Unlock the value – outsourcing in financial services

By Frank Gullone and Elizabeth Thomas

Some outsourcing contracts live up to their promise, but hardly any reach their potential. The topic of outsourcing is punctuated with tales of misery. Organisations can try so hard to avoid the problems that they fail to take advantage of the opportunities.

Outsourcing might be treated with the same enthusiasm as a merger or alliance. Outsourcing is an opportunity to harness a supplier's core competencies without the development time. It's a way of gaining access to capacity, knowledge, networks and preferential arrangements at speed.

When the arrangement's potential has been identified, there are ways to make it through the minefield. Fortunately for Australian financial services industry participants, regulatory requirements provide the basics for contractual rigour. From there, key steps in the contracting and management process will drive performance and effective risk management.

Whether the contract is under negotiation or already signed, there are ways that both supplier and customer can manage the arrangement for better results. This article explains how to go beyond avoiding the problems to create a mutually beneficial outsourcing agreement.

What goes wrong?

When a business function is outsourced for the first time, the client may specify the work to be handled in terms of averages – in volumes, quality or completeness. In fact, the work may be subject to huge degrees of variation, adding unforseen difficulty. What seemed like a neat work package delivered to the supplier may well open up to be a tricky tangle that will cost twice as much to manage.

In a recent survey of outsourcing arrangements by the Dept of Trade & Industry in the UK[1] found that the most common reason for failed outsourcing arrangements was that clients had not set clear objectives for their outsourcing project (Figure 1).

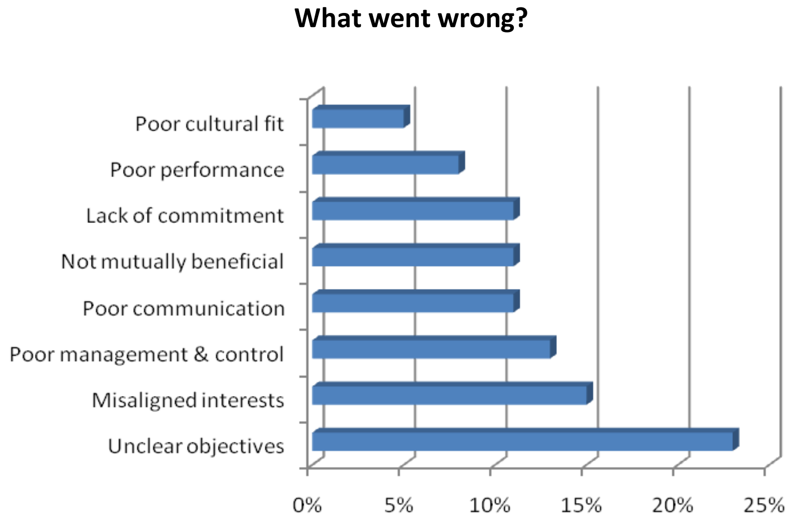


Figure 1

In the US, the 2006 InformationWeek survey identified that outsourcing arrangements most commonly failed due to poor service and lack of flexibility, followed by hidden costs, then inadequate planning by the client.

Deloitte Consulting conducted a survey of 25 large companies in 2005. Half the respondents identified hidden costs as the most common problem in managing outsourcing projects. The Deloitte study concluded that companies embrace outsourcing to cut costs, simplify projects, and tap expertise not found in-house. But many find outsourcing actually introduced unexpected complexity, adds cost and friction, and requires more senior management attention and deeper management skills than anticipated.

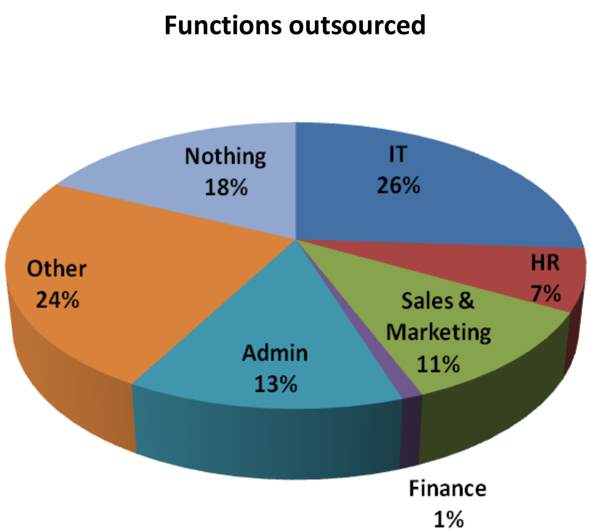


Figure 2

There is a saying, 'never outsource what you don't understand'. Despite this, many companies continue to outsource the mysterious. Referring to the pie chart (Figure 2)[2], information technology is often cited as the most common set of functions outsourced, yet technology requires specialist knowledge and skills. The complexity can be overwhelming. This lack of understanding can complicate communication, problem-resolution and frustrate the realisation of opportunities.

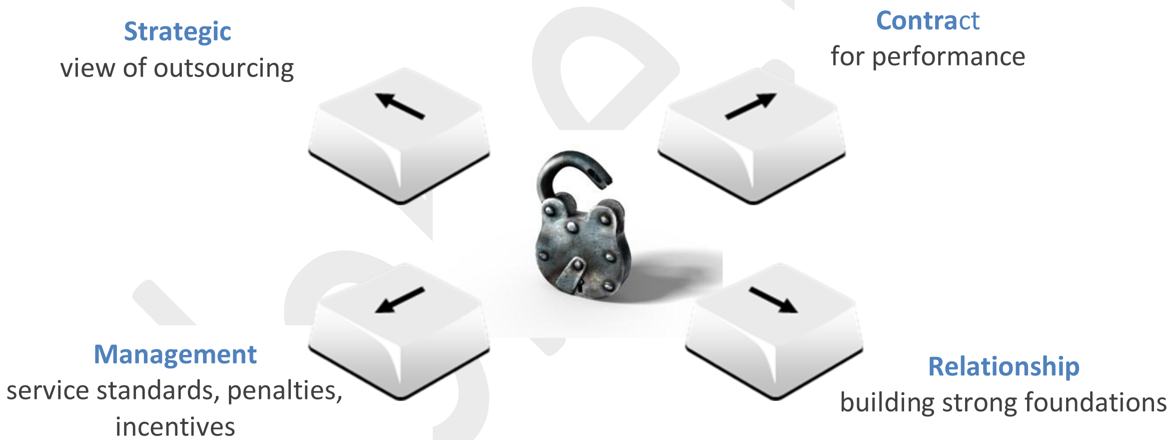
In summary, it is essential for both client and supplier to be clear on requirements and the work involved in fulfilling the contract. It helps to work with experienced partners who can anticipate the variation and exceptions that create complexity. Outsourcing objectives must be clear, and both client and supplier must be prepared to adopt the right processes and contractual content to get the right results.

[1] Dept Trade & Industry, UK, as cited in 'BusinessLink' 2007
[2] 'Outsourcing Essentials – 8th Annual Outsourcing Index', Outsourcing Institute, 2005 – a survey of 1,410 new members

Getting it right

Leaders can use several keys to unlock more value from outsourcing:

- A strategic view of outsourcing creates competitive advantage for both parties. Strategic intent should shape the nature of the arrangement. Outsourcing can support client strategy in surprising ways.
- Contract for performance. Effective regulatory compliance and risk management are essential components of the outsourcing agreement, but suppliers must deliver what really matters to client stakeholders. There are some basics that apply to the financial services industry, and particularly, in the superannuation sector.
- Effective contract management extracts the benefits written into the contract. When the contract is signed, the heavy work starts.
- The quality of the relationship affects every offshoot of performance. It works to everyone's benefit if each is confident in the others' positive intent and judgment.



The strategic view of outsourcing

Any outsourcing arrangement begins with the client's determination of their reasons, readiness and objectives for outsourcing. It helps to include potential suppliers in the discussions. Likely, they'll be able to make a constructive contribution to the process.

Why are you outsourcing, anyway? Are you simply buying a commodity, or are you trying to serve other strategic intents, such as developing new products or technologies? If you can identify the reason for an outsourcing arrangement's existence, consider the extra value you could extract.

Our outsourcing value stack (Figure 3) identifies the most common reasons for outsourcing. As the reason for outsourcing moves up the stack, so too does its potential value. The arrangement may provide better service levels, or yield unique knowledge. The potential benefits for clients increase. This is matched on the supplier side, with more intensive arrangements bringing higher fees, longer term contracts and increased customer reliance. The customer and supplier become more like partners, with each generating greater value from their relationship.

Outsourcing Value Stack

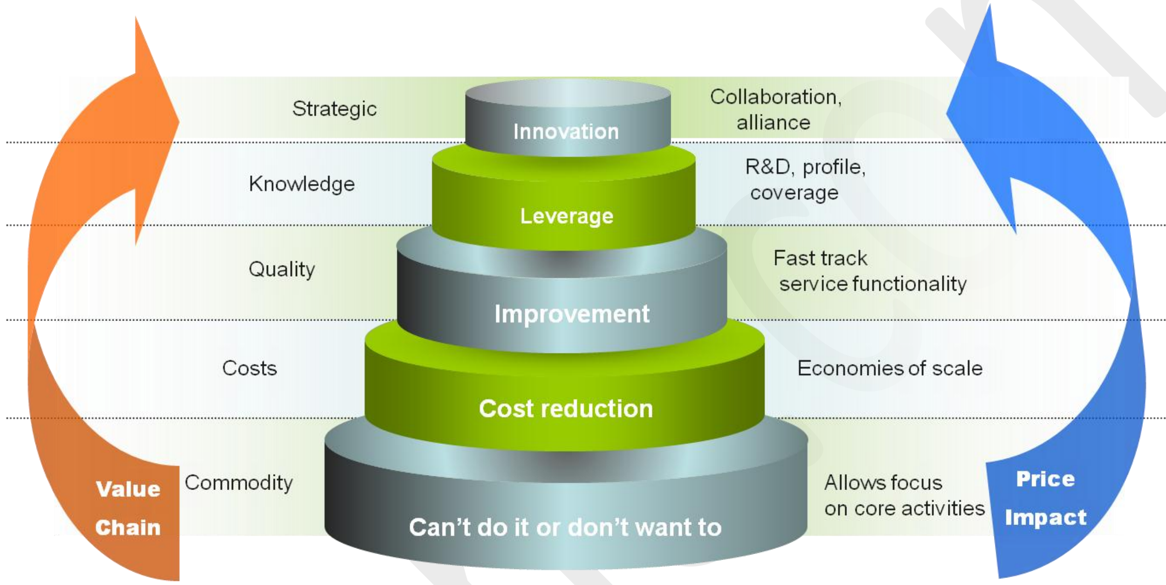


Figure 3

Any of the reasons listed may be a perfectly appropriate driver for an outsourcing arrangement, but leaders of both client and supplier organisations should examine what could be gained by moving up the stack.

Can't do it, don't want to do it

Unfamiliarity, complexity, prohibitive infrastructure investment or unpleasant, boring tasks – any mix of these factors can lead to one of the most common reasons for outsourcing. Such arrangements might not even involve a fixed contract. Consider postal services, utilities, telecommunications, plumbing. The use of an external provider is almost assumed because most would rather pay an electricity bill than hook up their exercise bike to a generator or have the capability to set up a telephone exchange in their parking lot.

Such outsourcing arrangements allow clients to focus on their core activities. When outsourcing for this reason, clients usually divest the end-to-end process and focus on key deliverables, such as service outcomes and pricing.

Cost reduction

Clients can reduce costs by leveraging from a supplier's ability to produce at lower rates. Suppliers may have access to economies of scale, bulk rates or efficient processes. If cost reduction has been achieved through a high degree of standardisation, it is difficult for the client to gain competitive advantage through the outsourced product or service alone. As the level of expenditure increases, more investment may be made in identifying preferential deals and more efficient processes.

Cost reduction-driven outsourcing will usually focus on key deliverables, but clients with significant volumes may begin to seek more control over processes to influence quality or cost improvement.

Improvement

Even when the client and the supplier have access to resources at equal cost (e.g. labour), suppliers can often provide a quality advantage due to their concentrated knowledge and accumulated competency base.

Outsourcing with the intention of improving quality influences the arrangement in several ways. Measurements become more qualitative. Clients should align internal stakeholders to define what 'quality' actually means. Frequent, direct and meaningful communication between the client and supplier throughout the contracting process and the ongoing management is vital. Without it, definitions and perceptions of success can become distorted. Clients should avoid eroding quality improvements by concentrating on price.

Contracts need to be very specific about the nature of quality improvement required.

Leverage

Suppliers develop expertise through focus on a particular product or service. This expertise may manifest itself as knowledge, beneficial business relationships or access to preferential arrangements. These advantages are relationship and knowledge-based. They are learned and developed over time. This makes them difficult to accumulate, and potentially more difficult to replicate if the advantage-owner has managed to effect exclusive use of the supply source.

Suppliers may also develop best practice expertise in transactional or management processes. For example, a client undertaking an unusual project may be unfamiliar with many of the emerging issues. Suppliers experienced in such projects can anticipate requirements and likely impacts and therefore manage the same project with higher degrees of efficiency and effectiveness.

If clients leverage from such advantages, they can rapidly derive benefit from others' competencies.

When leverage is an objective, clients should contract to ensure the benefits specified by suppliers can be realised. Measures will often be a mix of the quantitative and qualitative. It can also assist the customer to contract for frequent interaction or consultation (including reasonable levels of knowledge transfer) with the supplier to give the client an opportunity to develop greater capability the leveraged skill or resource. Clients should resist the temptation to insist on production control – doing so risks eroding the very reason for leverage-based outsourcing. Rather, stick to concrete results measures, and negotiate additional milestone checks and exception reporting.

Innovation

Outsourcing for innovation has the highest potential to create competitive advantage for both client and supplier. Both must be prepared to invest a lot of energy into establishing the collaborative process and relationship before the development process begins. Expect that measures will be almost entirely qualitative.

Moving up the outsourcing value stack

Our outsourcing value stack is a model for evaluating outsourcing arrangements. Clients and suppliers might use it to consider how an existing arrangement can be moved up the stack.

Clients tend to invest more time and energy into outsourcing arrangements with the greatest cost, rather than those with the greatest potential value. Suppliers can take the lead here – rather than simply showcasing their latest products, they can consider the contribution they can make to values further up the stack. When an outsourcing agreement is already in place, suppliers should demonstrate they are satisfying the existing arrangement before bringing new objectives into the arena.

Many outsourcing arrangements are capable of satisfying several values simultaneously, but it can be helpful to both parties to understand that each value requires different emphasis in the contracting approach and agreed measures. Satisfying two or more values naturally leads to conflict. For example, a client who is outsourcing to reduce costs will contract for price and outputs, with no control over the production process. If also attempting to outsource for quality, it is likely that cost to produce will also increase. However, the blurring increases associated costs for both parties - the measures become more qualitative, reporting is expanded, the quality definition may evolve and clients may likely need greater input into the production process to gain the required outcome, which increases management time. Eventually, cost benefits may be completely eroded. Similarly, clients seeking both leverage and innovation are faced with the need to rely and the need to collaborate.

This doesn't mean that it isn't sensible to address as many values as is strategically sensible, but it will assist both parties to understand the conflicts implicit in such a move and see them as a normal part of creating a valuable relationship, rather than a wrangle over agendas. It pays to anticipate this natural source of conflict.

Both supplier and client need to be clear about which paths are being pursued and understand how this will influence the other elements of the outsourcing arrangement – the contract, the relationship between customer and supplier representatives and ongoing management.

Contract for performance

Contracts are the fulcrum of the effective outsourcing arrangement. The contract should cover a broad spectrum of agreements on scope, conduct, performance, pricing and sustainability.

Be clear about boundaries. How much control does the client need over how the outsourced process is performed? If outsourcing to reduce costs or focus on core business, clients shouldn't need to collaborate on process. If trying to improve performance, the right degree of process transparency can be a valuable source of knowledge. If heading up the top echelons of the outsourcing value stack, clients will likely want and need more input into how processes are performed.

Restrict performance measures to those dimensions which are most important from an end-consumer viewpoint and to assure each party of the other's responsible, professional conduct. Use the appropriate mix of qualitative and quantitative standards. Try not to report on the trivial – it adds unnecessary time and cost to the process and acts as a catalyst for needless conflict.

Accurate, timely information and decisions allow suppliers to perform adequately. Where possible, include information inputs – such as volume histories, forecasts, upcoming developments – in the contract. Suppliers will need to know about the work they're handling before they receive it if they're to price and manage it effectively. Use transparency to reduce uncertainty. For events in the life of the contract that are difficult to estimate, such as future volumes, include clauses that specify what will happen should an event arise, or at particular levels.

Ill-defined contractual terms and conditions can form a breeding ground for discontent later. Clients should be as clear and specific as possible about their needs, and suppliers can guide them in articulating these in meaningful ways in the contract. When it comes to defining quality, it helps to ensure that everyone in the client's organisation has the same understanding of what 'quality' looks like. Inconsistent feedback will confuse suppliers.

Write into the contract how it, and the relationship, will be managed. For example, you might have fortnightly meetings (specify the agenda) with twice-yearly reviews.

Create flexibility in the contract. Allow for the terms to be reviewed on an annual basis. This gives both parties an opportunity to refashion the contract, taking a reasonable period of experience into account and allows for adjustments.

The performance elements of the contract must be supported by assurances for legislative compliance and effective risk management. In the Australian financial services industry, the legislative and risk management framework that supports outsourcing arrangements provides substantial basic rigour.

The APRA Outsourcing Standard specifies a range of contractual inclusions to build rigour into the outsourcing agreement:

- default events, termination provisions, dispute resolution
- liability & indemnity provisions
- confidentiality, privacy, information security
- pricing, fees and payment structures
- service levels and performance requirements
- audit, monitoring and assessment procedures
- business continuity planning
- insolvency events
- Trustee and APRA's access to information and premises
- Trustee and APRA's right to require an audit
- sub-outsourcing arrangements should comply with the Standard

While not expressly stated in the Standard, the contract should contain an obligation to report compliance breaches to the client. This is in the interests of both parties and also supports the breach register and reporting obligations of ASIC licenses.

Inset 1

All financial services providers are required to have an ASIC financial services license. The license application includes outsourcing proof, in which providers must detail their processes for selecting and monitoring outsourced service providers.

For super funds, APRA regulates outsourcing with the requirement of a similar, but more detailed, proof in the application for a fund license. Funds should follow the processes they have specified to achieve good governance.

To control risks and remain compliant with license responsibilities, the APRA Outsourcing Standard (which is mandatory for super funds) covers the key issues of monitoring, control, access and audit. These recommendations apply to key functions, not ancillary support services such as mailhouse, communications or IT infrastructure services. The Standard covers the key areas of due diligence for evaluation and selection of providers, monitoring performance of providers, provision for appropriate exit arrangements and contractual inclusions to build rigour into the agreement (refer Inset 1)

To assess the thoroughness of risk management practices, it also helps to refer to a range of external standards that might be considered in the course of identifying appropriate suppliers and risk management measures:

- APRA's risk management guidelines 120.1
- Risk Management Standard AS/NZ 4360:2004 (which provides guidance for consistently identifying and documenting strengths and threats for better corporate governance)
- ASX Corporate Governance Principle 7 (how to recognise and manage risk, using procedures that will encourage best practice)
- Aust. Standard on Fraud & Corruption AS 8001 – 2003 (how to control fraud and corruption against, and by, entities)

During the course of the outsourcing contract, a range of risk management measures will help ensure a robust and effective agreement. Indemnity insurance, confidentiality agreements, effective contract management, regular comfort letters, supplier visits and audits can provide substantial governance support.

Incentives and penalties

Intelligent application of carrots and sticks within the contract can serve to add tangible, foreseeable consequences to the arrangement's performance. They add to the transparency of the contract. One of the most important elements of this part of the contract is to tie the major interests of the client and the supplier together.

Incentives should not be used for merely meeting the conditions of the contract. It is reasonable to assume that contractual conditions will be met. It is also reasonable to expect there will be some failures on both the supplier's and the client's sides. We do not operate in a perfect world. But carrots and sticks help create a boundary between what is standard and expected and what events should be considered exceptionally positive or negative. Link penalties to negligence and breaches and to manage risk.

Suppliers will generally try to improve their products or services to enhance their own competitive position. These improvements can be ad hoc, incremental or intangible. This makes them difficult to schedule and measure. Incentives are a good way to encourage suppliers to go above and beyond to create measurable improvements that are completely aligned with the client's strategic objectives.

Management – realising the benefits

Signing off on a great contract is meaningless unless it's managed effectively.

'At the time of commitment, no value has actually been created. Post award management of supplier performance, in all relevant dimensions – safety, quality, delivery, and total cost – is essential to realizing the value that strategic sourcing has made available.' Chris Swain, Global Supply Chain Manager of BP Exploration

When the contract is signed, the heavy work starts. The diagram in Figure 4 was created by accountancy firm Geller & Company in their article, 'World-Class Procurement – Increasing Profitability and Quality'. It was their assessment of the impact of different supplier management approaches on the extraction of value in the outsourcing agreement. They estimated that without effective contract management, 75% of any potential savings would disappear within 18 months.

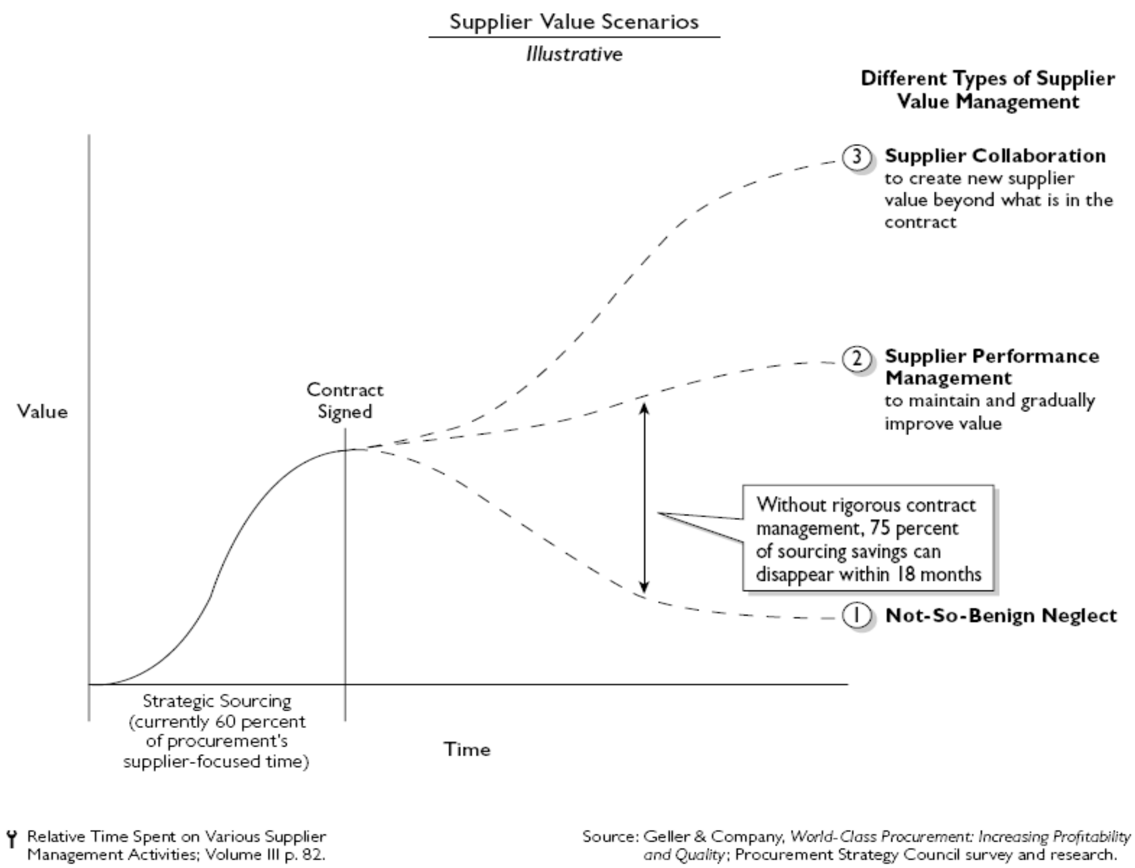


Figure 4

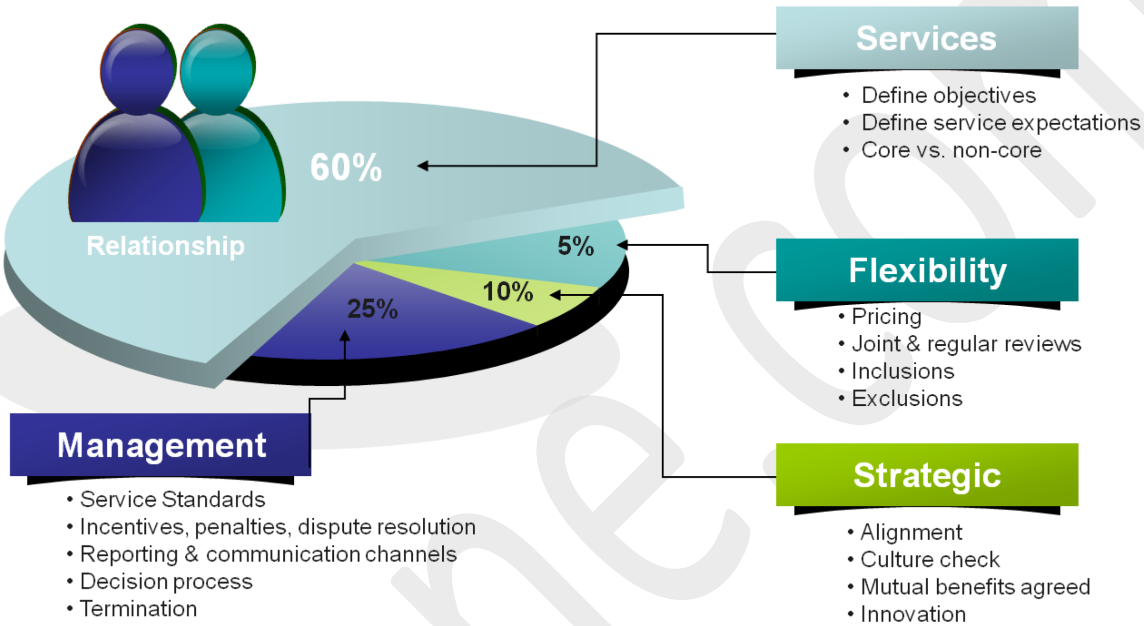
And so what are the basics of contract management? It's ideal if clients have resources dedicated to managing outsourced agreements. They, and everyone within the organisation, should understand the objectives of the agreement. Contract management will normally entail:

- checking for contract compliance
- ensuring the specified meeting schedule and agenda are still appropriate
- good change control
- invoice checking, payment, results monitoring
- establishing a purchasing and authorisation process
- looking for opportunities to innovate – processes, products
- exchanging feedback

Effective management will help reap the promised savings, but a collaborative relationship could create new value.

Relationships - building strong foundations

Collaborative relationships will change a fixed contract into an organic and growing arrangement. We estimate that around 40% of time is invested in the prescriptive parts of the process – identifying objectives, researching, contracting for successful performance. The remaining 60% occurs once the contract is settled. This is the period in which clients and suppliers adjust the way they work together to incrementally add greater value to the arrangement. This is the generative part of the process, and it's largely dependent on the quality of the relationship.



Relationships can provide the environment for transforming the existing arrangement. As an example, we know of one client who had outsourced a segment of their technology maintenance to a market-leading supplier to allow focus on core services. The supplier fulfilled its responsibilities and that could have been an outsourcing success story in itself. However, the relationship yielded greater benefits. During one of their scheduled catch-ups, the client mentioned an upcoming proposal that would need substantial business case analysis. The supplier consulted to many clients in other industries, supporting their operational technology demands. The supplier had come to understand the wide variations in operational demands and practice and developed diagnostic tools to estimate client requirements, and so (incidentally) developed a competency for operational planning. The supplier offered use of their diagnostic tool, saving the client weeks of analysis. The client's project was approved, which would lead to operational expansion. Ultimately, the client required another major product in the supplier's range. The outsourcing relationship informally moved up the outsourcing value stack to leveraging from the supplier's expertise, and ultimately to the benefit of both parties.

If the client / supplier relationship becomes a true partnership, it will unlock exponential value.

Negotiation shouldn't stop when the contract is signed. It should be an ongoing element of a living, breathing agreement that works for both sides. It doesn't mean frequent re-contracting. It does mean that by sharing interests and objectives, both will find workable solutions.

Clients must allow their suppliers to balance their focus on both short-term and long-term development. If clients only seem interested in delivery today, your supplier will try to attend to that and often, only that.

Performance failures happen. They should be acknowledged and addressed. But if a client browbeats, then that can make a supplier avoidant. They can become too anxious to venture new ideas or alert the client to potential problems until the worst has happened and everyone is trying to deal with the impacts. Performance failures shouldn't be treated lightly, but a balanced and respectful approach will ensure suppliers continue to strive for future developments and will keep clients informed of potential threats. Clients should try to avoid bringing up old problems that have been decided on and dealt with. If the supplier believes their news of an upcoming development will be met with cynicism and reproach, they're less likely to be open about it. Clients may well end up going to the trouble and expense of creating their own new product while the supplier is just about to release the same thing.

Suppliers and clients have knowledge to share - market trends, new technologies, service developments. Clients can make use of the supplier's position as the hub of market, product and service information.

Both parties should be conscious of developing trust and communication, which are vital for extracting the value of a collaborative relationship.

It's never too late to make positive changes

Creating value is a long-term prospect, but parties can act right now to make positive change. Clients or suppliers can ask:

- what information do you need?
- how can we improve the way we work together?
- do you experience any roadblocks on our side?
- what market / industry trends are you experiencing?
- do you have any ideas for new products or services?

Try renegotiating more meaningful, qualitative performance standards. Check with end-users to determine if performance is really hitting the mark. Reduce unnecessary complexity to improve efficiency or reduce cost.

By adopting a collaborative approach and taking immediate measures to reduce complexity and improve meaningful performance, clients and suppliers can drive your arrangement further up the outsourcing value stack. Even if the agreement was only meant to cut costs, most strategically-minded suppliers will be willing to work with clients to leverage from their strengths, or to collaborate to innovate.