

# Outsourcing and offshoring: A close look at a changing world\*

New York and Boston

## Outsourcing and offshoring: A close look at a changing world

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Dear Clients, Prospects & Friends—

Like almost everything else in the world of business today, the practice of outsourcing—either in the home country or offshore—is changing rapidly. Mistakes have been made, best practices have emerged and new approaches are being tested.

Setting up offshore services for mutual funds has not yet become a common practice, but it is happening increasingly and it can be done for some very good reasons—quite apart from cost savings. Certainly the practice is increasing in the broader financial services industry. A global survey of 156 financial services executives found that almost one-fifth had no offshore headcount in 2005—but that only 6% expected that to be the case in 2008. Meanwhile, financial institutions that were already offshore anticipated that there would be a significant increase in the number of centers and employees.

Despite this rush to global outsourcing, only about half of the respondents said they were satisfied with their present arrangements.

For all these reasons, PricewaterhouseCoopers conducted forums in New York and Boston to bring investment management executives up to date on the latest trends and best practices about outsourcing and offshoring.

The overriding messages were that the decision to outsource must be a strategic one, that it should be approached with the same due diligence as an acquisition and that the relationship must be actively and carefully managed. In no way can an outsourcing agreement be seen as an abdication of responsibility.

Given these criteria, it was also clear that the decision to go offshore—and where to go with which functions—is a highly individual one depending on your firm's strengths, objectives and needs.

We hope you find these highlights helpful, as you think about your own company's situation and its outsourcing plans for the future.

C. Steven Crosby  
Leader, US Investment Management Advisory Practice

## Outsourcing arrangements should be managed like an investment portfolio: Constantly monitored and rebalanced

An outsourcing arrangement does not abdicate responsibility. On the contrary, it increases it.

Companies contemplating a major outsourcing move should approach the transaction as if it were an acquisition, with all the due diligence and strategic thinking such a deal demands. Then the relationship should be managed and monitored as carefully and actively as an investment portfolio, taking into account shifting needs of the business and the changing environment in which it operates.

That was the key message of Matthew Shocklee, a specialist in information technology outsourcing with PricewaterhouseCoopers.

Companies should view their outsourcing arrangements “as mobile assets in an actively managed portfolio,” Shocklee said. “Everything is dynamic. You should continually monitor and rebalance this portfolio to align risk and reward and extract maximum value.”

“Most companies do not have the tools and techniques that can tell them whether or not they are achieving the results they contracted for,” he said. But this is all changing as companies increasingly understand the risks they face and the options at their disposal.

For one thing, ten-year commitments, many of which will expire over the next few years, are a thing of the past, Shocklee said. Change is occurring so rapidly—in technology, regulations, costs and management turnover—that three- to five-year agreements will become more common. In addition, companies are learning to structure and manage a wide variety of hybrid arrangements, such as those described further on in the “Outsourcing Glossary.”

Shifts are occurring as work moves around the world. “Ireland was really hot a few years ago, but wage rates have dramatically increased,” Shocklee said. “China and India are still hot because they have so many people. South America is going to be developing within the next three to five years. Eastern Europe will become a great market for certain skills.”

Companies are tending to use outsourcers in a variety of locations (called multisourcing) that are networked around the world. They do this at least in part to stay ahead of rising wages. Major outsourcing service firms are constantly opening facilities in new countries and new regions for just this reason. The key, Shocklee said, is to move the work to the resource, not move the resource to the work.

While cost savings remains the primary reason for outsourcing offshore, a PricewaterhouseCoopers survey found that financial services companies also reaped benefits in terms of strategic flexibility, the ability to focus on core competencies and improved service quality. At the same time, cost overruns were one of the major causes of dissatisfaction for these companies, the survey found.

Promises of savings ranging from 40% to 60% for going offshore should be viewed with skepticism, Shocklee warned, because they often don't include the costs of moving an operation and upgrading it when circumstances demand. He described one company that studied the situation carefully, then decided to keep its operation onshore, creating a special subsidiary to handle the work.

In addition, Shocklee said, demand for educated employees is pushing up costs in the most popular countries, especially India. Outsourcing has become a political hot topic not only in the United States but in other developed countries as well, where it is seen as a threat to workers at home, and concern is growing that new laws may be passed making it more difficult to move operations overseas.

All these factors are driving companies to become more thoughtful and flexible in their approach to offshore agreements. These contracts must be carefully written to reflect what is expected and how it will be monitored. "How you manage your portfolio of relationships is the single biggest challenge in the outsourcing world today," Shocklee said.

## An Outsourcing Glossary

“Outsourcing” is a familiar term, but how well do you know the jargon that has developed as the practice has matured?

**Shared services** – Consolidating certain operations in-house.

**Captive** – An outsourcing or offshore facility the company continues to own or control.

**Build-operate-transfer** – A sourcing strategy where a third party builds out the business capability, brings the assets to operating maturity and then they are transferred back in-house.

**Joint venture** – A sourcing approach that involves two or more separate business entities that combine their respective assets into an entity designed to drive business value to all parties that is shared based on a prescribed ownership/sharing approach.

**Managed services** – Another spin on outsourcing terminology where the emphasis is more on provision of services through business process and human resources management versus optimizing technology spend and other hard assets.

**Multisourcing** – Sourcing from multiple vendors with no single provider dominating the sourcing relationship.

**Insourcing** – Bringing a function back in-house. There may be a lot of this in the near future, as major long-term contracts expire.

**Onshore** – Performing the services or capabilities in your own backyard. Depending on what you call home, onshore can be anywhere in the world.

**Near-shore** – For U.S. companies, Canada or Mexico, to name the closest two.

**Offshore** – For U.S., India, perhaps; for a Japanese automaker, Alabama.

**Mess for less** – A provider who takes a company’s mess and runs it – for less.

**Transformational** – A provider that cleans up the mess.

**Transitional** – A provider that cleans up the mess, then transfers it back in-house.

## Benefits of offshoring

### Top benefits cited by financial services executives

Cost savings	74%
Strategic flexibility	33%
Greater focus on core competence	28%
Business continuity	27%
Improved quality of service	25%
Access to better talent and technology	24%
More efficient and transparent processes	23%
Increased revenue	16%
Risk reduction	14%
Other	13%

*While cost savings are the major advantage of outsourcing offshore, companies are realizing other benefits as well.*

Source: PricewaterhouseCoopers survey of 156 global financial services executives

## Risks of offshoring

### Top risks cited by financial services executives

Finding people of right quality	39%
Deteriorating quality of service	31%
Cultural differences	30%
Retaining top employees	29%
Rising wages	23%
Political/regulatory risks	22%
Changing taxes, VAT and transfer pricing regimes	22%
Cost overruns	17%
Inadequate compliance and internal controls	17%
Impact on management time	17%
Security of intellectual property	14%
Security of client data	13%
Political and regulatory risks at home	11%
Other	13%

*Companies that outsource offshore face complex risks. The top five are people-related.*

To obtain a report on this survey, “Offshoring in the financial services industry: Risks and rewards,” go to [www.pwc.com](http://www.pwc.com)

## Comprehensive strategic approach helps firms avoid mistakes and achieve success

Cutting costs may be the main reason for outsourcing, but losing sight of the overall needs of the organization is one of most common pitfalls facing companies as they move operations to outside providers.

“When companies become obsessed with finding the lowest rates, they tend to overlook things that are actually more important, such as intellectual property and security,” said Innocent Obi, a PricewaterhouseCoopers specialist in outsourcing and offshoring. Focusing on cost alone forces the service provider to use junior people, and this leads to problems in service quality and turnover, Obi said.

“The decision to outsource should be a strategic activity,” Obi said. Asked how a company should determine which functions to outsource, he said that it should be the result of a “strategic discussion on what represents your core business. Those are the things you should keep close to home. Functions that are not core and that others can do better are the ones to consider outsourcing.”

In addition to an obsession with cost savings, Obi said there were seven other common outsourcing pitfalls, many of which are related to the lack of a coordinated strategy. He then listed 12 guiding principles in establishing a successful outsourcing operation.

## Common pitfalls

- **Starting too small.** Outsourcing a unit that involves fewer than five people and less than \$100,000 is wasteful because it takes so long to set up and the savings, if any, are hard to measure.
- **Vendor proliferation.** When each business unit does its own outsourcing, no best practices emerge for the organization as a whole and it's difficult to validate real savings. "You often see the same company having multiple service contracts with the same provider because the left hand doesn't know what the right hand is doing," Obi said.
- **Poor planning.** Failure to consider all the logistical details results in unforeseen implementation costs, delays and budget overruns.
- **Absentee landlords.** Abrogating responsibility for project management is one of the worst mistakes companies make, Obi said. "If anything, management should spend more time, not less, in managing service providers. If a reputational issue comes up, it's the owner who suffers, not the service provider."
- **High staff turnover.** When wages rise, as they are doing in India, employee turnover increases and service suffers. "Organizations must work with their service providers to see that their employment practices are sound," Obi said.
- **Rigid contracts.** "Things are changing fast," Obi said. "Companies should take strategic ownership of their contracts to be certain they can respond to changing conditions, such as increased service demands from customers." When adherence to rigid contracts stands in the way of the ability change, lawyers start getting involved, Obi warned.
- **Cultural and communications issues.** "When you have language differences, you have cultural issues," Obi said. When these are not properly monitored by the company and the vendor, client service suffers.

## Guiding principles to achieve success

"Companies are bringing work back onshore because of unsatisfactory experiences," Obi continued. Somewhere along the line, they failed to follow these 12 guiding principles.

- **Challenge your objectives.** Do not overvalue cost savings. Have an expert third party review what you hope to accomplish to be certain it is realistic. Review your objectives annually.
- **Align your objectives with your risk appetite.** Many factors are more important to the company than saving expenses; understand how these factors will be affected by the new environment.

## Guiding principles (continued)

- **Leverage your strengths.** As with the successful integration of an acquired company, see to it that your company's strengths and cultural characteristics are carried into the environment of the outsourced operation.
- **Maintain a strict compliance and control program.** You can't outsource responsibility for regulatory compliance or your reputation.
- **Know the market. Local conditions are extremely important.** The lowest-cost countries often present the greatest challenges in terms of immature regulatory environments and poor language skills. "Everyone is going to India but India may not work for everyone," Obi said. Other countries, such as China, Poland, Ukraine and Russia, also have talents in application development. A great deal depends on your objectives and risk appetite.
- **Actively manage the operation.** Management oversight expenses should be budgeted at 5% of the cost of the total initiative. Company managers must be on the ground, interacting with vendor managers. There should be quarterly visits from executive managers.
- **Establish performance metrics.** Companies often overlook the important role of establishing a process for measuring performance against key success factors beyond financial and customer service numbers. These factors could include technology, process improvements, staff achievements and brand reputation.
- **Plan the transition.** A strong IT infrastructure is required to reduce the volatility and confusion that is inevitable during a transition.
- **Make business units responsible** when business processes are being outsourced.
- **Communicate, communicate, communicate.** Build a communications plan that addresses all constituencies, including those outside the company. Be clear about what is planned, how long it will take and how it will affect everyone concerned.
- **Establish a centralized governance structure.** This is the most effective way to manage large-scale projects, reduce risks and achieve the greatest overall value.
- **Develop a well-thought-out contract.** Good contracts go well beyond legal obligations, covering such subjects as service levels, turnover rates, intellectual property rights, developmental activities, penalties and out clauses.

## What do you know and how do you teach it to others? The story of a major learning experience for BFDS

Even the most carefully planned move offshore will encounter a few bumps in the road. This was one of the points made by Boston panelist Matthew Booth, Vice President at Boston Financial Data Services. BFDS is a joint venture between State Street Bank and DST Systems in Kansas City that provides outsourced services to mutual funds. After about 18 months of planning, BFDS outsourced some of its operations offshore to India in 2005.

The move has been very successful, and BFDS plans to expand its operations there, but despite all its careful planning, it underestimated the difficulty of transferring knowledge from the U.S. operation to the people working in the offshore facility. For one thing, U.S. immigration laws make it difficult to obtain long-term work visas for Indian natives to spend time in the U.S. to absorb the strengths and culture of the company so that they could return to their native country as well-trained representatives—almost as employees—of the company.

Even so, BFDS underestimated the effort it would take to bring the Indian workers up to speed. “We estimated that the tacit knowledge—that is, the knowledge that resides in the heads of our employees—represented about 75% of what we knew,” Booth said. “So we believed we could transmit about 25% of our knowledge through training without having to write it down.”

It turned out, however, that about 90% of the knowledge was tacit, and finding ways to transfer that knowledge slowed the transition.

To overcome this and other cultural barriers, BFDS is willing to change the ways it does some things. “Rather than trying to make the Indians look like Americans, we’re looking at what they do that’s uniquely different from what we do, so that we can adjust how we share knowledge with them,” Booth said. “We’ve discovered some very interesting things about very subtle differences in language usage. We’re learning things from them. It’s a two-way street. Now the Indian team is building its own version of the tacit knowledge required.” To preserve and build this tacit knowledge, BFDS puts a great deal of effort into programs that encourage employees not to leave.

Because of cultural differences, Booth said, “We have decided never to offshore functions that have a high cultural content, such as our telephone servicing work. There are small nuances that make a big difference in communications.”

BFDS “surrounded the whole project” with a system of controls, measures and audits to be able to demonstrate to clients that the offshore operation met the highest standards for accuracy and security, Booth said. The decision to go offshore, he said, was part of a growth strategy, not a cost-saving effort, since BFDS is adding employees in the U.S. as well. However, the firm does expect to achieve reduced costs through a process-improvement system it developed with its vendor in India.

## Knowing the country isn't enough. You gotta know the territory, too

When planning a move offshore, it's not enough to understand the laws, economy and culture of the country under consideration. It's also critical to understand the environment in the state, province or city you have mind, said New York panelist John Green, research director and head of the Asia practice for the Eurasia Group. Green's firm advises organizations on the risks inherent in political and social developments in emerging nations.

While the economic or political picture of the country itself might be appealing, the local environment can still cause trouble. "What's happening at the micro level can present the most difficult challenges to companies planning to outsource," Green said. "A lot of the risks are going to be at the province level in China and the state level in India. It's hard to speak generally about conditions in a given country because public policy, legislation, regulations and, perhaps most frustratingly, bureaucracy, can sometimes obstruct corporate goals more effectively than the risks at the national level."

Pressed to make a comparison between India and China, Green said that India's political and governmental system is "more complicated but more transparent" than China's. "So the expenses in India may be higher, but the risks are probably lower." China's difficult relationships with Taiwan, Japan, Korea and even the U.S. "attach far more risk to China than India," Green said.

As the global economy grows stronger and foreign companies expand their interests in other countries, feelings of national pride may also impede a company's ability to do business abroad, Green said. "Nationalism and other societal risks are increasingly prevalent, not only in developing countries, but in mature markets as well," he said.

As examples, Green described protests in Mongolia over a Canadian mining project and boycott threats in Thailand that followed the sale of a telecom company to interests in Singapore.

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