, and that management be rigorous in executing them. Of course, some firms are less than forthright in declaring their true outsourcing or offshoring objectives. There are the stated reasons, and then there are the "real" reasons. All too often, management resorts to outsourcing to fix broken processes or circumvent frustrating internal impediments. If one of those is the "real" reason, outsourcing is inherently constrained in how effective it can be and may even introduce new risks (see Exhibit 5).

2. Don't Outsource a Mess. In our experience, too many companies try to outsource broken or needlessly complex processes and fail to capture the total savings possible as a result. Management either takes too long to clean up internal processes or gives up and outsources the mess. Excessive complexity generally stems from a "one size fits all" approach to delivering services. Over time, this sort of "standardized" approach often embeds unnecessary functionality in processes as internal service providers try to devise one solution that satisfies all customer segments. Excess costs, systems interfaces, and management overhead result. Management's vain hope is that the outsourcer can make sense of the mess and realize savings with best practices. But that's wishful thinking. Instead, the complexities and inefficiencies become embedded in the outsourcer's processes.

In fact, the cost of complexity can overwhelm other value drivers, including scale and scope. In our experience we have observed that lower-cost, scale-sensitive operations (such as call centers) do not necessarily reap the expected economies as they grow in size and revenue. The cost of complexity is the culprit.

Management needs to either remove or determine *how* to remove underlying complexity to capture the full value from outsourcing processes. In so doing, a company can realize much of that value *before* outsourcing.

To isolate and manage complexity, many of our financial services clients have borrowed concepts from the manufacturing industry, such as lean manufacturing

Exhibit 5: **Companies Should Be Honest with Themselves about the "Real" Reasons for Outsourcing**

Stated Reasons	Often the "Real" Reasons	Risks
Reduce Costs	• Inability to reduce costs through classic reengineering or technology investment	• Are we just outsourcing a broken process?
Focus on Core Competency	• Distracted by constant "fire-fighting" • Lack of expertise or commitment	• Do we risk outsourcing processes that could have adverse impact if controls break down?
Instill Market Discipline	• Response to repeated outsourcing threats • Illogical pricing mechanisms and allocations	• Will we fix adverse user behaviors by shifting work outside the four walls of the company?
Improve Flexibility	• Major work force productivity issues • Inability to influence union	• Is this a response to frustration at the work force?
Improve Technology	• Unaffordable technology investments • Made poor investment decisions in the past	• Will systems need fixing anyway?

Source: Booz Allen Hamilton

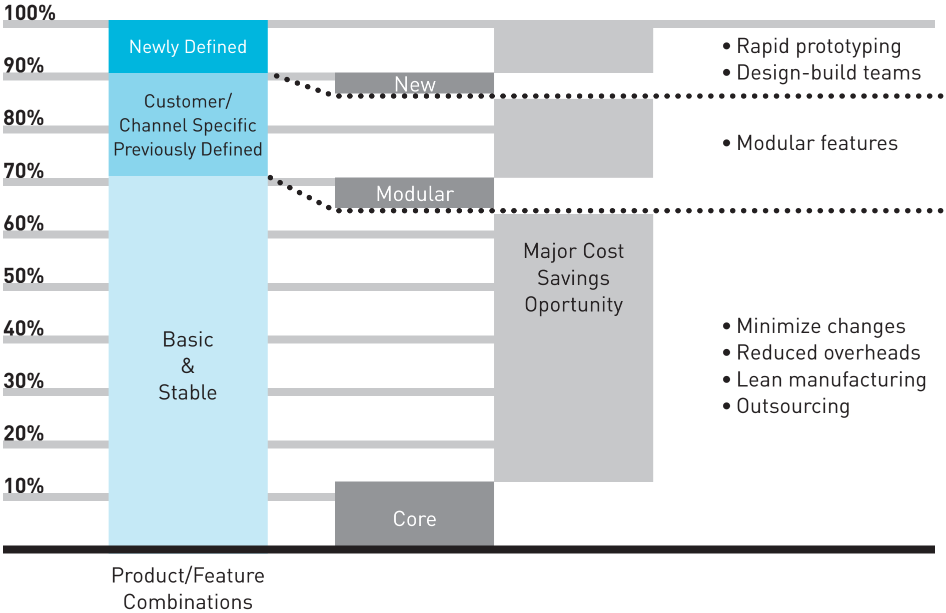
and tailored business streams. For example, an insurance company we advised used tailored business streams to isolate its complex system components from its base processes and systems with the use of object and integration technologies. This approach allowed the firm to consolidate 11 administrative systems into only two, and eliminate over 60 percent of the uniqueness (hence complexity) in its processes, as shown in Exhibit 6.

3. Maturity Matters. Not all outsourcing is created equal. Markets for these services mature according to the same supply and demand dynamics we see in any other

Exhibit 6: **Insurance Company "Re-Architected" Its Product Portfolio Using Tailored Business Streams**

Creating a Core and Modular Product Architecture...

Core and Modular Products



...Produces Results

Initiatives

Simplify	• 150,000 product functions and features	• 1,000 core • 500 unique to market -Local compliance -Truly value-added
Standardize	• Processors • Data elements • Service applications	• 70% sys dev saving • 15% Branch ops • 15% ATM servicing

Consolidate

	Today	Proposed
Operations sites	90	15
Sys dev sites	50	6
Data centers	30	3

Source: Booz Allen Hamilton

markets (see Exhibit 7).

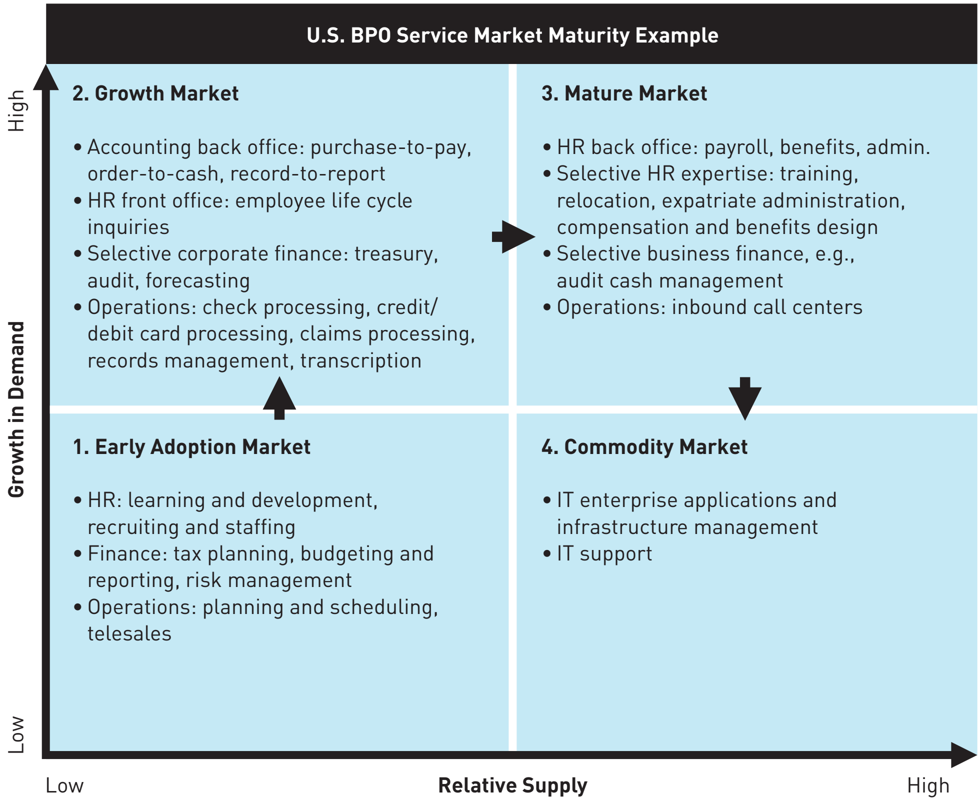
The way a company approaches and manages an outsourcing relationship will depend on where the process and supplier are on the market maturity curve.

In the emerging and growing outsourcing markets, consistent standards for performance have not yet emerged, and performance among service providers is highly variable. Players tend to be entrepreneurs or innovative firms, and margins are high, attracting many suppliers. As a result, the market is highly fragmented.

As the outsourcing market matures for a given business process, standards and streamlined methodologies create conditions for scale advantages. Consolidation begins. Winners leverage lower-cost labor to provide consistent quality at a differentiated price. The call center segment of the outsourcing market is going through this stage, as exemplified by Wipro's recent acquisition of Spectramind.

Finally, in mature/commodity markets, significant levels of automation and further consolidation take hold. At this stage, the outsourcing market is typically dom-

Exhibit 7: **Market Maturity Matters: Not All Outsourcing Is Created Equal**



Source: Booz Allen Hamilton

inated by a few large companies, who emerge as true scale players. IT applications management and various areas of IT support are approaching this stage.

In mature commodity markets, it is relatively easy to form long-term, arm's-length relationships given that high quality and efficient service delivery are assured. Competitive tension is maintained through benchmarks, service level agreements, and rigorous procurement practices.

On the other hand, in growth and early adoption markets, a consistent standard of performance is not assured, nor is the longevity of the supplier. Contracts tend to be more flexible and relationships more tightly monitored. Buyers also typically spread their spend among several suppliers to access best-of-breed expertise.

As anyone who has recently shopped the BPO market is aware, it is crowded with many players, each trying to take on a differentiated position. There are many different arrangements to pick from. At first, it's best to structure short-term contracts using a time-and-materials approach with incentives (not penalties). Buyers should initially keep internal resources in the mix to avoid overreliance on untested external vendors.

In cases where large, long-term contracts are being considered for less mature services, it's important that buyer and supplier align their objectives and incentives. The supplier needs to have intimate, working knowledge of the client's business and goals. Joint ventures and partnership arrangements where both parties have "skin in the game" work best.

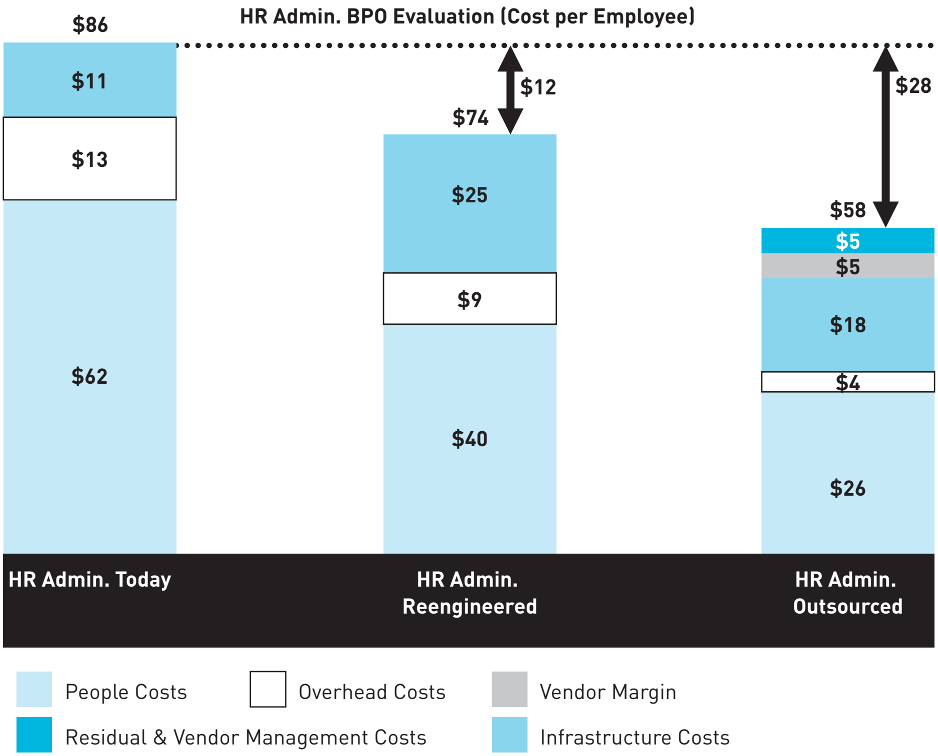
4. Know Yourself and Marry Well. In understanding an outsourcer's true value proposition, it is important that executives assess their own company's strengths and virtues. Can the outsourcer really provide sustainable leverage greater than what the company can internally generate? Does the company have assets that are attractive to the supplier?

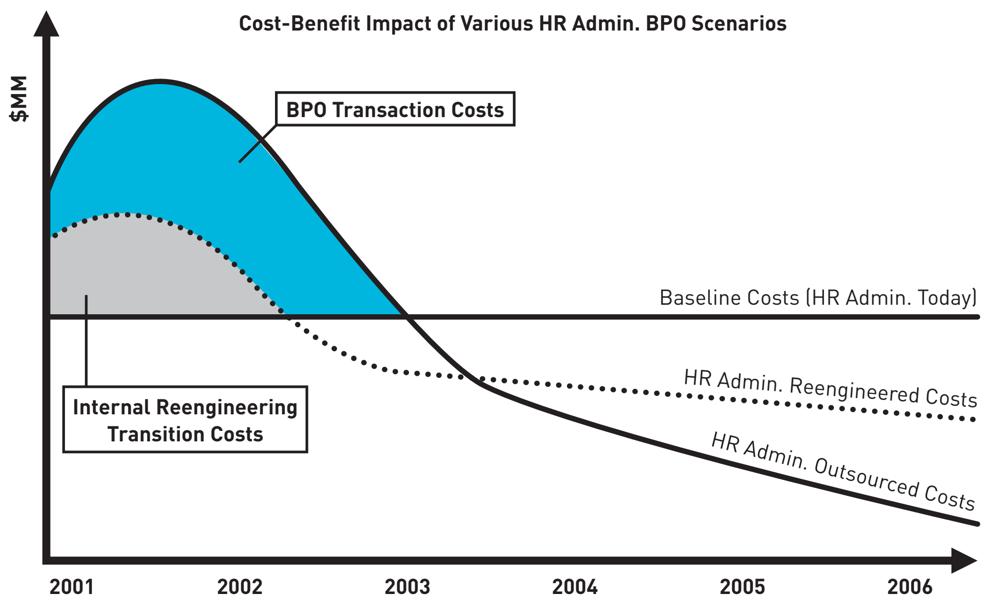
To extract as much of the potential benefits from outsourcing as possible, companies need to thoroughly understand their own underlying economics and performance as well as those of the outsourcer. Moreover, they need to understand the full economic impact of their outsourcing decisions. An external supplier may initially appear to offer cost advantages given its lower labor costs or higher utilization rates, but when total costs are taken into account — including remaining fixed overhead, new supplier management expenses, and transition costs — outsourcing may be more expensive than keeping the function or process in-house.

Oftentimes, the costs of an outsourcing contract are front-end loaded as the outsourcer comes up to speed and the client organization works through the transition.

Those initial costs could well exceed those associated with an internal reengineering of the function in question, so the timing as well as the magnitude of the

Exhibit 8: **Understand the Source of Vendor Value: Timing as Well as Magnitude of Savings**





Source: Booz Allen Hamilton Client Experience potential savings from outsourcing should be carefully evaluated (see Exhibit 8).

Some companies have bypassed outsourcing vendors by setting up satellite offices and call centers on their own. Some have gone even further by commercializing their own internal services. For example, in the financial services industry, Mellon Bank and Bank of New York are focusing on commercializing their end-to-end back-office services. In fact, Mellon Bank has gone so far as to exit the retail banking business.

It is also wise to understand the nature and source of a vendor's value to you. To make that assessment, the buyer should look beyond the bid and assess the vendor's maturity, reliability, industry experience (e.g., generalist versus specialist), service breadth (e.g., end-to-end processes versus functional specialist), service levels, and contract flexibility.

While an outsourcer may claim to offer advantages in infrastructure scale, factor costs, experience, capital access, and state-of-the-art technology, oftentimes the advantages are not as impressive as advertised.

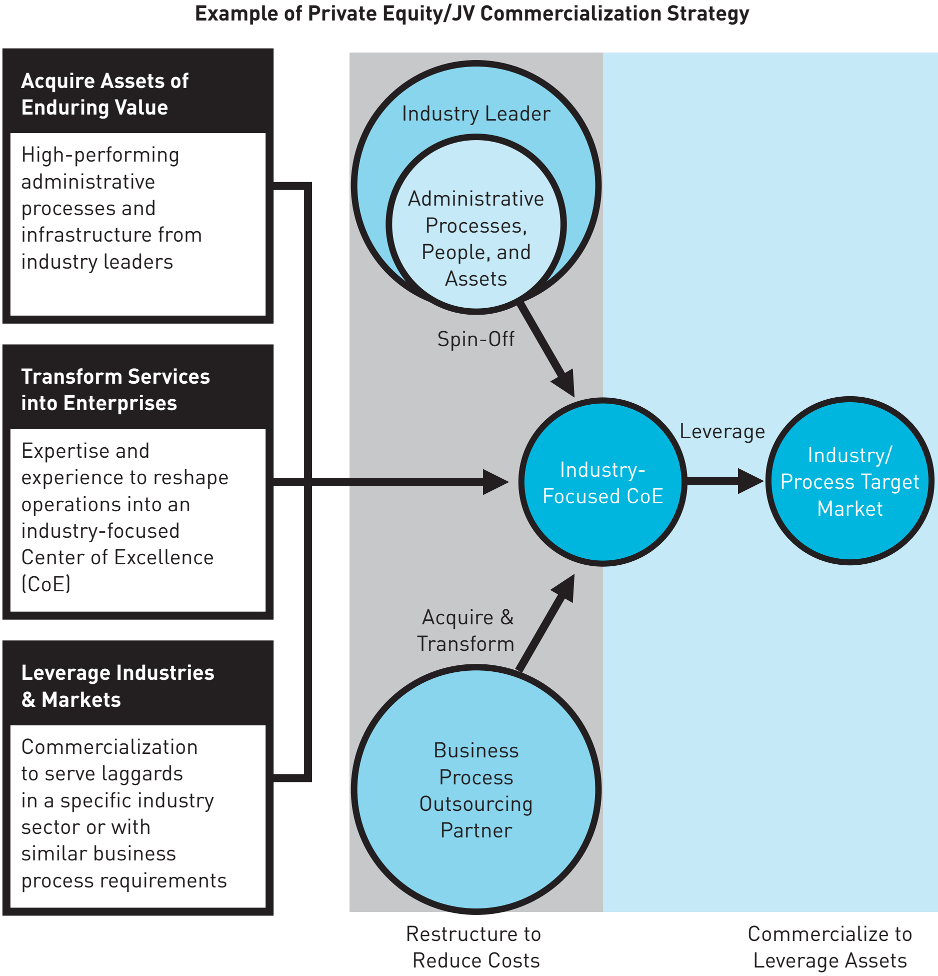
Regardless of the vendor, it's important to recognize that outsourcers are often just as constrained as internal units in accessing certain cost levers. Those levers that require strategic decisions or a higher level of business unit coordination (e.g., offshoring, demand management) can be as hard or harder to reach and exploit for an external vendor as they can for an internal provider. This helps explain why, in our experience, companies generally realize about 20 percent in terms of cost reduction from outsourcing rather than the 50 percent possible.

Lastly, as buyers understand their own potential and "assets," as well as the market for them, they realize they may have something to offer the vendor. Capabilities that would allow a vendor to instantly enter a new market, deliver new services, or enhance scale can be important bargaining chips. The relationship between British Telecom and Accenture to form Accenture's new HR outsourcing business is an example. British Telecom and Accenture combined their HR functions and Accenture's outsourcing expertise to instantly form a new global business. The concept is illustrated in Exhibit 9.

5. Exercise Good Governance and Relationship Management. Now the hard work begins. All too many companies negotiate a rigorous agreement and then fail to oversee it in a disciplined way. Outsourcing customers need to build the right organizational capabilities to manage outsourcing relationships, including a governance board.

In any outsourcing environment, building the right governance structure is essential to ensuring that costs go out and stay out. Many clients create a board comprising business unit and functional leaders who are vested with the authority to set

Exhibit 9: **Relationship Options Vary According to the Nature of the Deal**



Source: Booz Allen Hamilton

direction, fund, prioritize, and evaluate and who are equipped with the requisite tools, systems, skills, and well-defined processes. This governance board handles BPO provider management, performance analysis, contracting and risk management, alliance strategies, and end-user liaising. The governance board agenda needs to address:

- Scope: Are we doing the right things?
- Delivery: Are we doing these things the right way?
- Performance: Are the right things being done well?
- Value: Is the corporation getting the benefits?

A three-way tension will always exist between businesses, regions, and service providers (internal or external). More often than not, all will have different priorities and competing needs. A service provider will want to deliver standardized services to drive scale, consistency, and best practices across the enterprise. In contrast, businesses often demand customized services set to their unique needs and affordability levels. The regions want services tailored to local conditions and business requirements. Formal decision rights and rules of engagement are necessary in resolving these issues and moving forward.

Operating under the assumption that you need to walk before you can run, companies need to manage the transition to outsourcing methodically and systematically beginning from Day 1. Even veterans in the outsourcing trenches make mistakes, and the list of things that can go wrong is long:

- Wrong “level” of people involved, from both the functions and the businesses
- Too much reliance on the business units to make trade-off decisions
- Lack of discipline resulting in back-door deals
- No presentation of options, which draws out the decision process
- Insufficient or excessive level of detail
- Inability to “bundle” the portfolio so the customer gets a total cost view

What internal resources should management retain to manage outsourcing relationships? The size of the residual organization will depend on a number of factors. If the outsourcer is mature and the relationship long-term, the residual organization and its associated costs will be smaller. On the other hand, in the growth stage, you need a larger management structure as performance standards tend not to be set, and relationships need to be more closely monitored.

Using various tools (e.g., project tracking, team scorecards, work plan, costs detail, performance metrics), the governance board keeps the outsourcing relationship on track during planning and execution. Where most companies fail to realize full value is in the monitoring and performance management of these relationships. It is imperative that companies put in place the appropriate metrics, systems, and governance structures.

The Road Ahead

BPO is here to stay — the fundamental value proposition of outsourcing and offshoring is solid and only getting better as technology improves and experience grows. Our objective in sharing these lessons is to ensure that an outsourcing agenda is placed in the right context to capture value today. As the BPO market matures over the next few years, the changes will be felt along three dimensions: creative commercial/partnership models, enhanced scope of services, and expanded value capture mechanisms.

Creative commercial/partnership models: As they gain experience, suppliers will continue to improve their service delivery capabilities, understanding, and alignment with customer needs. Relationship models will become more sophisticated, and "industry vertical" and deep functional specialists will emerge. We may also see more creative commercial models take shape, such as multinational consortia involving multiple players to enable shared industry platforms. These models will not be limited to large customers but will penetrate the midtier market.

Scope of services: Innovation will drive improved service offerings and more sophisticated business models each year. Looking ahead, the services now frequently offshored will be rationalized in certain areas where intelligent automation tools will begin to offer a more cost-effective and reliable solution (e.g., scripted calls). That said, new services will be offshored, and eventually all remote touch-point services (barring political and legal constraints) will be commoditized and outsourced/offshored (e.g., time-critical processes such as NAB calculations). Technological advances (e.g., increased bandwidth), aligned incentives, and geopolitical drivers will fuel the next wave of outsourcing and offshoring.

Value capture: Value capture mechanisms will evolve as factor costs level off, differentiating the leaders, who will compete on the basis of innovation and best practice transfer. Companies will tend to use offshoring solutions as incubation labs to lead innovation and develop new processes.

In summary, outsourcing will continue to drive tremendous shareholder value when implemented with care … and eyes wide open. +