

Offshoring practice in European financial services companies

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Many organisations have struggled to achieve lasting value from offshoring. Although it's often presented as a "no brainer", successful offshoring relies on intelligent choices about what to offshore and how to do it. You need to throw out what you think you know and understand the truth behind common offshoring myths if you want to deliver real and long-term benefits for your business.

For many years, offshoring was seen as a tactic for reducing the cost of back-room functions such as payroll and IT, and for much of that time it attracted little attention. All that started to change in the late 1990s as companies began offshoring functions – such as manufacturing, IT applications development and maintenance, and call centres – that have a greater impact on customer service and top and bottom-line revenues. Suddenly, offshoring had morphed into an item on the senior management agenda.

Then came the backlash: there were social and political objections to moving work offshore, while offshoring wasn't even living up to its promise and delivering the expected benefits (see [Offshoring: Saviour or Value Destroyer?](#) by Pitman and Hammond). Offshoring, so simple and a "no-brainer" in theory, was turning out to be pretty tough to execute well. Companies were offshoring the wrong things, for the wrong reasons, and going about it the wrong way. In December 2002, for instance, JP Morgan Chase outsourced much of its IT provision, including data centres, help desks, distributed computing, data and voice networks, and part of its applications development and maintenance for £2.9 billion. Less than two years later, in September 2004, the company brought it all back in-house. Sufficient strategic thought hadn't been given to the implications of outsourcing before the deal was awarded.

However, CEOs shouldn't follow the public lead of some of their colleagues and strike offshoring from their agenda altogether. It still has value as a management driver – but to capture that real value, you will have to throw out much of what you thought you knew.

To get the most out of offshoring, companies need to think longer-term, about moves that will deliver company-wide outcomes such as improved ROI, higher customer satisfaction, better cost-to-income ratio, and greater shareholder returns. In other words: *when you are cutting cost don't forget to replace it with long-term value, not just short-term savings in administration costs.* This means the decision to use offshoring to handle a particular function or process should focus on generating external results, such as repositioning yourself in the marketplace or changing your value proposition to customers in some significant way.

Positive press coverage hides the reality of poor value

The financial services industry has made heavy use of offshoring of some IT functions and business processes, and such deals continue to receive positive coverage in the media. Over the last four years, although skepticism in the press has increased slightly, positive mentions of offshoring initiatives in financial services have outnumbered negative mentions on average four to one, and are still running at a rate of three positive mentions to every negative one (see Figure 1).

Yet our experience suggests that the positive picture being painted by the media hides the failure of many European financial services companies to capture much value from their offshoring efforts. We also found that most companies don't worry about the behaviour of offshore providers when they enter into legal arrangements with them. These European companies assume offshore service providers will always act in ways that maximize both parties interests. Unfortunately, that isn't a very sensible assumption to make. Like all supply chain partners, offshore service providers can, and do, have incentives to behave in ways that prohibit companies from capturing benefits from offshoring. For example, some offshore service

providers stop investing in training or employ people who are nowhere as skilled as the agents they presented during the contract negotiations.

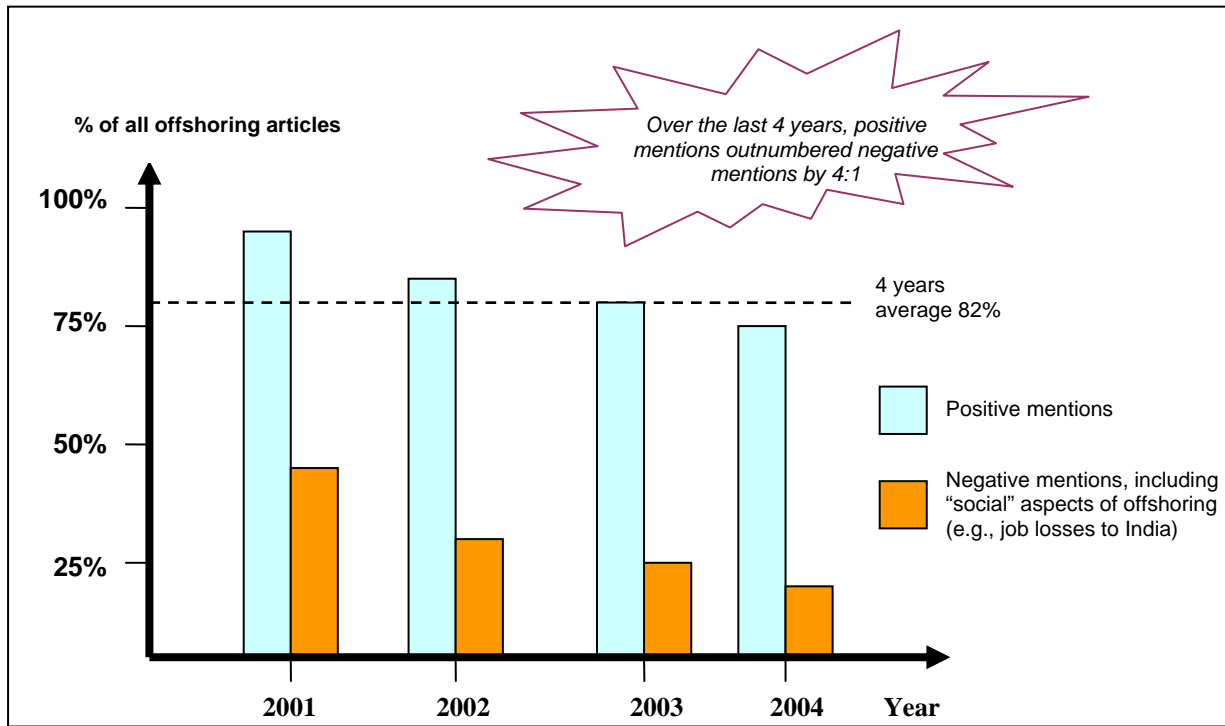


Figure 1: European financial services offshoring received favourable press
(Source: The Times, The Financial Times, Computing, Computer Weekly and Centrix Analysis)

Our work with clients suggests that European financial services companies *can* benefit from offshoring, and create value. But they can only do so if they stop pretending that they “know it all” and avoid falling prey to the common offshoring myths (see Figure 2). These deeply rooted myths, promoted by outsourcers and suppliers of offshoring services, have also gained popular support amongst in-house staff.

Myth	What it means to you
A highly competitive bidding process will ensure the best deal.	While loosely defined partnerships can scuttle offshoring efforts, so can overly complex bidding processes that push suppliers to the lowest cost rather than the best value.
Offshoring reduces management complexity.	Management complexity increases when functions are offshored for the simple reason that, while functions can be offshored, management understanding of those functions and how they related to other functions in the business cannot be handed over.
Our people cost five times more than offshore companies' personnel.	Comparing the salaries of a worker in Europe and a worker in an offshore location like India is misleading if you don't take into account their respective productivity, which can be much lower in offshore locations. A rigorous economic value assessment is needed.
Everyone is offshoring back office functions.	Not all back office functions can be offshored.
Don't worry about broken or unoptimised processes, the offshore company will fix it.	Companies must understand broken or unoptimised processes, and the measures and costs involved in fixing them, and agree these with the offshorer before concluding the deal. Otherwise, they are giving the offshore company a licence to print money.
Cosy partnerships lead to successful offshoring agreements.	It's a fallacy: while strong and open relationships are critical, deals must be based on well-defined contracts that capture all aspects of the service.
We know our cost structures and the offshore company's lower rate card will reduce cost.	Companies rarely have a clear view of their own costs or the impact offshoring will have on them. They need to conduct a comprehensive economic value assessment before offshoring any activity or function.
We're experts and we don't need to enhance or supplement our sourcing skills.	A little knowledge is a dangerous thing. Enhance your capabilities with help from truly independent experts.

Figure 2: Common myths about offshoring

By allowing these myths to determine how they tackle offshoring, European financial services companies are creating offshoring initiatives which contain the seeds of their own failure. They need to recognise that these myths are no substitute for real know-how and superior execution of prudent sourcing strategies.

A catalyst for transformation to add value while taking costs out

As offshoring starts to move beyond back-room functions into other areas of the business, the standard bidding process is losing favour: the smart companies are realising that their best partner is the one that offers them the greatest value, not necessarily the lowest cost. They're also recognising that any kind of transformation – whether it's changing their business model, implementing innovations in working practices or re-engineering processes – is hard work and doesn't always turn out the way they expect.

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Some forward-thinking executives – like Sir Fred Goodwin of Royal Bank of Scotland and Sir John Bond of HSBC – are beginning to use “rightsourcing” to drive major, company-wide transformation, such as a shift in competitive position or a major increase in market share or stock price. Rightsourcing involves selecting the right combination of internal and external suppliers: offshoring can certainly be a part of the overall sourcing strategy, but it sits alongside other options. Transformational rightsourcing can work because it goes outside for a critical missing piece, drawing on the expertise of a partner who can hit the ground running. If offshoring is the right strategic move, selecting an offshoring partner to support such transformation is not as simple as most companies think. For example, trying to identify the good players in the Indian offshoring market is rather like trying to nail water to the wall. New companies are constantly entering the market, while established players continually reinvent themselves in an effort to remain market leaders. Choosing a

location and partner who can deliver long-term value against a background of constant change is not easy.

Passage to India – or is it?

Offshoring decisions are about more than headline salaries or following the crowd to the most active territories. There are many other criteria that must be taken into account: the calibre, cost and productivity of the labour force; language skills; the cost and reliability of telecoms bandwidth; political stability; the tax regime; the enforceability of contracts; the general maturity of the business environment and corruption level; and the comfort that the senior management of the outsourcing company have in operating in different locations. The current global leaders for offshoring are India and China. However, central Europe, which entered the market a decade after the leading locations, is quickly catching up (see Figure 3).

While salaries for central European business services workers are around twice or more of those in India or China, productivity of business services workers in Europe is higher than in India or China, so that overall labour costs in these countries may be lower. And English language skills in India and other Asian countries such as Malaysia and the Philippines may make these popular locations for US and British companies, but many European companies are looking for knowledge of languages other than English - including French, German and Spanish – when transferring services offshore. Such language skills are much easier to find in central and eastern Europe than in traditional offshoring locations in Asia. Cultural affinity also matters, especially when offshore service centre staff are required to deal with customers. Geographic proximity is also important for some companies, especially those that require frequent contacts between service workers and customers in the west. Today, India is not the automatic choice of offshoring location for many companies (see *The myth behind India continuing as the offshore Maharaja* by Pitman and Fuller).

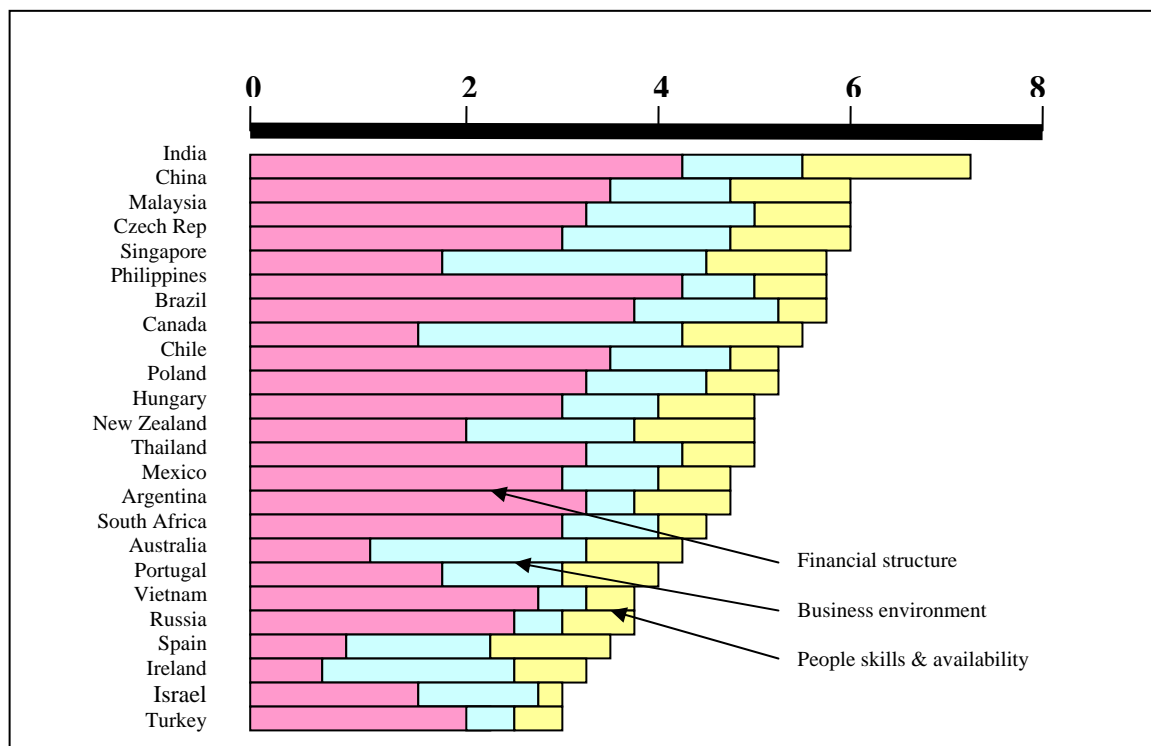


Figure 3: Offshore location attractiveness index (source: AT Kearney)

[Legend: The above bars represent index numbers. The weight distribution for the three categories (i.e. financial structure, business environment, and people skills and availability) is 40:30:30, meaning that the financial structure is rated on a scale of 1 to 4, and the business environment and people skills and availability are on a scale of 1 to 3.]

Not offshoring, but rightsourcing

Offshoring itself is also not an automatic choice, even though we continue to hear the mantra that “offshoring is a no-brainer”. Perhaps it is a no-brainer for people who see offshoring as just a cost reduction exercise. Yes, companies can use outsourcing to unload non-core activities or shed balance sheet assets, as a prominent UK grocery retailer did few years ago when it outsourced its entire IT function to boost its ROCE. But in February 2004, that same company decided to bring IT back under internal control after its pursuit of short-term gains created long-term operational weaknesses.

Time and again we see flawed decision-making by senior executives when they embark on offshoring or outsourcing initiatives without proper preparation and planning. A recent review of more than 200 offshoring initiatives by management consultancy Booz Allen Hamilton highlighted the poor nature of the results achieved to date. On average, respondents estimated they had achieved a 15% reduction in costs, but almost 33% of those surveyed believed their costs had declined only slightly (by less than 5%) or had actually increased. However, we believe even this rather gloomy picture may be over-optimistic because most surveys simply ask respondents to estimate the savings they have achieved, rather than asking them to state the actual savings, and therefore tend to over-estimate the value generated from offshoring.

What is clear is that European financial services companies ignore the lessons of mistakes made by others in offshoring decisions at their peril. Contrary to the propaganda put out by vested interests, offshoring and outsourcing need the highest level of intellectual capability. With the competitive environment changing rapidly, companies must monitor the situation constantly and develop the appropriate rightsourcing strategy. They should also beware of turning to the usual big name consulting companies for advice: they are also in the offshoring and outsourcing business and it is simply not prudent to ask companies with such a conflict of interests to help develop rightsourcing strategies.

About the authors

Lisa Hammond is the CEO of Centrix; Steve Pitman is a consultant.

About Centrix

Centrix is a leading independent consultancy that brings together the best of business, service and technology to create lasting value for its clients.

What Centrix Brings

Our consultants focus on helping clients with their most pressing offshoring issues and questions. Should we offshore – and what should we offshore? What are the risks and how do we guard against them? What is the best location for us to offshore to and how do we choose a supplier?

Centrix brings together expertise in business, service and technology to help clients develop and implement sourcing strategies that deliver lasting value. Our Rightsourcing Framework includes an Economic Value Assessment to make the business case and quantify the true costs and benefits of offshoring. We also provide a range of other tools, models, and methodologies to help you redesign business processes and technology infrastructure prior to offshoring to ensure you reap maximum benefits, design end-to-end programme management and governance processes and develop appropriate risk management strategies for the new ‘partnership’.