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Beyond transaction processing: is outsourcing right for the financial services industry?

Outsourcing has proved a logical move for banks – at least where 'production line' activities like clearing services are concerned. But can the classic outsourcing model work for core services, too? What are the potential gains – and what are the implications of getting it wrong?

Retail financial services: the last growth frontier?
Beyond transaction processing: is outsourcing right for the financial services industry?

The subject of outsourcing is a key focus for the financial industry. In addition to the issue of cost reduction, there are two main issues to address: regulation and industry convergence. Changing business models have given rise to a new breed of financial products and services, and new expert service providers are joining the industry on a wave of industry consolidation and expanded product lines.

Financial service providers that are exploring outsourcing as an option have typically been making a distinction between:

- commoditized activities (like transaction processing), which are perceived as suitable for outsourcing, and
- core competencies, that are perceived as critical to the success of the business and therefore assumed historically to be best kept in-house.

However, as players explore wider outsourcing options, the shape of the industry is changing. Businesses are no longer simply looking for a quick fix to plug a resource gap, but thinking about strategic partnerships which may take their business in a new direction. The characteristics of the outsourcing relationship are shifting: from ownership to shared leadership, from contractual obligation to proactive service. External agencies are becoming more closely involved with providing what have been viewed as core business functions, once believed not to be capable of being outsourced. The net result is much greater dependency between supplier and customer: more of a true partnership rather than an arm's length supplier-customer relationship, as in the past. Contracts, and especially the service level agreements that regulate them, are becoming much more complex as they need to delineate a relationship whose edges can become blurred through mutual dependencies.

Outsourcing is an inevitable development in the industry, a simple function of the labor market and the way economics develops

Companies which have set up shared service centers to manage business processes on a central basis and obtain economies of scale could take the logical next step: make the center into an external corporate structure, perhaps supported by corporate finance, which could then generate significant revenue by providing outsourced services to other financial organizations. This could work well, providing the equity stake of the founder is diluted to allay customer concerns about loss of confidentiality.

CEO discussion points

- Do we have the right controls in place to ensure our outsourced arrangements are working?
- Does the reputation/culture of our outsourcing partner fit? Could our relationship with them damage our reputation?
- Are we confident that our legal advisers fully understand the business implications of our outsourcing relationship?
- Have we fully integrated legal, tax, accountancy and service delivery aspects in our outsourcing plans?
- What is our backup position if our current outsourcing arrangement collapses?
- How flexible is our outsourcing partner? If our business model changes, will they penalize us? Will they be able to meet our service level needs into the future?

So how might this work? The outsourcing decision carries considerable risk. Financial service providers need to ask tough questions about their future direction. Even if you do outsource an area of business, you still have a responsibility to your customers and regulators. And if you outsource the wrong service or choose the wrong partner, the cost could be high in terms of lost custom and reputational damage. Which direction will financial institutions choose, and what will they seek to outsource?

Four main models seem to be evolving:

Option 1:

Having decided that they don't need their own 'label' any more, institutions focus on high-volume production – this works well, for example, in the credit card business.
The implications: High up-front investment costs, potentially good returns. Success with this option is heavily dependent on signing up massive numbers of customers, to balance your large investment in volume technology. You will be heavily reliant on the selling skills of your front-end partner.

Option 2:

The reverse of Option 1 – here institutions outsource all production operations and focus on formula management: combining products, distribution channels and brands specially tailored to a particular customer need (eg buying a house, sending a child to university, dealing with an inheritance).
The implications: Your selling skills have to be pin-sharp. If your production partner has not invested enough in the necessary technology, you may be heavily let down.

Option 3:

Institutions develop products which can be combined with a retail concept: they use their knowledge of product development and sell products using the 'look and feel' of established retailers like supermarkets and energy suppliers.
The implications: With this model, risk is shared rather than contracted out. The bad news is that history is strewn with the remains of failed joint ventures. Cultural matching and shared goals are key if you are not to end up as one end of a banking Push-me-pull-you.

Option 4:

Leading banks with high volumes of business, a solid infrastructure and a strong brand continue to operate in the traditional model, producing, selling and distributing products (both formula and volume management). At the same time, they open up their process capacity for retailers, using their own brand and acting as a shared service center for third parties.
The implications: Choosing 'business as usual' could still be a big risk; you need to maintain massive volumes of business to sustain the traditional banking model now.

Increasingly, the trend is towards outsourcing operations off-shore. Savings on labor costs can be as much as 70-80 percent for comparable activities, although of course certain costs like communication and management of remote locations are higher. India is emerging as a favored destination for many outsourced business processes, closely followed by Malaysia, the Philippines and China. The growth of this trend has been explosive, particularly in outsourcing tasks like loan applications.

Outsourcing is an inevitable development in the industry, a simple function of the labor market and the way economics develops. But historically, the main driver for outsourcing has been cost reduction, the outsourced element has typically been a simple, mechanical activity, and it has been easy to assess whether the outsourced service is performing well. The more complex the outsourced element, the more difficult and costly it becomes to measure, control and regulate. Significant issues for potential outsourcers include:

Taxation:

Transferring to an outsourced service, particularly if the outsource partner is overseas, will have serious implications for direct and indirect taxes. Tax structuring therefore needs to be fully integrated into overall service delivery planning and address complex issues around the transfer of people and assets.

Regulation:

The changing attitude of regulators will have a pervasive impact. The new businesses will still have to comply with standard reporting issues; new (retailer) entrants may need a license to operate – institutions which decide to develop retail management will be relying on their production house to fulfill service level agreements. Even if you are focusing on the volume function, you will still have to meet all regulatory requirements. The new capital adequacy standards due to be introduced in 2006 will have a major impact on capital planning. The combined result is a (potentially) highly expensive compliance function and increasing levels of regulatory pressure.

Outsourcing is no longer a pure accounting calculation, the dangers of getting it wrong are considerable

Ownership structure:

Retaining control over quality and service levels is vital. It is the only way to achieve real cost reductions and ensure the longevity of the outsource partnership. The arrangement needs to be structured to allow decision making and management input from both sides.

Scenario planning:

In addition to the normal strategic and operational planning process, contingency plans need to be put in place in case of major change or challenge in the business, covering areas such as systems, people, changes in regulation, taxation, and changes to the business model.

Cultural fit:

Mutual trust and a comfortable cultural fit is vital for the continuing health of both sides of an outsourced arrangement, particularly where staff morale and problem solving are concerned.

Adaptability:

To succeed, both sides need to view the arrangement as a long-term partnership, and the service provider needs to be agile and imaginative enough to respond to changes in the business model.

Outsourcing is no longer a pure accounting calculation, the dangers of getting it wrong are considerable. Payment of compensation (that is, interest) is not likely to be the only cost of failure – businesses risk loss of revenue, consumer alienation, damaged reputation, and the potential high costs of taking the matter back in house.

Hard strategic choices lie ahead.

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