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Outsourcing Success

The Management Imperative

Alpesh B. Patel and Hemendra Aran

OUTSOURCING SUCCESS

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ALPESH B. PATEL
HEMENDRA ARAN

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Hemendra Aran would like to dedicate the book to his great-grandmother, the late Shrimati Suraj Devi, his grandfather, the late Shri Chandra Shekhar Aran and his father, the late Shri Indu Shekhar Aran

Both authors would like to dedicate the book to the Aranca team who contributed to the book:
Mr Madhusudan Rajagopalan
Mr Sanjay Goyal
Miss Tahera Kanchwala
Miss Swati Kulkarni

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About the authors

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Alpesh is a seasoned professional in the financial services industry and has led several high-profile engagements. He has been a consultant to Merrill Lynch-HSBC and Barclays Stockbrokers where he was hired by the CEO to provide weekly independent company research. He has been a congressional intern to the Hon. Eliot Engel in Washington D.C. Alpesh is closely associated with the financial media, having served as the in-house Internet specialist for Bloomberg TV for more than three years. He is also a columnist with the *Financial Times* and a regular BBC commentator.

Alpesh has authored several international best-selling business titles which were published by the *Financial Times* and translated into Russian, Chinese, French, Spanish, Polish and German. Alpesh's achievements have made him a strategic adviser to governments, CEO's and senior executives. Her Majesty's government appointed him a member in the U.K.-India Roundtable. Alpesh was a visiting fellow in business and industry, Corpus Christi College, Oxford University and is on the board of advisers, Centre for Entrepreneurship, University of Reading and a governor of Luton University. Alpesh has a degree in law from King's College, University of London and in philosophy, politics and economics from St Anne's College, Oxford University. He is a fellow of the Royal Society of Arts and a council member of the Royal Institute of International Affairs.

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Hemendra Aran

Hemendra has substantial experience in business process outsourcing and now specializes in cost-effective outsourcing of high-end research. In his eight years of experience, he has sold and executed outsourcing projects of varied complexity in many industries. He worked with Infosys Technologies Limited and provided consultancy to Goldman Sachs, Reebok, and Thomson Consumer Electronics. In an individual capacity, he consulted Air Products and ensured the successful rollout of systems in five European countries in only four months. He holds an MBA from the London Business School and a BE in civil engineering from the Indian Institute of

Technology (IIT), Madras and has attended entrepreneurship courses at Hass School of Business, University of California, Berkley. Hemendra brings valuable experience of complex outsourcing, remote project management and process reengineering in addition to his exceptional leadership skills and entrepreneurial talent. Hemendra is the founder of outsourcing specialists Aranca.

List of Abbreviations

ASP	application service provider
B2B	business-to-business
B2C	business-to-consumer
BPO	business process outsourcing
BSP	business service providers
CAGR	compound annual growth rate
CEO	chief executive officer
CFO	chief financial officer
CMM	Capability Maturity Model
CMS	content management system
COO	chief operations officer
CRM	customer relationship management
CSR	corporate social responsibility
CTO	chief technical officer
ERP	enterprise resource planning
ESP	external service provider
FDI	foreign direct investment
GDC	global distribution company
HR	human resources
HRM	human resource management
IDC	International Data Corporation
IPO	initial public offering
ITES	information technology-enabled services
LMS	learning management system
NGO	nongovernmental organization
OECD	Organization for Economic Cooperation and Development
R&D	research and development
ROI	return on investment
SEC	Security Exchange Commission (U.S.A)
SIA	Securities Industry Association (U.S.A)
SLA	service-level agreement
SOW	statement of work
SRO	self-regulatory organization

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INTRODUCTION

This is not war, where one economy's victory is another's loss. We all win when these things go forward, but if we are not realistic about our strengths and how to act on them, then we could go backwards. The prescription for the U.K. and U.S. economic behavior is the same; they must be economies that build innovative products [and services]. **Bill Gates**

Outsourcing. It must be important, if everyone is doing it. But how to do it well? How to decide whether to do it at all?

The newspaper headlines at the time of writing tell the story:

- Abbey established an IT development presence in Bangalore in September 2002, employing 100. Another 400 jobs will be exported soon
- ABN AMRO Central Enterprise Services has call centers in Gurgaon and Delhi with more than 2,000 employees
- American Express first outsourced to India in 1994. It now has 4,000 employees there
- Aviva announced plans in January 2004 to outsource 2,350 jobs to India, where it already employs 1,200
- Axa Insurance has moved 100 back office jobs to Bangalore
- Barclays cut 150 U.K. jobs to use cheaper Indian staff in June 2003
- Citibank employs 3,000 people in Mumbai and Chennai
- Deutsche Network Services employs 50 in Bangalore
- Fidelity Investments set up base in Gurgaon in July employing 200–250, increasing to 1,000
- Goldman Sachs is to create 250 jobs in India
- HSBC first outsourced to India in 2000, and now has more than 2,000 employees in Bangalore and Hyderabad. Another 4,000 jobs will go to India, Malaysia and China
- Morgan Stanley employs 1,600 in Mumbai

- Prudential hopes to have a call center in Mumbai by the end of 2004 employing 850
- Standard Chartered Bank first outsourced to India in 2002 and now has 4,500 employees
- JP Morgan Chase first outsourced to India in 2001 and now has 3,000 employees
- Capital One first outsourced in 2002 and now has 1,200 employees
- Lloyds TSB announced plans in October to close its call center in Newcastle and outsource the 986 U.K. jobs

Business Week magazine sums it up well:

> India also is working to assure that it will be able to meet future demand for knowledge workers at home and abroad. India produces 3.1 million college graduates a year, but that's expected to double by 2010. The number of engineering colleges is slated to grow 50 percent, to nearly 1,600, in four years. Of course, not all are good enough to produce the world-class grads of elite schools like the IITs, which accepted just 3,500 of 178,000 applicants last year.

But it is a confusing world, the world of outsourcing. Consider the jargon in Figure 0.1. We'll deal with these terms in this book.

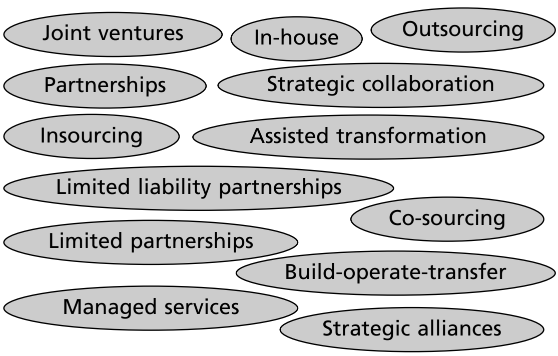


Figure 0.1 Terms in the outsourcing world

But explaining the forms of outsourcing relationships is just the start. Our ultimate goal is to understand whether it enhances shareholder value.

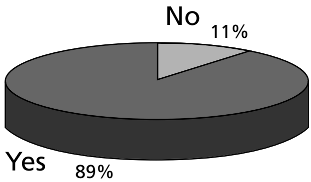


Figure 0.2 Does outsourcing enhance shareholder value? (n=508 CFO's)
Source: Hewitt Associates

Indeed the support for outsourcing is so overwhelming, that very few companies even try to measure the return on investment (ROI) – presumably because the figures are so clear, rather than because they measure very little.

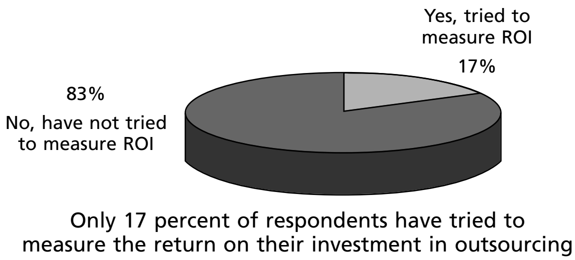


Figure 0.3 Measuring ROI (n=470 CFO's)
Source: Hewitt Associates

Consequently, little wonder so much is being spent on outsourcing. And where there is money being spent, there is money to be made.

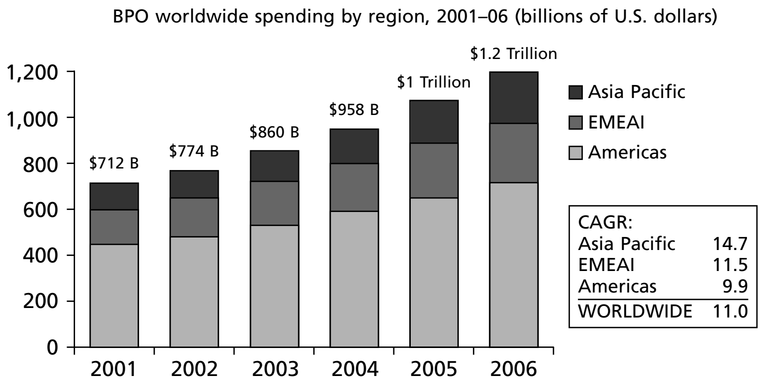


Figure 0.4 Business process outsourcing spending
Source: IDC

The focus of many has been on cost savings. But as we shall see, for successful outsourcing, cost saving is only one goal.

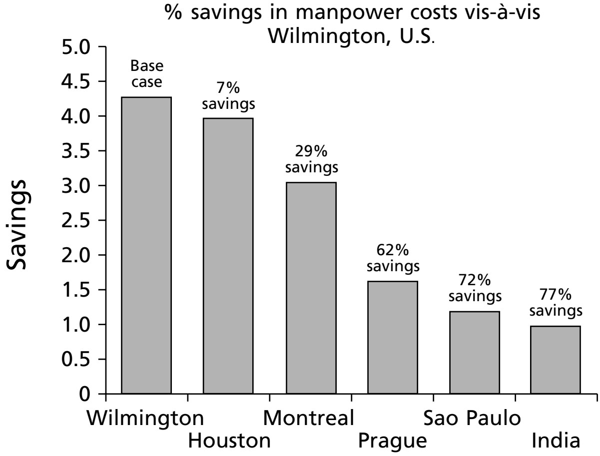


Figure 0.5 Percentage manpower cost savings

To succeed in outsourcing, we need to understand the leading player – India, which we will do in the book. We will explore the experience of outsourcing players with India.

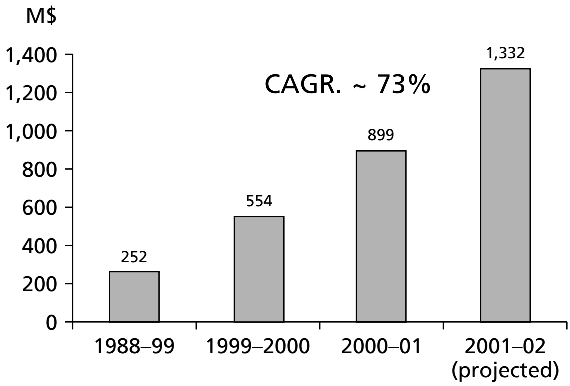


Figure 0.6 India's share of the BPO market in USD mn
Source: Accenture

Of course India is not alone as an outsourcing provider. Other countries provide differing advantages and we do not neglect them either.

IT-enabled services	1998–99		2008–09 (projected)	
	Employed	Cost $million	Employed	Cost $million
Back office operations	9,700	96	260,000	4,360
Remote maintenance support	1,600	15	180,000	3,100
Medical transcription	3,800	32	160,000	2,530
Call centers	1,400	9	100,000	1,380
Database services	1,000	10	100,000	1,500
Content development	5,500	62	300,000	5,747
Total	**23,000**	**224**	**1,100,000**	**18,617**

Figure 0.7 IT-enabled service delivery growth in India
Source: NASSCOM-McKinsey Study: Indian IT Strategy Summit

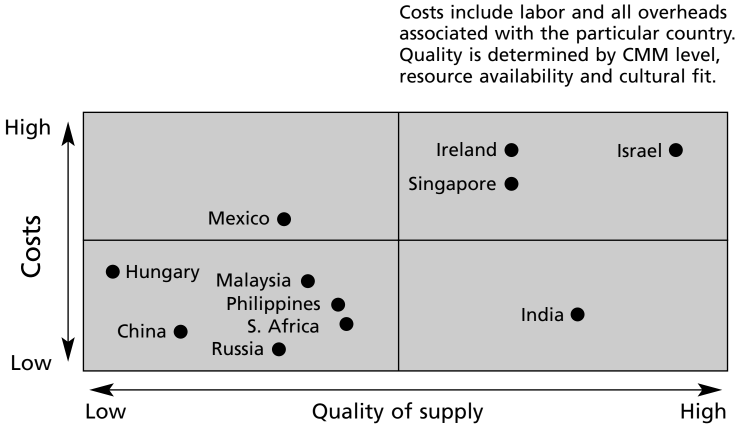


Figure 0.8 Quality and cost
Source: McKinsey

The final chapter of the book examines the bigger picture and the political arguments. How does outsourcing drive economic growth?

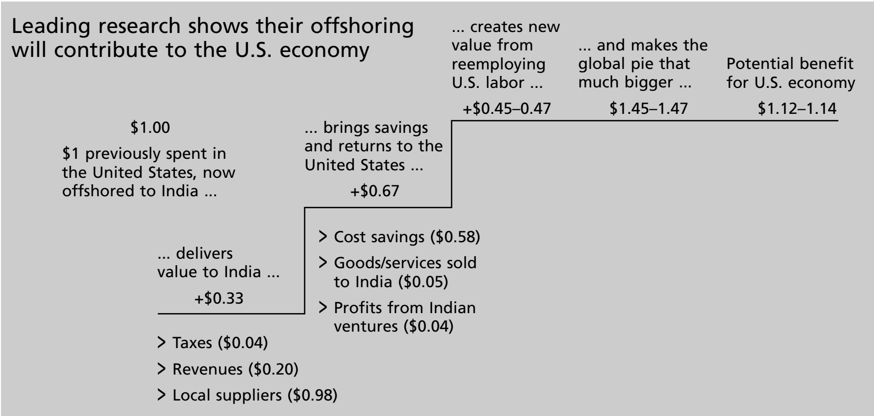


Figure 0.9 Offshoring value added to the U.S.
Source: McKinsey

But part of the bigger picture is also what can be outsourced too. Whilst we cannot examine every single industry in detail, Figure 0.10 highlights some of the issues we will examine to assist any CEO, CFO, and COO.

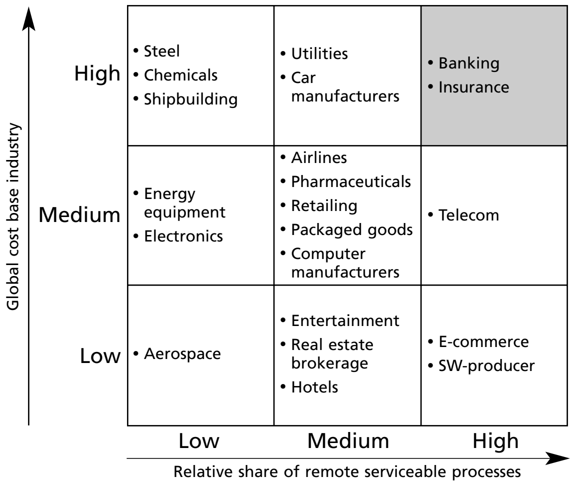


Figure 0.10 Banking and insurance are the key target industry segments for offshore

CHAPTER 1

What business process outsourcing means

Definition of BPO

According to Gartner Dataquest: "Business process outsourcing can be defined as the delegation of one or more IT intensive business processes to an external provider, who in turn administrates and manages selected processes based upon defined and measurable performance metrics."

BPO can also be defined as the contractual service of transferring one or more business processes to a third-party provider, where the latter takes over the management, ongoing support and infrastructure of the entire applications or processes. When these processes are executed by vendors in a different country, it is known as offshore outsourcing or offshoring. Figure 1.1 provides an overview of BPO.

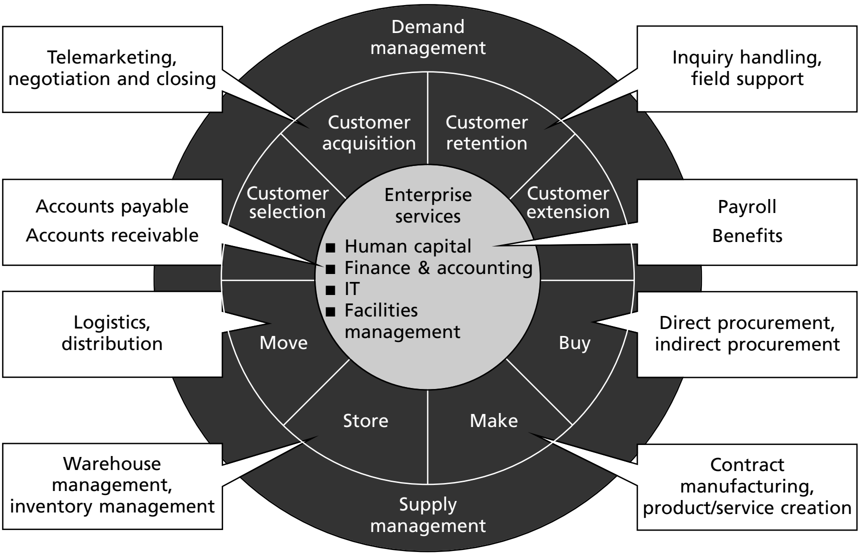


Figure 1.1 A BPO overview
Source: Gartner

What's the outsourcing imperative and does it work?

Accenture and the Economist Intelligence Unit conducted a wide-ranging survey of global corporate leaders ranging in industries and geographies. They reveal the outsourcing drivers and obstacles. The dark bars represent all industries and the light bars consumer and manufacturing industries.

In your view, what are the primary benefits of finance outsourcing?
Choose the top three benefits.

Lowering costs and maximizing efficiencies	66%	64%
Enabling sharper focus on core competences	55%	54%
Increasing business productivity of CFO and other finance staff	32%	28%
Accessing best-of-breed talent and technology	32%	51%
Improving quality of service	26%	26%
Delivering greater transparency and openness in the eyes of the market	25%	26%
Improving quality of finance-related data and analysis	24%	23%
Handing off development and compliance risks	15%	13%
Enhancing disaster recovery and continuity planning	13%	11%
Catalyzing wider organizational change	12%	11%
Other	3%	2%

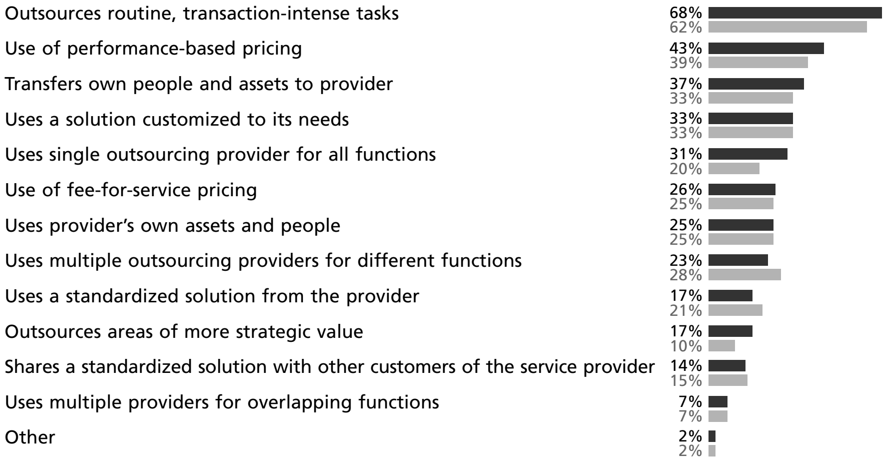
What are the critical success factors in finance outsourcing, in your view?
Choose the top three factors.

Mutual trust between outsourcer and outsourcing provider	71%	72%
Concise service level definitions and agreements	53%	56%
Hands-on support for the outsourcing project from the CFO and other senior management	52%	51%
Integrated technology platforms	47%	41%
Good pre-existing in-house processes and systems	37%	38%
Verifiable track record of outsourcer competence	33%	31%
Other	3%	3%

If you were making a choice between different finance outsourcing providers, which of the following factors would be most important to you?
Please choose the top three factors.

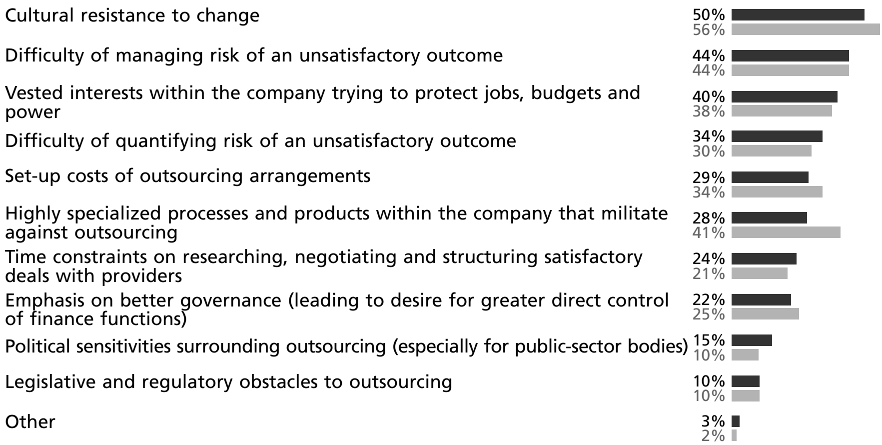
Functional expertise	62%	56%
Cost	61%	64%
Reputation	55%	56%
Industry expertise	46%	52%
Flexibility on rollout of the service (i.e., ability to run small pilot projects first)	33%	25%
Performance-based pricing	29%	33%
Location	9%	20%
Other	2%	2%

Which of the following typical attributes of a finance outsourcing arrangement would be – or have been – most sucessful for your own organization? Please choose as many as apply.



Barriers

In your own organization, what are the primary barriers that stand – or have stood – in the way of a decision to outsource finance and accounting functions? Choose the top three.



Outsourcing: an economic imperative

Roughly 68 years ago, a 21-year-old professor by the name of Ronald H. Coase gave a lecture to students of the School of Economics and Commerce in Dundee, Scotland. He explained why businesses exist as they do — why, for instance, they choose to produce some goods themselves and contract with outside companies to provide the rest.

Five years later, in 1937, Coase turned the lecture into a paper, "The Nature of the Firm," addressing what was then a gap in the economic theory. The gap was between the assumptions of the two theories – the one assuming that resources are allocated by means of price mechanism and the other theory assuming that this allocation is dependent upon the entrepreneur. Fifty-four years later, the Royal Swedish Academy cited the same work in awarding Coase the 1991 Alfred Nobel Memorial Prize in Economic Sciences.

At the core of Coase's theory is this notion: When a company tries to determine whether to farm out or produce goods or services on its own, market prices are not the sole factor. Rather, there are significant "transaction costs," in Coase's language, generated by the search for the right company to strike a supply agreement with, and the time and expense of cutting the deal. Those costs, he theorized, frequently determine whether or not a company will seek an outside supplier or service provider.

In his own words:

> The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of "organizing" production through the price mechanism is that of discovering what the relevant prices are. This cost may be reduced but it will not be eliminated by the emergence of specialists who will sell this information. The costs of negotiating and concluding a separate contract for each exchange transaction, which takes place on a market, must also be taken into account. Again, in certain markets, for example produce exchanges, a technique is devised for minimizing these contract costs; but they are not eliminated.

At the time Coase wrote his theory, transaction costs were prohibitively high. Information flowed at a glacial pace, supplies moved only slightly faster, and companies strove to manage the entire chain of production within the walls of their own corporations.

Six decades later the information and communication revolution reduced these transaction costs and the costs of using the price mechanism. Ironically, Coase, while discussing the ability of the entrepreneur to organize transactions when the firm is distributed spatially, theorized that inventions like the telephone and telegraph that tend to reduce the cost of organizing spatially will tend to increase the size of the firm. Six decades later, the rules have changed. Even if the technology has reduced the cost of organizing a firm spatially, it has brought about an even steeper fall in transaction costs and therefore it is no longer economical to organize everything in-house.

Figure 1.2 shows the fall in international calling rates in various OECD countries in the last 10 years. The standard peak calling rates in almost all the countries, except the U.S., have fallen by more than 50 percent. In the U.S., too, the discounted international calling rates have fallen by more than 80 percent. On average, international calling rates have fallen by 56 percent in 10 years.

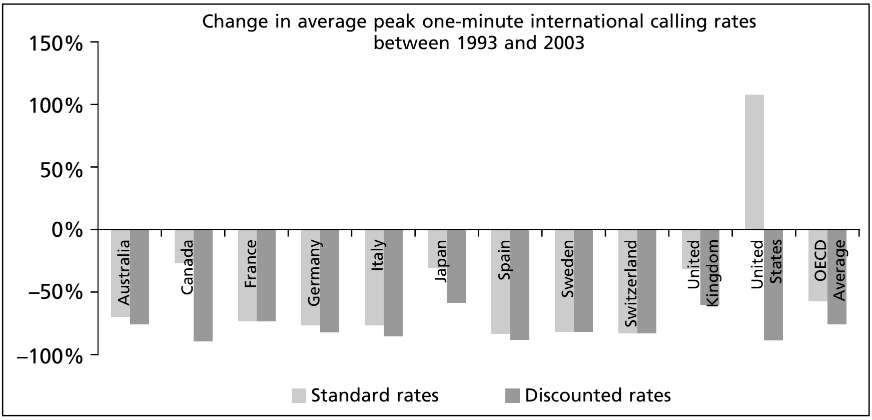


Figure 1.2 Steep fall in international calling rates in last 10 years
Source: OECD

Besides international telephony, the advent of the Internet has served to remove the information asymmetry to a large extent and greatly facilitated the price discovery mechanism. Information now flows at the speed of sound. Enterprises can get complete information about potential suppliers and business partners within a few clicks, and can therefore set up supplier agreements or form alliances with other companies for a fraction of what it would have cost even a decade ago.

As the transaction costs and costs of using the price mechanism started plunging, as suggested by the Nobel laureate, the size of firms will also reduce. To the credit of Coase, the trend has already started in the name of outsourcing/offshoring and is fast acquiring tidal proportions. Two parallel phenomena – increased competition threshold due to globalization and industrialization of service value chain – have bolstered the trend.

The very phenomena of liberalization and globalization that have brought about such a steep fall in international telephony have also exposed companies to competition from hitherto unknown sources. Global market expansion and the growing availability of products and services lead to increased competition, and consumers demanding better products and services.

The world asks for excellence, but it is extremely difficult if not impossible to excel in every aspect. Businesses must make tough decisions regarding the core value and specialization that will drive the entire business strategy. Success requires that everything that is part of the core business must achieve excellence and become a true competitive weapon and differentiator. However, the rest of the organization cannot remain aloof from this increased focus on core as it is part of the value chain and includes unavoidable functions and processes.

The noncore activities must also be set at competitive parity level to support the delivery of competitive advantage. Therefore the organizations need to transfer their noncore activities to the outside vendors for whom the activity is a core activity. This process of transfer is being supported by the industrialization of service sector value chain.

Technology has created an information assembly line – information now can be standardized, built to order, assembled from components, picked, packed, stored and shipped, all using processes resembling manufacturing's assembly line. Thus the noncore functions can be disassembled from the value chain of the enterprise, performed by an outside entity, which delivers quality better than can reasonably be expected from the internal organization, and then reassembled in the organization's value chain, much like the process in manufacturing.

Business process outsourcing has become an economic imperative and we reckon, despite protests, the trend will persist and gather more mass. It's a big opportunity for the firms to revalue their entire value chain and assess what are their core functions. The organization must excel in its core functions and keep them under tight control. In the rest of the functions, outsourcing provides an opportunity to achieve a competitive parity level and reduce the cost.

Despite such benefits, there is great confusion amongst the senior executives about the outsourcing phenomenon. This books seeks to remove the confusion and provide clarity.

The BPO route map

Over the last few years, the level of activity and concomitant media attention have brought outsourcing, or offshoring, into sharp focus. However, outsourcing is not a new phenomenon. As a business practice, outsourcing has been in vogue for more than two decades now. In the 1970's and 80's, manufacturing witnessed this trend as the search for cost efficiencies and the opening up of global markets spurred the transfer of the manufacturing of goods, such as products, components or textiles, to low-wage countries such as Mexico, China and other Asian countries. This phase of outsourcing primarily consisted of products or components.

Over time, this shift has been observed in the areas of services and processes. Quantum improvements in technology and the need to specialize in core business areas contributed to firms considering outsourcing their noncore activities such as IT functions and back office processes. North American and European firms initiated a move toward outsourcing to domestic third party vendors in the 1980's. Over time, this has expanded in scope to move to offshore locations as the capabilities of vendors abroad and associated cost efficiencies improved. IT outsourcing led the way in this phase as the development of application software, maintenance and also activities such as systems integration began to be delivered using the offshore model. This wave has then been seen in the area of back office processes. Functions such as customer care, help desks, and so on, moved to low-cost locations, Ireland, India and Philippines being the main beneficiaries of this. In parallel, a big thrust toward other business processes such as accounting, payroll and other noncore support processes began to move offshore. Companies such as Citibank, American Express and General Electric led this trend in the mid to late 1990's. In particular, GE's outsourcing initiative in India was recognized for its contribution by Jack Welch and served as a case study for several other global majors to seriously consider the merits of an outsourcing strategy.

Across these different phases of outsourcing, a common theme has been the steady increase in the complexity of activities and the degree of value added by the outsourcing player. In IT outsourcing, the progression was from activities such as pure maintenance and testing to complex activities such as systems development and product development. Similarly, business process outsourcing is seeing a ramp up in the nature of activities being outsourced. Pure data/transaction-oriented tasks have now migrated into decision making and more complex processes.

A parallel trend that has been emerging is that of companies outsourcing several of their core business processes too. Prominent examples of this trend are companies like Cisco and Texas Instruments, which outsource high-end engineering design and product development to their centers in India. GE has set up a technology center in Bangalore, India which houses over 1,400 scientists and engineers engaged in pioneering product research ranging from polymers to avionics.

In short, BPO, as a concept, has been evolving and maturing at a rapid pace, particularly over the last decade. The boundaries of the "possible" and "infeasible" are becoming blurred with every new path-breaking outsourcing initiative. Before examining the drivers toward BPO, the competitive space and issues related to outsourcing strategy, a broad outline of the contours of this space is necessary to appreciate the developments in this area.

Scope of outsourcing

Functions that are outsourced can be divided into horizontal services and vertical services:

- **Horizontal services:** These cover a wide range of services like HR, finance and accounting, and customer relationship management (CRM), which are common to all industries. Outsourcing is more common in these processes as they are typically back office processes and do not offer any competitive advantages to the outsourcer. Figure 1.3 shows the areas covered.
- **Vertical focused services:** These services are specific to certain industries, for example claims processing is specific to insurance. Industries which have taken the lead in outsourcing and hence dominate vertical focused services include financial services, insurance, healthcare, securities, and airlines.

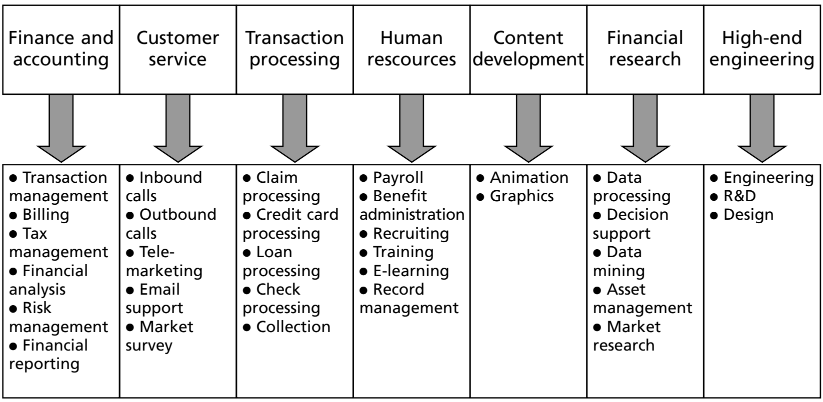


Figure 1.3 Scope of outsourcing activities
Source: Aranca

Horizontal services

- *Finance and accounting:* Typical activities in this area would include management of accounts payable/receivable, bank reconciliation, fixed asset management, cash management, financial reporting and risk management. The finance and accounting outsourcing market is worth $15 billion and is expected to register a growth rate of 13 percent annually.

- *Customer service:* This involves providing support for marketing, technical help, advice or disbursing information. Contact centers are generally equipped with high-tech telecom infrastructure, trained consultants, access to required databases, Internet and other online information resources. These centers provide customer service on a continuous basis, often 24 hours a day, 7 days a week. In many cases, the vendor deals directly with the client's customer, calling for a greater level of maturity of vendors and their personnel.

- *Transaction processing:* This includes the processing of sales order entry, claims, loans, checks, applications, credit cards and reconciliation.

- *Human resources:* This encompasses activities relating to payroll, benefits administration, training, recruitment, expense management, travel and employee records management. The vendor is also in charge of complying with state and federal laws.

  Payroll services encompass looking after payroll statements, bonuses, commissions, tax payments and so on. Employee records management includes personnel forms, policies, procedures and performance management records. Globally, HR is one of the most widely outsourced business processes.

- *Content development:* This includes animation, design services, multimedia CD and DVD authoring, web development services, development and maintenance of e-learning technologies, such as learning management systems (LMS's), content management systems (CMS's) and authoring platforms, and so on.

- *Financial research:* This is a new area in the field of outsourcing and includes activities such as data maintenance, basic financial analysis, research, financial modeling and so on. This enables senior analysts at the home location to focus on client interactions and other value-added activities. Examples of companies that have embraced this include JP Morgan, Citigroup and Morgan Stanley which have set up operations in India for this purpose.

- *High-end engineering:* This includes activities such as design, research and development and high-end engineering. These are, in most cases, core to the company's business and require personnel with high skill levels. The majority of these functions is typically outsourced/offshored to captive setups. For instance, the GE research and development center in India is home to over 1,400 research scientists and engineers.

Vertical focused services

This refers to outsourcing services that are specific to a certain vertical. Outsourcing is widespread among the following industries:

- *Healthcare:* The healthcare industry is expected to be one of the biggest beneficiaries of outsourcing. Timely execution of processes and reduced costs helps the healthcare providers improve their service levels and contain their rising costs. Some of the processes commonly outsourced in healthcare services are medical billing, claims adjudication, cashless hospitalization services, medical transcription and IT.
- *Financial services:* Financial institutions and banks have been leaders in outsourcing business processes. Customer care and transaction processing are the most commonly outsourced functions. Some of the other functions that are outsourced are tax processing, asset management, HR, loan and mortgage processing. However, this is now shifting to outsourcing core activities like treasury and investment banking activities like research support and so on.
- *Insurance:* Insurance has been a late entrant to the world of outsourcing. Competition, the volatile economic landscape and terrorist attacks have prompted insurance companies to look at outsourcing to improve efficiency and reduce costs. Outsourcing in insurance companies is expected to show a double-digit growth. Insurance companies outsource processes like application processing, underwriting, claims adjudication and customer care.
- *Airlines:* Airlines have been forerunners in the field of outsourcing. Customer care, data services, loyalty programs, revenue accounting, cargo support and revenue recovery processes have been typically outsourced. Companies such as British Airways and SwissAir adopted this strategy since the mid-1990's through their center in India. Recent terrorist attacks and global downturns have had a significant impact on airlines' financials and served to reemphasize the imperative to examine various cost reduction measures to remain competitive. Outsourcing has provided them with an opportunity to reduce costs while maintaining the same standards of quality.

Market size

By region

According to IDC (International Data Corporation), world spending on

BPO totaled $687.2 billion in 2003, a growth of 6.5 percent over 2002 (Table 1.1). IDC expects the spending on outsourcing to increase to $922.8 billion, a growth rate of 7.7 percent. America's share is likely to see a marginal decline from 63 percent in 2003 to 61 percent in 2008. Asia-Pacific is the fastest growing segment, with its share increasing from 13 percent in 2003 to 16.3 percent in 2008.

TABLE 1.1 Worldwide business outsourcing services spending by region, 2002–08

USD bn	2002	2003	2004 E	2005 E	2006 E	2007 E	2008 E
Americas	407.8	433	462.8	502.6	532.1	569.9	609.0
EMEA	156.6	165	173.9	184.6	198.0	209.2	224.6
Asia-Pacific	81.1	89.3	98.9	111.2	126.0	143.7	163.5
Worldwide	645.5	687.2	735.6	798.5	856.1	922.8	997.2

Source: IDC

By function

Among the business functions that are normally outsourced, logistics is the largest segment, accounting for 42 percent of total spend on outsourcing followed by sales and marketing, which accounts for 34 percent (Table 1.2). While the share of logistics is expected to remain stagnant at 42 percent, sales and marketing is estimated to go down to 27 percent. Engineering and R&D is likely to grow at the expense of sales and marketing to about 6 percent in 2008 from the current 2 percent.

TABLE 1.2 Worldwide BPO spending by business functions 2002–08

USD bn	2002	2003	2004 E	2005 E	2006 E	2007 E	2008 E
Human resources	7.9	9.0	10.7	13.2	15.9	19.0	22.5
Procurement	1.1	1.3	1.7	2.2	3.0	4.1	5.8
Finance and accounting	12.9	13.9	15.1	16.5	18.2	20.3	22.8
Customer care	37.5	40.3	44.9	50.5	57.3	64.6	72.4
Logistics	155.7	166.7	182.4	201.0	226.1	255.0	288.7
Engineering/R&D	6.2	7.7	12.5	19.6	24.8	30.8	37.8
Sales and marketing	126.3	136.6	147.2	158.1	168.7	176.1	183.4
Facility and ops mgmt	26.4	27.5	29.6	31.5	33.5	35.8	38.4
Training	0.8	2.0	3.6	5.3	7.3	9.0	10.7
Total BPO	374.8	405.0	447.6	497.8	554.8	614.9	682.5
Processing services	270.5	282.1	288.0	300.7	301.3	308.0	314.7
Total BPO + processing	645.2	687.1	735.5	798.5	856.1	922.9	997.2

Source: IDC

IDC anticipates BPO and processing services to grow at 8 percent. Training is expected to be the fastest growing segment, with a growth rate of 40 percent. Spending on training is likely to rise to $9 billion from the current $0.8 billion. Engineering comes a close second with a compound annual growth rate (CAGR) of 37 percent followed by procurement growing at 35 percent.

Human resource outsourcing is likely to witness a growth of 20 percent. IDC foresees the trend to shift toward comprehensive outsourcing deals, covering the entire gamut of services in HR. Offshoring of HR services is expected to become more pronounced. In a similar fashion, the customer care segment is also expected to move toward integrated contracts, covering the entire spectrum of services. Even in the case of facilities and operations management outsourcing, IDC predicts a move toward comprehensive outsourcing contracts. The various drivers and inhibitors to outsourcing are shown in Figure 1.4.

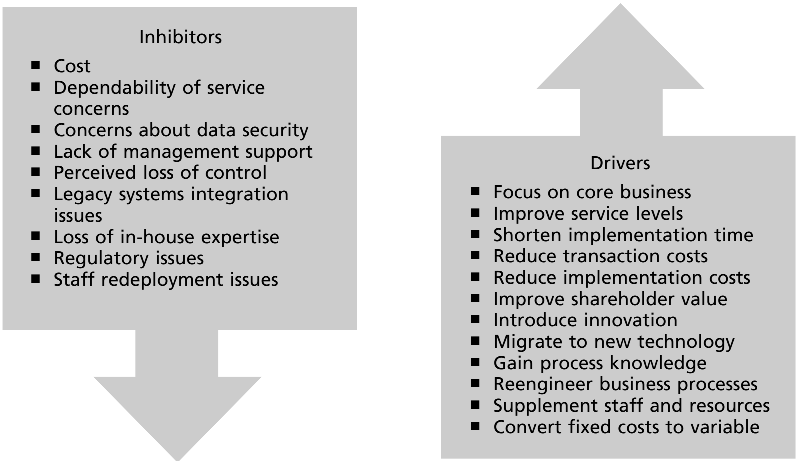


Figure 1.4 Drivers and inhibitors
Source: Gartner

The growth of different segments is driven by diverse factors. Logistics outsourcing is driven more by strategic considerations than cost, given the increasing adoption of integrated offerings and full service providers. Strategic considerations and the need for access to efficient, skilled talent are pushing companies to outsource even key activities such as engineering and R&D.

These drivers are examined in more detail in the following sections.

Drivers of BPO

Outsourcing is driven by a number of factors like costs, focusing on core areas, improved service levels, and process innovation. Of all these, cost considerations and the need to focus on core activities seem to be the prominent drivers (Figure 1.5).

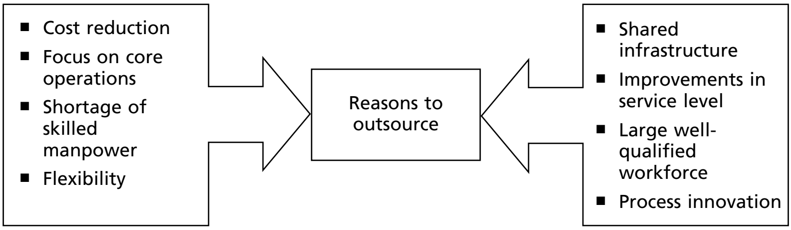


Figure 1.5 Reasons to outsource
Source: Aranca

Cost reduction

Cost savings are realized due to economies of scale, continuous improvements in processes and low wage rates in developing countries. Offshoring presents a great opportunity to reduce costs. Labor forms an important part of the cost structure as these processes are predominantly labor-intensive.

In a competitive market, companies have to look at reducing their costs in order to stay competitive. Incidence of fixed cost for owning the process lies with the company. For example, if a company owns a call center, it has to incur fixed costs for setting it up plus the essential costs of running it. Then in the case of a downturn in the economy, most of these resources remain underutilized. This scenario can be avoided if companies outsource call center operations, converting the fixed costs into variable costs. The vendors will be responsible for the capital costs involved in setting up the center while the outsourcers will be charged only if they use the service. This will enable the company to manage its resources effectively as a scarce resource like capital is freed for other purposes. While outsourcing within a country can lower costs, shifting processes to an offshore location reduces costs substantially. For example, moving the process to a low-cost location like India would result in typical cost savings of 40–50 percent.

Apart from opting for a third party provider, companies also have the option of setting up a subsidiary in a low-cost offshore location. This might result in more savings as a company saves on vendor's margins. However, this would still be a fixed cost for the company, as it would own the entire operation. Hence, these prove economically beneficial when the scale of outsourcing envisaged is substantial.

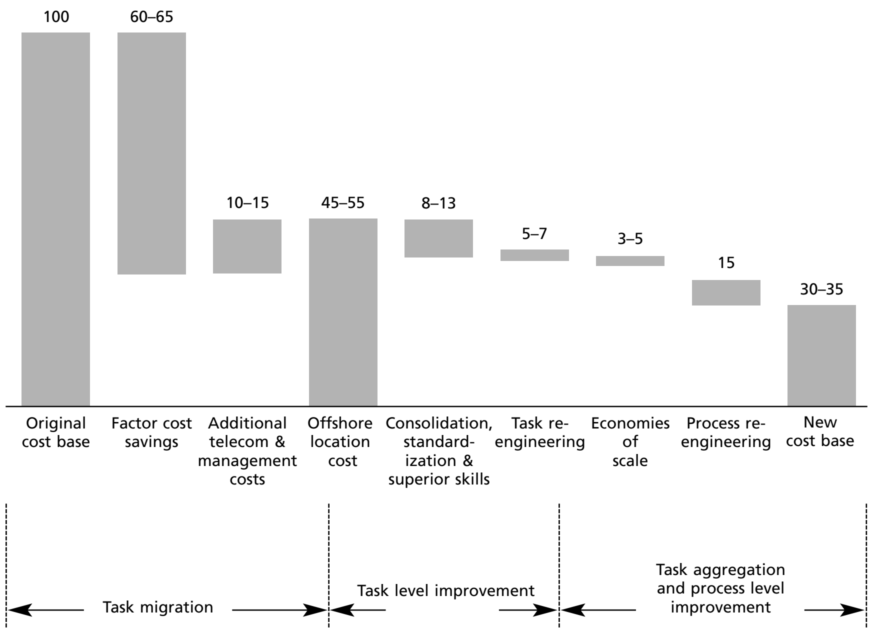


Figure 1.6 Cost savings from BPO
Source: McKinsey

Given that most outsourced processes are largely standardized, savings are directly proportional to the scale of work offshored (Figure 1.6). For example Citibank saves around $75 million annually by outsourcing its back office operations to India, while GE estimates that its annual savings from offshoring will touch $1 billion by 2005.

Focus on core operations

Offshore outsourcing is strongly influenced by the need to focus on core activities. Outsourcing processes frees up management time and capital and enables the best utilization of the two. Once the core processes are identified, the company should target to outsource peripheral/support business processes. Outsourcing these business processes will help management to concentrate on core activities, thus enabling the company to strengthen its position in the market.

The benefits of outsourcing are also manifested in peripheral processes, as noncore to the company is core to the outsourcing provider. Hence, noncore processes will receive greater attention from the provider than they would have received from the company's management. Most vendors try to meet quality standards like six sigma and the Capability Maturity Model (CMM) from the Software Engineering Institute, resulting in dramatic improvements in quality. As the errors and rework are reduced, the cost of running a process falls. Hence, outsourcing benefits both the vendor and outsourcer.

Shared infrastructure

An individual company usually has a limited ability to increase the utilization of infrastructure assets (facilities, networking, computer equipment, support staff, and management) beyond its own purposes. Outsourcing enables multiple companies to split the infrastructure costs with other companies, thereby lowering their cost. Another dimension of offshore BPO is that back office and call center work can be performed from the same workstations at alternate times, taking advantage of time zone differences.

Improvements in service level

Noncore for the outsourcer is core for the vendor. The vendor focuses on reengineering and running the processes efficiently. Since it is a core activity for the vendor, he would strive to bring about improvements in the outsourced process and deliver superior quality standards. There are a number of examples to illustrate this benefit. For example, Amex experienced higher first call resolutions and less error work in its captive unit in India. Similarly, Dell witnessed nearly 40 percent improvement in its outsourced technical help desk performance in terms of the first call resolution. Other companies which have outsourced data processing have seen steep improvements in the accuracy of data recording, often even up to 80–90 percent reduction in errors.

Access to large talent pool

Countries like the U.S. experience a shortage of professionals, which results in companies paying a premium for their services. They also have to pay for retaining that talent. The costs for recruiting and retraining fresh staff are also higher, in case an employee decides to quit for a better paid job.

However, countries like India, where the labor pool is large and diverse, can provide an abundant supply of professionals. Shifting processes to these countries will enable companies to access a large talent pool at a fraction of the cost in their own country. Also the jobs, which are considered low-end in developed countries, are rated very high in the developing world. Hence the outsourcer would have access to a large pool of qualified personnel in these countries.

Process and product innovation

If the process is a noncore activity for the company, maintaining best systems and practice for executing the process takes a back seat. However, if the process is outsourced, the vendor not only tries to incorporate the best available systems but also aims at doing the process in the most efficient way. The company's experience in dealing with the process is limited to its own process while the vendor has been executing the process for various companies. Hence, the vendor has a large experience base enabling him to leverage his learning and employ best practices to eliminate, simplify, and rationalize steps and costs in the business process to the benefit of the clients.

Additionally, BPO firms are usually motivated to improve the process to increase their efficiencies in order to reduce the costs because they are paid for completed work at contracted service levels.

Leveraging multiple time zone

If the functions are offshored to India, outsourcers can leverage different time zones. The difference in time zones enables faster development cycles. Some part of the process can be executed in the U.S. in the daytime and then transferred to India. This will enable the company to work 24/7. The vendor can utilize the workplace for call center activity during the night and processing or nonvoice work during the day. This enables the better utilization of resources and reduces costs per activity.

Changing customer needs

Outsourcing provides management with flexible and scalable services to meet their customers' changing requirements. Alternatively, the company would have to invest in regularly upgrading its systems and manpower skills to keep in line with customers' requirements. Outsourcing transfers the onus of investing in upgrading infrastructures and employee skills to the vendor.

Improving the bottom line

According to McKinsey, offshoring can result in a saving of 40–50 percent on costs, which has the potential to increase to 60–70 percent through reengineering and task-level improvements like training and so on. The study also states that offshoring and reengineering a contact center service process will have a positive impact of 40–50 percent on the bottom line. This analysis is further strengthened by some of the success stories.

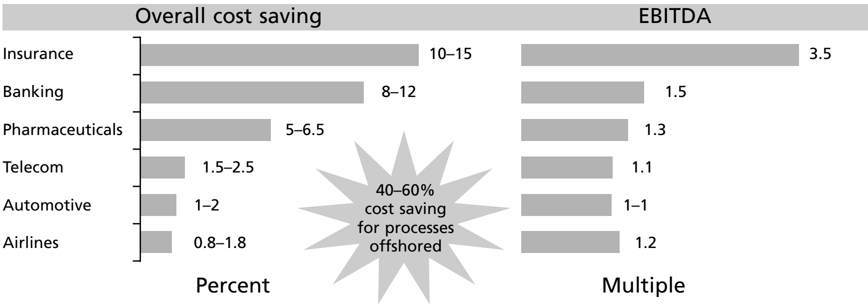


Figure 1.7 Costs and profits
Source: McKinsey-NASSCOM Report on ITES 2002

Amex set up its captive center in India in 1994. The bank experienced increased first call resolutions of customers' problems, and fewer errors mainly due to the quality of the workforce. Amex estimates that 79 percent of its employees are graduates, 12 percent are chartered accountants, 5 percent engineers and 3 percent hold MBA's. The captive center also resulted in a cost reduction of 40–50 percent. This was mainly due to low labor costs in India. To illustrate the wage differentials, a chartered accountant in India earns $7,000 per year as against $40,000 per year earned by a certified public accountant (CPA) in the U.S. GE, a pioneer along with Amex, began offshoring low-end work to India and now exports high-end jobs like engineering design and so on to its India center. Offshoring to India gives GE a cost saving of 25 percent in the case of low-end jobs and 60 percent in high-end jobs. Outsourcing call center operations to Daksh gave Amazon a cost saving of 60 percent, while Prudential could save 30–40 percent. Prudential outsources call center activity to ICICI OneSource. Citibank experienced a cost reduction of 30 percent by offshoring its IT services. Most of these announcements are driven by factors like cost savings, improved service levels, focusing on core operations, access to a large talent pool and so on.

Despite the huge benefits of outsourcing, there are inhibitors for outsourcing. We describe few of them here.

Inhibitors

Services quality

The offshore BPO industry is not as mature as IT services. This may affect the service quality in some cases. The company should bear in mind the maturity of vendors before outsourcing. It would be better to set up captive operations if the vendors lack expertise in executing the process to be outsourced. The outsourcer should take into account the implications for his business of the vendor's failure to perform.

Data security

The most obvious risks revolve around the access, storage and transfer of data. Compliance with regulations and U.S. privacy laws – such as Gramm-Leach-Bliley, which requires financial services companies to protect the privacy of customer data and prohibits them from sharing it with other entities without permission – are driving firms' efforts to secure their data.

Countries like India do not have robust data security laws. This may be a matter of concern to outsourcing companies, as the vendor may have access to some sensitive information. To mitigate this problem, outsourcers tend to prefer top BPO vendors, like Infosys, Wipro and so on.

Staff redeployment issue

Offshoring has been the eye of a storm for causing job losses in America. Although the job losses are more due to economic downturn than offshoring, offshoring has contributed its share to American workers' woes.

Due to this, many states in the U.S. have taken steps to counter offshore outsourcing. The social cost of outsourcing is too large for any company to ignore. The fallout from outsourcing is a loss of goodwill and the low morale of existing staff. The company might be able to mitigate the problem to some extent by investing in staff retraining and redeployment where possible.

Geopolitical risks

Before venturing offshore, the company should examine border unrest, the religious fabric of the country, government policies, terrorism and so on. With terrorist activity on the rise, the company should assess such risks before entering into an agreement with the vendor.

Although a company's assets are not at risk in such an eventuality, it would definitely suffer if there were to be a disruption in the supply of services by the vendor. Similarly, acts of disruption will have a bearing on the outsourcer's business. If the country is not too friendly toward the private sector and more tilted toward Communism, this will affect the companies transacting with BPO players in that country.

Cultural differences

Cultural differences need to be effectively managed, for example through exchange programs and by training the initial workforce at domestic facilities. However, some companies may prefer outsourcing to locations with a cultural proximity to their home country.

Many companies based in Western Europe have their call centers located in Eastern European countries, as these offer cultural proximity and lower costs. Similarly, the cultural proximity of the Philippines to the U.S. acts as a stimulator for companies to locate call centers there.

Regulatory issues concerning offshoring

Some states in the U.S. have introduced laws banning companies performing state contracts from offshoring their work to low-cost locations or subcontracting the work to overseas companies.

New Jersey was the first to ban outsourcing of state contracts to companies using overseas labor. The bill was inspired after the contractor for Jersey's Families First Program moved its operations to Bombay (Mumbai), India as a cost-cutting measure. The contractor, eFunds, moved the jobs from Winconsin to Bombay. However, the jobs were moved back to a New Jersey call center after the state agreed to renegotiate the deal. The renegotiated amount cost more than 20 percent of the original contract deal. The Bill intends to ensure that state funds are used to employ people residing in the United States and prevent the loss of jobs to foreign countries. Some of the states banning offshore outsourcing are New Jersey, California, Tennessee, Indiana, Michigan and North Carolina.

Although this legislation does not seem to have a large impact on India, what the Indian companies need to be concerned about is the level of data protection and privacy laws prevailing in the country. Some of the impending bills require stringent data protection and privacy conditions to be considered before offshoring processes.

The fact that India does not have data protection laws in place makes matters worse for Indian vendors. However, sensing the importance of privacy laws, some states like Karnataka have taken some measures to mitigate these issues.

The chapters ahead

Business process outsourcing has evolved substantially over the last decade, constantly expanding in its scope of services and regions covered as well as nature of service providers. Business models and the drivers for outsourcing have also modified themselves to suit the needs of the prevailing business climate. This book attempts to clarify the gamut of issues surrounding this topic and assist in shaping the thinking of a company that's considering outsourcing as a business strategy.

Chapter 2 examines the competitive landscape. A number of different types of players have emerged on the scene, with distinctly different backgrounds, approaches and customer focus. An understanding of this landscape is critical prior to a detailed evaluation of a suitable outsourcing strategy.

Chapter 3 discusses the fundamental issue of how a company should prepare a sourcing strategy in order to succeed in the connected economy. Chapter 4 throws light on the blurred lines between the sourcing strategy and the business strategy. We specifically examine in detail the process that a company should adopt before zeroing in on the strategy that best fits its overall business strategy and goals. We also look at the risks involved in outsourcing and their impact on the choice of outsourcing strategy, as well as the best ways of mitigating these risks.

Chapter 5 looks at the mechanics of choosing outsourcing partners and the issues to be considered.

Chapter 6 examines an underlying theme across the entire issue of outsourcing – the business value that it contributes, both directly and indirectly. While a few years ago, outsourcing may have been a decision taken at a small scale by a unit/function head, the growing recognition of its strategic importance has catapulted it as an issue discussed in boardrooms and by CEO's and CFO's. Particularly, CFO's have to examine the value perspective of outsourcing and the linkage between this perspective and the operational perspective taken by the respective process owners. We comment on the key issues surrounding this.

Chapter 7 examines the domain of financial research and the unique set of factors that have led to the emergence of independent research, particularly in the United States.

Chapter 8 explores the political risks and trends; something no senior executive can ignore.

Finally, Chapter 9 looks to the future and examines the outlook and trends that are shaping the future of this industry.

CASE STUDIES

Delta Airlines

Outsourcing is not an alien concept for the airline industry where, traditionally, functions like cargo handling, cabin cleaning and engine maintenance have been outsourced. Delta Airlines was making losses in 2001 and was under pressure to cut costs. During the same period, the airline industry was going through a bad phase due to economic downturns, and September 11 only added to the industry's problems.

All this forced the company to look at alternative ways of reducing costs. Delta decided to offshore some of its customer service operations like reservations, loyalty programs and so on.

In 2002, Delta had 20 reservation contact centers around the world employing 6,000 people and handling 120 million customers. The airline chose to move some processes from these centers to India and the Philippines. The two vendors selected were Philippines-based Sykes Enterprise and India's Wipro Spectramind. The two vendors were to be entrusted with the responsibility of general sales calls, loyalty programs, queue handling and incoming baggage service calls.

However, the company decided not to proceed with the Philippines facility, citing the political environment in that country. So all the processes were to be handled in India. Delta Airlines expects to realize a saving of $26 million annually from this arrangement. Within the first two months of offshoring, the airline saw improved service levels in terms of call handling time. The average call handling time dropped to 454 seconds from the earlier 639 seconds, besides reporting an improvement in the quality of call handling.

Companies going offshore benefit from the low wages prevailing in that country. The fully loaded cost for an employee in the U.S. is $46,000, as compared to $6,000 in India and $7,300 in the Philippines. The costs of employee acquisitions, retention and training are also very low. This is due to the educated workforce employed in call centers. Such jobs in India or other low-cost locations are viewed as prestigious jobs which is not the case in America.

Source: E-Business Strategies Inc.

Lloyds TSB

In October 2003, Lloyds TSB announced its decision to move 1,000 call center jobs to India. This decision came close on the heels of HSBC's plans to move 4,000 jobs to India and Barclays' plan to move 1,000 jobs to India. Lloyds' move to offshore outsourcing was accelerated to keep pace with the competition.

This decision would affect close to 1,000 employees working in Lloyds' Newcastle call center. The company would initially employ 250 people and later increase the strength to 1,500 by the end of 2004. The call center was set up in Mumbai in May 2004.

Lloyds has already started to pilot a processing facility in Bangalore. The facility engages in credit card processing and employs 250 people. Depending on the success of the pilot operation, Lloyds plans to move 1,500 jobs relating to call center and processing to India. A processing center at Hyderabad is also on the cards. The bank has not disclosed the resultant cost savings of going offshore.

The BPO competitive landscape

Currently the BPO market has many segments and the competitive landscape is evolving fast. The market is dynamic and characterized by consolidations, new entries and exits. But before we consider the latest trends observed in the BPO market, let us first define the various segments.

Various segments of the BPO market

A number of organizations have employed different approaches to define various segments of the BPO market. By and large, these approaches have used two distinct parameters for the classification of the BPO market. These are the identity of the players and the nature of the activities performed by the players.

Classification by the identity of the players

Of the various organizations that use this approach to divide the BPO market, Gartner is the prominent name. According to the IT research and consulting firm, there are seven types of players in the BPO market.

IT outsourcers
A large number of BPO service providers come from an IT outsourcing background. These players have rich experience in the outsourcing of IT skills, services and solutions. Therefore, their entry into the BPO market is a natural extension to their existing service portfolio. Although most of these players handle various processes, they prefer to concentrate on one or two specific vertical industries. Examples of this category include Affiliated Computer Services (ACS), Unisys, EDS, IBM, and so on.

> With the acquisition of Unibase in 1996, ACS was one of the earliest IT outsourcer entrants in the BPO arena. Unisys entered into the BPO space in early 2000 and IBM acquired PwC's BPO division in 2002 to get a foothold in the lucrative market. EDS was a late entrant in this market in 2004.

Besides having their centers in high-wage countries, most of these erstwhile IT outsourcers are fast establishing their offshore centers in low-wage countries. IBM has recently bought Daksh, an Indian BPO firm to strengthen its position. EDS has its facilities at multiple locations in the Asia-Pacific region. In April 2004, Unisys announced its plan to start centers in India.

Consultants

For the players in this category, BPO services are a forward integration to their management consultancy services. The consultant would provide the client with a complete outsourcing strategy and also take up the responsibility of execution. The client doesn't have to search separately for the consultant and the vendor. Thus the relationship has the advantage of reducing one layer in the outsourcing initiative.

Of all the segments of BPO providers, this has seen the most dramatic transformation in the past two years. PricewaterhouseCoopers Consulting (PWCC) has merged with IBM Global Services and the BPO unit of Andersen has been acquired by ACS. In both the cases, a consultant BPO player merged with an IT outsourcer.

Nonetheless, there are quite a few big players left in this space. These are Accenture, Deloitte Touche Tohmatsu, Cap Gemini Ernst & Young, PricewaterhouseCoopers and BearingPoint.

Pure-play BPO vendors

Pure-play BPO providers are companies that generate their entire revenues from BPO services and are typically venture capital-funded initiatives. The examples of this category are Exult and Xchanging.

Xchanging is a classic example of a venture-funded BPO. Since the formation of Xchanging in 1998, General Atlantic Partners, one of the leading private equity investment firms with over USD 5 bn of capital under management, has pumped in more than USD 60 mn in the venture. Today Xchanging employs more than 3,000 people and it provides HR services to over 250,000 client employees and dependants.

In the last few years, many such venture-funded pure-play BPO firms have cropped up; few have made it to the big league. The NASDAQ listed Exult is one of the biggest pure-play outsourcing firms, with over USD 480 mn of revenues.

Process specialists

These vendors are recognized in the marketplace for their expertise in a particular process. While some of these companies heavily exploit IT to serve their customers, others are more asset-based or labor-based. IT plays an important role for enhancing the speed and efficiency of the outsourced processes. The competitive landscape varies depending on the process outsourced.

Examples of process specialists

HR outsourcing and consultancy	*Logistics*	*Customer care*
■ Hewitt Associates	■ Ryder	■ Convergys
■ ADP	■ Excel	■ CyLynx
■ Ceridien	■ APL Logistics	
	■ IWLA	

Industry specialists

These vendors specialize in providing solutions specific to certain industries. These players usually provide outsourcing services for many functions, but specific to one industry.

> CareScience and TriZetto are the firms that provide a broad portfolio of technology products and services for the healthcare industry. Similarly, WNS, a leading Indian BPO player, provides services to the airline industry.

The offshore providers

As the market for IT outsourcing stagnated owing to the slowdown in the global economy, the Indian application outsourcers were forced to investigate alternative opportunities. High growth in the BPO market provided a perfect diversification alternative to them.

> In April 2002, Infosys announced the launch of its BPO initiative, Progeon. Although Infosys holds a majority stake in the venture, it also secured USD 20 mn from Citi Group Investments. Similarly, Wipro, the other IT giant from India, has started Spectramind which has already become India's biggest IT enabled services (ITES) company.

Business service providers (BSP's)

These players have extended the application service provider (ASP) model to infuse a BPO focus. The traditional ASP's, who have provided just application management services, realized that their offerings were not enough for their customers. Many important business needs are going unmet, which may threaten the ability of this business model to survive. Thus the ASP's are attempting to wrap business process outsourcing around their applications.

The need to integrate more functions into the ASP package has given birth to the BSP, a vendor that provides an Internet-enabled standard business process. A BSP takes on the full responsibility for the entire business process, providing more than just the technological solution.

The ASP-BSP model has an edge over pure-play BPO's in certain areas, for example hosting applications such as customer relationship management (CRM), enterprise resource planning (ERP), billing and email.

> Portera is an example of a classic BSP. The Campbell, California, company created a business services application for the service industry (law firms, architecture firms, public relations firms, advertising agencies, and so on) that it hosts in its own data center. If firms want Portera to handle their time keeping, billing and accounting, they can hand over these processes to the firm, too.
>
> NetLedger is a good example in the finance and accounting arena. Peopleease is a standout in the human resources sector. These companies are now providers of business services and not just ASP's. Corio is another company that has enjoyed a metamorphosis. It has gone from managing and delivering other people's software to providing business services, too.

In Figure 2.1, the competitive landscape in the BPO market is shown on two parameters – industry capability and process offering. The pure-play BPO model is most flexible, therefore offering solutions for multiple processes, and has a wide variety of industry capabilities.

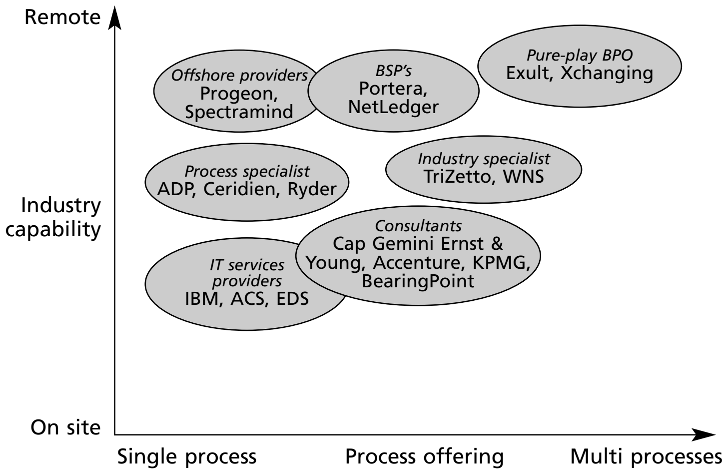


Figure 2.1 Approach 1 – competitive landscape of the BPO market
Source: Schroder Salomon Smith Barney and Aranca

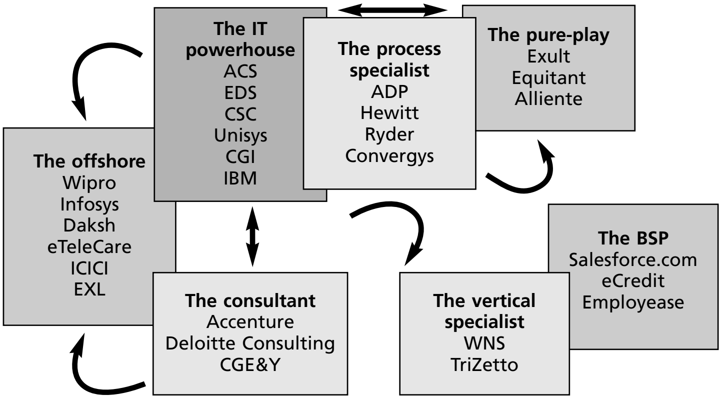


Figure 2.2 Another way to look at the competitive landscape
Source: Gartner

Classification by the nature of the activities performed by the players

According to this approach of classification, there are three types of BPO players.

Organizations providing customer focus support

This category includes BPO's providing front-end, customer-focused services such as database marketing, call centers, web sales and marketing and so on.

> The contact center outsourcer market is very crowded. Initially the services of these players were largely nonindustry-specific but soon many outsourcers started specializing in specific vertical markets for competitive differentiation. Outsourcers also direct their services toward specific customer sets with some firms strongly focused on business-to-business (B2B) services and others toward consumer products.
>
> Some of the prominent customer-focused BPO's are Convergys, Teletech, EDS and West Corporation.

Organizations providing specific support functions

The organizations in this category provide multifunctional services to a particular industry. Nonetheless, only a few BPO's are left that are serving just one industry, most have started providing services to more than two industries. Unisys is a BPO that remained an expert in insurance claims processing for a long time but now it has started offering services to other industries like transportation, media, and so on.

Generally outsourced functions in various industries

Insurance
- Claim processing
- Servicing
- Call center operations

Retail financial/banking services
- Loan processing
- Call center operations

Pharmaceuticals
- R&D

Telecom
- Call center operations
- Billing

Automotive
- Engineering and design
- Accounts payable/receivable

Airlines
- Revenue accounting
- Call center operations
- Frequent flyer programs

Organizations providing generic back-end support

These organizations typically provide back-end, nonindustry-specific process areas such as HR or administrative services.

All the BPO's providing nonindustry-specific back-end support services are part of this category. Examples are Arinso and Hewitt Associates in HR outsourcing and Spherion in administrative services.

How the BPO market is evolving

High growth in the BPO market is attracting many new entrants. Few of these players have the skills and strength to compete alone but others are building strategic partnerships to find a foothold in the market. The following trends were observed in the BPO competitive landscape in the past few years:

- *Consolidation:* Several providers merged with each other or acquired part or all of the other BPO providers to enhance their service offerings.
- *Entrance into new vertical markets by vertical specialists:* Several vertical specialists have ventured into industries outside their traditional domain. Companies that were focused on financial services industries are offering cross-industry services or expanding their focus to include new vertical industries.

- *Entrance of offshore providers:* Several new providers had entered the offshore BPO market as early as 2000, but most of them accelerated their BPO initiatives in 2002. Most offerings are out-tasking and operational-focused, rather than full end-to-end BPO.

- *Emergence of BSP offerings:* As the ASP model began to decline, providers tried to stay in the game by adding business services to their existing ASP platforms (such as process inquiry, call centers, transaction processing capabilities or even full process management). At the same time some BPO providers started investing in platforms and technologies (web services, business process management software and workflow) to standardize their BPO services and offer them in a one-to-many delivery model. This model is still emerging, but the first signs of its success can be seen in some narrowly defined, easily automated process offerings (credit ratings, benefits enrollment, travel and expenses, and so on).

We reckon that the BPO competitive landscape will change significantly in the near future. While on the one hand, consolidation and strategic partnership activities will increase considerably, on the other hand, many new players will enter the market. But not all these players will survive in the long term. BPO vendors will have to follow certain strategies in order to sustain success in the long term. Schroder Salomon Smith Barney, a leading research house, has identified three long-term strategies in order to be a winner in the BPO market:

- *End-to-end outsourcing solution providers:* The companies following this strategy must be able to offer a full range of services from consulting, through change management to processing services. Such players might develop most of the constituent services in-house, but they may also make strategic partnerships for some processes. However, they must provide their clients with one point of contact. Such outsourcing contracts are likely to be decided at a senior level within an organization (either private or public body). Hence, it is important that the BPO vendor has selling skills at a senior level within its own organization.

- *Support service area or process specialists:* BPO vendors may choose to specialize in one BPO process such as HR or accounting in order to become successful.

- *Customer segment specialist:* In an increasingly competitive marketplace, companies will look to adopt best practice within their industry. Therefore they may choose to outsource specific functions to the vendors following the best practices in that particular segment. The insurance, financial services and healthcare markets have been identified as industries that involve large amounts of back office processing and where specialist providers can reduce support costs.

CHAPTER 3

Sourcing strategy: an imperative in the connected economy

The need to maximize the use of outsourcing to improve financial, operational, and management performance has never been greater. Historically, the primary reason for outsourcing has been to reduce operating costs and this remains a primary factor. However, now outsourcing has become an important element of business performance transformation, which concentrates resources on core competences and aligns all resource decisions with key business strategies.

Outsourcing works because it can deliver higher value and frees up internal resources to focus on a company's core competency. Outsourcing has become a mainstream business practice and the factors behind the increasing use of outsourcing are becoming far more complex than the simple need to cut costs and increase IT efficiencies.

Outsourcing can provide a higher level of service than might reasonably be expected from an internal department. Faster response times, higher compliance, and convenient access to benefits engender employee loyalty, minimizing liability and turnover costs.

But senior executives of many organizations still have not realized the full potential of the "O" tool. Most of the time, outsourcing is resorted to as a tactical tool when forced by squeezing margins, either due to a loss of pricing power or an increase in the cost base. In such circumstances, more often than not, the desired results do not materialize. But blaming the tool is unjustified. Rather, in most cases, the planning and implementation is erroneous.

It needs to be understood that the benefits of outsourcing go far beyond cost savings. Enterprises must build outsourcing relationships as long-term partnerships to further the strategic goals of the organization. In the connected economy companies need to build an internal competency around outsourcing so that they can work with partners to build the kind of responsive business ecosystem they need to compete.

We reckon that to understand the complexities of the outsourcing

A.B. Patel et al., *Outsourcing Success*

arrangements and to master it, enterprises have to take several steps back to revisit their business strategy and design a sourcing strategy alongside it.

Sourcing strategy: the next step after the business strategy

Before considering the details of the topic, it is pertinent to define two important terms:

- **Business strategy:** The first step toward any business evolution. Everyone would agree that to stay in business in the competitive, connected economy of the third millennium, business strategy must drive every decision. Business strategy refers to a broad and general concept, including the broader business approach, that is, markets, business models, competitive approach, business processes, partnerships and so on. It also defines a set of objectives, typically associated with a perceived value.
- **Sourcing strategy:** The sourcing strategy defines who will fulfill various parts of the objectives as defined by the business strategy. The activity could be a project, a service or a process, related to IT or the business processes. The provider can be internal or external like an offshore external service provider (ESP).

In a classic world, the trend was toward integrating the organization forward and backward, which typically resulted in big monolithic organizations. The mantra was to define the business strategy and quickly develop/procure the abilities required to fulfill the business objectives. If internal capabilities were not enough or difficult to develop, the organizations used to look, often just tactically, to the external market to fill the gap.

We think this kind of business culture is on the wane and a partnership-based world is fast emerging. In this world, businesses will become far more virtual than they are today and highly dependent on their partner network, making each organization's value chain more connected to its partner's network than it is today.

Changing customer preferences and technological advancement have brought an end to the command-and-control era for enterprises. The days when an enterprise could generate value simply by building a better device (with a few partnerships) have given way to an age of interconnectedness in which value is built as much by collaborating with the right peers as by providing great products and services.

For organizations in this world, the sourcing strategy would be the second step. In this dynamic world, once a business strategy or initiative has been defined, that is, *what is to be done*, the next step is not to define how the fulfillment of defined objectives is achieved. Rather, the enterprises would have to identify what sources will fulfill different business processes, that is, *who will do it*.

This is an emerging world in which objectives become more important than how to achieve them, and external collaboration is leveraged not only to extend but also mostly to add value to the enterprises' business capabilities. This move can be synthesized into an evolution from tactical "out-tasking" toward strategic sourcing. Figure 3.1 shows an enterprise in the partnership-based world where the value chains of the external vendors are closely connected to the value chain of the organization.

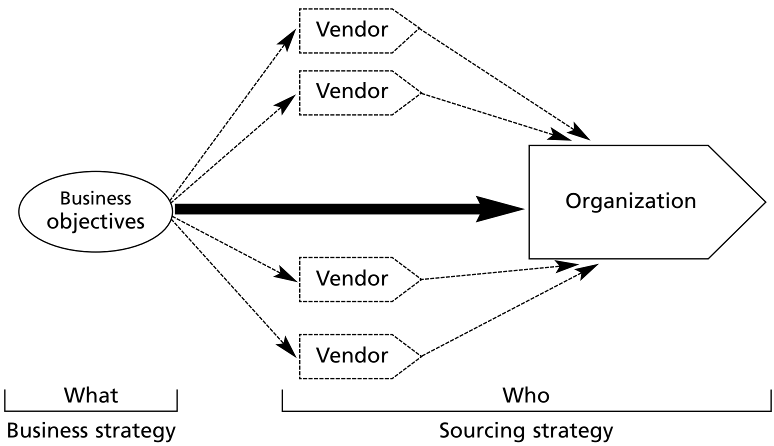


Figure 3.1 The extended value chain of an enterprise in the partnership-based world
Source: Aranca

In such a world, the sourcing strategy is practically fused into the business strategy. The business/sourcing strategy will be built with the network partners, and those that fail in their sourcing strategy will also fail as a business. We believe that a sound sourcing strategy has enormous potential to become a competitive advantage in the connected economy.

We reckon that two key tendencies are driving this paradigm shift and forcing enterprises to fundamentally reshape their business strategies while also constructing a sourcing strategy. For example, the shape of the telecoms industry has changed beyond recognition over the past 10 years as integrated monopolists adopt radical sourcing models (Figure 3.2). These changes are also reflected within the airline industry as it has disaggregated into a constellation of best-in-class service providers (Figure 3.3).

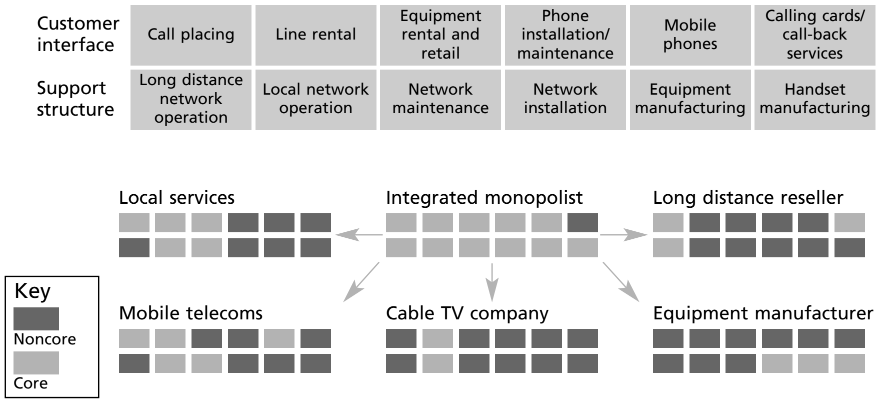


Figure 3.2 Telecoms industry overview
Source: ABN Amro

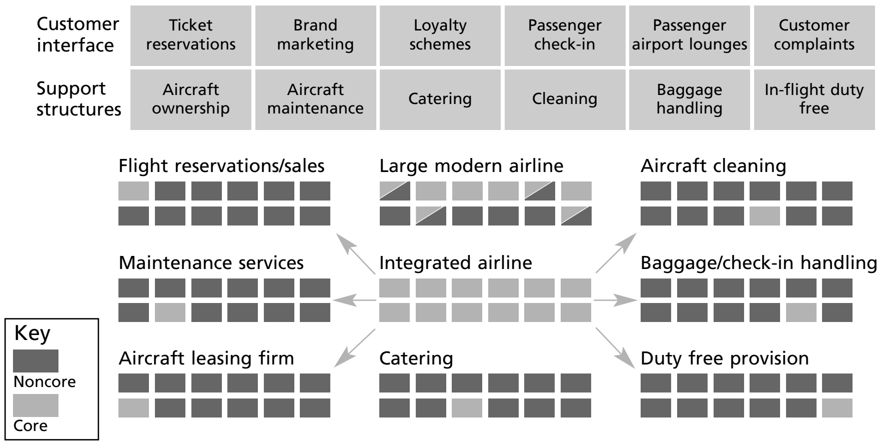


Figure 3.3 Airline industry overview
Source: ABN Amro

What are the drivers of a partnership-based world?

There are two key tendencies shaping a new partnership-based world: increasingly competitive thresholds due to globalization, and the falling cost of communication with the resultant industrialization of the value chains of service sector firms.

Figure 3.4 The two forces shaping a new world
Source: Aranca

Increasing competitive thresholds due to globalization

Global market expansion and the growing availability of products and services lead to increased competition, and consumers demanding better products and services. Businesses that were accustomed to running in a command-and-control environment where they had direct control over most of their value cycle must be prepared for the threat of competitors with better ability.

In the changed environment, they can lose business to a competitor with a better product or service, or a better production cycle and, therefore, a lower price. They can lose business because a competitor has a better and deeper understanding of client needs or a more established brand. The world asks for excellence, but it is impossible to excel in every aspect. Businesses must make tough decisions regarding the core value and specialization that will drive the entire business strategy. Success requires that everything that is part of the core business must achieve excellence and become a true competitive weapon and differentiator. Sourcing in this area will be very specific and controlled.

The rest of the enterprise cannot be left aside, as it is part of the value chain and includes unavoidable functions and processes. The objective of non-core processes will be set at a “competitive parity” level. As the IT/business process service market develops, partners that have such processes as their core business will make them available at a “competitive parity” level.

This is where the sourcing strategy will help enterprises to choose the right partner and build a long-term strategic relationship and where the market for BPO, BSP and specialized horizontal and vertical utility providers applies.

Industrialization of service value chain

We are now riding a tidal wave of change that, in the words of Uday Karmakar of the University of California, can be thought of as the "industrialization of services". He argues that technology has created an information assembly line – information now can be standardized, built to order, assembled from components, picked, packed, stored and shipped, all using a process resembling manufacturing's assembly line.

In the early twentieth century, manufacturing moved from the local shed to large-scale, mass-production facilities. Assembly line and economies of scale became the name of the game. By 1950, the small was out and big was beautiful.

By 1980, manufacturing firms in the U.S. started realizing the potential of offshoring production. In 1985, AT&T transferred production of residential telephones from its U.S.-based production facility to Singapore. In 1987, GM phased out production of some of its cars in the U.S. and moved it to Mexico.

At first, firms used offshoring as a tactical move to reduce costs but soon the sourcing moves snowballed into strategic weapons. Corporations that showed flexibility and adopted new strategies, such as IBM, GE and Intel, survived and succeeded. Companies like Zenith, American Motors and RCA, which remained entrenched in old positions, have gone away.

The offshoring movement in manufacturing started with the globalization of markets for manufactured products and a drop in transportation costs. Different components of a product were manufactured in different places, transported to different locations closer to the big markets, assembled and marketed.

With the advent of information technology, a similar phenomenon is revolutionizing the service industry as well. Technology is creating an information assembly line. Industrialized information becomes steadily more efficient, less expensive and more highly automated. The cost of logistics and storage are minimal; only labor and intellectual property matter.

Figure 3.5 shows six primary links in the value chain of a typical insurance company. Below each link are the specific business processes in the particular link. The support activities like human resources, IT infrastructure and physical infrastructure are also shown. The degree of grayness shows the level of potential for outsourcing/offshoring in the particular activity.

Technological advancement over the past two decades has enabled us to transfer massive amounts of data and information on the Internet at a very low cost, from one point in the world to anywhere else, in no time and with virtually no loss of quality. Therefore a UK-based insurance provider can have its back office application processing center in India, where low-wage but skilled Indian workers can carry out the job at nearly one-fifth of the cost of doing a similar operation in the U.K. The results of the processing can be communicated back to the U.K. office with similar ease.

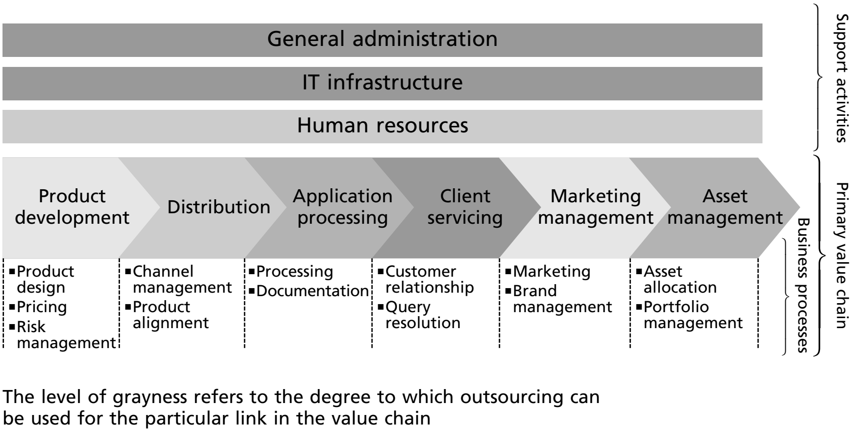


Figure 3.5 The value chain of an insurance firm
Source: Aranca

Similarly, steep drops in international telephony tariffs and huge bandwidth mean that the call center for customer relationship and query resolution can be located in nearby Ireland where again the wages are far less than wages in the U.K.

Except for core activities like product design, pricing, risk management, brand management, and portfolio management, where the scope of outsourcing will have to be limited and controlled, technological advances have made outsourcing a lucrative option.

A high degree of outsourcing is possible in support activities like IT infrastructure (software development, network administration, and so on), HR functions (payroll processing, recruitment, and so on) and general administration (accounting, tax related matters, and so on).

Figure 3.5 shows that most components and subcomponents of the value chain can be performed in different locations and then reassembled to create the entire value chain resembling the assembly line of a big manufacturing firm. Technology is turning information services into industrialized components.

It is therefore imperative for enterprises to map out their sourcing strategies carefully, as failing to do so might seriously undermine their competitiveness in the connected economy.

Various dimensions of strategic sourcing

Strategic sourcing is a critical competence that will provide business value. While the pressure on margins pushes organizations toward cost control measures, the need to streamline and interconnect business processes all along the value chain is high.

Strategic sourcing can be a core capability for business and government enterprises. It allows them to manage innovation, and deliver processes and services effectively and efficiently to the internal organization, business partners, and clients or constituency.

According to Gartner, there are five key dimensions of strategic sourcing:

- Business goals
- Internal capability
- External market capability
- Sourcing models
- Sourcing governance.

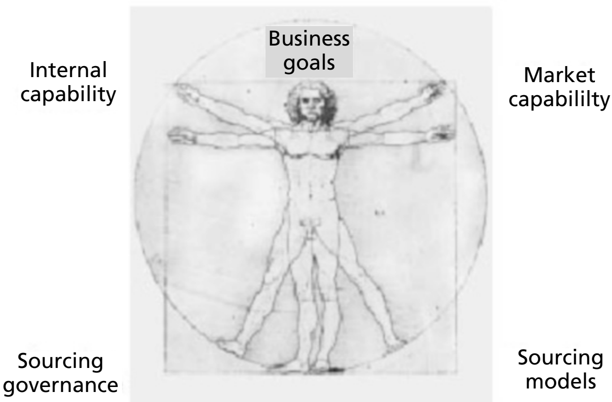


Figure 3.6 Gartner's representation of a complex sourcing scenario
Source: Gartner

Gartner believes that strategic sourcing is not about technology. It is about leadership and superior management capabilities and thus it is not easy. Figure 3.6 shows Gartner's representation of a complex sourcing scenario (that is, the circle and the square), with human capacity at the real core of its comprehension and management. These five dimensions are now discussed.

Business goals

The key elements in drafting a sourcing strategy are the defined business goals, the competitive position and the value proposition of business. Strategic sourcing is not just about outsourcing current business or IT services. The basis for executing any IT-enabled business strategy is part of the overall business question: How should an enterprise compete in the connected economy? In the changing world, sourcing strategies and their execution will encompass a wide range of business and IT initiatives aimed at exploiting a perceived business value identified by the business strategy.

This perceived value can be external (that is, initiatives regarding supply chain, CRM, new products and markets, and differentiation over the competitors) or internal (for example cost reduction, improvements in product and service quality or time-to-market, and systems supporting the virtual organization). The sourcing strategy must ensure that the business objectives are fulfilled and other relevant dimensions of this subject are understood and evolved accordingly.

Internal capability

All enterprises candidly admit that their internal IT capabilities and resources (that is, competences, business processes, IT processes and services) can no longer cope with their changing business needs in the connected economy. Thus the traditional outsourcing deals will not be able to cope with the pressure of continuous business change. Changing technologies and competitive pressure are leading to the increasing use of external service providers (ESP's).

Most current business processes are suited to change in the connected economy. Many manual internal processes – which are often bureaucratic and paper-based – will be superseded by the more direct interaction of IT systems, for example build-to-order systems connected to a web B2C front end or a B2B marketplace.

The sourcing strategy must help organizations to bridge the gap between the capabilities required to succeed in this fast-changing world and internal capabilities.

External market capability

Although the market for IT services is still in its infancy or early maturity, the service market for business processes, for example finance and administration, human resource management (HRM), logistics, general services and real estate management, should be considered more static and mature than IT services.

Besides business goals and internal capabilities, the sourcing strategy is also defined by the external market capabilities. The connected economy is changing the delivery methods of many traditional business services or processes, for example applications running as part of BPO are becoming web-based and interconnected with other customer or third party applications. The sourcing strategy needs to be flexible to adjust to the improvement in technology and therefore external market capabilities.

Sourcing alternatives and models

Once the internal and external capabilities are determined, these capabilities can be engaged and exploited through different sourcing approaches and models. This is largely a make-or-buy type of decision.

Various arrangements such as partnership, joint venture, merger and acquisition, and so on can be used, depending on a number of factors. We will discuss this topic in detail in Chapter 4.

Sourcing governance

The model of sourcing governance is in effect the sum of management capabilities, methods and processes, organizational roles and responsibilities, and rules and agreements that support the dynamic delivery of services in a mixed (that is, internal and external) environment. The model must cross traditional enterprise boundaries and be installed as part of the business, the internal IT function and the external providers, including, to some extent, even subcontractors and provider's partners. The two key elements of sourcing governance are skills and processes.

In the next chapter, we present a step-by-step guide to the sourcing strategy. Our approach will serve as a guide for organizations building a sourcing strategy. This is not a one-size-fits-all approach because it does not give organizations a premixed sourcing strategy. Rather it lays a framework within which organizations can find their own sourcing strategy, as the combination of elements will be unique for each organization.

CHAPTER 4

How to develop a sourcing strategy

Although every sourcing strategy exercise tends to be somewhat individual, common traits and activities can be identified. Employing these common elements, we have laid down broad guidelines for firms that will help them develop a sourcing strategy.

Figure 4.1 shows the six general steps in the framework of sourcing strategy. These steps have been superimposed on the complex sourcing scenario proposed by Gartner. We have used this framework to explain our thoughts.

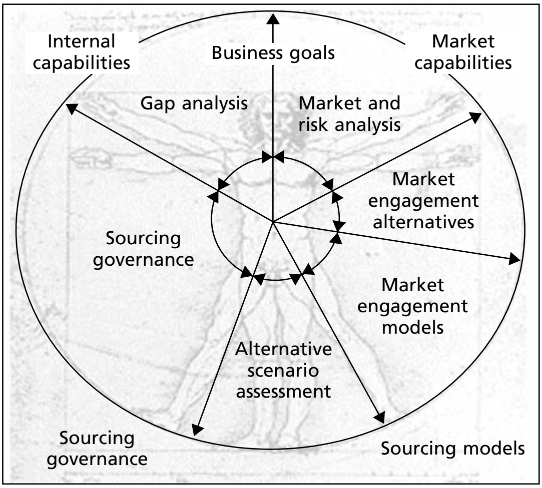


Figure 4.1 A step-by-step approach to sourcing strategy
Source: Gartner and Aranca

First step: strategic gap analysis

The process of conducting the sourcing strategy starts with a pragmatic assessment of how strong the change pressure is and how ready the organization is to change. This assessment involves cultural, financial, contractual and statutory factors, and will vary widely between enterprises. On concluding that the organization requires a sufficient degree of change to warrant the exercise – and it is capable of making the change necessary – a strategic gap analysis should be prepared.

Although there often exists a recognizable gap between capabilities and business expectations, another gap, frequently unrecognizable, exists between what is core and what is noncore. Often organizations have good capabilities but are doing the wrong things well.

The gap analysis must take into account the concept of core vs noncore as a basis for every sourcing decision. The value or potential value of an activity should be established on the basis of market principles, not on operational principles. The fundamental issue is the level of competitive advantage an enterprise can establish in the delivery of its products and/or services to its customers.

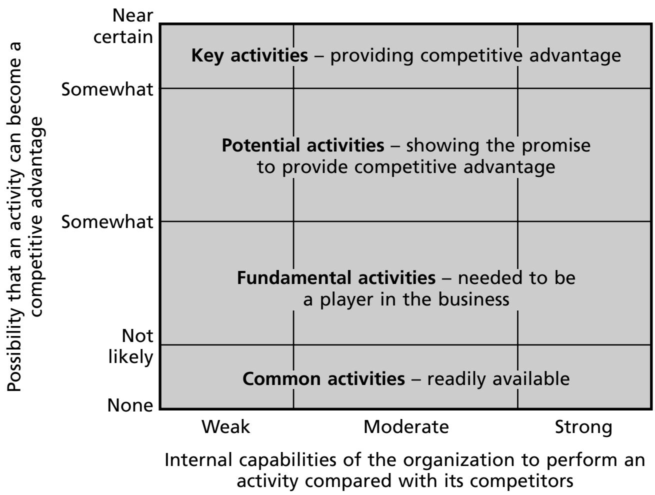


Figure 4.2 Strategic gap analysis matrix
Source: Aranca

On the vertical scale of Figure 4.2, we have divided business activities into four categories:

1. *Key activities:* These form the competitive advantage of the organization in the marketplace. Any damage to these activities would undermine the competitive position of the organization in the market and affect the top line.

2. *Potential activities:* These show promise to become the competitive advantage in the visible future. The factors behind the emerging competitive value of these activities could be technological changes, globalization, regulatory changes, and so on.

3. *Fundamental activities:* These are basic to the business and the organization is required to perform these activities in order to remain a player in the market. These activities are not a significant source of competitive advantage.

4. *Common activities:* These are required in order to complete other more valuable activities. Most support functions such as HR and internal accounting qualify under this category. Most of these activities are readily available in the market and are not a source of competitive advantage.

Once the activities are divided into the four categories, the next step is to make an honest assessment of the organization's internal capabilities. This is the second dimension of the strategic gap analysis, where the internal capabilities can be defined as strong, moderate or weak.

Any gap in the key activities between internal capabilities and competitors' capabilities is a cause for serious concern. The sourcing strategy should guide the enterprise to try and bridge the gap by developing/acquiring the necessary resources.

With the potential activities, the firm can rely on some form of relationship to obtain its competitive advantage. Relationships can be short term, followed by bringing the capability in-house, or long term, or even permanent. For such activities there is a degree of uncertainty regarding the potential for creating competitive advantage. Once that uncertainty is resolved, the organization can take appropriate action. The deciding factor on whether these activities should be brought in-house is their contribution to competitive advantage.

The sourcing strategy must address the organization's policy regarding the other two categories of activities. These two types of activities do not offer a significant source of competitive advantage. If there are gaps as determined by the strategic gap analysis, the organization must address this gap and the external market may contain the answers.

Second step: market and risk analysis

Enterprises facing an internal inability – as determined by the strategic gap analysis – must understand what the local, relevant service market (that is, IT or business processes) can provide today and in the expected time frame.

This understanding must include the market availability of a service to cover such aspects as service maturity, quality and stability.

Enterprises should also understand that what a provider's marketing people claim they can do can be very different from what they deliver every day to an average client. Therefore a degree of skepticism is required to correctly measure the capabilities of a provider.

The outsourcing market is evolving fast and service providers are offering newer forms of deals. Enterprises must be careful in assessing the risks associated with these deals as often the offerings are immature, and not well understood by either the provider or the client. Sometimes, there are also not enough reference customers.

The sourcing market is witnessing the emergence of large number of pure BPO players. Some of them have already developed a sound level of service, while others have not. Enterprises seeking to revise and improve noncore yet critical processes like HR, finance and administration or vertical functions can investigate the BPO offerings relevant to their geography or vertical market.

The offshore service providers are also expanding their coverage in Europe and the U.S. However, dealing with offshore providers requires the ability to manage differentiated relationship models and generally puts significant stress on relationship management. The potential benefits (for example lower cost, better quality and faster time-to-market due to potential 24-hour operations) can be easily offset by management failures. Indian vendors, especially, have some of the best methods to manage multinational application delivery and management.

Enterprises are starting to discover that new offerings are coming in the market. Since the overall market, its providers and its processes, is still immature, enterprises should evaluate not only the service offered but also the partners' ability to work together and enforce contractual terms and conditions and best practices to support a single end-to-end responsibility.

Because of the fast-changing marketplace, a superior sourcing management capability needs to be developed and put in place to transform the potential value into real business advantage.

Third step: market engagement alternatives

Sourcing decisions may seem to be simple make-or-buy alternatives, but normally they are far more complex than that. In most cases, the right sourcing decision is not always evident. It may remain obscure until it is placed in the context of the business strategy and all alternative options are evaluated carefully.

An organization should not use external capabilities just because it cannot fulfill its objective with its internal capabilities. The more difficult and business-critical the objective is, the more likely it is that the result will be reached (or not) by exploiting internal and external capabilities simultaneously. Using only external capabilities when the internal ones are unable to reach an objective is a high-risk approach.

If the organization relies on the external provider to carry out important business initiatives without building enough internal capabilities, the situation may very well lead to systems and solutions that are suboptimal or even disconnected from the current organization and business needs.

Sourcing alternatives apply at the level of a single business objective; and once the objective has been defined, the organization has three broad sourcing alternatives:

- Source internally
- Outsource skills or deliverables
- Outsource services or solutions.

There are two critical parameters every organization should evaluate while choosing any sourcing alternative:

- Risk transfer
- Management responsibility transfer.

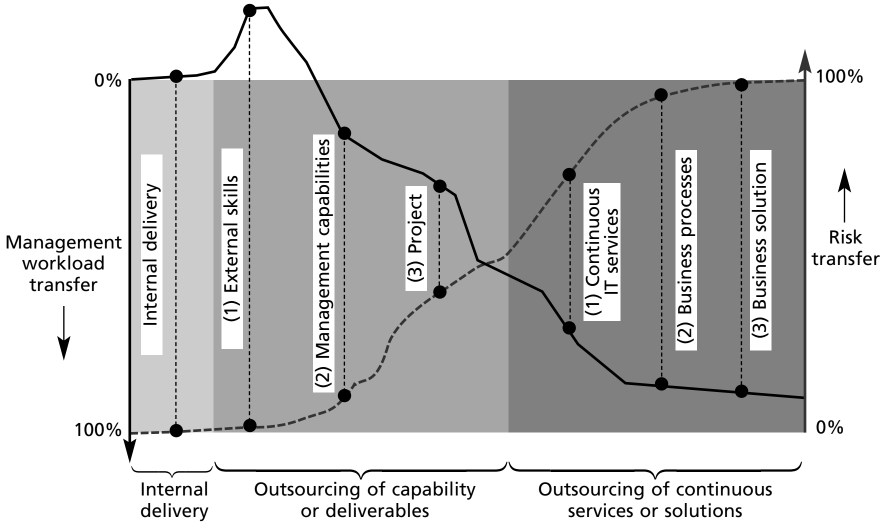


Figure 4.3 Sourcing alternatives: risk and management workload transfer
Source: Gartner and Aranca

Figure 4.3 provides a general evaluation of the risk and management responsibility transfer outside the client organization in the three sourcing alternatives. To understand the risks, let's assume that an organization has set the strategic objective of replying to clients' queries on Internet chat in real time. The organization also identifies that this is a noncore activity. From the IT perspective, that means starting a "LivePerson" like initiative. How can this initiative be sourced?

Source internally

A real-time Internet chat initiative requires the implementation of one or more software packages, and usually the internal IS organization does not have the right technical skills.

The organization can choose to develop internal capabilities but this entails taking up all the risk and there is no transfer of management responsibilities. As the real-time chat initiative is a noncore activity, most organizations will find this alternative unacceptable.

Sourcing of capabilities or deliverables

The second alternative here is to outsource skills or deliverables. Enterprises have three options to choose from: outsourcing technical skills; outsourcing management capabilities; or outsourcing the entire project. Each is now discussed.

Outsourcing technical skills

A first option is to source those skills from the market, usually through the engagement of external consultants. The business initiative may require the setup of a contact center, which requires specific knowledge in terms of organization, processes and staff management. Therefore, business skills can also be sourced externally by hiring or engaging as a consultant one or more experts on building and running a contact center in the relevant industry or region.

This staff augmentation approach tends to be technically oriented and does not imply risk transfer outside the client organization. The enterprise does not receive significant relief from project management duties, rather the onus may even be increased because of the additional people, different cultures and methods.

Outsourcing of management capabilities

A real-time Internet chat initiative requires the integration and interoperability of most, if not all, organization processes and applications, as well as changes to them all. This means that the project is complex and requires precise coordination of many areas with different needs, opinions, processes and applications. All that requires a serious management effort to drive the initiative toward success.

Because the internal management bandwidth is always limited, the second level of sourcing is about management capabilities. These can be sourced from the market through a body rental approach or even through a program management engagement, typically from a consulting firm.

This staff augmentation approach still does not imply risk transfer outside the client organization, but it can partially relieve some of the client project management duties. Depending on the contractual form, the program management approach starts by transferring a small part of the risk from the client to an external provider.

Outsourcing the entire project

The third option for the organization is to outsource the entire project and the change management phase to an external provider who does this every day, in parallel, for many client organizations

Starting from this level of sourcing, a significant amount of the management work is transferred to the provider. In addition, risk could be transferred to the provider through best practices in selection, negotiation, project and deliverables management, and risk-sharing mechanisms. Although the risk transfer potential can be lost entirely because of client weaknesses in these practices, engaging a provider for a project is the first significant step outside the "body shopping" approach and, therefore, may lead to risk and management workload transfer up to 50 percent usually, and even more in special arrangements.

Sourcing of services or solutions

Instead of capabilities, the organization has the alternative to go for the outsourcing of services or solutions. This alternative enables organizations to transfer more risk and management responsibilities to the external provider. Here again there are three options: outsource continuous IT services; outsource business process; or outsource business solution.

Outsource continuous IT service

A growing possibility in the market is to buy an IT application that is already "up and running", as delivered by specialized service providers. The ASP model is based on the delivery of one-to-many business applications with low levels of single-client customization and a pay-per-use approach (that is, typically a per-user-per-month rate). Outsourcers and other service providers can also deliver these kinds of capabilities.

This is a very compelling proposition for the client and includes:

- No significant investments
- Limited or no acquisition of hardware and software
- Limited customization
- Short time-to-solution.

However, project and organization changes are still required, but these are limited and mostly oriented toward application integration, training and organization readiness. In this case, up to 90 percent of the IT risk and management workload is transferred to the provider.

The disadvantage of this approach is the reduced level of customization and direct control that a user organization may have on this process, as well as the increasing role of internal risks (for example difficulty in or resistance to adapting to the service, or weak relationship or contract management). Going back to our real-time Internet chat example, the service provider makes the application available, and the organization puts the staff (that is, contact center and support staff) in front of the desk-side application.

Outsource business process (that is, BPO or BSP)

Instead of outsourcing just IT services, the organization can choose to outsource entire business processes. In this option, the responsibility of managing the day-to-day operational matters like staff training, turnover and shift management is transferred to the external provider.

With this sourcing option, the degree of externalization goes well beyond the IT sphere and enters the process realm. The enterprise no longer worries about the applications, architectures and technologies that are fully embedded in the process that it buys as a service. IT risk and management duties are externalized up to 100 percent, and a certain amount of business risk and business management is also externalized at the same time.

The disadvantage is that it relies on a reduced level of process customization and differentiation, and the loss of direct control over the process. Accordingly, internal risk and relationship management grow in importance. However, another important issue that applies here is the integration of the application with other parts of the information system.

Outsource the business solution (that is, create, buy, partner, merge and acquire)

A final sourcing alternative exists for more complex, challenging and business-oriented objectives: the organization sources the entire business result it is looking for. If an enterprise wants to open operations in an area where it has no existing presence, one way would be to send people there, look for an office, start hiring a manager and salespeople, start an IT project to acquire PC's, buy network connections, and so on. However, it is highly probable that attempting this with the internal sourcing approach would take too long and might be vulnerable to business culture or legislation obstacles.

In most cases, the objective will be sourced by:

- Creating a new company in the new region
- Acquiring an established sales organization in the new region
- Partnering with a local player
- Leveraging mergers and acquisitions to achieve the desired objective and capabilities.

When the organization chooses to create a separate entity, its risk reduces significantly and there is a near 100 percent transfer of management responsibilities.

These seven sourcing alternatives for reaching an objective represent different paths toward the same objective. The alternatives range from very technical to very business-oriented, and only the right mix of technical and business aspects, and a factual evaluation of time, cost, risk and implications, will reveal the right sourcing decision for an enterprise and its objective.

Having selected the right sourcing alternative to fulfill a business objective is still not a strategy. A strategy requires a whole vision of the overall balance between internal and external capabilities toward a certain business objective and a certain scope. This is where the sourcing models – the fourth step of the sourcing strategy – apply.

Fourth step: market engagement models

Internal or external capacities can be engaged and exploited through different sourcing models. Again this might seem like a make-or-buy decision. But, in some cases, a partner solution may also be envisaged, ranging from partnering agreements, building joint ventures or business partnerships for a complete business result, as well as buying capabilities through mergers and acquisitions.

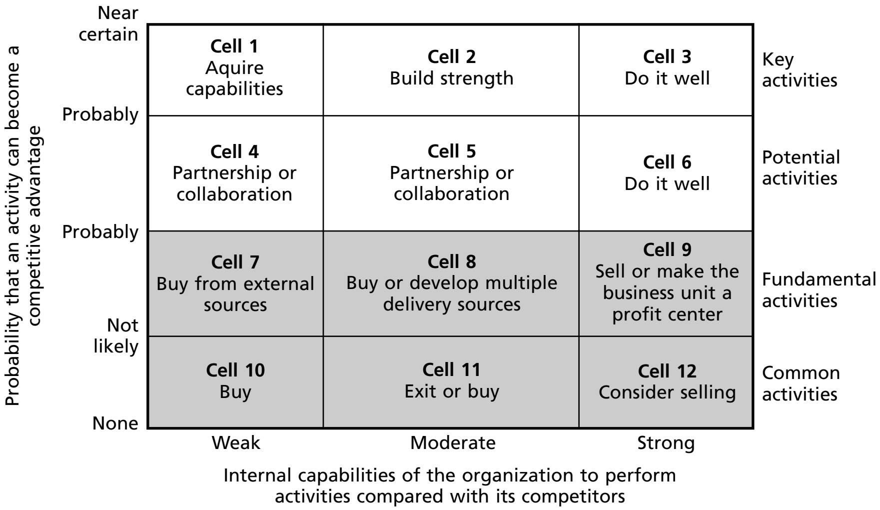


Figure 4.4 Matrix of outsourcing models under different scenarios
Source: Aranca

Figure 4.4 shows the same matrix that we have used in the strategic gap analysis section with the addition of proposed outsourcing models under different scenarios. The different models are suitable for particular types of activities, at a certain level of organizational maturity and used at different stages of implementation of a sourcing strategy. Time is always an important factor, as some of these models are unstable and would evolve as a part of the overall sourcing strategy.

Proposed models for "key activities"

Cell 1: *Acquire capability:* If an enterprise's capabilities are weak in an area that is discovered to offer significant competitive advantage to its competitors, it should move to obtain full ownership and control by acquiring the capability in-house.

Cell 2: *Build strength:* As in Cell 1, if an enterprise's capabilities are moderate in an area that is discovered to offer significant competitive advantage, it should invest to build internal strength and move toward strength.

Cell 3: *Do it in-house and do it well:* If an enterprise has strong capability relative to its competitors and the activity clearly provides significant competitive advantage, the enterprise should be performing the activity in-house under tight control.

Proposed models for "potential activities"

In Cells 4, 5, and 6, where the activity is categorized as emerging, the firm can rely on some form of relationship to obtain its competitive advantage. Relationships can be short term (followed by bringing the capability in-house), long term, or even permanent. The deciding factor on whether these activities should be brought in-house is their contribution to competitive advantage.

Cell 4: Because competitive advantage is judged to be possible or probable, activities in this cell need to be watched carefully for movement either upward, which implies that competitive advantage has become more certain, or downward, which implies competitive advantage is less likely. The result of this movement will determine the strength of the relationship needed or whether the activity should be brought in-house.

- *Partner:* When there is a weak internal capability in an activity that has a significant probability of being a source of competitive advantage, the enterprise should seek to partner with a more capable group in order to remain competitively viable. If possible, the partnership should provide a definitive ownership posture, while positioning to acquire more ownership if the activity truly becomes a key source of competitive advantage.
- *Collaborate:* When there is a weak internal capability and only a possibility of competitive advantage, collaboration with a more capable group or groups is warranted. In this situation, a less definitive ownership posture is needed than in partnering. The goal of the collaboration is to strengthen the enterprise's position, while limiting the inherent risks in a commitment, until the possibility of competitive advantage becomes certain.

Cell 5: Activities in this cell need to be monitored for movement either upward or downward, depending on the evolution of their potential for competitive advantage. The result of this movement will determine the strength of the relationship needed or whether the activity should be brought in-house.

- *Partner:* This situation resembles Cell 4, except that the enterprise's position is stronger because of moderate internal capability. The recommendation is to partner with a more capable group; however, the partnership agreement can be structured more to the enterprise's favor because of its stronger internal knowledge base and capabilities. As the level of certainty for gaining competitive advantage increases, the enterprise should be prepared to shift the work in-house and/or under more direct control.

- *Collaborate:* Another option for the enterprise is that it can be less definitive in its relationships. In this middle ground, collaboration with a more capable group is warranted to strengthen the capability in case the potential for competitive advantage increases.
- *Share risk:* As the level of potential for competitive advantage diminishes, the movement should be toward sharing risk and investment with others. Sharing risk means the enterprise recognizes that it might not ever need full ownership in-house for this activity. Sharing risk also allows the enterprise to maintain a level of involvement in the activity, while conserving its resources for application elsewhere. If, in the future, the activity shows higher potential for competitive advantage, then additional resources can be allocated to it.

Cell 6: This is a strong position to be in for activities that are emerging sources of competitive advantage. Activities in this cell need to be monitored for movement either toward or away from becoming key.

- *Do it in-house:* If the enterprise has a strong in-house capability relative to its competitors, and the potential for competitive advantage is high, the enterprise should continue to do the work in-house with full control and ownership.
- *Share risk:* The other option could be toward sharing risk and investment with others rather than trying to retain a strong position. This will allow the enterprise to maintain a level of involvement with the activity, but conserve its resources for application elsewhere, or for when this activity shows clearer potential for competitive advantage.

Proposed models for "fundamental activities"

As in the potential activities, the enterprise can rely on relationships to acquire the fundamental activities. For historical reasons, the enterprise may be strong in some of these activities. In that case, the guide suggests moving toward relationships rather than keeping the activity in-house. However, the firm might wish to take advantage of its strength to generate income from others, even competitors in its industry, without fear of harming its competitive position.

Cell 7: *Buy:* If the potential for competitive advantage is low, and little internal capability exists, the activity should be bought in the marketplace. Relinquishing a weak in-house capability avoids any further drain on the enterprise's resources.

Cell 8: In this cell, the enterprise has a moderate capability in an activity that might not be a source of competitive advantage. Therefore the enterprise should consider moving toward outsourcing these activities to minimize its investment as well as its operational risk.

- *Develop second source:* Dependency on the internal capabilities could be reduced through development of one or more external sources. Because the possibility of competitive advantage still exists, a reasonable level of internal capabilities should be maintained to help the enterprise be a smart buyer in the marketplace.
- *Buy:* If competitive advantage is not likely, and only moderate internal capability exists, the activity should be bought from the marketplace to avoid any further drain on the enterprise's resources. Once a stable external supply system is established, internal investments should be withdrawn.

Cell 9: The enterprise has strong capabilities here and while it might be attractive to be strong for its own sake, those activities categorized as fundamental should be carefully investigated. Activities in this cell can tie up resources that could be devoted instead to generating competitive advantage. One must be certain, however, that these are truly fundamental activities.

- *Make it a profit center:* When the potential for competitive advantage is less likely, yet in-house strength exists, the need to limit the activity to support only internal requirements is diminished. The enterprise should consider reducing the level of investments in this area, as appropriate for an activity with a low potential for competitive advantage. If prudent, the enterprise could create a profit center, selling to the market in order to generate cash to continue its strong position and invest elsewhere. In the event that the enterprise chooses to make no further investment in this activity, its strength might be allowed to diminish, moving toward the left in the guide.

- *Consider selling/buying:* When an enterprise has a strong capability that is unlikely to yield competitive advantage, it should consider selling off the capability and reinvesting the proceeds elsewhere. Since the capability is still needed, the newly sold capability, which is strong, could continue as a source for the divesting company.

Proposed models for "common activities"

The firm should buy common activities in the marketplace as far as possible. If, for historical reasons, the firm is strong in one of these activities, then it should consider ways of exiting that activity while getting value for its past investments.

Cell 10: *Buy:* If there is neither competitive advantage nor significant internal capability, any in-house activity should be stopped as quickly and cleanly as possible to avoid any further drain on the enterprise's resources. Instead, the enterprise should buy what it needs in the marketplace.

Cell 11: *Exit/buy:* If an enterprise determines that it has moderate resident strength in an area where no competitive advantage exists, we recommend an exit strategy wherein the capability is abandoned or allowed to weaken. Once again, the enterprise should buy what it needs in the marketplace.

Cell 12: *Consider selling/buying:* Where an enterprise has a strong capability, but can gain little or no competitive advantage, it should consider selling off the capability and reinvesting the proceeds elsewhere. As with the preceding two cells, the enterprise should buy what it needs from the marketplace.

We reckon that the matrix is fairly simple to use yet strong on functionality. Depending upon the position on the matrix, the enterprise can take a decision to either insource or outsource or better still use a combination of both.

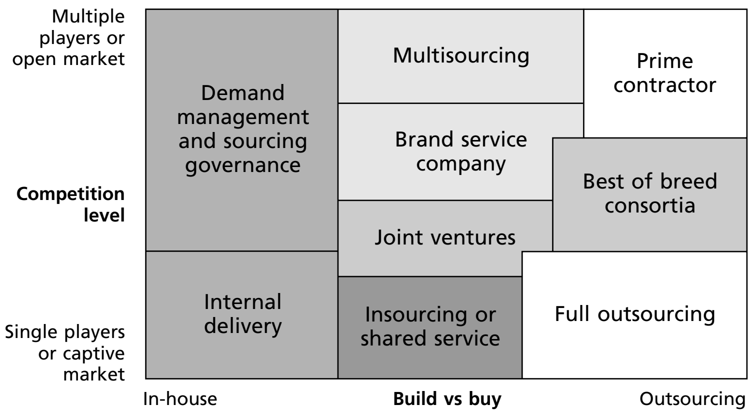


Figure 4.5 Gartner's strategic sourcing models
Source: Gartner

As part of their sourcing strategy, few organizations have been employing these models in the marketplace. Gartner has observed various sourcing models across the European market and in other places, shown in Figure 4.5. It has plotted these models on two scales:

1. *Build vs buy axis:* It represents the enterprise's will to leverage (buy) or not (build) on the providers' capabilities to satisfy the IT or business needs.
2. *Competition-level axis:* It represents the enterprise's will to have mainly a single provider (that is, minimizing management overheads but with a risk of becoming a captive market) or to fully leverage competition (that is, managing different providers and accepting the overheads and complexity of a multiprovider or multicontract situation).

   The factors which are relevant include:

   - *Internal delivery:* This is the current status of most enterprises' IT or business process operations as well as the delivery model that every manager knows. The internal organization provides services to the enterprise, and implements new services and architectures through internal projects; everything is managed through the direct relationship between an organization and its associates. It is the most elastic model, because the unit manager may change the rules and the processes as much and as often as it is needed.
   - *Insourcing:* Insourcing is the process of separating the IS or process organization from the enterprise as a business unit, usually measured

by its own profit and loss. The insourced organization provides the enterprise with services on a business rules basis (for example semi-formal contracts, service-level agreements and definition of tariffs for services). IT insourcing has been used quite often by large European enterprises that also have the scope to sell IT services to the market. In the case of business process, the insourcing model is also known as "shared services".

- *Joint venture:* To exit from the internal IT or insourcing model limitations (for example economies of scale or knowledge), the enterprise builds a separate service company and shares it with a market provider. Normally, the ESP gets the majority of the joint venture shares (that is, typically 50 percent to 80 percent) and manages the joint venture operations.
- *Full outsourcing:* This is the most classical outsourcing model. It is based on a single contract with a single ESP, for all the in-scope services. The main characteristics of the full outsourcing model include:
  - Single-provider and single-contract approach
  - Covers a large part of the enterprise's IT or process needs
  - Often includes a top-management strategic partnership with the provider
  - Often a long contract (that is, 5–10 years).
- *Best-of-breed consortia:* This model appeared in the market as an evolution of the full outsourcing model for very large deals of major multinational companies or for government deals. It happens when the client requirements exceed the capabilities of a single, large provider. Based on a customer request, or an ESP's decision, a consortium is built up, and one of the providers takes the role of prime contractor.
- *Brand services company:* Similar to the insourcing model, a company is built to provide services to a large organization or a group of business-oriented companies. Services provided, which may include non-IT services and business processes, are carefully compared against the market, and the services company leverages ESP's, selectively outsourcing part of their services. The services company can be allowed or is even intended to serve the external market.
- *Prime contractor:* An organization providing the ability of managing and integrating multiple providers (for example products, projects

and services) to derive a single or global solution or service for the client. General, prime or main contractor, management contracting and contract management are different flavors of the same role: the ability to manage and integrate multiple providers.

Fifth step: alternative scenario assessment

The fifth step in building a sourcing strategy is based on creating alternative scenarios. Two or more sourcing scenarios can be built at the alternative level (for example sourcing of a project or a continuous process) or at the model level (for example evolution from internal delivery to another suitable model). These different scenarios need to be evaluated from the following angles:

- *Alignment with the business objectives:* Since the achievement of business objectives is the reason to run this complex exercise, the first element to be judged is how a given scenario provides a better ability to achieve the objectives.
- *Time-to-solution:* Different scenarios may well require different elapsed time to achieve the objectives. Running an end-to-end outsourcing deal may take 9–12 months, while a contract for standard, commodity-like services can be done in 3–4 months or less. Running a complex customized project can take 18 months.
- *Deals scope and shape:* The nature of outsourced capabilities or services is what is termed "the scope" of the deal. Similarly, the shape of the deal is how the organization is going to buy the capabilities or services.

At the core of the scenario assessment exercise is the ability to forecast as much as possible the future positive and negative implications of different scenarios. Different scenarios will have different levels of risk, and the best sourcing scenario is the one that achieves the objectives at the lowest level of risk.

Risk can come from different aspects and issues, and choosing a different model of service delivery poses a considerable challenge on a number of fronts, including planning, operational, financial and political. In particular, the following risks should be taken into account in analyzing individual sourcing scenarios (see Figure 4.6):

- What is the potential for costs to exceed forecasts, and by how much?

- How likely is, and what are the consequences of, a failure to deliver the envisaged business value from this scenario?
- What are the financial and business consequences of an operational failure in this scenario, and can they be mitigated?
- How rapidly can this scenario yield the required operational results in a reliable way?
- What political barriers may exist to compromise the viability of this scenario, and can they be mitigated?
- Does this scenario compromise the enterprise's future flexibility, and will it irrevocably remove future business options?
- How is the level of management complexity affected by this scenario, and could that complexity become unmanageable?
- If skills and knowledge are excised or transferred to another party, are they irrecoverable?

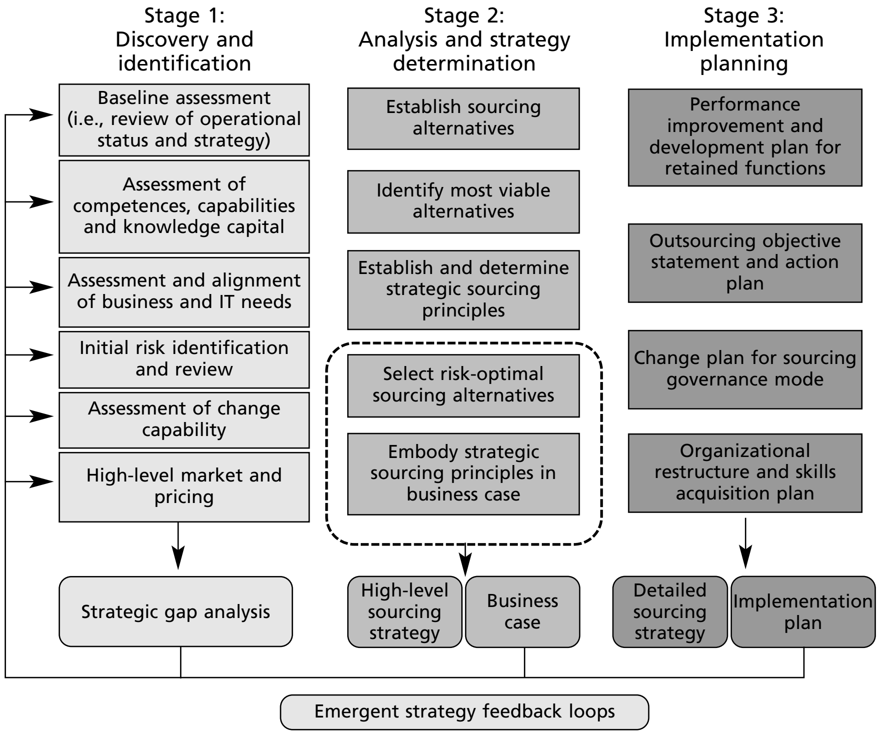


Figure 4.6 Sourcing strategy matrix

Source: Gartner

Finally, sourcing scenarios should be evaluated and ranked in terms of risk, taking into account strategic imperatives. A complete strengths, weaknesses, opportunities and threats (SWOT) analysis may be used as a tool to represent the final scenario analysis; and the final decision should be taken at the strategy level before entering the final stage of planning for governance development and strategy execution.

Figures 4.7, 4.8 and 4.9 provide some self-explanatory key points.

Final step: sourcing governance

A sourcing strategy cannot be executed without the right governance and execution capability. It is necessary to take into account the governance and management issues at an early stage of the strategy.

Sourcing governance addresses the capabilities needed to regulate and support multiple service providers, including management methods and processes, organizational roles and responsibilities, and service delivery rules and agreements. An effective governance model must overcome traditional enterprise boundaries and become an integrated part of the business. Establishing effective sourcing governance is critical to the success of any sourcing strategy. According to one Gartner report, the main tasks to be attained by the governance model include:

- Being the active repository, as well as the execution engine for the sourcing strategy, including reapplying the methods and decision models when new initiatives start or when significant changes or problems arise
- Being responsible for the financial impacts and cost–benefit analysis (that is, business case), which is part of any sourcing move
- Managing the program and projects running as part of the business initiatives toward business goals
- Managing the service relationship with internal and external providers
- Evolving and marketing internally and externally, if appropriate, the innovation capabilities and sourcing strategy.

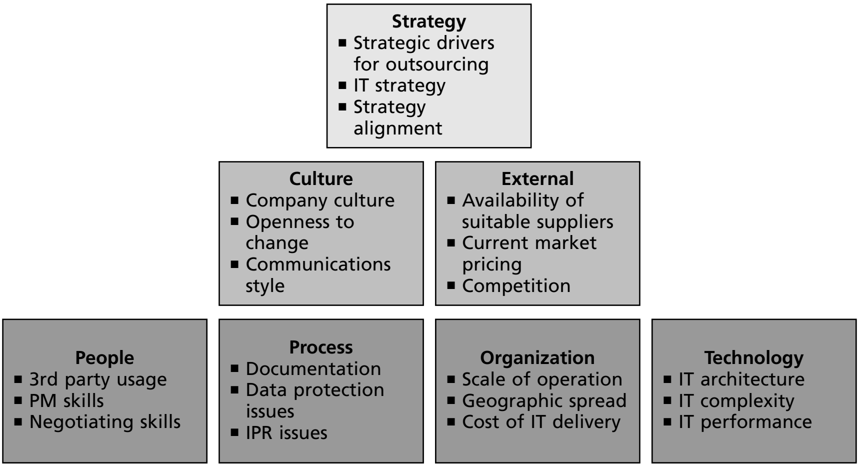


Figure 4.7 Summary of critical success factors
Source: AJBurgess

	Outsource	**Peer joint venture**	**Assisted transformation**
Control	Well tried, clear roles, can be inflexible	Less control than outsourcing as two parities need to be accommodated	Challenging to control complex interaction but remains substantially in-house
Price certainty	Very clear but often renegotiated before end of term	Can be deeper savings, but certainty can be eroded by added complexity	Can be challenging to pin down value but remains very much in your own hands
Exploitation of market position	Have to build this value into the original deal, often heavily discounted	Offers opportunities for right market and position – a low success rate	Not really relevant
Ongoing industry involvement	Generally involves withdrawal from detailed knowledge – hard to return in-house	Continued and sometimes enhanced involvement – hard to return in-house	Relatively unchanged
Term	Often requires lengthy term to enable investment to drive overall value	Can take longer than outsource to drive value, on the other hand allows peer learning	Very flexible, needs to be long enough for change to stick

Figure 4.8 Summary alternatives
Source: LloydsTSB

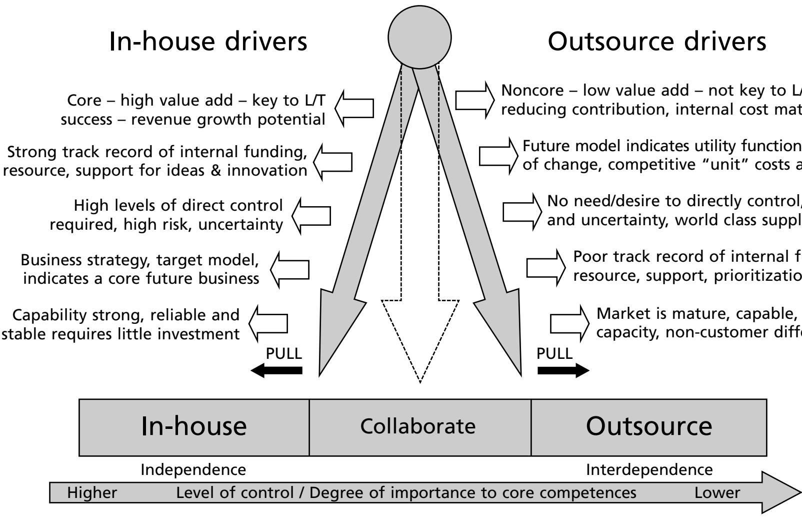


Figure 4.9 Strategic decisions – the Barclays model

CASE STUDIES

Accenture

WHAT

Accenture has over 13 years of experience of large-scale outsourcing engagements over long contract terms. At the heart of this approach is its global network of 40 delivery centers, including facilities in Bangalore and Mumbai.

These delivery center facilities offer both customer contact and process delivery capabilities to multinational corporate clients around the world. The first Bangalore facility was opened in January 2003. Two additional facilities were opened in Bangalore in April and December 2003. The process delivery center in Bangalore is currently home to professionals who focus on finance and accounting processes, HR and procurement processes and industry-focused processes.

BEST PRACTICE

The delivery centers have recently been assessed the highest Capability Maturity Model certification, a level 5 rating. Capability Maturity Model is an industry standard for assessing process excellence in application development and maintenance organizations. The award is a result of a program to enhance the quality of the Accenture delivery center and helps extend its leadership in technology services globally. Chet Kamat, India delivery center network leader explained:

> The Capability Maturity Model quality framework helps us institutionalize our delivery center software engineering processes. The India delivery center currently is in a period of rapid growth and this assessment highlights further our ability to provide the most advanced and high-quality solutions to our clients.

The culture at Accenture revolves around teamwork, knowledge sharing, innovation and enrichment. It's an environment where open communication is encouraged and the spirit of excellence is rewarded.

Well-structured counseling and mentoring programs are in place to provide employees with easy access to key management and leadership of the India delivery center. Each employee is assigned a designated HR representative and a mentor. This provides employees with an open forum to discuss any issues they may have, as well as help shape them into leaders.

In addition, Accenture continuously seeks employee feedback on key issues and takes spontaneous action to address employee issues. Through regular internal communication meetings, Accenture disseminates information, shares future plans and past achievements and provides a listening ground to all its employees.

OUTSOURCING SUCCESS

In June 2004 Accenture said strong gains in its outsourcing and consulting businesses helped it achieve 21 percent revenue growth in its fiscal third quarter ended May 31 compared with a year ago. Accenture saw the most growth during the quarter in its outsourcing business. The company's outsourcing sales increased 37 percent to $1.4 billion on the strength of major deals with Payless ShoeSource, Danish transportation conglomerate DSV Group, and several other large customers.

Accenture Customer Contact Solutions is a global BPO business that helps companies to transform customer relationship management (CRM) operations quickly and affordably, while generating new sources of revenues and improved service levels.

The team on the ground in India represents the front line of this rapidly growing business. Their contact center professionals have the opportunity to work on some of the largest and most innovative deals in India's contact center market today.

General Electric

WHAT

While companies such as Daimler-Chrysler, British Telecom, Barclays Bank and HSBC are flocking to India to capitalize on the huge call center industry, old giants like GE have been reaping the benefits for over a decade.

A large part of GE's business in India is in remote processing centers. GE positions its call centers as "productivity enhancers". According to GE, companies could be spending two-thirds or more of their time on things that have to get done but have little to do with what makes their business successful.

GE Capital International employs over 1,000 people in its Centre of Excellence at Gurgaon near New Delhi in India. The call center facility at Hyderabad was expected to be running by March 2004. These centers provide IT-enabled business process outsourcing services to GE and non-GE customers around the world. GE's business objective is to consolidate back office processing into India for client organizations and deliver quality services at a competitive cost.

GE Productivity Solutions offers companies services and software that help them to grow revenue faster than expenditures by reducing resources and time devoted to back office processes.

WHY

GE was attracted to India because its intrinsic strengths make it a major success as an outsource destination for call center work.

1. A booming IT industry, with IT strengths recognized all over the world
2. The largest English-speaking population after the U.S.A.
3. A vast workforce of educated, English-speaking, tech-savvy personnel: A boon in a high-growth industry faced with a shortage of skilled workers
4. Cost-effective manpower: in a call center operation manpower typically accounts for 55–60 percent of the total costs. In India, manpower is available at a fraction of the cost overseas. However, some people are deterred by the fact that cost savings are not seen immediately. Initial investment in infrastructure and training can be expensive and make one believe that the promise of cost reduction is false. However, there will be savings and the fact that several global giants continue to set up call centers in India is proof of this

5. The government of India has recognized the potential of IT-enabled services and has taken positive steps by providing numerous incentives
6. The presence of most international technology vendors and solutions would enable the creation of the most advanced setups in this technology-intensive segment
7. India's call center industry accounts for a quarter of all software and services exports from the country, according to the industry association Nasscom, and Indian call centers employ 160,000 professionals.

EXPANDING

GE is investing approximately $130 million (over a three-year period) in the multidisciplinary John F. Welch Technology Centre in Bangalore, the largest research and development (R&D) center of its kind in the GE family outside the U.S.

The center, which was built in a record 10 months, was inaugurated by John F. Welch Jr., chairman and chief executive officer of GE. It incorporates the latest technology and e-engineering tools that facilitate real-time global interaction with GE's customers, suppliers, businesses and technology centers, including its U.S. lab in Schenectady, New York.

- *Large pool of scientists and engineers:* The technology center will eventually employ 2,200 scientists and engineers who will work in the areas of advanced chemistry, polymer science and new synthetic materials, chemical engineering, advanced six sigma and process modelling/simulation, mechanical engineering, electronic and electrical system technology, ceramics and metallurgy, information technology and e-business.
- *E-knowledge center:* GE's e-knowledge center, which is fully integrated with the facility, will access and disseminate knowledge globally to accelerate competitive technology developments for the benefit of GE's customers.

Hewlett-Packard

WHAT

HP revealed plans in March 2004 to outsource its accounting back office services from India to its customers such as Procter & Gamble.

HP will begin by launching a back office accounts processing facility in Bangalore for Cincinnati-based Procter & Gamble, the largest household products company in the world, operating in markets such as foods, beverages, personal care, laundry and cleaning.

HP has three similar outsourcing deals in the pipeline.

In order to process accounts from non-English speaking countries, HP is creating a team of language experts at its back office facilities in Bangalore.

WHY

Although HP is outsourcing its jobs to nine different countries in Asia and Europe in a bid to diversify operations and take advantage of varying manufacturing costs and tax benefits, India is a natural favorite.

On the quality of Indian outsourcing work, HP marketing manager Larry Tracy said India has an educated workforce, which is committed to work. "India and Singapore have excellent educated workforces while Mexico does not. However, we are planning to diversify our outsourcing operations in addition to increasing outsourcing jobs to India." HP is among several companies that have moved a variety of high-skilled tasks to countries such as China and India, which offer English-speaking, technically skilled workers at much lower wages.

The decision to expand came after a successful three-year stint operating its own global accounting functions from a subsidiary in Bangalore. This gave the company the experience and assurances about extending its operations in India. "Having gained the confidence that we can do this out of India, we are extending these accounting services to our clients," said Tracy.

CHALLENGES

In August 2003 HP Australia's outsourcing of its support functions to India hit some hurdles, according to the *Inquirer*. A few weeks after it moved jobs to Indian Bangalore-based Digital GlobalSoft, HP was forced to recall a number of people. It was thought that Indian support staff were proving to be more expensive because a lot of support calls handled over the phone required visits by technicians.

HP'S OUTSOURCING STRATEGY

HP aims to minimize outsourcing risks and ensure it meets its targets:

> HP with PRTM, recognizes the challenges and obstacles of outsourcing and offers a service to help companies reduce costs and improve the quality of their products and services. One of PRTM's recent surveys shows that over 70 percent of companies outsourcing development, for instance, are not satisfied with performance.
>
> Our Outsourcing Excellence offering brings together HP's 30 years of experience in designing and deploying high technology environments,

and PRTM's expertise as a leading management consultant in operations, with an extensive experience in collaboration, outsourcing, and partner management.

Outsourcing excellence helps to achieve:

- *Improved financial performance:* HP says an effective outsourcing strategy will create a compelling cost advantage for an organization that leverages outsourcing vendors' lower cost base. It will help improve balance sheets by teaching how to exchange equipment and other fixed assets for cash and avoid future capital investments. Cost advantages will be gained by the increased availability and scalability of a business/IT process.
- *Improved execution capabilities:* HP says it will help a company focus organizational resources on core competences and processes and help transition traditional fixed services into a more variable model that can expand and contract with the business demand. The organization will be able to use strategic partnerships to share risks and reengineer and/or replace suboptimal processes.
- *Better technology leverage:* Through its strategic relationships with an outsourcing partner, an organization can share the risks of new and aging technologies. It may outsource existing solutions, enabling internal staff to focus on new technologies introduced organically. A new partner could add emerging technologies to the organization's capabilities.

Aviva

WHAT

Aviva, an insurance company in England, will send 2,500 jobs offshore to India this year, where it already has 1,200 employees. Aviva, which trades in the UK as Norwich Union, will move 2,000 back office administration, processing and IT roles offshore along with 350 call center positions and 150 administration roles to support its general insurance business in Canada. The transfer will increase the number of staff in its existing offshore operations to 3,700 by the end of 2004.

Call center positions will be moved to processing centers in Delhi and Bangalore to deal with motor and household insurance enquiries and claims, while some IT service positions in the general and life insurance business will be transferred to Delhi, Bangalore and Pune.

CEO Richard Harvey hinted that the latest round of jobs moving offshore will not be the last. Aviva will continue to assess what future application offshore operations could have to other parts of its business.

WHY

Aviva claims offshoring will give the company extra flexibility and capacity for its UK business, while providing further scope to enhance efficiency and improve service to customers. Aviva CEO Richard Harvey said: "It is vital that we continually explore opportunities to improve our efficiency."

He also said the action was necessary for the group to remain competitive and that it will secure a long-term future for the business:

> We are operating in an increasingly competitive environment. Our customers want value for money products and high levels of service so it is vital that we continually explore opportunities to improve our efficiency while maintaining service levels. Our staff in India are an important part of this process and our experiences to date have been positive.

CHALLENGES

Amicus, the union representing the workers, called the move "deplorable." According to Dave Fleming, the national secretary of Amicus: "This decision is based purely on greed and ignores Aviva's responsibility toward its U.K. employees and customers."

The union has called on the government to establish a forum for unions to sit down with companies and plan for technological change. Lee Whitehill, spokesman for Amicus, said: "These are the first signs of a landslide which is going to engulf the British economy. The workforce is very angry and we will support them in any steps they see fit."

The company reacted by saying 80 percent of the jobs moved to India will be accommodated in the UK by a combination of expansion, current vacancies, staff turnover and voluntary redundancy. But that still leaves 500 positions under threat and Aviva said it cannot rule out compulsory redundancy.

LESSONS

Georgina O'Toole, analyst at Ovum Holway, said that the proportion of back office functions being moved offshore by Norwich Union reflects a wider growing trend, especially in the financial services sector, for firms to keep the customer-facing elements of their businesses in-house and not automatically put call centers offshore:

> There is a retreat away from that but it depends on the priorities. If they want to differentiate on customer service they are keeping core customer-facing processes in-house. If the strategy is to offer the cheapest mortgage then the pivotal thing is to keep costs down.

IBM

WHAT

In April 2004 IBM struck a $170m Indian call center deal to acquire Daksh e-Services, the third biggest call center in India. Sector analysts say this could strengthen corporate America's commitment to outsourcing offshore. The acquisition is the biggest deal of its kind in India's youthful technology services industry and analysts say the initiative could trigger copycat mergers as overseas technology companies seek to acquire a low-cost service base in India.

Privately owned Daksh employs 6,000 people at call centers across India to manage services such as customer care, telemarketing and transaction processing. Daksh's revenues broke through the $60m level last year.

The move came weeks after it was awarded a $750m ten-year outsourcing contract to manage the technology needs of Bharti Tele-Ventures, the big Indian telecoms group.

"These (two deals) will frighten competitors because they show IBM's commitment to India as a market and a place from which to deliver services," said Supratim Basu, technology analyst at ICICI Securities in Mumbai.

IBM has been a leader in outsourcing, notably to India where it employs 9,000 technology professionals on tasks such as systems integration.

In June 2004 it announced plans to move even more jobs overseas. IBM Global Services plans to outsource to India more than half the information technology positions, providing systems integration for Lincoln National Corp. Workers from India visited Fort Wayne to gain training to write code for system interfaces used by the Philadelphia-based life insurance and financial services company.

WHY

IBM's latest moves indicate a desire to step up its presence in a market where abundant IT skills and low costs are drawing other global technology and IT consultancy companies.

Lincoln spokesman Rob Fleener said of the outsourcing: "Cost saving is definitely a factor, but we wanted to make sure we had strong information technology resources to help us with our ongoing business success."

CHALLENGES

IBM began eliminating more than 60 positions in June 2004 and most of the outsourcing will be completed by the end of September. Many of the workers losing jobs are former Lincoln employees. The company contracted with IBM Global Services in 1997 to handle its information systems operations for its life division. As part of that agreement, IBM offered jobs to Lincoln information technology employees.

For IBM employees in Fort Wayne and other locations where its workforce in downsizing, a $25 million retraining program was launched designed to teach them new sets of skills that will help them find jobs either within IBM or elsewhere.

LESSONS

IBM's outsourcing dominance derives from its understanding that offshore outsourcing is not just about cost. It realizes that initial investment in infrastructure, training, and other such preliminaries are paramount for long-term cost advantage. This is seen over a period of time in an outsourcing venture which involves a committed relationship and understanding between both parties involved. Aranca says:

> Outsourcing services companies frequently have to make substantial investments in IT equipment, facilities and personnel. Yet IBM, HP and others prize these multiyear contracts because they can help bolster higher-margin sales of hardware and software by creating a long-term, interdependent relationship with clients.

Cisco

WHAT

Networking giant Cisco Systems said that it would invest $150 million to expand its technology development center in India over the next two years. This will be Cisco's second largest R&D facility globally and the largest outside the U.S.

The R&D facility will be based in Bangalore, where it will increase its workforce to 1,500 technical professionals over the next two years from the current 500.

The company has already invested $75 million in India since January 1996.

WHY

Cisco officials said the investment was part of the firm's strategy to tap the rapid business growth in the Asia-Pacific region. The center will play a strategic role in Cisco's ability to rapidly develop technologies and quickly deploy solutions and products that customers are demanding. The low cost of engineering staff in India is an obvious attraction for the company.

Since many telecom equipment companies saw their R&D budgets squeezed by the economic slowdown in the U.S., they have been turning to local India companies. During 2002, Cisco offshored more work to its three Indian partners, Infosys, Wipro and HCL Technologies, even as it stopped hiring for its own development center.

Multinational companies such as Cisco also appear comfortable outsourcing product development to companies that are also doing product development for their competitors. Wipro's telecom and internetworking solutions business, for example, has 2,200 people doing product R&D for a number of telecommunications equipment makers, including Cisco, Ericsson, Nortel Networks, Nokia and Motorola.

BEST PRACTICE

Infosys attributes much of its success to rigorous quality control. Software developers in India have made quality something of an obsession. Most developers here pursue and win the International Standards Organization (ISO) 9000 certification for excellence and then go on to climb the Capability Maturity Model (CMM) ladder.

CMM is a product of the Software Engineering Institute (SEI), run by Carnegie Mellon University in Pittsburgh. It describes the practices that make for effective software development, and it lays out a five-level progression from ad hoc, chaotic processes to mature, disciplined approaches.

Relatively few software shops in the U.S. seem prepared to invest the considerable time and effort needed to reach these lofty levels, but there's much they could learn from Indian developers, such as how to improve software quality by measuring and analysing defects, rework costs and estimation accuracy. Software quality experts say the payoff isn't just in less buggy software but in big productivity gains as well.

CMM isn't the only quality game in town for many Indian developers. Infosys has embraced ISO, CMM, six sigma and the Malcolm Baldrige National Quality Award framework for tracking software quality.

As a result, Infosys – whose clients include Cisco Systems and Nortel Networks – today has well-defined and repeatable processes for measuring quality. It measures and manages such things as in-process defects, rework costs, defects delivered to customers, cost overruns, schedule slippage and estimation accuracy.

Investment banks

Having successfully outsourced to India such back office functions as IT, investment banks are now sending some of their financial analysis and research overseas. At the start of 2004, firms including J.P. Morgan and Morgan Stanley quietly hired Indian firms or set up their own subsidiaries in India to handle basic financial modeling and comparable analysis.

Why

Two main factors are driving this trend:

- First it's cheaper. According to Dushyant Shahrawat, a senior analyst with Needham, a financial services industry research firm, the fully loaded cost of hiring an experienced junior analyst in India is between $20,000 and $25,000, compared with between $85,000 and $90,000 in New York. Such savings are especially attractive now that banks are no longer subsidizing sell-side research with investment banking fees.
- Second, banks hope that by freeing senior analysts to concentrate on analysis rather than running numbers, they will produce better and more research. "The bank always has to have the equity analyst sitting in New York, being able to talk to CEO's," says Joseph Sigelman, co-CEO of OfficeTiger, one of the Indian firms serving Wall Street. "But if we can take away some of the very structured, repetitive tasks, the number of companies the analyst can cover increases significantly."

This will sound like good news for coverage-starved companies. During the past few years, there has been a steep dip in analyst coverage, particularly for small- and midcap firms. According to Thomson First Call, 6,100 companies had at least one analyst covering them in 1998; today that number is 4,142. Coverage will naturally increase as the economy improves, says Chuck Hill, Boston-based director of research at First Call, although not to the levels of the exuberant 1990's.

But sending research to India is not likely to improve things for companies that have lost coverage. Despite talk of severing the links between research and investment banking, sell-side analysts still have few incentives to cover companies that don't generate investment banking fees for their companies. For now this will likely mean more intensive analysis of the fee-generating Fortune 500, not broader coverage. "The focus is not to send your research abroad to cover more companies," says Shahrawat, "but to do a much better job with the companies you're covering now." And do it for less.

CASE STUDIES

Ford

Close on the heels of making India its accounting headquarters, the U.S.-based auto giant Ford Motor Company is now working toward making India the IT hub for its global operations.

Software development

Ford will set up a software development center in India by January 2005 for its future e-business solutions.

Ford has decided to infuse $3–5 million over the next 6–18 months into the IT venture. This can go up to $30–50 million per annum. "We have already started getting the IT work from other manufacturing bases to India", said John Larson, the company's director (IT) Asia-Pacific and South Africa. The company is in the process of finalizing the modalities of the venture, which is likely to be floated as a separate company.

"India would play a major role in Ford's global strategies and it would be the pilot for our new e-business solutions," said Larson, adding that the company had tested some new IT solutions in the country before their global launch.

B2B automotive portal

Ford is also planning to set up an India chapter of its web initiative, Covisint. Larson said:

> Covisint has been floated as a joint initiative between Ford, General Motors and Daimler-Chrysler for common purchases on the Net. Since all the three partners already have manufacturing bases in India, we are looking at setting up an exclusive exchange for us. At a later stage, we will also look at including other automobile manufacturers into the system.

The three partners are merging their respective current exchanges under Covisint. The exchange will help in online purchasing, price comparison and configuration.

Remote processing and call centers

Larson said Ford was also planning to set up call centers in the country to do back office processing work on the lines of GE. "The company is opening an office in India to explore possibilities of establishing call centers in the near future," he said.

Ford has shifted much of its computer-aided design, manufacturing development, and application development tasks to a subsidiary in

Chennai. This was expected to help cut its costs by an additional $30–60 million as IT labor costs in India are a fraction of those in the U.S.

Ford planned to spend $10 million on the first phase of getting the subsidiary, Ford Information Technology Services of India, up and running. That investment covered the equipment and technology needed to operate the IT hub but not the costs for personnel. To handle its labor, Ford will outsource all its software development, email processing and other IT management services – a staff of 700–1,000 workers – to Indian contractors.

WHY

"There are advantages to having IT systems in India, in terms of the costs, time difference and other features," said Gerard O'Shea, an analyst at the Yankee Group in Boston. For instance, according to Yankee Group research, it costs $12 for a U.S. company to field a 30-minute customer support call in the U.S. and $3–5 for an email response. By contrast, those costs may be significantly lower in India. Larson said GE's success influenced Ford's decision to open the hub in Chennai.

CHALLENGES and LESSONS

Ford will still have to contend with India's wobbly infrastructure and high turnover rates for IT staff. Ford's accounts payable processing unit in India typically loses power three or four times each day. On top of that, it's difficult to establish a telephone connection.

To meet those challenges, Ford is planning several steps. The Chennai subsidiary will link to Ford's global private network using a 2M bit/sec. circuit that runs through Singapore. Ford plans to double the capacity of the network to 4M bit/sec. by year's end.

And to help lower its IT turnover rates in India, Ford plans to offer U.S. and European work visas to the top 15 percent of the outsourced developer staff. Most developers "are going to move outside India anyway, so they might as well work on Ford programs," Larson said.

Oracle

WHAT

Oracle has drawn up huge plans for India. On the drawing board are plans to set up an off-site consulting center to provide a virtual consulting resource for Oracle worldwide. Oracle has also started an initiative in India to focus on incubation for evaluating start-ups.

According to Gary Bloom, Oracle's executive vice-president who also looks after the company's venture capital operations, India has a lot of small technology companies that have good ideas. He says:

> There is a lot of incubation happening in India and we want to focus on that. The board has authorized us $500 million for global investments and we haven't allocated any sum to any location. If we find $200 million of great investments in India, we'll invest $200 million. But there are no allocations by geographical regions.

Oracle Consulting has plans to set up an extension of its e-business studio at Hyderabad, which will provide virtual consulting capability and knowledge to all Oracle clients worldwide. "At this point of time, we might start off with just 100 people. But, over time, I see that growing to over 1,000 people," said Oracle Executive Vice-President Edward Sanderson. Oracle already has global software development centers in Bangalore and Hyderabad.

JU Oracle Corp. plans to increase the number of staff it has engaged in India in software development and other areas, such as customer service, from 3,000 to more than 6,000, said Larry Ellison, the company's chairman and CEO.

Having set up software development operations in India in 1994 at its centers in Hyderabad and Bangalore, in 2003 Oracle began moving other services, such as support, to India. The company's global support center, divided between Bangalore and Hyderabad, is one of four centers in the world that offer technical support on Oracle products. A shared services center in Bangalore provides back office services to Oracle subsidiaries worldwide.

WHY

Ellison said:

> As a global organization, we have to be able to service our customers 24 hours a day, seven days a week, and that means we have to be in multiple locations and operate across different time zones. Also, the availability of skilled manpower in India is compelling enough for us to outsource to India. While China is specializing in the area of outsourced manufacturing, India is ahead in services. In general, it seems like the world economy is going in the direction of outsourcing.

Oracle has been adding 100 staff each month, on average, over the past year and a half, according to Budge.

English language skills in the country and educational institutions such as the Indian Institutes of Technology have been important in developing the service sector in India.

LONG CASE STUDY

Cooper Health System

COMPANY DETAILS

Cooper Health System is a premier provider of comprehensive health services and advanced medical technology in southern New Jersey. It consists of a regional hospital and an extensive ambulatory care network including practice sites across eight counties in southern New Jersey. The only clinical and core teaching facility in the area, Cooper has become a national leader in medical education and research. Its 544-bed, acute care facility provides a full continuum of primary and tertiary care, innovative diagnostic and treatment options and access to cutting-edge research and protocols.

Cooper's ongoing mission has been to provide the highest quality of clinical services to its patient population to help build a healthier community. However, in 1999, Cooper was forced to make some hard decisions around its staffing due to market conditions and financial performance. This decision included a significant reduction in its outcomes and quality performance departments. As a result, performance improvement became fragmented and isolated, provided little value, and had minimal buy-in from executive management or physician leaders. It also resulted in the loss of proper quality-focused resources and key skill sets such as clinical data analysis for performance improvement. Despite Cooper's achievement of a $40 million turnaround and positive net margin in 2002, its long-run market position and mission achievement goals remained at risk.

THE OPPORTUNITY

Having achieved financial stability, Cooper wanted to attack this problem aggressively. It believed it had to make quality the centerpiece of its market strategy in order to gain true, sustainable market advantage. Further, it needed to develop and maintain corporate competences to grow physician affinity, and operational excellence, while maintaining its safety net focus and positive operating margins.

On our strategic gap analysis matrix (see Figure 4.2), the activities that Cooper decided to outsource could be classified as a potential activity with a high probability of becoming a competitive advantage. The in-house capabilities of Cooper vis-à-vis its competitors could be termed as moderate, as the company has a history of managing these activities in-house.

On the sourcing models matrix (see Figure 4.4), the situation lies in cell number 9. Our analysis suggests that when outsourcing a potential activity that is showing a high probability of becoming a competitive advantage, a company can choose a partnership or a collaborative or a risk-sharing model.

The choice of model is also determined by the sourcing alternative employed. Cooper had the alternative of choosing to outsource either skills (capabilities) or services (solutions). Let us see what sourcing alternative and model Cooper employed as part of its outsourcing initiative.

THE PARTNER

Cooper approached CareScience, a leading care management solutions company, because it was interested in developing a sound business strategy and organizational infrastructure to improve patient care quality and efficiency. A leading expert in care management design, CareScience provided an initial assessment to identify the key elements required to implement a coordinated, data-driven care management program built on Cooper's existing organizational strengths.

The initial assessment took place over a two-month period. It consisted of interviews with key leaders and management staff and a thorough review of organizational documentation such as business plans, organization charts, performance improvement plans and quality flow reports. CareScience employed the use of a peer-based dimensional rating system that scored the hospital on nine different functional areas (culture, organization, leadership, strategy, staff, information, process, incentives and accountability). The results of this dimensional assessment were compared to a knowledge base of more than 50 other organizations.

Based on the findings of this initial assessment, CareScience recommended that Cooper aggressively implement a care management infrastructure in three sequential phases:

- Mandatory quality reporting
- Performance improvement
- Care management

This approach was not a significant new cost outlay. Instead, each phase would require some incremental investment from Cooper but would offer an associated return on investment. The three-tiered infrastructure would be implemented over a five-year period via a unique strategic sourcing partnership model.

The strategic sourcing model would allow CareScience to work side by side with Cooper to provide vision, leadership and support and manage its care management functions. The key characteristics of the sourcing partnership included:

- *Deployment of on-site staff:* Full-time, on-site CareScience staff that report directly to Cooper's executive team. The staff would blend seamlessly into the organizational infrastructure of the hospital and be viewed internally as "Cooper employees."
- *Alignment, leadership and strategic development:* Dedicated involvement of CareScience executives that would help to develop leadership strategies for obtaining physician buy-in and selecting the best types of interventions. This team of CareScience executives would work closely with Cooper executives to define mutually agreed upon strategic goals and metrics. Yearly targets would be established and used to measure the success of the partnership.
- *Specialized technologies:* The installation of the CareScience care management system that includes data management, performance measurement, risk assessment and patient care management.
- *Gain and risk sharing:* A metric-driven gain-sharing agreement that drives return on investment for Cooper, but allows CareScience to benefit when key metrics are achieved.

With the information it can be inferred that Cooper's decision employed the alternative of outsourcing services and the option of outsourcing complete business process. The alternative allowed Cooper to transfer a significant amount of risk and management responsibilities over to the ESP.

The model employed for the outsourcing relationship was a partnership structure, which was one of the recommended models for the cell 5 situation on the sourcing model matrix.

The outsourced activities were potential activities with significant probability of becoming a competitive weapon and the theoretical framework suggests that the organization should also try to move toward a position of strength in terms of internal capabilities.

A careful look at the partnership structure reveals that although it involved the outside vendor in delivering the services in the initial period, it also facilitated the development of skills in-house. Thus the partnership structure addresses all the requirements and concerns. No wonder it delivered spectacular results for Cooper.

THE PROCESS

Once the proposal was communicated to the executive and clinical leadership at Cooper, it was accepted and implementation began. Implementation occurred in three separate phases. The first phase focused on building an infrastructure so that mandatory quality reporting could take place.

Phase 1: implementation – mandatory quality reporting (6 months)

CareScience hired, trained, and placed staff on site at Cooper. The CareScience team subsequently developed a performance improvement plan for mandatory quality reporting targets and the involvement of the clinical team, with the goal of zero type I recommendations on the "improving organizational performance" standards during Cooper's Joint Commission Accreditation of Healthcare Organization's (JCAHO) survey that was to take place in eight months. This goal served as the first year's key metric. The new plan and staff were introduced to the board of trustees, senior leadership, medical staff, management teams and department managers. The plan detailed the new staff's roles and responsibilities and how they would integrate into existing departments.

At the same time, CareScience installed the care management system. All relevant staff were trained on the system and began generating and analyzing performance data. The team focused its initial risk share target on the upcoming JCAHO survey in January of 2003. The goal of the target was to improve the hospital's overall score in the areas of "performance improvement," "leadership" and "medical staff".

To do this, CareScience conducted mock surveys to assess compliance with standards, any required changes and potential exposure to any negative survey findings. Once this assessment was completed, the team met weekly to develop an action plan and timeline to address any potential type I recommendation findings. Accountability for each action item was defined and communicated across departments, and status reports were communicated regularly to the board of trustees, steering committees and senior leadership at the hospital.

In January 2003, Cooper received top reviews on its JCAHO survey, including no type I recommendations related to CareScience's accountability for "improvement of organizational performance."

Phase 2: implementation – performance improvement (6 months to present time)

After implementing an infrastructure for mandatory quality reporting (phase one), the team turned their attention to building the second tier of the infrastructure for performance improvement and focused on establishing year two targets. The team established performance improvement targets for a set of clinical and operational initiatives. The clinical areas consisted of: stroke, atrial fibrillation, and coronary artery bypass graft procedures, while the operational areas consisted of: emergency department throughput, radiology turnaround time for MRIs and CT scans, and operating room throughput. In conjunction with phase two, CareScience expanded the team by hiring and training outcome managers to facilitate the care coordination and achievement of these targets.

As part of this work, the team continued its work on integrating the care management system into the performance improvement staff's ongoing monitoring activities. Reports generated from the system identified target patient populations with the greatest improvement opportunities. Once this was complete, educational campaigns were designed to help address the specific opportunities for improvement. These campaigns included a monthly newsletter on performance improvement, risk management, and patient safety and specialized medical staff educational sessions. Organization-wide education programs on performance improvement methods were also held.

Phase 3: implementation – care management

In phase three, the team entered into early discussions on how to redesign their care management initiatives to support the final tier of the infrastructure. The risk share targets for this phase will focus on increasing care coordination between three critical care management functions:

- *Care management:* performance improvement, JCAHO compliance, clinical excellence, and regulatory reporting
- *Loss prevention:* patient safety, evidence-based medicine, compliance and risk management
- *Care coordination:* denial management, discharge planning and utilization management. The team will take six months to evaluate current care management processes and offer up a plan for redesign and implementation.

ACCOMPLISHMENTS

Within one year of the sourcing arrangement, the CareScience-Cooper partnership has accomplished the following milestones:

- *JCAHO accreditation:* Cooper Health System underwent the JCAHO survey in January of 2003 and received no type 1 recommendations in the designated CareScience areas. Through its unique strategic sourcing partnership with CareScience, Cooper was able to accomplish this goal because it had access to external experts, additional resources, and management focus.
- *Change in culture:* A cultural transition ensued in which many organizational barriers were surmounted. In order for the sourcing model to be successful, the team had to tackle several issues surrounding organizational culture, turf, trust, and the value of the services offered. This was accomplished on many fronts. New

staff were integrated into the organizational structure at an early stage. Policies and procedures were developed and goals and targets were defined for years 1 and 2. An appropriate reporting structure and accountability for results were also established to help create a culture of collaboration versus one that was punitive and retaliatory.

- *Strong executive sponsorship and commitment:* Performance improvement was incorporated into the strategic business plan and the overall information technology strategy. Strategic priorities and improvement targets were presented to the board of trustees, senior leadership, middle management and physician champions to ensure buy-in and cross-departmental support. This helped reverse the organization-wide perception that change could not be effectively achieved. It also helped to engage senior management in day-to-day clinical and quality issues.
- *Integrated performance improvement program:* The strategic sourcing model enabled the team to create a politically neutral ground for performance improvement. Cooper had access to quality data via CareScience software, which provided performance, care process, and outcomes reports as well as data-mining opportunities. This enabled the groundwork for a performance improvement infrastructure and the blueprints for the redesign of a comprehensive care management infrastructure.
- *Focus on clinical and operational processes:* The strategic sourcing relationship allowed Cooper to be more data-driven. Using the care management system, it was able to evaluate performance and conduct opportunity analyses to determine areas that offered the greatest yield for improvement. From these findings, the team was able to set specific targets for senior management, drive the need to establish clinical improvement goals, and focus on increasing capacity to improve throughput.
- *Good understanding of the value of quality:* The sourcing relationship also allowed Cooper to benefit from capitalizing on the best of two organizations with different core competences. Both organizations were able to address the same issues with varying levels of expertise. The shared-risk arrangement helped the two organizations align incentives which ultimately led to realizing more value in performance improvement; specifically, improving clinical excellence (reduced mortality and complications), increased bed capacity by freeing up beds through reduced length of stay, and lower cost of care through more appropriate or timely resource utilization. The organization learned that these improvements supported its initiatives to increase market share and payor preferences in strategic priority areas.

This case study on Cooper Health System is a testimony that a carefully planned and well-structured outsourcing initiative is a guarantee of success. It also highlights the fact that the benefits of outsourcing go well beyond cost savings and can facilitate process improvement and cultural transformation. The case study underscores another aspect of outsourcing arrangements – the important part played by the external vendor (CareScience) in designing the right kind of outsourcing deal and its execution in order to ensure success. We address this critical topic in the next chapter.

CHAPTER 5

Guidelines for choosing outsourcing partners

Once the company has prepared its sourcing strategy and decided to outsource/offshore a few functions, the question facing it is with whom will it walk down the aisle. As we described earlier, the first, and critical, step in the partner selection process is to identify the business aims being pursued. Indefinite or vague business strategies become ill-conceived alliance strategies. The business aims being pursued stem from the strategic gap analysis that is conducted by the company.

Business process outsourcing (BPO) is a fairly nascent industry – a good fit will work out over time. One should proceed with caution; test the waters before taking the plunge. BPO alliances have to be built for the long term and allow for flexibility. Various decisions have to be taken once the company has decided to enter into the arena, where it chooses to outsource some of its processes. The decisions will center on the task to be outsourced, which shore to outsource it to, and with whom. This chapter explains the various steps that a company goes through in choosing a partner.

Partner choices framework

How can companies interested in entering the BPO market navigate this complex environment and make intelligent choices as to when, how and why, where and with whom to partner? The earlier chapters have detailed the why, when and how parts. This chapter will concentrate on the where and with whom.

Figure 5.1 outlines the major steps involved in moving from business strategy to partner strategy. The narrative that follows describes each step in the specific context of choosing a BPO partner.

A.B. Patel et al., *Outsourcing Success*

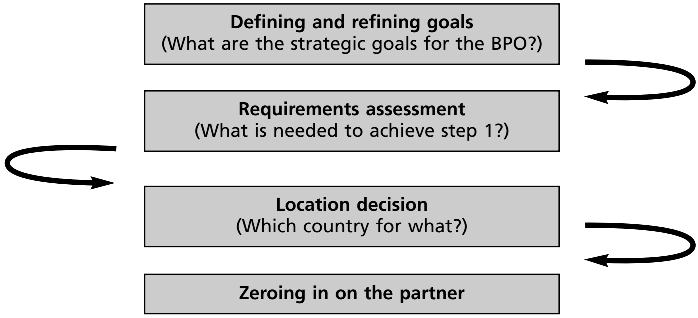


Figure 5.1 Partner choices framework
Source: Aranca

Defining and refining goals

Participants in Gartner Dataquest's 2002 and 2003 alliance best practices study identified "mismatch" of strategies, goals and corporate cultures between or among alliance partners as the top reason for alliance failure.

It is essential that goals be clear, actionable and measurable. Further, goals should be identified at as granular a level as possible. If multiple segments, such as finance and accounting, and HR are being pursued, then the goal-setting exercise should be repeated for each.

Requirements assessment

With strategic goals established, the next step is to understand what is required to achieve these goals. As mentioned previously, one of the challenges of identifying a BPO strategy is that roles and requirements are more fragmented and complex than may be realized.

A company outsourcing certain processes in order to gain cost reductions may determine its requirements on the basis of the pricing that the provider offers. While pricing may be important, the company must keep in mind the qualitative factors required. Another company may be outsourcing due to a lack of a particular skill set. At this stage, each company looking to outsource must prepare an exhaustive list of its particular requirements that will lead to the fulfillment of its business objectives.

Location decision – which country for what?

In the outsourcing decision, a major evaluation is the shore on which the process needs to be outsourced. In deciding on the country where the work will be shipped to, there are a variety of factors that need to be looked into: cost considerations, quantity as well as the quality of labor, education and language skills, cultural compatibility issues, infrastructure issues, and political stability. The major contenders for being the favored shore for the BPO can be broadly divided among the following continents:

- **Asia:** India, China, Malaysia, the Philippines, Singapore, Thailand, Vietnam, Australia, and New Zealand
- **Europe:** Ireland, Poland, Russia, the Czech Republic, Portugal, and Spain
- **Americas:** Canada, Brazil, Argentina, Costa Rica, and Chile.

Manufacturing outsourcing tended to migrate from higher labor cost countries to lower labor cost countries, irrespective of their cultural or linguistic differences. However, in BPO, cultural and linguistic factors come into play, especially in areas like customer relationship management. Therefore, the greatest outsourcing opportunity will come about in areas that have language and culture similarities along with wealth disparity.

In the English-speaking regions, the U.S.A. and U.K. are wealthy nations whereas India and Pakistan are the lower cost nations; so this linguistic region has the highest potential. One of the main limiting factors that have so far kept China second in the outsourcing race is the linguistic factor, although it is trying to catch up by educating its populace in English.

A. T. Kearney, in its 2004 index (see Figure 5.2), measures the various countries on three major parameters – financial factors (40 percent weighting), people skills and availability (30 percent), and business environment (30 percent):

The financial structure

- Compensation costs
- Infrastructure costs
- Tax and regulatory costs.

People skills and availability

- Cumulative business process experience and skills
- Labor force availability

- Education and language
- Attrition rates.

Business environment

- Country environment (economic and political aspects)
- Country infrastructure
- Cultural adaptability
- Security of intellectual property.

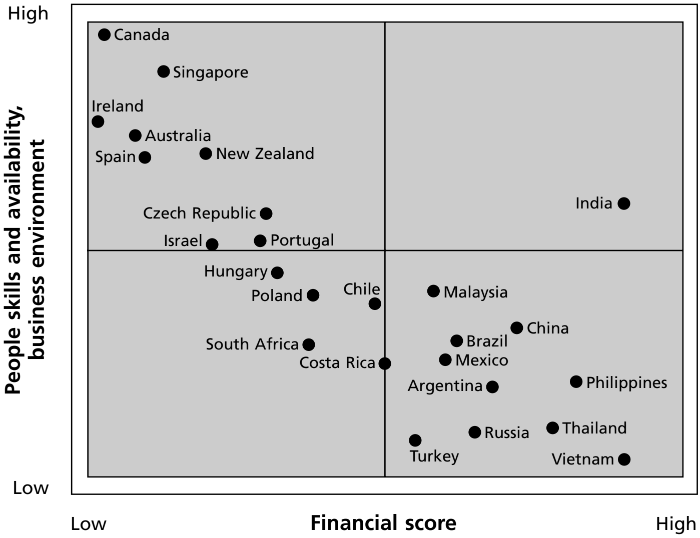


Figure 5.2 25 most attractive offshore destinations
Source: A. T. Kearney 2004 Offshore Location Attractiveness Index

There are some key points to note:

1. *India* remains at number one due to its strong mix of low costs and significant depth in human resources.
2. Low costs and a large labor pool helped *China* to secure the second position – it lags behind India on experience, IT and management education, and language skills.
3. *Malaysia* is a rising alternative to India and China, given its well-developed low infrastructure costs and strong government support.

4. The *Czech Republic* has scores almost identical to those of Malaysia. The country offers European clients low costs, good language skills and cultural similarities, a competitive infrastructure, and a stable political and economic environment.

5. *Singapore*, although not considered a low-cost location, remains a favored shore due to its excellent education and language skills, superior infrastructure, and pro-business tax and regulatory environment.

6. *The Philippines* is at number 6 due to experienced and talented low-cost labor.

7. *Brazil* is in favor because of its people skills and labor availability – it offers a huge labor force and low costs.

8. *Canada* ranks eight in the index – compared to the U.S., it offers lower costs, has a low-risk environment, with similar or even superior levels of education and infrastructure.

9. *Chile* has the best business environment score in Latin America.

10. *Poland* has a highly educated, scientifically oriented, and relatively low-cost workforce, with *Hungary* in close contention at number eleven.

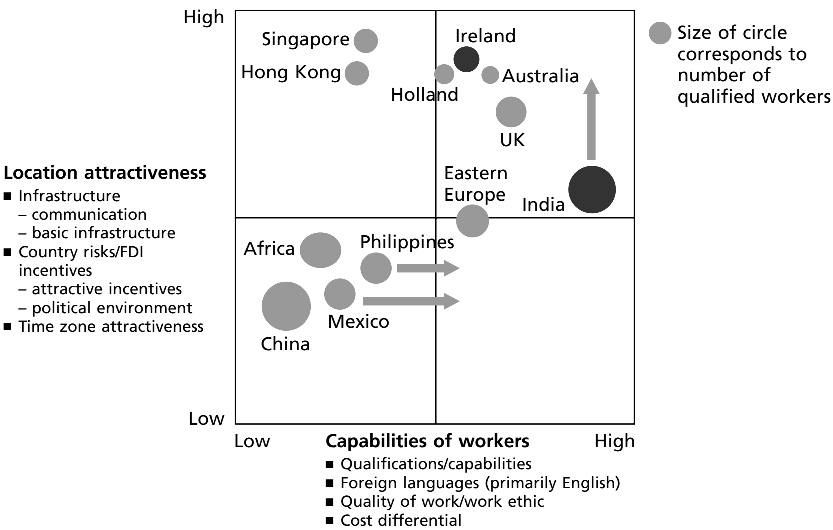


Figure 5.3 McKinsey analysis of best offshore locations
Source: McKinsey

There is no "one size fits all" solution that can be proffered. Each company will align its business objectives with its location strategy. Companies may have differing objectives for BPO such as enhanced productivity, improving service and superior technical skills. Some companies consider the compensation costs, quality of human resources, as well as geopolitical risks, while for certain companies the decision may be based on matching precisely defined skills to the tasks that are to be outsourced.

A major factor contributing to the attractiveness of India and China, and to a lesser extent, Russia, Brazil and the Philippines, is the breadth and depth of the skill base. At the other end of the scale, Singapore, New Zealand, Canada and Ireland have their strength in excellent infrastructure and education systems, high degrees of global integration and business-friendly, low-risk environments. The above-mentioned study by A. T. Kearney may well be the starting point in identifying the usual suspects. However, to zero in on the ideal locale, the company's specific needs are of utmost importance – depending on the goals assessments and the requirements assessment, the key result areas are to be mapped and matched.

Zeroing in on the partner

Once the decision on the location has been taken, the next step is to find the right outsourcing partner. The first task will be to decide which kind of partner will be chosen. Based on the types of BPO players mentioned in Chapter 2, a match has to be made with the strategic gap as well as the requirements. In choosing the partner (after deciding on the type of player), the company must ask the following questions:

■ *Does the provider have a track record of service commitment?*
In an outsourcing relationship, service-level agreements are the key to measuring the success of the liaison. In partnering with someone, one needs to estimate whether the fit exists. The best metric for gauging this will be to see how the outsourcing provider has performed on their past contracts. Whether the provider has performed well on key, service-level agreements in the past would be a reliable indicator. After all, if one is going to trust someone else with a part of their business, one needs to be sure that they understand and execute it well.

■ *Who are the provider's existing customers, and how satisfied are they?*
Talking candidly with a cross-section of the provider's existing and former customers would be the centerpiece of the due diligence efforts. Prospective providers should furnish a representative sampling of their customer base. Many outsourcers provide selective references that would more than likely be aligned with the industry and business needs.

- *What type of technology infrastructure does the provider have in place?*

It's to one's advantage to have a basic understanding of the technology platform because it serves as the foundation for business process delivery and administration. Infrastructure is the backbone of outsourcing operations. The technology infrastructure encompasses everything necessary to host, manage, operate, and protect the security of the important and sensitive data and applications central to the process being outsourced. It's important to ensure that the provider's data center is staffed with highly qualified, experienced, and committed IT personnel. The redundancies and the security that a provider offers are also key variables in the decision making.

- *How are the services priced?*

Service levels, not pricing, should be a key factor while evaluating a provider. However, in reality, pricing plays a large role in most decisions. Pricing is often not fully understood by buyers. Find out whether or not there are any hidden costs. It's also important to get a clear idea of how pricing will change as the needs scale up or down over time. In this case, it would be important to understand whether or not the provider's practices are flexible or rigid.

- *How much flexibility does the provider offer to accommodate specific needs?*

This can be tricky to assess. The key is to determine whether a provider is simply trying to sell by overpromising, or whether it is genuinely committed to tailoring its service to meet a company's unique needs. As always, look at the evidence on the table. Has the provider established a pattern of working with existing customers to meet their needs? Equally important, does the provider demonstrate a willingness to help clarify and hone one's needs and map these onto its service offerings? Keep in mind, though, that one should not expect any service provider to reinvent its business model. Be very worried if the prospective provider offers to do so.

In the long run

Asking pertinent questions like these can make a world of difference before choosing an outsourcing provider. Remember, the outsourcing relationship created with the provider is long term and one needs to feel secure that the relationship is an important arrow in the company's strategic quiver.

LONG CASE STUDY

Rhodia is one of the world's leading manufacturers of specialty chemicals. Its products are found in industries as diverse as automobiles, healthcare, apparel, electronics and environmental protection. Listed on exchanges in both Paris and New York, the company boasts a global presence. Yet for all its strengths, the French company has not been immune to the persistent slowdown in the chemical industry, a situation that has been aggravated by a heavy debt burden.

Rhodia was breaking new ground by deciding to outsource at all; this simply wasn't done in France. Moreover, according to Accenture engagement partner Christian Marchetti, it is also "probably the first European company" to do so on such a scale, in central Europe and on a wholly new, greenfield site.

Prague was, in some respects, a natural choice for Rhodia. The company initially considered creating an internal, pan-European shared service center for its finance function, which would have boosted productivity simply by consolidating the work of the various processing offices. However, any potential benefits would have been severely compromised by the cost of such a change.

"The existing IT landscape was extremely complex," explains Marchetti. "Rhodia's European offices operated with three enterprise resource planning systems, which included eight different SAP platforms and 12 different purchasing systems." Renewing all these systems across multiple countries would have been prohibitively expensive.

Looking east

By early 2000, the prospect of actually outsourcing the finance function to an external provider capable of delivering a comprehensive, integrated solution in a low-cost, well-resourced location was looking increasingly attractive to Paul Van Beveren, Rhodia's change manager for finance. But before he could choose a provider, he needed to decide on the location. Southern Europe – Lisbon, for example, or Barcelona – might have filled the bill, but "we were not convinced by these places," Van Beveren recalls. Central Europe, by contrast, was attractive to Rhodia; the company had operations in Poland and an important plant in Slovakia. Consequently, the search was narrowed down to three potential sites: Prague, Kraków and Budapest. Based on a number of criteria, including both cost and quality of resources, Prague quickly emerged as the most attractive of the three. First, labor costs – some 70 percent of the total cost of any shared service center – were "significantly lower" in the Czech Republic than in Poland, explains Van Beveren. Prague also offered one of the best-educated populations in Europe, if not the world: 88 percent of the Czech labor force, between the ages of 24 and 64, have completed secondary school.

Add to this excellent transportation and communications facilities, as well as some of the best values in commercial real estate in Europe, and the Czech capital came out well ahead of its competitors. The fact that Prague is about as close by plane to Paris as Nice seemed to settle the matter.

But Van Beveren still had to sell the whole idea of outsourcing to Rhodia's management. "Outsourcing is still a very new concept in Europe," he explains. "Many companies fear a loss of control." He need not have worried. Rhodia Chairman and CEO Jean-Pierre Tirouflet "had no preconceived notions" about the outsourcing concept, says Van Beveren. "His attitude was, 'If it can improve profitability and we have the guarantee that it will not affect quality, let's do it.'"

In May 2000, Rhodia's executive committee gave Van Beveren the green light to outsource, and by early July, requests for proposals were circulating among the big consultancies. At the end of September, Accenture was selected. According to Van Beveren, Accenture's commitment to Prague was decisive. "They were willing to go to what was a completely greenfield environment," he says. "No one else was." To be sure, Accenture, which had had a large practice in Prague for more than 10 years, was no stranger to this ancient city at the heart of Europe. Nor was the company a novice in business process outsourcing – far from it. Between having 20 delivery centers worldwide offering finance outsourcing solutions, and its emphasis on using the outsourcing concept as a strategic tool, Accenture was capable of achieving the sort of improvements in information flow and decision making that Rhodia sought. Accenture's shared service center in Nove Butovice, a 65,000-square-meter, four-building business complex to the west of Prague, was almost tailor-made for Rhodia, the center's first client.

So far, the transfer of the company's finance function to the site has been not only remarkably smooth but also surprisingly swift – a tribute to the power of a partnership that Van Beveren likens to a marriage. "If one of you makes a mistake," he says, "you can't lay back and tell [the other] to fix it – you have to jump in and help one another until it is solved. You can't put that kind of a relationship into a contract – it has to be built on mutual trust." Indeed, because centralizing processes would involve substantial organizational change for Rhodia, a cooperative relationship was essential. The six-and-a-half-year contract signed by Rhodia and Accenture in March 2001 recognizes this need for cooperation: It commits Accenture to run the Prague operations and provide finance back office services to Rhodia subsidiaries in France, the United Kingdom, Germany, Spain, Italy, Switzerland and Slovakia. Accenture is responsible for the "knowledge transfer" process – a key element, for it was assumed that no employees from the existing finance organizations would want to transfer from their home countries, and new personnel, therefore, would have to be recruited and trained.

Inhibitor – a question of culture

The project has not been without its challenges, of course, especially in regard to these social aspects. The first wave of the transfer, which went live in July 2001 and involved UK finance, went relatively smoothly. But the second wave, in November 2001, which involved consolidating activities from France, Switzerland and Slovakia, was considerably more problematic. "It's a question of cultural differences," Van Beveren explains. "In France, a proposal is a starting point for negotiations; people always need to discuss, to argue." As a result, he says, valuable time was lost in completing staffing arrangements, and "knowledge gaps" arose because there simply weren't enough new recruits in Prague to do the job properly. Van Beveren insists, however, "even in difficult situations, we had things under control." What's more, Accenture's rather novel approach – moving Rhodia's existing systems to Prague and then working on standardizing them, rather than standardizing first and trying to transfer the new, common system – has greatly facilitated the overall process.

Considerations – smoothing out the roadblocks

Outsourcing is probably one of the most complex of all business relationships. Both parties – the service provider and the client – enter a contract full of optimism and high expectations. However, despite the best intentions of both entities, many potential pitfalls exist for those who do not set a cornerstone on due diligence and clear communications.

The foundation for a successful outsourcing experience is built upon three truisms. First, the service provider and the client must agree on a well-defined statement of work (SOW). Second, both parties must select the proper liaisons to manage day-to-day interface. Finally, both the service provider and client must establish a plan of communications that includes regularly scheduled meetings and meaningful reporting mechanisms.

Key principles for win–win client relations

Three key principles govern the creation and maintenance of positive outsourcing relationships: trust and confidence; responsiveness; and innovation.

Trust and confidence

Many client stakeholders are typically involved in each outsourcing decision. Since lack of support from any single stakeholder has the potential to weaken the outsourcing relationship, a number of things can be done to help prevent this erosion. For instance, it is imperative that:

- Communications with all client stakeholders and the outsourcing team are regular and consistent
- All appropriate parties are included in the communications process
- Information is shared between the relationship managers to ensure that decision makers and stakeholders have access to the same information.

Both the service provider and the client need to understand and manage the idiosyncrasies that have evolved in each organization. Maintaining a clear bilateral definition of the roles and responsibilities of both the service provider and the client stakeholders will help to set the stage for clear communications.

It is easy for managers in both organizations to get fixated on terms and conditions, SOW's and other substantive issues, and inadvertently ignore the interpersonal challenges that complicated, interdependent outsourcing relationships create. Good communications, inclusion, and information sharing will go a long way toward building trust. The more both parties can reach mutual understanding on goals, metrics and mechanisms, the less often barriers will arise.

Responsiveness

Challenges will arise in every outsourcing relationship due to changing requirements or organizational afterthoughts. The client expects and deserves responsiveness to these dynamic situations. The service provider who can respond – or even anticipate – possible changes or additions and address them in the early stages will add value to the relationship.

That being said, unexpected developments or contingencies will always surface, even in the best of relationships. When these challenges become points of contention, a natural reaction for each party is to build its own encampments – the service provider around the SOW and the client around the service-level agreement (SLA). Neither of these knee-jerk reactions is particularly productive in solving these challenges. The more responsive and productive approach is for the service provider to help the client recognize possible changes in requirements in a timely fashion.

At other times, the service provider may see a shortcoming in the client's needs assessment, or the client decides to make additions or alterations to the SOW. The responsive service provider will quickly ascertain the impact of the new requirement and let the client know both the monetary impact and/or delivery impact of the request. Continuously analyzing and measuring both the outsourcer's performance and the customer's deliverables also helps to ensure responsiveness by both parties.

Innovation

While many service providers claim to be technology innovators, the truth is that problems are usually solved by a fairly finite set of tools. It is usually only in other areas of solution delivery that service providers can be truly innovative.

The ability of a service provider to demonstrate innovation in its processes and procedures is one way to do this. Outsourcing usually means delivering highly customized solutions for very specific problems. Therefore, it is in the processes and procedures related to the solution where the most innovative, out-of-the-box thinking can provide the most value.

Don't underestimate the value of innovative thinking. This can be a major discriminator when choosing and assessing the performance of a service provider. Innovation is best nurtured when inspired and rewarded and should be a touchstone of the provider's corporate culture.

Best practices

It is a given that an outsourcing service provider needs to know how to organize and manage its performance for maximum effect in achieving the buyer's desired outcomes. Presumably, it follows (or has even shaped) industry best practices. However, in an environment where information technology (IT) is clearly a key factor in cost-effective, efficient performance and innovation, best practices are no longer just static guidelines of measurement or efforts to achieve standardization and centralization. Rather, new and radically different best practices are born as the bar is raised in association with new business processes, technology and changing markets. Best practices demonstrate the best in both practical and innovative ways to work together to accomplish business objectives, including:

- Capacity building

- Matching resource supply levels with demand
- Teamwork approach in implementation, change management and go-to-market strategies
- Responding to current trends and/or emerging issues
- Responding to new opportunities
- Collaborating to enhance the value in outcomes.

As is evidenced in the case studies that follow, the viewpoint that best practices are the responsibility of the provider is no longer always applicable. “Teamwork,” “responding” and “collaborating,” as noted above, require best practices to be followed as a joint effort. Sometimes they are even initiated and undertaken by the company choosing to outsource.

CASE STUDIES

Transition/Implementation Teams

Company: Prudential Financial
Service Provider: Exult

When Prudential outsourced all its human resources (HR) functions to Exult in 2002, it used a joint team approach to manage the transition phase. Both Prudential and Exult employees with subject matter expertise were formed into joint teams for each of the payroll, benefits, staffing and compensation functions. Each functional team was responsible for joint assessments and recommendations regarding transition. Executive leaders managing the teams' program consciously strengthened each team by adding people experienced in change management and competent in dealing with human dynamics.

Their role was crucial in bridge building between the opinions of technical (IT) people versus opinions of HR process/functional experts. After an initial 60-day assessment, each team produced transition plans for its particular HR function, and the rationale for those plans, and established the interdependencies of business processes. Together, their assessments formed the framework for the overall transition plan.

Later, each team was also responsible for assessing the readiness criteria for the actual transfer of the work to Exult. Subsequent to evaluating risks, the benefits team recommended postponing the move. Because delays can mitigate some risks but cause others, as well as increase the provider's costs, this is a challenging situation in any outsourcing relationship. Both parties, however, were able to make a rational joint decision based on the objective criteria produced by the benefits team.

Balanced Scorecard

Company: TRW Automotive
Service Provider: Satyam Manufacturing Technologies Inc. (SMTI)

TRW Automotive outsourced several of its global IT services (data center management, applications management, e-business solutions, embedded systems, engineering services) to SMTI in 2000. In its monthly operations reviews, TRW rates Satyam on a scorecard; Satyam also rates TRW on a scorecard. Based on the ratings, the two companies then collaborate on course corrections in order to improve the ratings on both scorecards.

As an example, the scorecard on Satyam could reflect quality or schedule issues. The scorecard on TRW might reflect inadequate provision of all requirements on new projects. In their joint review, the two would then collaborate on opportunities for improvement in eliminating misunderstandings from a requirements perspective.

Innovation

Company: CI Mutual Funds
Service Provider: RBC Global Services

A Canadian money management marketing firm, CI Mutual Funds places a high emphasis on technology but also operates as lean as possible. In fact, the company prides itself on being the lowest cost operator in its Canadian marketplace. Outsourcing its custody fund administration, securities lending and manager transitions processes to RBC Global Services in 2001 is its strategy for low-cost operations, while, at the same time, pursuing its growth strategies.

As a way of identifying in its response to the buyer's request for proposal (RFP) that it would push forward with value-added ideas, the service provider proposed that a portion of revenue be set aside as an innovation fund. The fund now provides capital for innovative projects deemed to be important for both parties. One of the projects resulting from the innovation fund is a data warehouse for investment information. Designed with a wide range of value, this central repository solves the buyer's need for a flexible reporting tool and access to risk mitigation and marketing data, while also solving the provider's need to decrease the amount of data from its database flowing back and forth to the company.

Stakeholder Buy-in

Company: Saint Vincent Catholic Medical Center
Service Provider: CSC

Despite communicating the benefits anticipated from outsourcing initiatives, many organizations (companies outsourcing) are faced with internal resistance from various employees and management (stakeholders) trying to protect their own "turf." When Saint Vincent Catholic Medical Center outsourced its business and clinical information systems and application development to CSC, it took steps to ensure stakeholder buy-in. Physicians were included on the team selecting the provider. This gave them an opportunity to better understand the objectives and how the potential providers would meet those goals. The detailed process also helped the physicians to see the outsourcing initiative as a commitment to building the information systems infrastructure. On the clinical side, questions were raised about what outsourcing would mean in terms of the selection of hardware and software. The buyer resolved this issue by adding clinicians to the team of administrators ultimately involved in hardware/software selections at the outset and going forward.

Incentives

Company: Harrah's Entertainment, Inc.
Service Provider: APAC Customer Services

Harrah's Entertainment outsourced its casino hotel business's call center and online CRM processes to APAC Customer Services in 2000 in order to ensure world-class reservations services to its customers. As motivation for the provider's services to consistently exceed Harrah's expectations, the buyer established an incentive performance payout. Believing each individual has an ability to impact Harrah's business outcomes, the bonuses are paid at the level of individual call center employees, as well as payouts to the provider overall. The incentive plan, together with the provider's sincere approach to exceeding expectations, has resulted in call handling times lower than expected, surveyed customer satisfaction levels higher than expected, and a sense of urgency in acting/reacting to requests.

Partnership Charter

Company: Bank of Canada
Service Provider: EDS Canada, Inc.

The Bank of Canada, a fiscal agent for the government of Canada's Retail Debt Program (RDP) (similar to the U.S. Savings Bonds program run by the U.S.Treasury), outsourced its back office operations and systems support for administration of the RDP to EDS Canada. At the outset of their outsourcing relationship, both companies established and developed a partnership charter as a means of governing their relationship. The charter's intent is to ensure both parties' flexibility in resolving issues, not only to their mutual satisfaction, but also to the betterment of the RDP. It establishes a framework for building trust so the parties will be able to work together in resolving issues. One of the Bank of Canada's measurements of return on investment (ROI) in this outsourcing initiative is based on the number of issues resolved at the operational level instead of escalating to the management level. Because of the partnership charter and the two parties' efforts to work together, it has not been necessary to bring any issues to the attention of the bank's board of directors since the RDP program was outsourced.

Incentives

Company: Travelers
Service Provider: Trammell Crow Company

Often in a facilities management outsourcing arrangement, the outsourcing service provider subcontracts from time to time with vendors for specific services as needed. Travelers, in an effort to ensure these additional resource costs are kept in line, designed an incentive arrangement whereby its outsourcing service provider, Trammell Crow Company, is rewarded for its efforts in meeting that objective. A two-pronged plan, the incentives are tailored around (a) value engineering and (b) the provider's ability to self-perform versus contracting out to another vendor.

Within the focus on value engineering, the provider must put all capital projects out for bid as designed before contracts are let. It is then incumbent on the provider to present Travelers with value engineering solutions before developing change orders. The second prong of the incentive plan motivates the provider to consider implementing more cost-effective alternatives to contracting, such as adding people to its own staff rather than paying contractor costs that can be three or four times higher than compensation for a provider's full-time employee.

The incentive arrangement gives the provider 50 percent of the initial savings from achieving cost-cutting measures in these areas, as well as 5 percent of savings going forward.

CASE STUDIES FROM BEARINGPOINT

1: Large global manufacturing company

Client challenge

The company's senior IT management was interested in lowering costs and increasing quality of application development and maintenance activities through outsourcing. Understanding that they had no experience with large-scale or offshore outsourcing, the CIO and senior firm members engaged BearingPoint.

BearingPoint approach

The following tasks were completed by BearingPoint:

- Created a business case to evaluate outsourcing opportunities. The business case presented expected savings in different sourcing scenarios (in-house optimization, on-shore, off-shore, mix) and risk-levels
- Implemented business case through an outsourcing program office managed by the BearingPoint team
- Evaluated the current IT organization, spending, processes, and application portfolio for outsourcing readiness
- Benchmarked against industry standards including the SEI Capability Maturity Model
- Performed market and vendor analysis
- In continuing phases of work, the program office assisted the client with vendor selection, contracting negotiation, and design of organization and processes for working with the offshore provider

Results

BearingPoint helped the client to achieve the following results:

- Identified $4–6m (20 percent) in annual operating savings for the company's IT department
- Defined and optimized outsourcing opportunities

2: Large oil and gas company

Client challenge

The client was interested in reducing their $300 million annual application development and maintenance budget by $40–80 million through the use of global technology resources.

BearingPoint approach

- We worked closely with a cross functional team from our client to choose what applications were candidates to leverage global IT resources
- We used our Decision Making Framework to determine the optimal mix of in-source, out-source, and managed services for the entire application portfolio
- We measured each application's readiness for offshore in order to estimate transition time and development efficiencies
- We measured the potential total cost takeout and ROI for the global sourcing program
- We developed strategies (offshore PMO, adoption of CMM level 3, IT process change management) for our client to adopt to better drive the organization toward making application outsourcing "business as usual"

Results

The combined industry experience and knowledge of the BearingPoint business consultants and systems integration team engaged on the project provided the client with a strategic global sourcing strategy. The implementation of this strategy has the potential to significantly reduce the cost of IT resources for our client. Our client is currently in the process of implementing this strategy.

3: Large global financial services institution – consumer finance division

Client challenge

The client was looking to reduce costs by consolidating a number of diverse call center systems in creating a new web-based CRM system that could be deployed across all global call centers.

BearingPoint approach

Our approach delivered an end-to-end solution including a global program management office and systems integration executed with an offshore GDC [global distribution company] (over 50 resources) while coordinating with a second GDC responsible for the maintenance and enhancement of backend systems.

The development plan iterated on management processes effectively developing and improving offshore engineering methodologies. Processes that were created, managed, improved, and measured included: offshore resource selection, contract management, alignment of conflicting SLA's between multiple GDC's, and project implementation.

Offshore resources worked in conjunction with BearingPoint designers and developers throughout the project life cycle from proof of concept and prototypes during requirements analysis through implementation and testing.

Results

BearingPoint successfully piloted a new GDC relationship through building a new application through the entire software development life cycle. This created the framework and processes required for future new software initiatives. Project planning risks associated with conflicting SLA agreements across GDC's were reduced resulting in a highly iterative process with the realization of incremental business value measured against the ROI of the CRM initiative.

4: Global financial services institution

Client challenge

The client identified offshore development as a major initiative and critical component to the future success of the firm. The client wanted to create a sound strategy to support offshore development that captured the benefits and advantages to working in an offshore environment. In order to accelerate the realization of benefits and gain a competitive advantage, the client was seeking a partner to assist in the practical deployment of its strategy across the organization. The client recognized that BearingPoint had the practical experience in evaluating and partnering with offshore service providers in addition to an understanding of their business and its complexities.

BearingPoint approach

To provide direction and support in piloting two software development projects that leverage offshore providers to support the client's Securities Lending and Global Corporate Actions business units. In conjunction with the pilot efforts, the client also requested that BearingPoint assess the readiness of its technology organization to support planned and future offshore development initiatives. This included creating the tools and techniques necessary to operate in an offshore development framework. BearingPoint maintained three concurrent tracks to manage the project: outsourcing capability building, securities lending development and global corporate actions development.

In Track 1, Outsourcing Capability Building, BearingPoint determined the client's present capabilities for operating in an offshore development framework and created an iterative process for future offshore development work. In Track 2, Securities Lending Development, BearingPoint worked with the Securities Lending team to assist in the offshore vendor selection process. In Track 3, Global Corporate Actions Development, BearingPoint performed a readiness assessment and provided a development model for working with the already selected offshore vendor.

Results

BearingPoint provided an experienced team of individuals that were adept in the offshore services environment and that provided strong recommendations and readiness assessment to the executive management at the firm. Numerous deliverables were provided within the short duration of the project that focused on providing tools, techniques and strategies for working in an offshore services environment, including "Offshore PMO Manual".

5: Large global financial services firm – asset management division

Client challenge

The client was looking for a solution that would easily provide web front-end user interfaces with their functionally rich back-end legacy systems. They did not have the internal resources to do the development work, and had a limited budget for external resources.

BearingPoint approach

To provide the required creative and development capabilities and meet the needed price point, BearingPoint worked with the client's technology management team to help develop a concept the CIO and CTO had been working on. Our approach was to build a development team comprising conceptual thinkers from the client, architecture and design teams from BearingPoint, and developers from an offshore company.

It was decided that we should create prototype code at the client site and then send the prototype to the offshore site for creation of "industrial strength" code. We were concerned about the challenge of creating a completely new technology at a remote location. To address this issue, we had the offshore developer leads come to the client site for an orientation. We also had one of the leads on the client site at all times, and rotated the leads every few months to keep current knowledge at the offshore location.

We used a "rapid iteration" development technique that was supported by frequent code drops to the client site team and daily conference calls between the client site team and the offshore development team, to share ideas for product improvement, resolve issues, and improve the development process.

Results

We used BearingPoint's Collaborative Delivery Framework to provide the overall process framework. The architecture team successfully used the concept of prototyping the desired deliverables for the offshore team and then BearingPoint was responsible for the receipt of daily code drops and providing final QA. Using this approach the software was delivered on time and on budget against a very aggressive delivery and cost schedule. New applications are being delivered in less than half the time and at less than half the price of previously.

The view of a CTO

To try to understand some of the key decision-making processes, we asked one CTO of a major financial services group his decision-making thoughts when it came to outsourcing. The replies are by Pan Kokkalis and they represent his personal views and not necessarily those of Eden Group plc. What seems clear is that the successful outsourcing company is almost a management consultant educating the client too and assuring and guiding them in know-how.

What informs your decision to outsource?

Companies outsource their noncore activities to other companies in order to save time and money; being noncore means that these activities do not give them any competitive advantage. On the contrary they can be standing in the way of developing faster and concentrating on what differentiates the company from others. And this is the reason outsourcing makes sense for companies, especially when the activity has become such a commodity that it is the norm rather than the exception.

Outsourcing is not to be confused by running operations in a specific area to save costs. In such cases, a company is running operations close or inside a different country to take advantage of much lower labor costs but retaining control of such operation. In the U.S. companies set up factories near the Mexican border – the workers live in Mexico but commute to the U.S. on a daily basis. In northern Greece, companies have set up factories just inside the borders with Bulgaria so that products are produced cheaply but can be transported easily back to Greece.

The outsourcing company's core activity is to offer the outsourced activity and therefore they are experts on that – they have the infrastructure, knowledge, experience, setup, enough staff and economies of scale.

A company that decides not to outsource could be "reinventing the wheel". Some activities have been organically grown over the years and seem to be an integral part of the company. But tough economic conditions, like the ones encountered over the last years, have forced companies to look at cutting costs without cutting down on services offered. One way to do that is to outsource.

By outsourcing, companies:

1. Can shop around for competitive deals from companies offering the same activity
2. Reduce their employment obligation such as employer responsibilities and liabilities and pay only for what they get
3. Benefit from economies of scale.

What do you look for in a target company?

Typically, what you are looking for in an outsourcing company, except for the obvious cheaper cost, is:

1. Track record of running operations for a similar company
2. Management structure that allows for responsibility to be clearly defined
3. Service-level agreements that are strict and well defined, with the relevant penalties for underperformance
4. Currency exposure issues with payment for services
5. Interfacing with people that fully understand (or are part of) the cultural norms and expectations of the client.

What kinds of activities have you not outsourced?

Core activities and activities that are client sensitive.

Would you consider outsourcing more? What are your fears about it?

- Language barriers and regional accents
- Level of knowledge and experience
- Cultural differences
- Different attitudes and behavior
- Copyright and security issues
- Project management
- Remote control of functions
- There is inside knowledge that cannot be easily outsourced.

CHAPTER 6

The CFO perspective

CFO's are increasingly using business process outsourcing as the tool to juggle with costs and revenues to show increased profitability. The question is no longer whether or not to outsource, but rather what to outsource, and to what extent. The compulsions of capital scarcity further make a compelling case for outsourcing noncore activities. This chapter essentially deals with the ways in which outsourcing appeals to the CFO. We shall look at it from three major vantage points: profit and loss perspective; balance sheet perspective; and operational metrics improvement perspective.

Profit and loss perspective

Companies today are being pushed to lower their costs while maintaining or increasing the quality and quantity of their outputs. These pressures are created by competitive intensity, wherein one is not in a position to increase prices without affecting the status quo in the market share; and by shareholders, who want to generate greater returns on their ownership interests. Compounding this dilemma, the costs of complying with changes in legislation and regulations cannot be readily passed on to consumers. As a result, companies are under immense pressure to do more with less.

Accordingly, organizations are reviewing their entire cost structure to see where and how they can cut costs without affecting their output. Over the past few years, the "easy stuff" related to cost cutting has been done. Organizations controlled unnecessary travel and purchases, negotiated or renegotiated third party maintenance and ongoing operational contracts, and basically addressed all the obvious sources of excessive spending. Organizations have also initiated larger programs to increase supply chain efficiency and automate processes to reduce costs.

However, many labor-intensive jobs still exist in the back offices of organizations. In many instances, these back office processes do not require face-to-face contact, as the primary activities involve humans making business decisions based on collected data and subsequently transferring data from one medium or form to another. When these labor-intensive activities are performed in high-wage locations, they become prime candidates for a move to lower wages locations to reduce ongoing operating costs.

The issue may be taken as an arbitrage of talent for tasks, which can be offshored. Countries like India make available qualified and well-skilled labor at a fraction of the costs in more developed countries. Further, the outsourcing of activities enables the conversion of capital expenditure and fixed costs into variable costs. For instance, an organization may have seasonality in sales, but the administrative and other costs would be fixed. By outsourcing the tasks, the organization builds in a certain amount of flexibility.

UTStarcom is a major player in the wireline, wireless, optical and access switching solutions, with China, Japan and India as its primary markets. R&D comprises a significant cost component for the company. The company has more than 1,400 engineers in China and 150 engineers in India. Mike Sophie, its CFO, says that UTStarcom's engineering costs offshore are about 25 percent of what the company would have spent in the States. This brings his R&D costs down to just 10 percent of sales. "If we were to assume that all those engineers were domiciled in the U.S., our R&D would be well over 15 percent of revenues," he says.

Balance sheet perspective

The next statement of accounts that we would look at is the balance sheet. Outsourcing enables an organization to convert its capital investments into variable costs. The organization may want to further cement its relationship with its customers by offering telephonic support services and other customer relationship tools. The choices before it are setting up its own team, outsourcing the function to another provider, or a combination of the two. If the organization were to choose to perform the function in-house, it would first have to provide the physical setup in terms of office space and infrastructure requirements. The organization would have to invest capital in order to acquire those resources. In the decision to outsource, these capital outlays do not need to be made. In an arrangement with an outsourcing service provider, the infrastructure is installed by the provider. The capital could be redirected to other core activities of the organization.

> When Wherehouse Entertainment Inc. outsourced its HR, payroll, and payroll tax business processes to ProBusiness Services Inc., it was able to focus on higher end employee relations issues. Like many retail operations, Wherehouse, a music CD, video, and DVD retail chain with 550 stores in 34 states, faces a high rate of employee turnover, particularly after the holiday and summer seasons. The revolving-door workforce wrought havoc on the company's

payroll staff, which processed between 15,000 and 18,000 W-2 forms last year, even though the company had only 8,000 employees.

"It was unbelievably labor-intensive," says Karen Cass, director of payroll. "We were required to stay on top of the payroll tax laws, which change every day in the 7,600 taxing jurisdictions in this country." Wage garnishments alone, for everything from unions and child support to motor vehicle obligations, consumed countless hours. And with 30 separate fields to be filled out on each paycheck, Wherehouse was immersed in a clerical nightmare, while such issues as recruiting, benefits, and employee retention got short shrift.

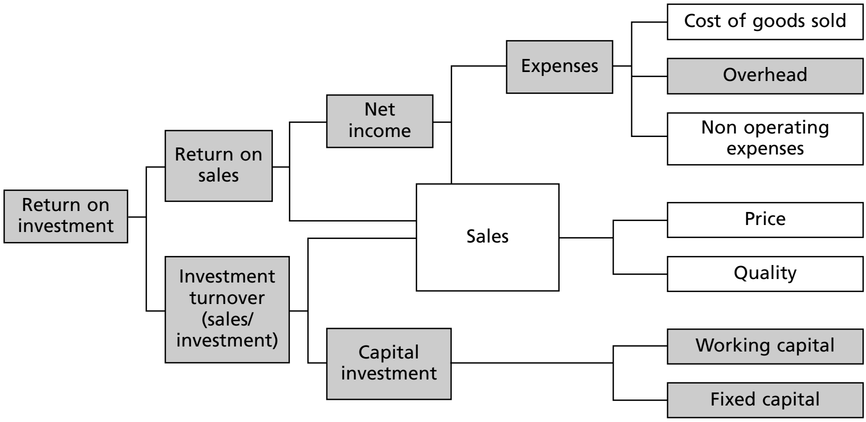
ProBusiness not only handles routine functions but also provides high-level data on what Matt Keller, ProBusiness's client support manager, dubs "the true cost of employees," which can help Wherehouse make better decisions on whom to hire and how to staff each store.

The organization may also choose to outsource its accounts receivables and accounts payables management. The provider would specialize in the task – have more efficient processes, trained specialists, and better technology. The organization's administrative department, due to its general nature of duties, may not be able to provide that level of attention. This would result in lower days sales outstanding, and fewer bad debts. This may lead to a shortening of the working capital cycle, thereby reducing the working capital requirements.

Operational metrics perspective

Outsourcing provides the fulcrum that prevents the operating leverage from causing wild swings in the bottom line of the enterprise. The margins of the organization tend to fluctuate much less (and in many a case also show an improvement) due to the conversion of fixed costs into variable costs. A look at Figure 6.1 shows the interlinkages of how outsourcing affects ROI. With noncore activities outsourced, the companies can bring about a reduction in expenses, leading to an improvement in the net income. In conjunction with that, better working capital management and a reduced need to invest in fixed capital will lead to a decrease in incremental capital investment. These measures yield an improvement in the return on sales and the asset turnover, which will finally result in better ROI.

Having looked at outsourcing from the three perspectives, we now look at how outsourcing applies to the finance function in particular and the major threats and advantages.



Note: The shaded portion indicates the interlinkage between outsourcing and ROI

Figure 6.1 Domino effect of outsourcing on ROI

Source: Aranca

Outsourcing the finance functions

The blade of specialization, wherein each organization sticks to its knitting, has been applied to the BSP's as well. Whereas there may be some outsourcers who focus on the industry, there are others that focus on support functions like HR or finance. In the financial arena, there are outsourcers who handle an assortment of functions, including fixed assets, document imaging and record keeping, bank and balance sheet reconciliation, transactional accounting, and financial statements. Initially the contract may be billed on a fixed monthly cost. As the business of outsourcing matures, it is likely that there may be metric-based fees.

The key activities in the finance department mainly include maintaining accounts, managing the cash flow requirements, and raising low-cost credit. Besides these key functions, the finance department acts as the provider of strategic inputs for key decisions, provides financial forecasts, enforces internal financial controls, and manages financial risks. Transparency and accuracy of data are key requirements. In addition to this, the speed of data information dissemination – both internally and externally – is an important factor.

The virtues and threats of virtual

Companies are increasingly moving their accounts receivable management function to outside providers. Since the provider is focused on a particular service, there is more specialization. Where on one hand there is a certain amount of efficiency gain, given the specialization, on the other hand there is a certain amount of risk involved in sharing financial data outside the organization.

While companies are willing to outsource the more routine tasks, the strategic tasks are kept in-house. While companies are more disposed to let providers do their payroll processing, tax compliance and planning, travel and expense processing, accounts receivable and collections, accounts payable and vendor management, they are more reluctant to hand over tasks like budgeting and forecasting, risk management, and management report preparation and analysis.

Publicly listed companies have to report financial statements of operations on a quarterly basis. Frequent restatements of financial reports cast a doubt on the accuracy of the statements. In the wake of accounting scandals like Enron and WorldCom, accounting is probably the most sensitive area of corporate governance. There is far greater scrutiny in the accounts for anomalies. Further, the new Sarbanes-Oxley Act in the U.S. has made it mandatory for senior management to attest personally as to the veracity of the financial statements. This personal burden on the CEO adds further complexity to the outsourcing decision.

On one hand, outsourcing would separate the accountants charged with making the accounts and the managers responsible for delivering the performance, thereby lessening the scope for "massaging" the figures. On the other hand, the loss of control over the accounting function may make companies wary about the accuracy of the numbers. The loss of control can be countered by working in close cooperation with the provider, and standardizing processes in compliance with accepted accounting rules.

LONG CASE STUDY

AT&T is among the world's premier voice, video and data communications companies, serving consumers, businesses and government. Backed by the R&D capabilities of AT&T Labs, the organization runs the world's largest, most sophisticated communications network and is a leading supplier of data and Internet services for businesses.

Business challenge

AT&T Consumer Services provides a broad range of communications options to consumers, including transaction-based services such as prepaid phone cards. While highly skilled at delivering telecommunications services to customers, AT&T had minimal experience in the supply chain management processes needed to bring tangible, packaged goods such as prepaid cards to channels such as convenience stores and mass merchants. In an effort to enhance business performance, improve operational efficiency and obtain significant cost savings, AT&T made a strategic business decision to outsource its prepaid card end-to-end supply chain management functions.

Accenture teamed up with AT&T to develop an innovative, customer-focused supply chain operating model that integrates all its supply chain business processes, including sourcing, production, scheduling, account service, warehousing, fulfillment, inventory, billing and systems management. Next, it created a new organizational role that provides comprehensive management of the entire customer life cycle by assigning responsibility for customer-facing supply chain functions to individuals or small teams, rather than multiple individuals across organizations. This unique, strategic approach was a key step in transforming AT&T's prepaid card supply chain processes from a functional view across many organizations with many hand-offs, to a customer-focused approach that optimizes the end-to-end supply chain.

As part of the supply chain transformation, personnel from several AT&T organizations moved to Accenture. AT&T and Accenture worked together to realign employees within the new operating model and initiated training programs to ensure a fast, seamless transition. Leveraging its skills and experience in information technology outsourcing, Accenture also transitioned responsibility for development and production support of AT&T's prepaid card supply chain management systems.

To help accelerate results for AT&T prepaid, Accenture applied its supply chain management expertise to AT&T's warehouse operations. By integrating procurement and other decisions that impact the cost of warehouse operations across the supply chain, Accenture helped AT&T reduce costs while supporting increased volumes with improved service levels. Recognizing an opportunity to transform purchasing and inventory decision-making processes and substantially reduce inventory levels and cost, Accenture also initiated a strategic sourcing approach for prepaid card production. In addition, Accenture contracted with one of North America's largest third party logistics providers, for the handling of AT&T prepaid's day-to-day fulfillment activities.

Lastly, AT&T and Accenture worked together to enhance existing and establish new contractual service-level targets within the prepaid card operation, and develop methods for tracking, measuring, and reporting them. As part of its commitment to delivering results for AT&T, Accenture introduced strong performance metrics to help ensure that the new supply chain operation meets or exceeds the agreed service-level targets.

Together, AT&T and Accenture transformed AT&T's prepaid card supply chain operation and accelerated the delivery of bottom line business results, including:

- 15 percent reduction in prepaid card production costs
- 25 percent improvement in warehouse productivity
- 25 percent reduction in raw materials inventory.

These results were achieved in parallel with enhanced performance in key service levels, with no disruption in service to retailers or consumers. Other key benefits to AT&T prepaid include measurable service levels, increased speed-to-market, and enhanced retailer service and satisfaction. In addition, by outsourcing its prepaid card supply chain to Accenture, AT&T is now free to devote maximum attention to its core competences: sales, marketing and network technology. According to AT&T, the ability to focus on these revenue-enhancing activities is helping to provide a path to long-term, sustained business growth.

CHAPTER 7

Sourcing investment banking research and independent stock research

Over the past few years, high-end activities such as financial research have begun to be outsourced. Several of these changes have been driven by significant corporate events and regulatory pressures. This chapter examines some of the issues surrounding the outsourcing of research.

Regulatory changes altered the competitive landscape

> New equity research models are rapidly emerging. The new business models are the product of structural changes, induced largely by dramatic alteration of the regulatory landscape. This in turn is transforming virtually every aspect of how the research is produced, distributed and funded …
>
> Management of research providers has had to redefine the roles and responsibilities of research analysts and the process of preparing and distributing research in order to comply with evolving reporting and disclosure rules, while simultaneously meeting the budget constraints imposed on an industry whose revenues had been in decline for three straight years. To meet these challenges many managers have sought cost savings and improvements in efficiency through a number of approaches, including: greater standardization or streamlining of research preparation and distribution; increased outsourcing; reduced coverage of individual stocks; provision of research only to institutional investors; discontinuation of investment banking activities; and, reductions and research staff and their average compensation. (From a year-end report of Securities Industry Association (SIA) – December 2003)

The new set of regulations was introduced by the Security Exchange Commission (SEC) and the self-regulatory organizations or SRO's (that is, NYSE, NASD, and so on) to address the issue of "conflict of interest".

Although the incidences of conflict of interest in the securities brokerage industry in Wall Street are not new, what sparked a tough regulatory move was the extent to which the firms resorted to malpractices.

After the dot-com bubble burst and the spectacular failure of a once titan of Wall Street, Enron, New York State Attorney General Eliot Spitzer launched an enquiry into the incidences of conflict of interest.

The Subcommittee of the House of Representatives started hearing the matter and was overwhelmed by the degree of irregularities. Investigators found that analysts had given "buy" calls on the stocks they had referred to as "junk" or "trash" in their internal emails. Many research analysts were significantly involved with start-up companies well before the companies had established an investment banking relationship with a broker-dealer and later, when the company went public, the analyst issued a positive research report on the company.

The episode of Enron failure offered few more glaring examples of such conflicts. A prominent brokerage house never dropped its "strong buy" rating of Enron, as the firm was working for Dynegy in the proposed merger with Enron and so had an incentive to ignore damaging information about Enron.

Laura S. Unger, commissionaire at the SEC, noted in her testimony before the subcommittee that the research analysts are subject to several influences that may affect the integrity and quality of their analyses and recommendations. She further noted that there are numerous pressures that exist within a full-service brokerage firm, but four potential areas of conflict stand out:

1. *Attracting and retaining clients:* The analyst's firm may have underwritten an offering for a company or seek to underwrite a future offering. The analyst may have been a part of the investment banking team that took the company public.

2. *Firm profits:* Positive reports by brokerage firm analysts can also trigger higher trading volumes, resulting in greater commissions for the firms.

3. *Compensation:* An analyst's salary and bonus may be linked to the profitability of the firm's investment banking business.

4. *Equity stakes:* The analyst, other employees, and the firm itself may own significant positions in the companies the analyst covers. Analysts may participate in employee stock purchase pools that invest in companies they cover or they may own stock directly. And, in a recent trend called "venture investing," firms and analysts may acquire a stake in a start-up company by obtaining discounted, pre-IPO shares.

After much deliberation, the SEC and the SRO's enacted numerous regulations, asking the analyst to certify the integrity of the analysis in every report he/she writes, barring him/her from taking part in a firm's investment banking activities and making the full-service brokerage firms separate the investment banking and equity research divisions. The federal and state agencies were also in no mood to let go the wrongdoers without heavy penalties.

On April 28, 2003, the SEC along with other federal and state agencies announced that enforcement actions against ten of the nation's top investment firms had been completed with the finalization of the global settlement.

That settlement followed joint investigations by the regulators of allegations of undue influence of investment banking interests on securities research at brokerage firms. The ten investment firms agreed to pay US$ 875 million of penalties, US$ 80 million to fund and promote investors education and US$ 432.5 million toward funding independent research. The penalties alone (that is, not including the disgorgement, independent research, and investor education payments) are among the largest ever obtained in civil enforcement actions under the securities laws.

The changes in regulatory framework have further added to the large cost base of the securities industry and have made the existing business models of investment firms unsustainable.

In the good old days, a broker could get $1 a share to trade a stock. But the ultra-competitive market forced the firms to lower their commission rates and they soon found that they were lucky to get a dime. By the end of the decade, most big institutional investors have got some investment houses to do transactions for a nickel or less.

But even with the falling broking commissions, the need for big in-house equity research teams and the reluctance of institutional investors to pay for the research directly kept increasing. As a result, the business models based on revenues from pure broking commission were becoming increasingly unsustainable.

Most investment firms started concentrating on investment banking activities and these revenues were used for cross-subsidizing the equity research function. By 2000, investment banking functions funded on average 35–40 percent of research budgets of research firms. In return, the equity research analysts were performing all the research and nonresearch functions for the investment banking arms.

The regulatory changes in 2002–03 not only put the brakes on this practice but also increased the costs for investment firms on three accounts:

- **Additional research analysts to be hired for investment banking divisions:** The new regulations prohibit the equity research analysts from taking part in investment banking activities. Thus the investment banking divisions would have to hire additional analysts.

- **The compliance cost increases:** Increased supervisory and regulatory requirements prompted the need for new policies and procedures that enable constant monitoring and real-time disclosure of a broad array of issues. These issues range from analysts' compensation and the personal trading of analysts, to their communication within and outside the organization. Before putting out a research piece, the firms have to determine if they have provided any kind of service to the company that is the subject of the research.

  These changes require the re-engineering of many processes and greater coordination between research, legal, compliance and operation staff, all of which comes with a price tag, plus the cost of hiring additional legal staff and supervisory analysts.

- Firms might have to increase spending on independent stock research. Of the various facets of the global settlement, the most innovative and forward-looking was the commitment by the ten investment firms to provide their customers with independent research. It provides a mechanism for the direct comparison of independent and in-house research and a structure to judge the objectivity of investment firms' research.

  The ten firms party to the agreement would spend US$ 432.5 million in purchasing research from third parties. But the spending on third party research would not be restricted to the firms party to the global settlement.

  The SIA noted in its 2003 year-end report that providing third party research to customers might be necessary even for the nonparty firms, as customers might start expecting it or the third party research might be viewed as important to counter customers' skepticism about the objectivity of the sell-side research.

The changes in the regulations and sharp increase in cost could not have come at a more inopportune time for the securities industry. Investment firms were already struggling to keep their heads above water as three years of slow economic growth and a bear market dried up their revenue stream. In the changed regulatory landscape, research managers are forced to rethink whether having in-house research is sustainable for them or not.

Equity research functions: a strong case for outsourcing

The research function is increasingly becoming a noncore activity for investment houses. Most investment houses do not earn revenue by selling the research directly as it is supplied free to the institutional and individual investors. Having a hugely competitive in-house research team does not offer any competitive advantage for the firms.

Rather, on our strategic gap analysis matrix (Figure 4.2), research is fast becoming a fundamental activity, something that is needed just to be a player in the securities industry. On the lines of our matrix of outsourcing models under different scenarios (Figure 4.4), firms having weak to moderate capabilities in equity research functions should not waste their resources in developing the capabilities in-house but outsource these activities. Firms having strong capabilities should either exit and outsource or make it a profit center.

We reckon equity research functions in investment houses present a very strong case for outsourcing. The firms should either outsource or offshore the noncore research function altogether to the independent third party vendors, whose core function is research.

If the research functions are offshored, investment houses will be able to reduce their cost base significantly and the quality and quantity of research available in the market will improve. However, there are few roadblocks in the way.

Roadblocks in the way of outsourcing/offshoring research functions

On October 8, 2002, the chief financial officer (CFO) of the Credit Suisse Group said: “Research is exceptionally costly and does not have a business model of its own”. The chief executives of top investment houses on Wall Street have been actively investigating opportunities to transfer the responsibilities of research onto independent third party vendors.

But despite a strong demand-pull, the truth is, as yet, examples of end-to-end independent research firms that provide reports as detailed as Wall Street’s are few and far between. Setting up competent research teams in the U.S. is hugely expensive and few have that kind of budget.

Offshore third party vendors would raise more skepticism. Although broad-based improvement in information and communication technology has made it feasible to disseminate information, doubts concerning the quality of research prepared in this manner are widespread, particularly since it lacks functions such as site visit, conversation with the management and familiarity with the product and the customers.

But we believe that the case for research offshoring is so compelling that firms would discover innovative ways to overcome these roadblocks. The process has already started with many big Wall Street firms like JP Morgan, Morgan Stanley, Citigroup, and so on setting up their offshore research centers in India.

How are firms using the services?

Given the relatively new state of this market, multiple models are being evaluated by firms seeking to outsource. However, a common theme across most outsourcing in this area relates to the scope of activities involved. While research in itself is high end compared to the rest of activities outsourced, firms are adopting a cautious approach toward outsourcing in this area. There has been a clear stratification of services from relatively low end to high end.

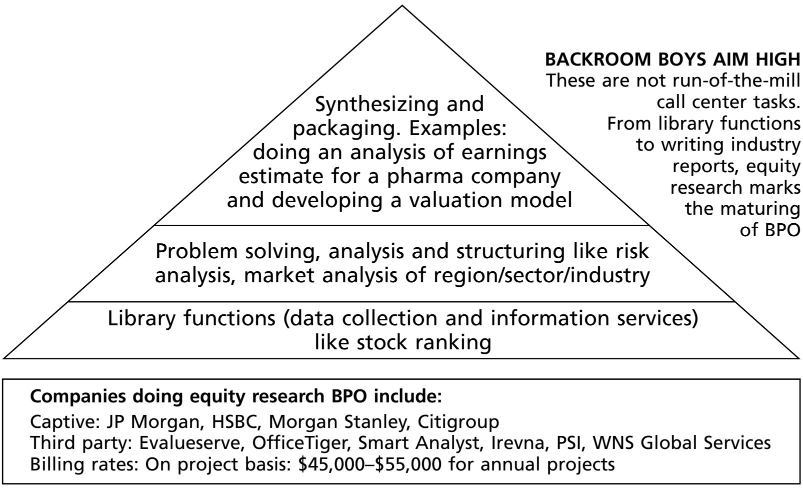


Figure 7.1 Backroom boys aim high

Most firms are outsourcing the lower elements of the pyramid such as data maintenance and library functions. Few firms have also outsourced analytical tasks such as risk analysis and market/company analysis to offshore locations. For now, the dominant theme is for offshore analysts to collect data, do basic number crunching and create basic financial models. The aim is to provide inexpensive support for senior analysts in the home location, who would have more time to finish research reports, meet clients and cover more companies.

While this has been most noticeable among investment banks, consulting firms have also embraced this trend. Firms such as McKinsey and A. T. Kearney utilize research divisions in places such as Delhi and Chennai, India. These analysts in the offshore location support the consulting team through research reports or on live project support. According to A. T. Kearney, outsourcing research to India, apart from providing cost advantages, makes the work faster. The senior analyst in the U.S. can request information from the analyst sitting in India and he can receive the information the next morning in his email. This is possible as the companies can leverage the time zones differences. This enables a 24-hour work cycle for the company and efficient utilization of resources.

What operational structures?

The trend suggests a mix of captive and third party outsourcing being adopted in this arena. Large investment banks have established captive operations. Banks such as JP Morgan, Citigroup and Morgan Stanley have set up operations in India. The teams will focus on data collation, analyzing balance sheets and working on basic financial models. Some other banks have adopted a third party route. Lehman Brothers has launched a series of pilot programs for assessing the proposition of outsourcing research. The company has adopted a multi-vendor model. The pilot program is being run by a few Indian outsourcing vendors.

The key drivers behind the choice of operating structures are varied:

- **Size and scale of operations envisaged:** A captive operation involves a higher financial outlay and greater management effort in managing the operations. However, if the size and scale is sufficiently large, in the medium term, a captive operation makes economic sense.
- **Need for control and confidentiality of data:** Housing analytic operations within a company's own control is a top-of-mind consideration for several organizations. This is particularly true in the context of the strict regulatory issues that have arisen in the equity research area over the past two or three years. Firms which need to maintain absolute control over this aspect would prefer a captive setup.
- **State of the market:** The timing of the outsourcing decision and the degree of maturity in the supply market is also a key factor in determining the structure. Since JP Morgan and so on were early movers, the nascent state of the market makes the captive option more attractive from multiple perspectives.

Key pitfalls?

Research outsourcing is at an early stage and firms are still learning about the best ways of extracting value from this opportunity. Some key concerns that have been expressed include the following:

- **Degree of interaction required:** The nature of activities implies that offshore analysts need to have close interactions with the home location in order to prepare a good quality research report and the process is often iterative, which introduces complications that most organizations are not yet prepared for.
- **Delivering to fluid and multiple timelines:** A research analyst is required to handle multiple assignments with frequent reprioritization. Managing this with offshore analyst support calls for additional robustness and readjustments in processes so as to cope effectively with the business requirement.
- **Regulatory concerns:** Anything more than number crunching that is outsourced comes under the purview of the regulatory bodies. These legal and regulatory issues need to be managed when the investment bank decides to offshore research.

Learning from others' mistakes

Although research outsourcing is still new, a few key messages emerge as lessons to learn prior to outsourcing.

- **Research is different from other outsourcing, but not very**

Although the nature of research is less standard and more fluid in its requirements, certain essential characteristics are shared with most other outsourcing activities. Hence a clear classification of requirements and sourcing strategy is a necessary first step.

- **Recognize sociocultural issues that may arise**

Often, research outsourcing is done at the cost of existing resources at home locations. This, in conjunction with dealing with support analysts in a different background and environment, poses sociocultural issues that need to be managed effectively right from the beginning in order to make the outsourcing a success.

- **Learn from other parts of the organization**

Typically, research outsourcing is done by organizations that have already embarked upon outsourcing in other areas. This in itself offers valuable lessons that can contribute significantly to the success of the initiative.

- **Manage the transition, internal and external**

While the transition management to the outsourced location would be critical, equally important would be to ensure buy-in from all key stakeholders within the organization. Unless this is achieved, the chances of success would be significantly reduced.

CHAPTER 8

The politics of outsourcing: trends, risks and strategies

No CEO of any major company, or indeed would-be CEO, can neglect the politics of outsourcing. We asked Paul Morrison, managing consultant and offshore expert at ALS Consulting, specialist advisers on BPO and shared service center strategy, for his view. Paul was formerly head of Offshore Advisory Services at Percept Risk and Strategy. He has written on a range of globalization issues, and also co-organized the Percept Foreign Policy Centre Roundtable "Beyond the Headlines: The Real Impact of Offshoring". He can be contacted at paul.morrison@alsconsulting.com.

The politics of offshoring

The most striking result of the rapid growth of offshoring has been the noisy public controversy it has generated in the U.K. and the U.S. For many executives this is a source of exasperation, as the "offshore backlash" appears to them to have been driven by the wrong-headed whingeing of the economically illiterate. In my discussions with businesses considering offshore, I often detect a sense that business should just "get on" with doing business, and let the concerns of the media, politicians and society evaporate as they get used to the idea of offshoring. Many of the fears about offshoring are indeed exaggerated, even sensationalist. But business would be well advised to take the offshore debate seriously.

Offshoring simply relates to the cross-border relocation of service activities – either in-house, or outsourced. Globalization in the extractive and manufacturing sectors has been around for a long time, so why is the offshore debate significant? To some extent, offshore is indeed "business as usual". The pioneers such as British Airways and General Electric have been "offshoring" for decades, even if they labeled it as something else. Yet as the globalization of services gathers pace, it is clear that offshoring represents a profound revolution of how service activities are provided. Offshore redefines where business

> is done, how it is done, opening up new opportunities, and new risks along the way. These shifts in the status quo are too significant to occur uncontested.
>
> Any look at past episodes in globalization show that they have almost always been controversial – through union activism, customer boycotts, legislative restrictions or media controversy. The same has been and will continue to be true of offshoring. And despite the controversy of recent months, the offshoring debate is not over. As the trend accelerates and broadens into new activities and industries, political and reputational skirmishes will continue to limit the boundaries and speed of offshoring strategy – whether criticisms of offshoring are misguided or not.

The thesis of this chapter is simple: There are business benefits to understanding and, where appropriate, addressing the wider concerns regarding offshoring. Many organizations have not embraced this line of reasoning, assuming that offshoring will simply become uncontroversial. This may turn out to be correct in the long term, but it represents a poor risk management strategy. If the aim of your organization is to develop a best practice global sourcing strategy from day one, you need to understand the offshore debate, its implications, and the options that are available to address the risk.

Dissecting the offshore debate

In order to address the reputational risks posed by offshoring, an understanding of the key themes underlying the debate is essential. Offshoring first hit the headlines in late 2002 in the U.S. and U.K. During 2003, the volume of press stories, web chat, and TV coverage grew substantially, and "offshore" gained common currency as a term relating to the location of jobs and business – rather than oil rigs, wind farms or tax havens.

As with all complex controversies, the offshore debate has been driven by a web of interlinked issues – perceptions, events and concepts that bring the interests of different groups into conflict. The profile of offshoring can be partly explained by the fact that it offers scope for different perspectives on so many levels – including corporate strategy, corporate social responsibility, trade and investment policy, competitiveness, unemployment, education and skills, immigrant labor, national security, intellectual property, globalization, international development, and developing country exploitation. But in order to gain an understanding of the major drivers of the offshore debate, a few recurring issues stand out – the economic impact, quality, security and exploitation.

The economic impact

The timing of the emergence of offshoring as a public issue in 2002 is significant. It marks the simultaneous growth of global sourcing with the prolonged economic fallout of the technology boom. This naturally focused attention on the primary theme of the offshore debate – the question of the economic impact and, in particular, the job impact of offshoring.

Whether based on fact or speculation, the growing offshore trend is seen as a direct cause of the widespread layoffs that affected many business sectors, but particularly the technology sector, from 2000 onward. At a time of a perceived "jobless recovery", press and TV coverage of offshoring in the U.S. focused almost exclusively on the impact on employment. This is typified by the CNN *Lou Dobbs Tonight* news program, which has for several months featured critical coverage of the economic impact of offshore projects. The CNN website features "a list of companies we've confirmed are 'Exporting America'. These are U.S. companies either sending American jobs overseas, or choosing to employ cheap overseas labor, instead of American workers."

In the U.K., most of the early coverage of offshoring focused on the impact on the call center industry, a dynamic sector that had grown rapidly from the 1990's, representing up to 2 percent of jobs, with particular significance in many poorer communities in postindustrial regions.

To some extent, the cruder "jobs exodus", economic allegations against offshoring have receded, in the face of a growing body of analyses that identify the net economic gains of offshoring. Many observers are predicting an end to the offshore debate altogether as the U.S. economy appears to be emerging from its job slump.

> There is a global economic recession leading to loss of jobs. The politicians are capitalizing on this. However, once the economy picks up, all this will disappear. *Rolf Jester, Gartner.*
>
> The backlash … will pass, go away; just stop talking about it. *Kevin M Campbell, president and COO, Exult.*

But economic questions remain, particularly regarding the effect on higher value activities, the nature of next generation service activities, and the hollowing out of strategic sectors such as R&D, pharmaceuticals and biotechnology.

Quality

Quality of service has also been an important subject of contention. To offshore vendors, quality of service has long been a key marketing message. Quality accreditation was a major aspect in building India's credibility as an IT destination, where adherence to rigorous level 5 Capability Maturity Model (CMM) software development processes is increasingly widespread. As a result, many offshore strategies are now justified on the basis of the quality capabilities that can be accessed – not just on cost reduction. This is reflected in the proliferation of other quality methodologies, such as six sigma.

Yet anecdotal accounts of poor quality from a range of offshore locations have been widely circulated in the media, such as stories of bug-ridden IT development, or poor customer service at call centers. The call center quality debate has focused on questions of accent, cultural clash, and lack of local knowledge despite the language neutralization and induction training provided to call agents. For example, a technical help desk at Dell was recently recalled from an offshore location, at least in part due to perceived poor service quality.

As the initial driving force behind the backlash, the economic impact, loses some of its potency, questions about quality of service have gained increasing prominence in the U.K. and U.S. debates. Although cases remain isolated or anecdotal, these perceptions are powerful and widely held, as underlined by a number of market research reports.

The Economist
27 May, 2004

Now hiring

> The story is similar in Britain. According to a study published on May 25 by Intervoice, an American technology firm that is pushing voice-recognition-based software as an alternative to hiring humans, three-quarters of the 92 British call center managers the firm interviewed had a "negative perception" of the service quality offered by offshore call centers. More than half of them said that they would never use offshore call centers.

Security and regulatory compliance

Concerns have also been raised about the security and data protection implications of offshoring. Offshoring shifts business activities to new jurisdictions, but how well are the security requirements adhered to? Can offshore facilities meet the regulatory requirements of the European Data Protection Directive, or the Sarbanes-Oxley Act, section 404? Offshore facilities have tried to address such concerns through extensive employee vetting, secure infrastructure, paperless offices, and the rollout of standard global security technologies and processes.

Nevertheless, a number of stories about the disclosure of sensitive financial or medical data have emerged in recent months, raising questions about the integrity of offshoring sensitive activities. As a result, sensitive government activities will remain forever beyond the scope of offshoring, and much of the legislative activity in the U.S. currently focuses on tightening the security requirements for private sector offshoring such as the bills in California. In America, these concerns are linked to the issue of national security, and the vulnerability of distributed global sourcing networks to terrorist sabotage. Sensitive to these perceived shortcomings, NASSCOM, the industry association for Indian software and service companies, has launched an initiative to identify and fill any potential security gaps.

Exploitation

Finally, there is the emotive theme of exploitation, based on the idea that lower costs in offshore locations rely on poor working conditions. This theme has been highlighted by some union groups, and builds on the anti-globalist thinking previously directed against extractive and manufacturing businesses. Of the four themes identified here, exploitation is the least salient, but as with other episodes in globalization, it could gain potency with time.

Applying "sweatshop" allegations to offshoring would appear to most as extremely far-fetched. Services are innately "clean" and attractive jobs, as demonstrated by the promotional videos and tours of offshore locations organized by vendors, and the large number of applicants for each offshore vacancy. Indeed it is hard to make the case that offshoring is linked to coercion where employers such as Infosys attract over a million job applications a year. The leading service companies in India have high-profile corporate social responsibility values and programs, and their leaders are often highly respected social figureheads.

Yet criticism of offshore facilities does not include crude allegations of sweatshop conditions. Instead, there has been a questioning of general levels of wellbeing, and why, in some cases, standards appear to be lower than in the West. For example, the small size of workstation cubicles, excessive shift length, or the "psychological stress" for a call center agent of maintaining a U.S.-friendly persona are cited as examples of inappropriate pressure on offshore workers.

Indirectly, offshoring could also be discredited through association with the poor human rights record of a country. For example, many predictions about the future of offshoring point to China, a country with a number of obvious human rights issues, not least the effectively non-existent union representation which directly contradicts fundamental International Labour Organization human rights conventions. In addition, in India, certain Western unions have made an issue of perceived low levels of unionization, arguing that this has been and will be a basis for exploitation.

The perceived mistreatment of employees, both those onshore and offshore, could also contribute to another perception – that offshoring is inconsistent with corporate social responsibility (CSR) commitments. At a time when businesses are striving to demonstrate a positive in their interactions with society, offshoring could potentially be represented as undermining such credentials, by "taking advantage" of workers at home and abroad.

It is difficult to predict how the offshore debate will develop in the future, but it seems highly likely that offshoring will remain controversial, based on two rather obvious facts. Firstly, all analysts predict that offshoring will continue to grow in terms of scale – more companies will adopt it, in more countries (for example France, Germany), on a bigger scale. Secondly, all the evidence indicates that the scope of offshoring is ever-widening, moving up the value chain to more sophisticated activities, such as design, journalism, legal services, equity analysis, accountancy, and possibly also moving into previously out-of-bounds activities (notably in the public sector). This means that offshoring will continue to encounter new sets of vested interest. Every time offshoring advances, it will face debate, criticism and potential opposition.

Business risks

So why is the offshore debate relevant to businesses considering new offshore plans? Exponents of the "business as usual" school are correct in noting that despite the backlash, offshore sourcing has been continuing to grow rapidly. But even though the debate has not stopped or reversed offshoring, this does not mean it has had or will have no impact. *Perceptions will continue to determine the boundaries of what can acceptably be offshored.*

The questions raised in the offshore debate (such as unemployment, quality, security) have the potential to resonate with the company's stakeholders. In the case of offshoring, the three most important groups are employees, customers, and government. These groups are the levers by which the debate becomes a real business risk – a business will face major problems if its employees, customers or the government is opposed to such a strategy.

For *employees*, actual or imagined offshoring plans could generate fears about redundancy, loss of opportunity and long-term employability – even though an offshore strategy could be a crucial step in safeguarding a company's employment potential. This anxiety goes beyond damaging the motivation and productivity of employees working in departments that are transitioning work offshore. Uncertainty can spread among other areas, particularly where the scope and nature of the global sourcing strategy is poorly communicated. These issues could damage productivity, retention, recruitment and morale. In addition, more severe disruption could be caused by confrontation with unions through protests and strike action.

Regarding *customers*, offshoring could damage brand positioning and reputation. This could ultimately impact sales and profitability. If an offshore strategy were to be unpopular with consumers (for example through a perceived impact on quality of service), it is not difficult to see some form of negative sales impact, even without a coordinated consumer boycott. Offshoring could particularly clash with "community" or "national" brand values. For example, a retail chain or bank that has built up a reputation as a local, community-focused organization could alienate customers if sourcing work from overseas was perceived as damaging to local employment prospects.

Politicians have the power to curtail offshoring via legislation and public policy. As with all multinational activity, offshoring is only possible because it is allowed by a regime of national and international legal and political permissions. Both home and foreign governments have the ability to modify how or whether offshoring is conducted – using tools such as taxation, subsidies, new technical specifications, workforce standards or sectoral prohibitions.

Assessing the impact so far

So if these are the potential levers of impact – employee, reputation or regulation – what has been their impact so far?

Regarding *employee relations*, there have been only a few examples of outright disruption caused by offshore plans. Amongst unionized workforces, in November 2002 there were protests at Prudential which was forced to review and refine a plan to relocate work to India following protests from the Amicus union. The economic impact of sourcing work overseas to India is no stranger to controversy. For example, in the late seventeenth century, a writer lambasted merchants for sending increasing quantities of cloth to the subcontinent to be finished, for fear of undermining England's industrial base (see Landes, 1998, p. 228). BT was affected by protests in late 2002, and SBC in June 2003 where 300,000 Communication Workers of America union (CWA) workers went on strike at proposed offshoring plans. The Bank of America experienced union opposition to new offshore IT facilities on the grounds that they were leading to unemployment in their "home" market. The Bank of America's plans to close a number of IT departments in the Bay Area of San Francisco generated national and local press attention, heightened by the suicide of worker Kevin Flanaghan apparently after losing his job and completing a "knowledge transfer" handover with his offshore replacement. In addition, some companies appear to have experienced a growth in unionization, most notably in the Alliance@IBM (an affialiate of the CWA). IBM was lambasted by Alliance@IBM for appearing to be stealthily building up its global sourcing capabilities at the same time as pursuing rigorous job cuts.

At the less conventional end of the spectrum, the Communication Workers Union (CWU) launched a Pink Elephant campaign against offshoring in 2003, and the union Amicus sang anti-offshore Christmas carols outside Aviva's office in December 2003 – both with questionable impact.

But what is notable is the degree of collaborative work between employers and unions, particularly in the U.K. This is illustrated by the Connect union's agreement with BT, and by UNIFI's agreements with HSBC and Lloyds TSB. So regarding union opposition, the degree of collaboration, rather than confrontation, has been striking.

Looking beyond the union dimension, in private many executives continue to flag the employee relations impact of offshoring as a major headache – how can an offshoring strategy be effectively yet sensitively communicated to our workforce? How can I prevent an offshoring strategy demoralizing our remaining onshore teams? The evidence for these issues is anecdotal, unsurprisingly so, because employee anxieties are qualitative and not the sort of information that employers want to disclose. One source of information on this perspective is through employee chat rooms, where offshoring has been a major topic of obvious employee concern.

Consumer attitudes have not yet significantly mobilized against offshoring. Blue-chip offshore clients are clearly concerned about how offshore could influence brand perceptions, as indicated by the highly secretive nature of most offshoring strategies. Most big brand organizations have chosen to keep a very low profile on offshoring, and vendors have complained in private about their inability to get clients references of their services for external marketing purposes.

In addition, a number of leading consumer brands, such as Nationwide, Alliance & Leicester and Northern Rock in the U.K. have publicly adopted "nonoffshore" positions, choosing instead to emphasize their commitment to local operations. Exactly how this will play with consumers remains to be seen. A number of surveys suggest there is broad consumer disapproval about offshoring, with Amicus suggesting that 60 percent of Scottish customers would move from Lloyds TSB as a result of offshoring. Despite such strident predictions, there is no evidence to indicate that this reaction has yet happened.

The *legislative* dimension has been the focus of the offshoring debate in America, where politicians have been quick to tap into widely held concerns. There have been dozens of proposals against offshore, focused on measures such as the restriction of public contracts, new visa limits, and "right to know" proposals. In particular, Senator Kerry made an issue of offshoring in the 2003/04 presidential campaign, lambasting CEO's for undermining the U.S. economy, and proposing his own federal "right to know" legislation to moderate offshoring. As of June 2004, there were state bills and federal-level bills proposing various restrictions on offshoring.

Yet despite this intense debate and lobbying, there have been only limited political measures against offshoring. Only one federal bill has been passed into law but this only applies to the departments of treasury and transportation, and has been estimated to impact only around 1–2 percent of Indian offshoring revenues. The White House has followed an increasingly pro-offshore line, despite the controversial reception of Gregory Mankiw's report in February 2004.

State-level legislation has been noisy but limited, focusing on specific areas of procurement. For example, the state of Indiana cancelled a $23 million contract with Tata Consultancy Services (TCS) in November 2003, requiring that the project be supplied by local vendors. This was symbolically significant, but not material in terms of overall offshoring flows.

Furthermore, the U.K. has seen no legislative activity at all. Relatively high levels of employment have reduced the political temperature regarding offshoring, and a strong free-market argument has been widely broadcast by the government, both by the Department for Trade and Industry, and the prime minister.

Yet the role of politicians could be irrelevant here. As offshoring grows in new sectors (such as R&D or public services), there could be renewed pressure to redefine the boundaries of what should be offshored. Similarly, legislation in the U.S. regarding security, and the requirements for offshore contractors to comply with the Sarbanes-Oxley Act, section 404, show that offshoring is still subject to political control. As a result, the political climate could yet hold back the offshore development of certain sensitive sectors and activities.

So to summarize at a macro-level, the impact on each level has so far been limited. Worker disruption has not been widespread; there is little evidence of sustained consumer activism on offshoring; and anti-offshore legislative moves have been minor in scope. But although the offshore backlash has had a limited impact overall, individual companies are deeply concerned about avoiding potential damage and becoming a "flashpoint" company. Offshoring has not been a systematically damaging reputational issue for business – but executives are nevertheless alert to the potential pitfalls. There remains scope for reputational damage, and responsible business leaders are managing these risks accordingly.

A recent Percept straw poll of business opinion gives a snapshot of corporate views on offshoring, and the relative weight of concerns (Figure 8.1). Ninety percent of respondents indicated that business was not doing enough to tackled the offshore backlash, and that it would continue to be a problem in the future. Further:

- 87 percent of respondents showed concern about the potential impact of offshoring on workforce morale
- 57 percent of respondents cited the potential for corporate brand/reputational damage
- 43 percent identified the potential for damage of corporate social responsibility credentials
- 32 percent saw negative perceptions of offshore sourcing potentially damaging customer demand and bottom line performance.

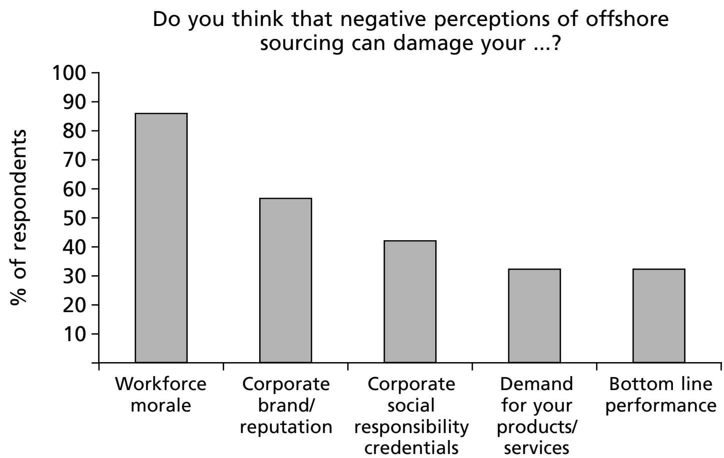


Figure 8.1 Potential impacts of negative perceptions
Source: Percept Risk and Strategy, "Offshore Perceptions 2004"

Strategies

There are three basic choices for business to handle the reputational risks of offshoring:

1. A company could delay or reject offshoring altogether. The popularity of this type of reaction is also reflected in the extensive anecdotal evidence that offshore plans have been scaled back, delayed or cancelled, and by the "pro-onshore" strategies adopted by some U.K. financial services organizations (see above).
2. A company could choose to evade the reputational issues by conducting "offshoring by stealth". This is no longer a viable strategy for many organizations, particularly global players or leading national brands. The first-mover, low profile available to the pioneers of offshoring such as British Airways, General Electric and American Express is no longer available.
3. A company can choose to understand and address the concerns of stakeholders systematically.

This final choice will be the only appropriate choice for most businesses in globalizing industries. The right approach will obviously vary significantly according to the type of offshoring, the industry, and the profile of the organization. But there will be a set of common considerations for any organization considering developing or ramping up an offshore strategy and these are now discussed.

Understand current and future stakeholder concerns

A systematic analysis of the perspectives of all stakeholder groups is an invaluable tool. This involves identifying all key stakeholder groups (for example employee, customer, media, regulator, community) and subgroups, and then mapping against each the relative importance of different offshore issues (such as security, quality, economic impact). This issue stakeholder map can then form the basis for a plan of action to address the offshore debate. This tool should be dynamic, as the makeup of your stakeholders and their concerns will evolve with time.

Develop a plan for displacement management

Offshore sourcing will not necessarily lead to retrenchment among employees. But where this is the case, carefully considered plans can dramatically reduce the potential disruption caused by offshoring, firstly by avoiding displacement where possible, and secondly by supporting displaced workers where avoidance is not possible. Avoidance strategies include retraining, voluntary redundancy schemes, and active redeployment programs. Support strategies for displaced workers include retraining allowances, compensation, and outplacement assistance. In addition to the measures applicable to displaced individuals, consideration should also be given to communities where substantial numbers of redundancies could result in more systemic displacement problems. In such cases, liaison with local and national public bodies will be valuable.

Make the case for offshoring

Effectively communicating the rationale for offshoring is crucial. This is a complex task, relying on a sound understanding of the offshore plans, the perspectives of stakeholders, and clear thinking regarding mitigating strategies for the potential downsides of offshoring. The communications need to combine a recognition of the concerns that offshoring can generate, with a clear dismissal of the "myths" of offshoring, and reaffirmation of the company's core commitments – such as the development and welfare of the workforce as a whole. Communication should of course be in terms that are meaningful to the end audience (an employee communication should avoid the jargon that infests offshore business cases, or the macroeconomic terminology of the business press). But at the same time, any realistic communication needs to underline the powerful business factors that drive offshoring. The mode of communication may well take a number of forms, according to the audience in question (such as internal memos, speeches, articles, white papers, press releases). In many circumstances, it will be appropriate for your organization to make use of industry associations as a collective voice, but in all cases this should always complement, not replace, your own bespoke internal and external communications activities. By aiming for communications that are clear, comprehensible and honest, you will be taking steps to minimize the scope for misunderstanding, anxiety and uncertainty, both inside and outside the organization.

Ensure the highest standards

Any offshoring plan will need to build in mechanisms for maintaining operational standards, such as quality of service, security, business continuity and data protection. This applies equally to an in-house facility (via processes, methodologies) as to an outsourced facility (via contractual and service-level agreements). Service-level expectations must be defined and monitored, both during transition and ongoing operation. Failure to comply with expected standards could be exploited by offshore critics, and result in significant reputational damage – operational shortcomings could have a reputational impact.

Align offshore plans with your CSR strategy

Given the significance of offshoring, both for groups in developed and developing countries, your CSR teams should be involved at an early stage to advise on the implications of different offshoring options. Ensure that the offshore rollout and operations do not compromise your CSR commitments, such as minimum labor standards, environmental impact or (in the case of exit management) community support. This will involve audit activities to ensure compliance, consultation with local stakeholders (for example community groups, NGO's), and identification of strategies to mitigate negative local impacts, such as changes to working patterns and pressures on traditional family life. Although the CSR angle of offshoring has not yet been widely scrutinized in public, it is likely that it will form an increasingly significant risk area, especially for leading brands.

Conclusion

No doubt many executives will have skipped this chapter altogether, or if they reach this stage, will be foaming at the mouth –the above suggestions might appear to get in the way of "just getting on with it." However, we have tried to show that although there are a range of complex and deeply held concerns about offshoring, there are also practical options to help to address the reputational risks. No doubt the future will provide a rich case history of examples where companies have clearly appreciated the reputation risks of offshoring, and where they have not.

CASE STUDIES

BT

BT was one of the first UK companies to experience an offshore backlash, despite a long-standing sourcing link with India via BT Mahindra, a partly owned technology subsidiary. In November 2002 it announced plans to source 800 call center jobs in India, at the same time as job cuts were announced in call centers in the UK. Fearing that this was indicative of further job cuts, the CWU led vocal protests across the UK in late 2002. Although falling short of strike action, the CWU's position here was reflected in its later Pink Elephant campaign against offshoring. The local and national press picked up the story, with one tabloid labeling BT as "British Delhicom" and others criticizing the short-sightedness of offshoring.

As well as engaging with the CWU, BT reached a significant agreement with Connect, a managerial union. This laid the basis for a more collaborative approach to offshoring, in which BT undertook to consult Connect members at least six months in advance, and compensate any displaced employees fully on any offshoring activities, in return for the positive engagement of Connect regarding offshoring plans.

In addition, BT chose to openly tackle the political and reputational questions raised by offshoring, in a detailed white paper. Prepared by independent consultants, this was released in late 2003, and provided a frank impact assessment of offshoring both in the UK and India. By recognizing stakeholder issues, it presented a sophisticated global sourcing position, contrasting sharply with the "offshore by stealth" approach that characterizes many businesses.

Barclays

One of the UK's leading retail banks, Barclays announced in a news release in January 2004 that it had reached a major agreement with the union UNIFI to work collaboratively on offshoring, "designed to minimize job losses and the consequent impact on people and communities, which will result as Barclays continues to reshape its business".

Barclays and UNIFI reached agreement on a range of activities, including a redeployment program, a £2 million fund to provide training for displaced employees, outplacement support, plus an agreement that all staff whose jobs are potentially to be offshored will be given three months' advance notification of potential displacement, plus another three months if they are actually displaced. In order to minimize compulsory redundancies, the agreement also included provision for a "voluntary redundancy register" and "job matching" to be administered by an HR team at an annual cost of £250,000. In addition, Barclays agreed to provide clear visibility of its global sourcing plans, providing full details on new offshoring projects at least six months in advance.

Regarding the question of exploitation in developing countries, Barclays repeated its commitment to the human rights standards of the UN Universal Declaration of Human Rights and the ILO conventions, and agreed to refer to these standards as part of a third party supplier evaluation process.

Significantly, this deal was in place in advance of significant offshoring plans that where announced in February 2004, in which Barclays outsourced several hundred application development jobs to the technology consultants Accenture. This announcement was accompanied by limited media interest, unlike the criticism that greeted similar announcements by Barclay's high street competitors.

CHAPTER 9

The future: outsourcing, innovation and your company's and country's future growth

> *"There is no more science fiction." The outlook is, indeed, that there will be no break in the acceleration of innovation, and that the innovations in prospect will be as difficult for us to comprehend as those now thoroughly familiar to us would have been for our ancestors.* **William Baumol, speaking at an Allander lecture in 2004**

To talk about the future of outsourcing, it would be too simple to talk merely about the increasing number of services that could be outsourced, or the improvements in technology which will make processes more efficient and productive.

No, the future of outsourcing means understanding prosperity in a modern economy. And that means understanding the drivers of growth, innovation and intellectual property. This is the "big picture." Moreover, the big picture also requires understanding the imperative of outsourcing to a nation's economy. Can outsourcing improve not only your company's, but also your country's ability to innovate?

Prosperity in the modern economy

The discussion in this chapter is divided into the following four themes:

- *Technological advances* should continue to drive globalization, prosperity and, where competition is strong, innovation.
- *Economic globalization* will continue to expand export markets, improve access to good value imports, increase the international division of labor, and present new opportunities for moving up the value chain.

- *The service sector* will continue to become increasingly important for future prosperity – promoting productivity growth in services will be key to wealth creation.
- *The knowledge economy* will continue to demand skilled workers, and managers, who can adapt to change.

Realizing these opportunities depends on being open to, and equipped for, change. This requires institutions and policies that promote *flexible, enterprising and competitive markets* and equip firms and workers to adapt quickly to new opportunities and change.

Technological advances

> The most basic proposition of growth theory is that in order to sustain a positive growth rate of output per capita in the long run, there must be continual advances in technological knowledge in the form of new goods, new markets, or new processes. *Aghion and Howitt (2000)*

Social

The substantial increase in material wellbeing that has taken place in advanced economies since the Industrial Revolution has been characterized by change and innovation (Aghion and Howitt 2000). For the one and a half millennia before the Industrial Revolution very few innovations were introduced and GDP per capita growth rates are estimated to have averaged about zero. Some technologies available to people living in the third century, such as engineered water supplies providing hot baths, actually disappeared and didn't reappear until the nineteenth century (Baumol 2004; Sharma 2000). However in the past two centuries, firms, stimulated by competition, have brought enormous amounts of new goods and services to market and, accordingly, GDP per capita is estimated to have grown by 20 to 30 percent in the eighteenth century, by around 200 percent in the nineteenth century, and by close to 400 percent since World War I (Maddison 2001; Crafts 2002). Between 1913 and 1999, Crafts (2002) estimates that GDP per capita has grown by about 387 percent.

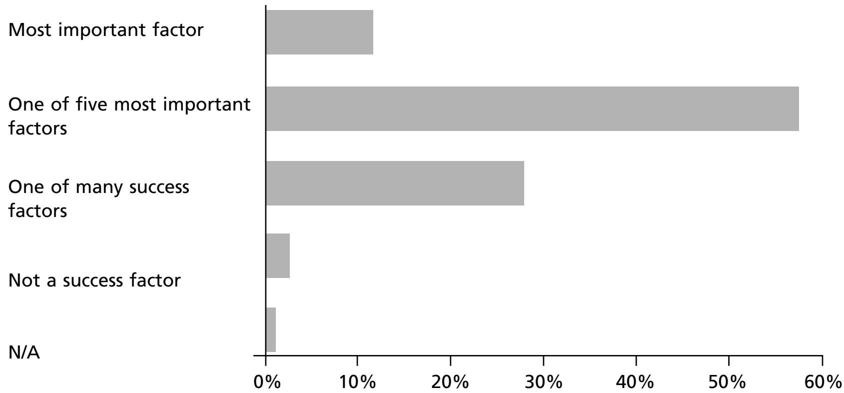


Figure 9.1 Compared to other factors, how important is your company's ability to innovate in achieving competitive advantage?
Source: Accenture and *Chief Executive*

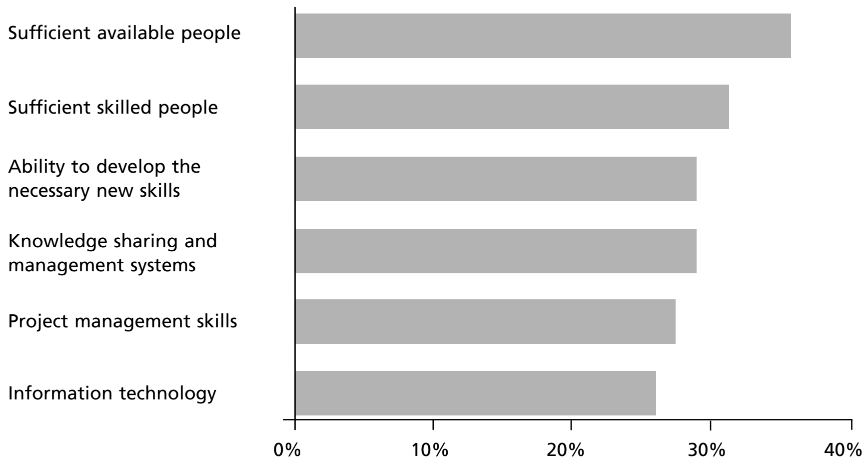


Figure 9.2 My company is limited in its ability to implement ideas by lack of the above
Source: Accenture and *Chief Executive*

Figure 9.3 Real GDP per capita 1500–1999
Source: Maddison 2001; Crafts 2002

The scale and speed of new developments has increased particularly rapidly over the past century, transforming economic and social interactions. This constant stream of innovation will continue to be the most important requirement for future growth in productivity, prosperity and living standards (Baumol 2004). Literature surveys (Griliches 1995) have consistently shown a positive relationship between various innovation indicators and measures of economic output. For example, a study by Boskin and Lau (1992) found that by far the largest contribution to economic growth from 1948 to 1985 in five major countries was technical progress when compared to capital and labor, accounting for over 75 percent in the U.K.

The fast pace of technological breakthroughs makes foresight difficult (for example, Stewart (1997) estimated that 90 percent of all scientists who have ever lived are alive today), but it is predicted that technological change – whether through advances in IT, biotechnology or emerging fields such as nanotechnology – has the potential to revolutionize all dimensions of life – social, economic, political and personal. For example, the think tank RAND (Antón et al. 2001) predicts that by 2015, advances could include:

- *Smart materials:* Several different materials with sensing and actuation capabilities will increasingly be used to combine these capabilities in response to environmental conditions. Applications that can be foreseen include: Clothes that respond to weather, interface with information systems, monitor vital signs, deliver medicines, and protect wounds;

Personal identification and security systems; And buildings and vehicles that automatically adjust to the weather.

- *Nanofabricated semiconductors:* Hardware advances for exponentially smaller, faster, and cheaper semiconductors that have fueled information technology will continue to 2015 increasing the availability of low-cost computing and enabling the development of embedded sensors and computational systems in consumer products, appliances, and environments.
- *Molecular manufacturing:* A number of visionaries have advanced the concept of molecular manufacturing in which objects are assembled atom by atom (or molecule by molecule) from the bottom up (rather than from the top down using conventional fabrication techniques).

In addition, synergies across technologies and disciplines will generate advances in R&D, production processes, and the nature of products and services, and the organization of the workforce (Karoly and Panis 2004).

Science

> Science is the highest personalization of the nation because that nation will remain the first which carries the furthest the works of thought and intelligence.
> *Louis Pasteur*

Investing in expanding the capacity to innovate (science, education and enterprise) will therefore provide the best foundation for future prosperity. The links between innovation and growth, and business university collaboration, are explored in more detail in the DTI innovation report *Competing in the Global Economy* (2003), and the Lambert Review of Business-University Collaboration, respectively.

The Lambert Review reported that the scale of a country's overall investment in R&D has a direct relationship with the dynamism and productivity of its economy: as a general rule, countries and regions which do not invest much in research will generate less value added and have a poorer productivity record than those which do. Studies consistently confirm that engagement between innovators and the science base creates strong economic benefit (Adams 1990). Investment in the public science base makes an important contribution to this. In 1986, the U.S. Office of Technology Assessment *Research Funding as an Investment* (1986) stated that "every $100 of public money put into academic science yields, on the average, a perpetual return of approaching $30 per annum in industrial, commercial, medical and other social benefits". The OECD estimate a 1 percent growth in public R&D leads to a 0.17 percent increase in total factor productivity (Guellec and van Pottelsberghe de la Potterie 2001). Moreover, this effect increases with the share of public science conducted in universities (Bergman 1990; Martin 1998).

There are also complementary social, environmental and cultural benefits of publicly funded research. Estimates of the social rate of return on publicly funded research vary widely but are consistently significant (in the range of 50–160 percent).

Publicly funded basic R&D has also been found to complement privately funded basic R&D – raising business' R&D effort, rather than substituting for it. There is, therefore, a clear role for governments' funding for science and research that needs more development before it can be commercialized, but has the potential for greatest spillover benefit. The Lambert Review stressed the importance of public funding recognizing excellent research undertaken with industry or other users as of equal value to excellent academic research.

Publicly funded research also feeds directly into private sector R&D through the publication of scientific papers. In a survey of U.S. R&D managers in firms in differing industries, it was found that about 10 percent of new processes and products could not have been developed without a substantial delay in the absence of academic research (Mansfield 1991). A similar study in Germany (Beise and Stahl 1999) found that around 5 percent of new products could not have been developed without academic research. It has also been found that nearly 30 percent of R&D managers in industry cited publications from public research as a useful input into their projects within the last three years.

Of course it is also in the interests of companies to innovate: as well as providing a means to retain competitive advantage, whether in products or processes, high sales growth is more likely with high R&D intensity (R&D as percent of sales) and there is a strong correlation of sales per employee with R&D per employee.

CASE STUDIES

Avaya, a global leader in business communications solutions and services, outsourced learning development, delivery and operations management in a contract that included more than 1,800 courses delivered in 20 countries to employees, customers and business partners. After six months, results showed the potential to reduce students' time to proficiency by 50 percent or more. In addition, learners enroll online and launch web courses upon enrollment without waiting or traveling. Seventy percent of learning eventually will be online, enabling Avaya to reduce its classroom space requirements by up to 50 percent.

(Source: Accenture)

Universal Leven, an insurance company based in the Netherlands, leveraged outsourcing as a way to gain capabilities and technology at speed. Universal Leven identified an opening in the insurance market: other firms required three months to process an insurance application. This three-person firm reckoned it could provide private label products to big firms inexpensively by processing applications in one day – with the right process and technology. It decided that partnering with an outsourcer was the only way to accomplish this, as its existing back office organization was unable to deliver these new services on time and at the high service levels needed. By outsourcing the back office to an outsourcing provider, the costs become controllable, giving Universal Leven the option of maintaining an attractive price level for the brokers as well as the policyholders in the long term. Universal Leven is able to concentrate on its core business activity.

(Source: Accenture)

Investment in the public science base has to be viewed as a long-term venture. There has been a significant lag between scientific discovery (subsequent publication of a paper) and commercialization – various studies have estimated that there is from a 7-year to a 20–30-year lag between publication and productivity improvements (Adams 1990). For example, Professor Peter Mansfield started work on the MRI scanner in 1972 (supported by a research grant). The first commercial scanner was not produced until 1980, for which Professor Mansfield jointly won the Nobel Prize in Medicine in 2003. There is evidence however that product generation is getting faster – in 2001 car development in the U.K. was around two-thirds the time of five years previously, according to research part-funded by the DTI.

Science and research is becoming more "international" in terms of shared use of international facilities and global reach of business (for example, BP works with numerous U.S. universities, and Tsinghua in Beijing as well as Cambridge University and Imperial College in the U.K.). But the strategy of free riding on R&D investment by others is not viable in the long term. National technology has strong roots in domestic science – studies shows that patents cite research papers from their own country two to three times more than those from other countries (*CHI*

Research 1992). Rapidly increasing levels of investment in R&D by many smaller nations (from 1981 to 1999, Sweden, Finland, Denmark and Ireland have increased their spending by 72 percent, 172 percent, 88 percent and 104 percent respectively) also support the view that spillovers often occur within countries.

However, investment in science and the production of excellent research alone will not be sufficient to generate wealth. The actual realization of new discoveries and technological possibilities will depend upon translating research from the labs into productive use by business. Firms need the ability and incentives to adopt and adapt new discoveries in order to introduce new improved services, products and processes. This requires actively competitive markets which force firms to innovate and improve efficiency, and the availability of skilled, adaptable workers who allow firms to make the most of new opportunities (see below). Public acceptance of technological change is also important, as seen by the recent reaction to GMO's (*Newsweek*, April 5, 2004). In addition, levels of technology and infrastructure investment are an indication of the strength of the science infrastructure.

In particular, public investment in a skilled and talented workforce is crucial to the production of good research and its translation into wealth creation. Production and retention of highly technically trained scientists, engineers and managers will in practice provide the means for companies and public organizations to produce new research and absorb and apply work produced elsewhere (University of Sussex 2000). A number of international studies have shown that the extent to which a country benefits from knowledge generation depends on factors such as the availability of a workforce appropriately skilled to understand and adapt this knowledge and the extent to which the country links into international knowledge networks (for example OECD 2001).

Foreign direct investment (FDI) and the resulting R&D is also important as it brings significant potential for spillovers of technology, innovation and best practice. Foreign investment allows firms to apply new technologies developed in one country to plants or units in another country.

Wealth creation will ultimately depend upon firms' ability and incentives to adopt and adapt new discoveries in order to introduce new improved services, products and processes. This requires actively competitive markets that force firms to innovate and improve efficiency, and the availability of skilled, adaptable workers who allow firms to make the most of new opportunities.

The Allander Series

The Allander series of seminars, which ran through the winter and spring of 2003/04, brought together some of the world's leading economists to assess how Scotland can best respond to the challenge of globalization, European enlargement and devolution. The series reflected a conviction that a "Smarter, Successful Scotland" needs to focus on higher growth. The series included papers by William Baumol on sources of innovation and the stimulation of growth in the Scottish economy, Paul Krugman on economic growth, and Edward Glaeser on the key challenges for Scotland's cities.

The authors were chosen not only because of their outstanding expertise in economics but also because of their understanding of its application to policy. The intention of the Series is, therefore, to create an environment in which new policy ideas and their creative implementation come together, and to set the policy agenda for further economic, cultural and social change.

Key messages from the seminar series include:

- To encourage innovation, governments can play a useful role in encouraging the acquisition and absorption of technology from abroad, particularly in the case of smaller/regional economies, through incentives for inward investment, venture capital, and immigration (Baumol).
- Whilst cost is important for attracting FDI, a bid by Scotland to become a low-cost region within Europe has become less viable as globalization will tend to move very cost-sensitive business activity to emerging economies. Rather, a large role for public investment – tangible and intangible – in enhancing regional attractiveness and the promotion of clusters by the government is worth pursuing (Krugman).
- USA examples show that most, although not all, growth success stories are generated by promoting higher education, not basic education – the relationship between Silicon Valley and Stanford University is a case in point (Krugman).
- The success of metropolitan regions above all depends on attracting highly skilled workers, who are in turn attracted by education, urban amenities and reasonable taxes (Glaeser).

Innovation

> In today's economy many of these rival "oligopolistic" firms use innovation as the main battle weapon, with which they protect themselves from competitors and with which they seek to beat those competitors out. *William Baumol*

Firms that thrive in the modern economy will be those which are quick to identify and exploit new opportunities, and compete by introducing new innovations. According to David Vice, the CEO of Northern Telecom (Peters 1992): "In the future there will be two kinds of companies – the quick and the dead." For example:

- In 1995, 1,000 new soft drinks were launched on the Japanese market. A year later, 1 percent of them were still for sale.
- At Hewlett-Packard, the majority of revenues comes from products that did not exist a year ago.
- The number of grocery product launches in the U.K. increased from 2,700 in 1981 to 20,000 in 1996.
- In 1996, Sony launched more than 5,000 new products – more than two new products per hour.
- The average product life cycle for consumer electronics is now three months.
- Disney's CEO Michael Eisner claimed that the company develops a new product – a film, comic book, CD – every five minutes.
- The U.K. now has around 7.5 million Internet banking customers, and Barclays has forecast that, by 2008, 40 percent of transactions will happen online.
- To keep up with all the product launches, Procter & Gamble has more scientists on its payroll than Harvard, Berkeley and MIT combined.

Whilst invention has typically been associated with small firms, the bringing of innovations to market has often depended on the competitive pressures that force larger firms to innovate. Wealth creation, and value added, is generated by the accumulative effect of incremental improvements to new inventions, such as those that increase capacity, reliability and user-friendliness, improve design and reduce cost. For example, between 1971 and 2003, the "clock speed" of Intel's microprocessor chips – the number of instructions each chip can carry out per second – has increased by three million percent, to reach about three billion computations per second. Between 1968 and 2003, the number of transistors embedded in a single chip has expanded more than ten million percent, and the number of transistors that can be purchased for a dollar has grown by five billion percent (Markoff 2003, p. 1). These developments have changed the face of services – such as banking and retail – as well as the manufacturing industries that produce them.

Free competition, that is, competition not handicapped by severe government regulations or tightly enforced customary rules (like those of medieval guilds), appears to have played a critical role in the growth of the capitalist economies by forcing firms to innovate and introduce, not only new goods and services, but also new and better ways of organizing their businesses (Baumol 2004).

> The result is precisely analogous to an arms race … each firm is driven to conclude that its very existence depends, at the least, on matching its rivals' efforts and spending on the innovation process. *Baumol (2004)*

In a competitive economy, therefore, a constant stream of innovations can be expected to appear.

In addition, less productive firms who fail to innovate, or improve efficiency, are replaced by new firms, in what Joseph Schumpeter called "creative destruction". This process depends upon the continuous churning of a flexible competitive economy in which the new displaces the old. Standards of living rise because depreciation and other cash flows of industries employing older, increasingly obsolescent technologies are redeployed, along with new investment, to finance the production of capital assets that embody more cutting-edge technologies. Through this process, according to Alan Greenspan, who was speaking at the Enterprising Britain Conference, wealth is created, incremental step by incremental step, as high levels of productivity associated with innovative technologies displace less productive activity.

Geographical regions with the highest growth rates and most dramatic success stories, such as Silicon Valley and the Houston IT cluster, have also experienced an extremely high rate of corporate mortality. As well as reflecting the creative destruction of less successful firms, high "failure" rates also reflect low barriers to entry and growth that allow firms to enter markets, test new ideas and exit with ease. The experience of ICT has demonstrated that experimentation and competition are key in selecting those firms that seize the benefits of ICT and in making them flourish and grow.

> In the current time of rapid technological change, greater scope for more experimentation may enable new ideas and innovation to emerge more rapidly, leading to faster technology diffusion. *OECD (2003)*

This also depends crucially upon fostering an enterprising environment in which entrepreneurs are willing to take risks and experiment.

Consumers are the key beneficiaries of competition – primarily through lower prices, or better value for money – and also have a role to play in stimulating innovative activity. Increasing information, the Internet and other advances in ICT should mean that consumers become increasingly active, discerning and demanding, thereby increasing competition. Consumers can group together, reducing the role of middlemen and increasing efficiency by reducing rent-seeking behavior.

Flexibility

> *Special emphasis should be placed on searching for policies that will foster still greater economic flexibility while seeking opportunities to dismantle policies that contribute unnecessary rigidity.* **Alan Greenspan**

Flexibility is important for allowing firms to take advantage of new technological advances and innovations. ICT-induced productivity gains have demonstrated that investment in new technology alone is insufficient to reap the full potential of new developments. Characteristics that have allowed countries (such as the U.S.) to increase the benefits from new technologies include flexible and competitive markets characterized by features such as:

- low risk aversion, related to low cost of failure – so that entrepreneurs are willing to experiment and take risks
- opportunities for risky financing to innovative entrepreneurs
- low regulatory burdens that enable firms to start at a small scale, experiment, test the market and their business model and, if successful, expand rapidly
- a competitive environment – leading firms to invest in ICT as a way to strengthen performance and survive, and putting downward pressure on the costs of ICT
- good management skills, and an environment that helps workers to acquire the skills they need to adapt to change.

New technologies can also aid flexibility. ICT can support lifelong learning, for example, and ICT systems can improve inventory management and promote lean manufacturing, thus improving productivity. At Wal-Mart, 97 percent of goods never pass through a warehouse – the goods go directly from maker to shelf to customer.

Increasing flexibility is also important for protecting the economy from adverse shocks. Flexible economies will be most able to maximize the benefits and minimize the costs of rapidly emerging opportunities and the changing business environment.

CASE STUDY

TiVo, a start-up television service provider, used a solutions integrator-type outsourcing arrangement to quickly develop distinctive customer support capabilities to take a new market by storm. TiVo realized that its unique product had unusual needs: success would depend on helping each customer install, understand, and use the new product in a way that specifically suited them. Using TiVo's CRM application, call center agents are able to feed a rich description of customer problems back to TiVo's product development and marketing organizations. This deep market intelligence helps to enable TiVo to stay one step ahead of its competitors.

(Source: Accenture)

Globalization

From an economic perspective, the globe has indeed shrunk … National boundaries are less and less a barrier to trade as companies more and more manufacture in many countries and move parts and components across national boundaries with the same ease of movement exhibited a half century ago within national boundaries. As a consequence, in the eyes of many, if not most, economists, world per capita real GDP over the past three decades has risen almost 1½ percent annually, and the proportion of the developing world's population that live on less than one dollar a day has markedly declined. *Alan Greenspan*

> Advances in information technology have reduced transport and communication costs and have driven economic globalization and integration. For example, in 1930, a three-minute call from New York to London cost $250 (in 1990 dollars). Thirty years later, the cost of a similar phone call was down to $50. Now we are approaching zero (Cairncross 1997). Similarly, HSBC estimates that the cost of a one-minute telephone call from India to the U.K. or U.S. fell by more than 80 percent between January 2001 and October 2003. At the same time, average tariffs have decreased from 50 percent to less than 5 percent, over the past 40 years, and international trade has simultaneously increased by 1500 percent (Knoke 1996). As transportation and communication costs continue to fall, the trend toward increasing globalization and economic integration looks set to continue.

Growth

Economic integration of the world economy not only can lead to a higher aggregate global welfare as predicted by trade theory (for example Krugman and Obstfeld 1997), but also may produce dynamic gains in the form of higher long-run growth rates. The World Bank estimates global welfare gains of $500 billion from free-trade/multilateral liberalization. International trade, for example, may affect rates of productivity growth through a number of channels (Cameron et al. 2000) and be directly responsible for:

- the *quick transfer of technology between countries*, for example trade may allow domestic firms to "reverse engineer" products of their foreign rivals
- the *spillover of ideas*, enhancing the dissemination of ideas amongst researchers. Trade generates a larger pool of knowledge to assist future innovation, thereby raising the productivity of research and boosting long-run growth rates
- *eliminating incentives for duplication in innovation* by increasing competition between researchers based in different countries
- *increasing the potential market for goods and services*, allowing firms to capitalize on economies of scale, and the potential market open to research and innovation, encouraging research activity
- *enhancing the intensity of product market competition*, forcing domestic firms to improve efficiency and providing access to cheaper and/or better product inputs and consumer goods

- promoting increased specialization between countries, allowing individual countries to shift resources from less productive to more productive sectors, thereby leading to a more efficient allocation of global resources.

In addition, FDI brings significant potential for spillovers of technology, innovation and best practice. Foreign investment allows firms to apply new technologies developed in one country to plants or units in another country. Host countries therefore benefit from gaining access to technology which might not otherwise be available to them.

There is indeed a strong correlation between the expansion of global trade and per capita income during the twentieth century, particularly in the period from 1950 to 1973. In a study of U.K. productivity growth and openness, Cameron et al. (2000) also find that, within manufacturing, open sectors have recorded markedly higher total factor productivity (TFP) growth than closed sectors. Their research also shows that labor productivity in the U.K. is correlated with a number of measures of openness, consistent with the hypothesis that openness affects growth through the rate of technological change, and that international openness – as measured by the flow of goods and the flow of ideas – speeds convergence to U.S. levels of productivity within manufacturing (Cameron et al. 2000).

Greater openness to trade will not automatically lead to higher growth, however. Countries will only be able to realize the full potential gains if they have the infrastructure, institutions (promoting flexible labor and capital markets) and incentives that allow firms to make the most of new opportunities. Countries that have provided fertile soil for these developments, such as the U.S., countries in Western Europe (especially small open economies such as the Netherlands, Ireland and Finland) and Asian countries such as South Korea, Singapore and Taiwan, have witnessed high productivity growth in recent years (Poots 2002).

Production

> This is not war, where one economy's victory is another's loss. We all win when these things go forward, but if we are not realistic about our strengths and how to act on them, then we could go backward. The prescription for the U.K. and U.S. economic behavior is the same; they must be economies that build innovative products and services. *Bill Gates, speaking at the Enterprising Britain Conference*

More recently, industrialization in developing countries, particularly China and India, has significantly changed the face of global production.

On current trends, by 2025, 50 percent of global manufacturing exports will be produced in today's developing countries up from around a quarter today. In addition, falling communication costs are now making the outsourcing of services increasingly viable, exposing service industries to new international competition. Whilst industries that have chosen to move from advanced economies to take advantage of an abundance of cheaper labor, and often relatively soft environmental and safety regulations, have tended to be concentrated in low-skill sectors of the economy, increasing education and skill levels in countries like India and China mean that they are increasingly able to compete at higher levels in the value-added chain. For example:

- In China, the enrolment ratio for tertiary education has increased from 2.9 percent to 9.5 percent during the 1990's, and in India the rate rose from 6.3 percent to 10.5 percent over the same period. In 2000, China produced 739,000 graduates and India produced 687,000, while the U.K. produced 265,000 graduates in the same year.
- China annually produces 350,000 engineers with an average monthly salary of slightly above $100, has more high school graduates than America (by a couple of hundred million) and contains 413.7 million people who are under 20.
- During the eighteenth century it took Great Britain some 60 years to double its GDP … 100 years later, Japan managed to do it in half that time. Recently, South Korea did it in 11 years.

In the long term, these trends pose challenges for the U.K. but also represent opportunities. In particular:

- Rising incomes in the huge emerging economies such as China and India open up vast export opportunities for the developed world (Poots 2002).
- Increased competition incentivizes U.K. firms to raise performance, particularly in industries and segments of the workforce relatively insulated from trade-related competition in the past. According to Sir Digby Jones, director-general of the CBI: "China and India are not just low-cost locations. They have technology and skills to match those found anywhere in the world. They are raising the bar for the rest of us".
- The cheaper production of goods abroad and the offshoring of services to cheaper locations represent input cost savings, which can

be passed onto consumers or to investors to reinvest. For example, DRAMS – dynamic random access memories – are made in Southeast Asia, exported to Mexico for assembly as laptops and PC's and then shipped to markets throughout the world, reducing input costs for a number of industries. The Centre for Economic and Business Research (CEBR) estimates that over the next five years, business profits will be raised by around £1.7 billion through greater cost efficiencies derived from outsourcing.

- Increased specialization, niche marketing and outsourcing (also facilitated by falling communication costs) allow industries to move up the value chain, transferring labor from less productive to more productive activities. It has also led to the re-emergence of the small firm, encouraging competition and innovation (Poots 2002).

Facilitated by ICT, some sectors of the economy are already taking advantage of these trends by moving toward more specialized, vertically disintegrated firms. The production process is divided up such that firms can specialize in products and services that define core competences, and outsourcing noncore activities. Such activities might include steps on the production chain, such as industrial design and the manufacturing of intermediate goods, or support activities, such as computing services and human resources.

In 2002 it was said that the new competitive battlefield was neither the engine nor the air conditioner – it was the design, the warranty, the service, the deal, the image and the finance package. For example, by 1994, some 70 percent of the value of a new car already lay in the intangibles (*The Economist*, September 28, 1996).

The U.K., for example, is well placed to do this. Creative industries in the U.K. are making an increasing contribution to the economy. For example:

- The creative industries grew by an average of 8 percent per annum between 1997 and 2001. This compares to an average of 2.6 percent for the whole of the economy over this period. In 2001 they accounted for 8.2 percent of gross value added (GVA) in 2001.
- Total creative employment increased from 1.6 million in June 1995 to 1.9 million in June 2002. Over the period 1997–2002, employment in the creative industries grew at a rate of 3 percent per annum, compared to 1 percent for the whole of the economy.
- The sectors which have shown increases in employment above average for the whole of the creative industries in 1997–2001 were software and

so on (+8 percent p.a.), design including fashion (+7 percent), and film, video and photography (+5 percent).

- The U.K.'s games developers have built a global reputation for their combination of creativity, innovation and originality, and an Edinburgh-based development studio, Rockstar North, produced the best-selling game of 2002 (Grand Theft Auto III).

Sectoral change – services

> Discussions of innovation in manufacturing have often missed the enormous contribution that science and technology can make to wealth creation in service industries which now account for 70 percent of value added and 77 percent of employment. *Nick Stern*

Productivity growth

Service industries now account for 70 percent of value added and 77 percent of employment. This reflects a long-term historical trend, common across advanced economies, that has reduced the importance of manufacturing and increased the share of services. As transportation technologies continue to improve, it is likely that labor-intensive manufacturing industries will continue to relocate to the most viable low-cost regions, and that higher value-added services will continue to increase in importance in advanced economies.

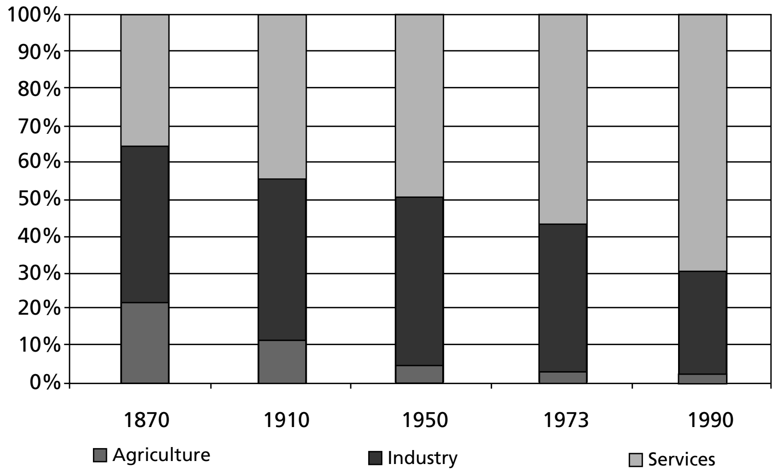


Figure 9.4 Structural change: employment share
Source: Crafts (2002)

The traditional boundaries between manufacturing and services continue to blur. Manufacturing companies are being transformed from having a little service, to service companies with a little manufacturing. A company such as Ericsson is more than 50 percent service and pure knowledge work, and at Hewlett-Packard and IBM this figure is closer to 80–90 percent. The service components of a firm also have the potential to be the most profitable. For example, in 1998, more than two-thirds of General Electric's revenues came from financial, information and product services (Crainer 1999). These trends should continue, as comparative advantage increasingly lies with knowledge-intensive, brain-based (rather than brawn-based) activities.

In order to understand the factors that will drive prosperity in the future, it is therefore essential to understand the drivers of productivity growth in the service sector. In particular, a number of trends are worth highlighting:

- Research, technology and innovation have the potential to drive further improvements in service sector productivity. Wal-Mart has led the way in developing new, more efficient approaches in retail, for example, and has made huge productivity gains as a result, accounting for 35 percent of the entire efficiency gains in the U.S. retail sector (Asserley 2004). Financial services have pioneered technologies such as data warehousing and mining methods enabling sophisticated CRM. Banks use technology in call centers to automate simple functions, which led to a 20 percent increase in labor productivity (Asserley 2004).
- Technological advances are also exposing some services to increasing competition. The Internet has allowed new entrants to enter the financial services market, increasing competition and forcing established banks to provide similar services, reduce prices, and provide more innovative products and greater choice. Improvements in ICT mean that international trade in services (including outsourcing and offshoring) is more viable thereby increasing international competition in the service sector.
- The service sector is becoming more research intensive in response to these trends. Although service sector firms are less likely to do R&D than their manufacturing counterparts, almost a fifth of U.K. business R&D expenditure today takes place in services, a greater proportion than that in most European countries, and a similar proportion to the U.S.
- At the same time, it is likely that domestic demand for service sector jobs will rise as households increasingly "outsource" household activities such as childcare, cooking, cleaning and gardening that used to be

performed by household members to the paid workforce, as women, in particular, take paid work in greater numbers, and to service the needs of an aging population.

- Planning restrictions may constrain growth in service industries in particular. For example, planning regulations restricting land supply may prevent U.K. retail firms from realizing the benefits of ICT and organizational change that have led to the significant productivity growth experienced by Wal-Mart and the U.S. retail sector.

Technology

> Clusters: moving up the value chain: "In the knowledge-based economy, agglomeration … arises from a greater potential for tacit knowledge accumulation in dense regions with the right physical and social infrastructure." *Jacques Poots (2002)*

It has been argued that cities and regions, rather than nations, now compete in the global economy, and that "regions do not compete anymore exclusively within their national territory, but are seeking for new opportunities in an international – and often global – action space" (Poots 2002). It has therefore become increasingly important to ensure that regions have the right conditions to attract high value-added firms and businesses. The type of agglomerations that emerge in regions and cities depends fundamentally on the levels of technology and intensity of knowledge inputs as described in Table 9.1.

TABLE 9.1 Regional specialization based on the level of technology and intensity of knowledge inputs

	Intensity of knowledge inputs	
Level of technology	**High**	**Medium or low**
High	(1) Regions specializing in innovative new products	(3) Large scale production of technology-intensive products
Medium or low	(2) Product design and advanced services	(4) Large scale, low-skill intensive products or services

Source: Poots (2002)

Regions that combine high technology with a high level of knowledge inputs are the regions that generate technological innovation, such as in ICT and biotechnology, for example Silicon Valley and technology parks such as Tsukuba Science City in Japan, Sophia-Antipolis in France (1 in Table

9.1). The success of such regions is due to providing the right "seedbed" conditions for the generation of tacit knowledge.

However, successful agglomerations are not limited to those that rely on high technology inputs, but also emerge in areas which contain highly educated and skilled staff (2 in Table 9.1). Firms providing business and consumer services, financial services, product design and market research have therefore concentrated in areas such as London and the city economies of Hong Kong and Singapore.

In areas of medium or low skills, clusters of industries producing low-skill intensive products and services on a large scale are more likely to prevail. The key challenge for these regions is to enhance both efficiency and equity:

> There is a broad consensus that government can only effectively act as a facilitator of entrepreneurial activity, rather than as an active player in regional markets. While the availability of finance and "know-how" are crucial factors in local economic development, and necessitate a role for national fiscal and monetary authorities, there is also a clear trend toward de-centralized "bottom-up" development initiatives. *Poots (2002)*

Evidence suggests that human capital policies that focus on education, on-the-job training and research, and policies that enhance regional infrastructure are likely to be more effective than tax cuts or local demand stimuli. For some regions to break away from low-growth equilibria both the demand and supply side will need addressing.

Some commentators argue that easing regional transition is also important to reduce the risk of a backlash against further change at the expense of future wealth creation. The danger is that political forces will work toward reversing the process and reintroduce barriers to further economic and social integration. The cost of such a reversal would be costly. According to Poots (2002):

> The challenge is to apply the "creative diversity" of the 21st century to design effective and transparent policies that promote the sustainability of the economic gains and the equitable distribution of these gains among all citizens of the global village.

Location

> The importance of density, scale, specialization and knowledge spillover effects make cities the engines of growth. *Glaeser (2004)*

International comparisons also show that regional prosperity is typically built on city prosperity – successful European regions typically contain European-competitive cities. Furthermore, in an increasingly knowledge-driven economy, cities, which provide access to a large pool of labor, proximity between firms and between people, and facilitate social and economic networking, become increasingly important drivers of agglomeration and growth. For example, the importance of density, scale, specialization and knowledge spillover effects makes cities the engines of growth. Whilst ICT has freed up the transmission of "codified knowledge" (which can be written down and documented), proximity remains essential to the transfer of "tacit knowledge" (which is learned by experience). The record of scientific citation shows that scientists are much more likely to learn ideas from people who are physically close to them, and the Lambert Review also found that proximity matters in collaborations between companies (particularly SME's) and the research base. Although, in theory, geographical variations in the creation of knowledge would not be an issue if knowledge could be transferred quickly and efficiently to firms throughout the country, enabling them to apply it to their processes and products.

These conditions can lead to the type of clusters described by (2) in Table 9.1: industries that specialize in knowledge (as measured by having highly educated workers) tend to be far more urbanized than other industries. Business services, which depend on personal interaction, and therefore proximity between people, also tend to be highly concentrated within urban areas. Technological developments in ICT have arguably increased the agglomeration advantages of large cities. Glaeser (2004) argues that a hundred years ago, it was predicted that telephones would eliminate the need for cities (like the Internet today). However, in general, telephone usage has more often been a complement to face-to-face interactions rather than a substitute for them and phone calls occur much more often between people who are physically close and see each other more often.

Resources are mobile (both financial and labor) and world cities are highly interdependent. In order to retain, or encourage, productive sectors and firms, cities must be able to compete internationally. A number of key features remain important for maintaining the international competitiveness of cities (Glaeser 2004):

- Human capital will continue to dominate urban success. The single most important thing to ensure that a city will do well is therefore to attract and develop skilled residents. In 1900, the primary force driving the location of cities was proximity to transportation hubs and productive amenities (such as coal). In 2000, improvements in transportation have freed firms from the necessity of having to locate near these factors. Instead, firms are increasingly moving to where people want to live.

- Urban policy should therefore focus at least as much on attracting people as attracting firms. This means good schools for children and amenities that are attractive to skilled, often younger, workers. Safe streets are particularly important. For example, New York's renaissance in the 1990's is built in part on its increasingly safe urban environment.
- Good quality infrastructure is essential to attracting both firms and workers: in particular, this requires building more roads and reducing congestion, whilst continuing to apply pressure on car manufacturers to reduce environmental costs.

> Since cars are the future, urban success requires regulating the car. To a small degree, this requires non-car alternatives particularly buses. However, advantages of the car mean that the biggest gains will come from making congestion less problematic. *Glaeser (2004)*

- An increasing body of evidence shows that high taxes and aggressive regulation discourage firms. A favorable business environment becomes even more important as firms are increasingly able to relocate effectively.

The knowledge economy

> In today's world, education is key to more and better jobs, effective science systems, environmental management, preventive medicine and a healthy population, investing wisely in financial markets and benefiting from multilateral trade and investment … The Bill Gates of tomorrow could be languishing in a world bereft of opportunities. Can we afford to waste that potential? *Donald Johnston*

Changing skills

Job skill requirements have been shifting across all sectors as a result of new technologies. Significant occupational changes have occurred over the last 25 years – manual occupations accounted for around half of all employment in 1971, by 1999 this had fallen to below 40 percent; and jobs in managerial, professional and associate professional categories expanded to account for 37 percent of the workforce in 1999, compared with 27 percent in 1971. Machines can now be programmed to do the sort of routine activities that less skilled workers used to do. Business computer systems generate demand for highly skilled technical staff.

The growing importance of knowledge-based work also favors strong nonroutine cognitive skills, such as abstract reasoning, problem solving, communication and collaboration, for example, to profitably analyze increasing amounts of data produced by computer systems. Increasingly, the term "knowledge workers" is applied to workers who go beyond just providing information to now being responsible for generating and conveying knowledge needed for decision making (Karoly and Panis 2004).

The overwhelming evidence is that the continued pace of technological change is expected to further increase demand for a more highly skilled workforce, and a workforce with the ability to *adapt* to changing technologies and shifting product demand (Karoly and Panis 2004). Workers who will increasingly interact in a global marketplace and participate in global work teams will require the skills needed to collaborate and interact in diverse cultural and linguistic settings. But at the same time, demographic and others factors will drive demand for traditionally lower skilled jobs such as retail trade, health services and other personal services. Training, rather than post-secondary education, will be the most important component of preparation here.

The overall pattern of demand toward higher skilled jobs has been driving up the salary premiums paid to workers with higher education. For example, between 1973 and 2001 the wage premium for a U.S. college degree compared with a U.S. college diploma increased 30 percentage points, from 46 percent to 76 percent (Karoly and Panis 2004). On average, across OECD countries, a person aged 25–64 without an upper secondary education could expect to earn 23 percent less than someone with such an education. An individual with a higher (tertiary) education qualification could expect to earn 47 percent more than a person qualified to upper secondary level (DfES 2003).

This trend to higher level skills also looks set to continue – the Institute for Employment Studies (2004) project the U.K.'s future employment needs to 2012. It finds that, broadly, it is the more highly skilled occupational categories (managerial, professional and technical) that will see greatest industry expansion and hence the greatest future demand for increases in these higher level skills. By 2010, it is forecast that 80 percent of new jobs will be in higher level occupations – most likely to be filled by people with higher level qualifications (DfES 2003).

Where higher skills become more important for the global workplace so too will the educational role of universities and colleges. However, the growing importance of knowledge-based work will require most workers to have strong nonroutine cognitive skills, such as abstract reasoning, problem solving and communication, and the role of vocational training in an economy where workers need to adapt (by reskilling and retraining) will also be increasingly important.

Knowledge is the most important input to production in modern economies. Workers therefore need skills to compete and prosper in a knowledge economy. Higher skills, and more flexible and transferable skills, are also key to allowing workers to adapt to the modern economic environment. As technology operates to increase the demand for more skilled labor, workers often need to undergo retraining in order to take advantage of how new technologies are utilized in the workplace or to operate within new organizational structures. Within this context, education and training become a continuous process throughout the life course, involving training and retraining that continues well past the initial entry into the labor market (Karoly and Panis 2004).

Evidence also shows that more educated workers are better equipped to deal with change and tend to be reemployed more rapidly than their less educated counterparts and their relative earnings losses tend to be smaller, presumably because their skills transfer more easily from one job to the next. This suggests that, while painful, future job losses associated with higher skilled services sector employment might not be as costly in terms of unemployment and permanent wage loss as were earlier waves of blue-collar, trade-related job displacement (Karoly and Panis 2004).

The rise of the knowledge economy also makes management skills more important. The key to high performance will increasingly be the ability to manage a large number of skilled people, ideas and knowledge effectively. In addition, managers will need to be flexible and adaptable. In the past, managers had a job for life. This is not the case now, and new jobs mean new skills, so that today there is a greater need to learn new skills.

The global labor market

> If the developed economies do not help everyone to develop skills required in their changing labor markets, they will create a protectionist backlash that seeks simply to preserve jobs that match the available skills. The brake on trade expansion will, in the end, damage all. *Donald Johnston*

There is some evidence that technological advances and increased globalization are creating an expanding gap between the educated and the uneducated. Poots (2000) notes that the main driving forces of regional employment growth are proximity and linkages with the emerging global city system, knowledge creation, FDI and ICT innovations. These developments appear to be generating a widening gap between the "knowledge rich", who are able to exploit the opportunities that globalization offers, and the "knowledge poor", who are increasingly marginalized and under threat of "social exclusion". Even throughout the EU, wide gaps in achievement levels are seen by the time young people are 15 years old.

The competition from abroad has risen to a point at which developed countries' lowest skilled workers are being priced out of the global labor market. Various commentators, including Alan Greenspan and Catherine Mann at the Institute for International Economics, have noted that this diminishing of opportunities for such workers is why retraining for new job skills that meet the evolving opportunities created by our economies has become so urgent a priority.

Rapid technological evolution makes it difficult to predict future changes to the structure of the economy as the U.K. adapts to the challenges of the global economy; which sectors will contract, and in which new sectors jobs will be created to replace those lost in competition. But there is reason to expect that (albeit with some short-term pain) as one industry closes another opens. Alan Greenspan points out that this process is not new. Human ingenuity has been creating industries and jobs that never before existed, from vehicle assembling to computer software engineering. With these jobs come new opportunities for workers with the necessary skills. Over time, more than 94 percent of the workforce in the U.S. has, on average, been employed, as markets matched workers seeking employment to new jobs. Greenspan sees that we can thus be confident that new jobs will displace old ones as they always have, but not without a high degree of pain for those caught in the job-losing segment of America's massive job turnover process. As the economy is exposed to increased international competition, and takes advantage of new opportunities, the process of creative destruction means that market share and jobs will be lost in some economic sectors, and will be counterbalanced by employment gains in other sectors (Karoly and Panis 2004).

Key challenges for a modern economy – the U.K.

The discussion here exposes a number of areas that will be of key importance for U.K. prosperity in the modern economy in a world of increasing outsourcing:

- *Science and R&D:* Investment in science and R&D – by public and private funders – is the platform for future growth. However, the ability to realize the commercial gains of new discoveries will depend upon the effective translation of research from the science base into innovation by firms. Levels of public investment and public acceptance of technological change, as well as technology breakthroughs and advancements, will also affect outputs from the science base and the ability for these to be used productively. For example, Sweden and Japan have the highest R&D spend in the OECD but low growth.

- *Skills:* The knowledge economy requires more highly skilled workers better equipped to respond to shocks and structural change. A highly skilled and talented workforce is crucial to understand, adapt and use knowledge and translate innovation into wealth creation. But it is also important to focus on equipping low-skilled workers to ease the adjustment costs implied by technological change and economic gains. This is also important for moving out of the low-skill, low-wage equilibrium which seems to exist in some U.K. regions and industries, and helping such regions to make the transition to more competitive economies with higher living standards, which of course means developing the right skills, not just high skills.
- A responsive labor market also requires *migration policy* that allows the U.K. to attract highly skilled workers (including scientists and engineers), that the economy needs, and quickly and effectively integrates new workers into the economy.
- *Flexibility:* A flexible economy is able to respond to changes in economic conditions efficiently and quickly. Flexibility minimizes disruptions to output and employment and helps an economy to sustain high rates of productivity growth. Firms and individuals need to adapt to a continually changing economic environment so that growth and prosperity can be maintained. Flexible and dynamic markets are therefore a precondition for economic strength.
- *Competition:* a strong competition regime, removing barriers to entry (for example planning) and tackling cartels, increases the incentives to innovate and allow firms to seek out, and take advantage of, new opportunities.
- A strong *business environment:* macroeconomic stability, efficient regulation and competitive tax rates. According to Ruffin, the ex-director of UNCTAD, speaking at the GEM conference in 2004:

  There is a negative correlation between tax and all types of entrepreneurial activity in all countries.

  Certainty of both tax and regulation is also important for businesses making long-term location and investment decisions.

- *Enterprising* firms and individuals: who have the courage to seek, and exploit, new opportunities – generating a "can-do" culture. R&D expenditure alone is not sufficient for innovation – enterprises are the funnel through which scientific discovery is translated into new products and processes and brought to market.
- *Management:* the modern economy requires managers who are adaptable, entrepreneurial, innovative and forward-looking in their strategies and investments. "People can make your organization, your products, and your service solutions unique. How you manage and lead people, how you organize your operations, will determine whether or not you succeed."
- *Infrastructure*, in particular transport infrastructure, is important for the economy to be able to grow and increase efficiency. This means having high-quality transport in order to reduce congestion in areas suffering from inefficient transport networks, rather than simply increasing the aggregate quantity of transport investment. Improving infrastructure may also stimulate business investment in physical capital – 72 percent of studies on the growth effect of infrastructure show that these effects are conclusively positive (Higano et al. 2002). Real gains are also to be found in better taxation of roads and drivers and in reducing the environmental costs of car travel (Glaeser 2004).
- *Planning:* reducing unnecessary planning restrictions that constrain growth and development (especially re housing, retail and services).
- *Services sector productivity:* improving our understanding of how this works.
- *Cities/regions* need access to know-how and science, to finance and to dense markets, requiring connectivity within and between regions; and also endowments of more people actively engaged in the labor market with higher skill levels. Ultimately, this will depend on local initiatives, civic leadership, and entrepreneurship to be nationally and – particularly – internationally competitive.

The U.K. already shows a strong performance in several of these areas:

- *Higher level skills:* the U.K. compares well with other countries in terms of highly skilled workers and has a proportionately high number of graduates in the workforce.

- *U.K. science base:* the number of U.K. citations per head has increased from 12 percent less than the U.S. in 1993 to 18 percent more in 2002. The number of papers per head has also increased from 12 percent more than the U.S. in 1995 to 23 percent more in 2002.
- *Strong business environment:* low costs of setting up a business and macroeconomic stability. The U.K. was rated by the OECD as having the lowest barriers to entrepreneurship of any major economy. The World Bank estimates that it takes 18 days and 264 U.S. dollars to set up the average firm in the U.K. – significantly better than in either Germany or France and comparable with the U.S. in terms of cost of start-up.
- *Labor market flexibility:* especially in comparison to European counterparts. Labor market flexibility has improved significantly since 1997, as shown by evidence on wage flexibility, while price flexibility remains reasonable, with relative prices both rising and falling with the overall inflation aggregate.
- *Reforms to competition regime:* now perceived as one of best in world. The global competition review peer rating by the Office of Fair Trading has improved from 2 out of 5 in 2000, to 4.25 out of 5 in 2003 (now ranked second only to the U.S.).

But there remain key challenges for the U.K., typical of modern economies, including:

- *Science/business R&D:* The U.K. has relatively low levels of investment in R&D, particularly by business. The U.K. ranks roughly fifth among G7 countries in terms of spending on R&D. Alongside past underinvestment, we must also ensure that the current excellence of our science base is sustainable, by investing in infrastructure, skills, and stronger financial management and cost recovery by institutions.
- *Intermediate skills:* The U.K. still lags behind internationally on intermediate skilled workers. In particular there are shortages of skilled craftspeople. The U.K. needs to focus on matching skill provision to economy-wide needs and specific skills shortages. This means, for example, focusing on the quality of vocational education delivered by the further education sector and raising post-16 participation in education.
- *Public sector investment:* The U.K. has also seen historically low levels of government investment in public service infrastructure.

- *Planning:* The recent OECD report (ECO/EDR 2003) identified planning as a key constraint on U.K. growth compared with other leading economies. In addition to the streamlining of planning processes set out in the planning bill, we need to take further measures to ensure that nationally set guidance does not act as a barrier to innovation and competition in the U.K. economy.
- *Management:* U.K. managers are, on average, less well qualified than their counterparts in other countries. The culture in U.K. firms places less emphasis on creativity – influenced by management. (The DTI Innovation Report *Competing in the Global Economy* (2003) proposed measures to aid skills acquisition by managers of high-tech, fast growth businesses.)
- *Cities/regions:* With London the largest city in Europe, the U.K. is still very centralized and key challenges remain around devolving power and flexibility to the right level and building the capacity of regions and cities to drive through change.

Appendix 1: location summaries

At the time of print, below are some location summaries for Asia, Latin America and Eastern Europe, sourced from Capgemini.

Location Summary: Hungary

- **Entry Salary for Finance Clerical Staff*:** € 6,500 per annum
- **Technology Infrastructure Ranking**:** 30

Over the last few year several large U.S multi-nationals such as GE Capital and Lucent Technologies have relocated financial operations and call center operations to Hungary

"Pro's"	"Con's"
• Largest relevant size multi-lingual labor pool in Eastern Europe. Large concentration of English speaking university population • Low rental costs (€ 10-20 per sq. meter for quality office space) • Relatively high productivity levels compared to other eastern European locations • Stable political environment	• Inconsistent infrastructure (electricity generation requires back-ups) • Low degree of unions, but restrictive regulations. Tighter than other European Countries • High trade barriers and inflation

* English speaking. ** 2002 technology readiness rating from the World Economic Forum.

Location Summary: India

- **Entry Salary for Finance Clerical Staff*:** € 2,800 per annum
- **Technology Infrastructure Ranking**:** 39

India is a well-established location for 'offshore outsourcing' as well as a location for "in-sourced" shared service centers. Recent experience highlights steep wage inflation in major population centers

"Pro's"	"Con's"

• Large pool of native English speakers
• Many "Global 1000" experienced personnel
• India's government is trying to open doors to more companies by:
  ◦ Reforming India's rigid labor laws allowing companies to fire workers more easily
  ◦ Building new highways, ports and airfields
	• Growing competition wage inflation
	• Increasing real estate prices in popular cities
	• Low language diversity compared with Hungary, Czech Republic, Poland, or China
	• High infrastructure charges, such as voice lines and data lines
	• Suspect or inconsistent infrastructure
	• Perceived geopolitical risk

* English speaking. ** 2002 technology readiness rating from the World Economic Forum.

Location Summary: Mexico

- **Entry Salary for Finance Clerical Staff*:** € 14,400 per annum
- **Technology Infrastructure Ranking**:** 47

During the last two decades Mexico has proven itself a pioneer in Latin America by encouraging private sector participation in the economy. Mexico still faces infrastructure challenges as well as corruption

"Pro's"	"Con's"
• Low yearly wages for a Spanish speaking individual - $6,000 • Larger labor pools than Eastern Europe countries and some South American countries • Low rental cost (€ 14-18 sq. meter. Quality office space is readily available in Santa Fe, Mexico City, and Guadalajara) • Flexible employment laws (companies have more discretion over employment policies)	• Slow legal process • Persistent corruption and safety issues • High prices for telecommunication (government monopoly) • Low non-Spanish language accessibility, other languages can be difficult to source or expensive • Inconsistent productivity levels

* English speaking. ** 2002 technology readiness rating from the World Economic Forum.

Location Summary: China

- **Entry Salary for Finance Clerical Staff*:** € 1,710 per annum
- **Technology Infrastructure Ranking**:** 43

There are many options in China for offshore capabilities, including cities such as Shanghai and Guangzhou (Canton) which are well-established centers of international commerce

"Pro's"	"Con's"
• Large pool of English and Asian Language speakers • Increasing foreign investment • Reliable infrastructure in major cities • World's largest labour pool with increasing rate of university and technical school graduates • Low rental costs (€5 per sq meter in some cities) • Easy access to popular locations	• Persistent issues regarding ownership and property rights (typical entry strategy is with a Joint Venture partner) • Limited non-English European Language skills • Inconsistent infrastructure in remote areas

* English speaking. ** 2002 technology readiness rating from the World Economic Forum.

Appendix 2: the political issues

The politics of outsourcing even found their way into the U.S. presidential elections of 2004. The level of debate in the U.K., however, has been far more sophisticated than that in the U.S.

An adjournment debate on the outsourcing of U.K. financial services took place on Wednesday December 10, 2003 in the House of Commons. Interesting points concerning the loss of jobs, data protection, applicability of U.K. legislation vis-à-vis financial crime on activities offshored, Indian government incentives for companies setting up operations in India, retraining and reskilling of staff, also the strength of consumer power resulting in the boycotting of goods and services provided by British companies who outsource and so on were discussed. The following is a summary of the ministerial response to the debate:

- That (newspaper) headlines don't always tell the whole story. Last year (2002), inward investment created more than 5,000 jobs.
- We must also remind interested persons that the U.K. call center is not in decline. Experts suggest that there are about 5,500 U.K. call centers, employing nearly half a million people on these shores.
- Given our language, location, infrastructure and customer service skills, Britain remains in a strong position to attract, in particular, high added-value call center work.
- Protectionism is clearly not the right response. U.K. exports are worth £270 billion a year; that includes £86 billion of service exports. Many jobs depend on open markets abroad.
- Instead of taking protectionist measures, we must enable and encourage firms in the U.K. to invest in new technology and workforce skills. We should continue to make the U.K. an attractive place in which to invest and do business.
- Our response to competition is not to be complacent, but to recognize the arguments that have been made about protectionism. There are three arguments:
  - First, we should be raising our game, ensuring that companies and their staff continually upgrade their skills and technologies.
  - Secondly, where jobs are lost, we must do everything that we can to help people to find new jobs, and new skills, if necessary, as quickly as possible.
  - Thirdly, we are taking action to do even more to build strong and sustainable economies in all regions of the U.K.

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