Is operations outsourcing the best solution?

Outsourcing provides many benefits. But financial institutions should not embark on outsourcing based on industry pressure or a perceived lack of viable alternatives, argues *Jonathan Dolby* of UBS.

OPERATIONAL efficiency impacts every company's profit and loss. Financial institutions, which are subject to general business pressure to continuously improve their service to clients, are no exception. Their specific challenge, however, is managing to achieve this profitably in an industry where margins have shrunk and the rising cost of technology implementation precludes all but the largest market participants from undertaking upgrading and expansion projects. Even mid-sized financial institutions have trouble amortizing the investment required for such projects, and of course for smaller players the costs are simply prohibitive.

Faced with this conundrum, financial institutions are searching for ways to reduce costs, improve productivity and optimise resource allocation; to achieve these objectives, the efficiency of internal operational processes is key. Often, outsourcing a business process - Business Process Outsourcing (BPO) - is a tempting option, but is it the best solution for all financial businesses?

Many considerations

A BPO project is a significant undertaking for any company regardless of size or scale. An international bank, a national corporation and a regional asset manager are all equally vulnerable to being undone by a mismanaged BPO project; suffice to say, there are some fundamental issues which all clients should actively address in order to unleash the benefits of BPO without succumbing to its pitfalls.

The first step in contemplating a move to outsource is to understand the real reason why it is being considered. Traditionally at this stage, it is suggested to define core versus non-core activities, and only the latter should be in scope for outsourcing. However, given evidence from certain financial product areas, the whole service quality throughout the value chain is a driving factor in winning and retaining clients.

Giving up direct control of the middle and back office functions that are classically regarded as non-core may be tantamount to handing over the chance to differentiate one's company in the market place.

The second step is to honestly appraise the state of the processes to be outsourced. Outsourcing is not a panacea solution, and exporting a broken or convoluted process only shifts ownership of the problem. In fact, given that most outsourcing service providers need to standardise their offering to safeguard their own profits, they are usually ill-equipped to solve the outsourcer's embedded problems, and the resultant inefficiency can even endanger other processes that the provider bundles together. In the long run, outsourcing a problematic and/or overly complex process only moves that problem out of sight and lowers the chance that a company will pro-actively manage the role of that process in the overall strategic development of their front-to-back capability.

Central to the above two steps is the rule that the outsourcing project will be bound for failure unless the right things are being attempted from the very beginning. Once these two steps have been thought through and the decision is taken to outsource, significant challenges still need to be addressed if a company is to fully reap the benefits of this move.

Perhaps the most daunting challenge, after the initial set-up phase, is to constantly manage the expectations of all involved parties - in particular, the expectation that the outsourcing service provider and the internal stakeholders of the outsourcer share a common understanding of their objectives and the status reporting mechanism and language.

Managing this relationship with the help of Requirement Specification and Service Level Agreement documents is vital to the success of any outsourcing project. The communication within this relationship is a formidable undertaking given the difficulty of maintaining strong control of cost and performance data, and this is even more the case when an element of offshoring is introduced into the outsourcing equation.

Another area of concern is flexibility: Excessive standardisation among most outsourcing service providers (frequently this is also driven by inflexible service contracts) means that they are unresponsive to changing business needs, and this slower time-to-market will impact a company's ability to service a new business opportunity.

Differences across business segments should not be underestimated

The ability of a BPO exercise to deliver cost savings and evidence from the outsourcing provider that the BPO transition will be expertly managed are both highly prized among all businesses. However, the business segments may have specific requirements and may even be able to play certain strengths to its advantage (e.g. when negotiating an outsourcing Service Level Agreement).

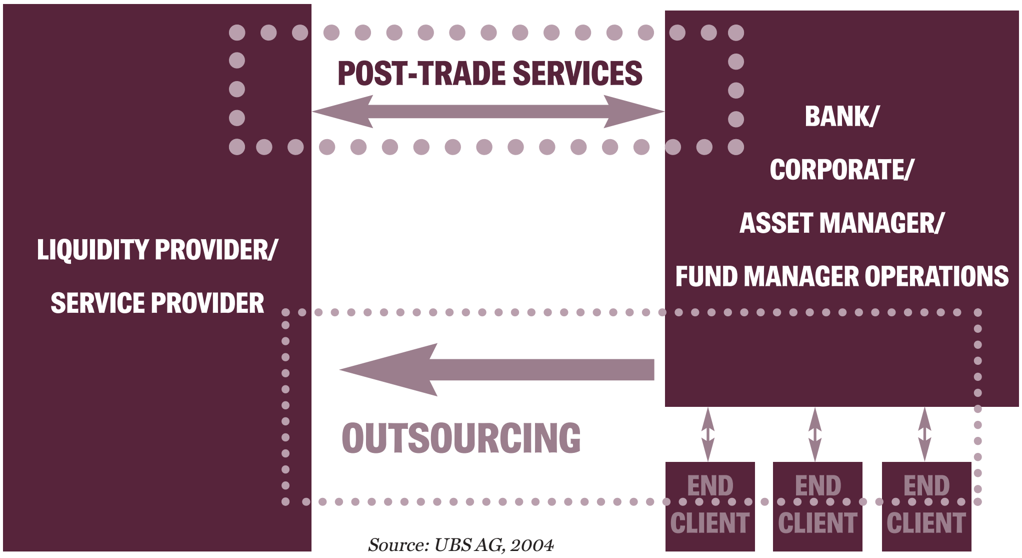
For an international medium-sized bank, which on average has many processes ranging in complexity and covering different products, one key requirement is the ability for an outsourcing provider to integrate smoothly the processes it performs with those which still remain under full control of the bank. A strong motivation for a bank to outsource part of its operations processing is to reduce costs. To this extent, a bank may even use its size to negotiate a clause in the outsourcing SLA that guarantees a certain percentage reduction in costs. Often a bank may make assumptions that accounting and other "control" functions are easy to outsource. However, given the now stricter regulation by international governing bodies, and a recent spate of high-profile scandals with accounting irregularities at their root, banks should be careful that BPO of a "control" function does not actually result in less control.

A treasurer of a corporate often has a dual function: to manage the assets of the company, and to maintain the company's liquidity. In managing the company's assets, a treasurer is unlikely to have a mandate to speculate outside strict, predefined risk parameters. Often the treasurer will trade mostly to maintain the company's liquidity, as in the classic example of a corporate with revenues in a foreign currency which enters into an FX Swap trade, perhaps coupled with a derivative instrument to hedge the exchange rate risk. A treasurer may consider the post-trade administration of such trades to be suitable for a BPO project. Given that these trades only occur due to the company's principal business activities, the post-trade workload may follow a predictable pattern (e.g. if a company needs to ensure it can transform its U.S. Dollar revenues into Mexican Pesos at the end of each month to fund a factory payroll). If the volume of such post-trade administration is not too high, BPO may be inappropriate, and simply optimising the process instead could deliver equivalent cost reduction and efficiency gains.

Since asset managers' core revenue business is managing their clients' assets, central to any consideration of outsourcing should be how to continue providing high quality service to their end clients. As this client satisfaction is central to asset managers' long-term viability, any processes which are outsourced must be seamlessly integrated via an open interface with the asset managers' own system in order for them to retain a full overview of all activities that directly impact their clients. For this reason, it is essential that asset managers have accurate and complete information available in different reports which are sufficiently flexible to be tailored (e.g. KPI reports for custodian performance and mark-to-market position reports).

Even if all the challenges are successfully overcome and an outsourcing solution can be designed to incorporate a company's specific requirements, it should be noted that outsourcing does not lead to an actual com-

Diagram 1: Post-trade services versus outsourcing



Source: UBS AG, 2004

petitive advantage since other competitors can quickly adopt the same strategy - perhaps even employing the same outsourcing service provider as their competition. Often seeing other institutions jump into outsourcing is enough to trigger a panic response out of the fear of being left behind.

Partnership first, outsourcing second

If the challenges associated with outsourcing seem too formidable, what can a company do to lower costs and free-up resources while still remaining in full control?

If the main advantages of outsourcing can be condensed into two areas, namely cost reduction and optimal resource allocation (leading to productivity improvement), then these can often be achieved simply with excellent support from one's main product and liquidity provider.

In many cases a major market player will have gone through similar challenges, and can share key lessons learned with other companies who thus benefit from this experience. Additionally, most major financial service providers boast an array of client tools and services, and a company can do well to analyse its needs together with providers in order to pick and choose the tools and services which compliment its existing strengths while removing waste and improving STP. Important in any such offering is that the solution can be integrated into the company's existing process environment and that it be scalable and enable a lower-cost structure. In the unlikely event that an institution's requirements cannot be fully met with a main player's existing range of tools and services, then the latter is usually enthusiastic to work with clients to develop an appropriate solution; so a financial institution may be the lucky recipient of a bespoke service and, in the role of a pilot client, it may also even be significantly involved in the design phase of a solution.

Diagram 1 shows the contrast between outsourcing and closer collaboration (here named post-trade services). Where outsourcing involves handing over a strong service element which is central to the relationship with the financial institution's own end-clients, post-trade services enable a financial institution to better serve its end-clients while still owning all aspects of the relationship with them. This post-trade services approach also has the advantage of requiring minimal initial investment without carrying any of the standard risks associated with undertaking a BPO project.

Understandably, companies are sometimes reluctant to adopt a strategy which makes them even more dependent on a single provider. In addition, where cost pressures are acute, it might seem easier to satisfy internal demands for action by quickly signing an outsourcing contract rather than begin by engaging in closer dialogue with a market-maker. However, within a short time-to-market, achieving the optimal combination of cost reduction while maintaining full control can hold significant value; and only full control will enable a company's management to accurately guide the overall strategic development of the value proposition to its own end-clients.

The benefits of outsourcing a business process in all its forms and fashions (e.g. "lift-out", offshoring, smartsourcing, rightsourcing etc.) have been well-documented. When approached carefully, and if all known issues are actively managed throughout the conceptual, transitional and maintenance phases, outsourcing can deliver on its promise of lower costs and better resource allocation. However, financial institutions should not take this step based on industry pressure or a perceived lack of viable alternatives. Talking to one's main market provider will help optimise one's processes, delivering results quickly that can also be included in a longer-term outsourcing strategy.

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