1. Beyond outsourcing
One of the responses financial services firms gave to the financial crisis is an increased level of Business Process Outsourcing (BPO). While this seems at first glance contradictory, BPO can represent substantial value to service providers by reducing risk and increasing value delivered to clients — whether through lower service cost, increased service quality or extension of service offering.

Reduction of risk — many industry players have chosen to focus on core and strategic activities in light of ever-increasing regulatory burdens, risk-averse shareholders and operational complexity. As an illustration, private banks are increasingly outsourcing the production of tax reports for their high net worth and global clientele. This allows them to acquire capacity and mitigate the risks associated with the various fiscal regulations across the globe whilst centralizing production to align service levels and controls.

Lower service cost — stronger transparency requirements and increased competition from low-cost and alternative service providers put industry players under fee pressure. Outsourcing non-core business activities allows financial service providers to benefit from economies of scale that they would not be able to achieve if these activities were kept in-house. Moreover, it transforms a fixed cost into a variable cost through the application of the "pay-as-you-go model".

Increased service quality — transparency, "bank shopping" attitudes and standardization/ring-fencing of service offerings through tighter regulatory constraints can make it difficult for financial service providers to differentiate through their core activities. Differentiation can, however, still be achieved through an outstanding service quality. For instance, fund factsheet production may be seen as a commodity. This said, in this field,
BPO providers not only apply but also define industry best practices. Leveraging their expertise can give financial service providers that competitive edge in service quality, further reducing operational risk (see above).

**Extension of services offering**—fighting against an image of an industry that is non-innovative and facing competition from non-traditional service providers, the financial industry is increasingly urged by its customers to reinvent itself. This can, for instance, happen through the integration of innovative digital solutions. BPO is typically seen as covering existing processes only. However, BPO service providers act as business integrators, allowing financial service firms to access a whole range of new, non-core services and solutions, and this off-the-shelf without substantial implementation effort. They can also bridge the capability and knowledge gap when it comes, for instance, to the integration of disruptive digital solutions within traditional banking environments. The perfect scalability of BPO services allows BPO clients to benefit from higher operational flexibility and the availability of resources “on demand”.

Actually, outsourcing is nothing new to the world as the first evidence of BPO can be traced back to traditional manufacturing industries such as Coca-Cola, which outsources large segments of its supply chain to be more cost-effective and efficient. Despite the significant benefits of BPO for the industry, the financial service providers, however, still lack the degree of outsourcing leverage applied in other industries.

As an illustration, private banks are increasingly outsourcing the production of tax reports for their high net worth and global clientele.

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It is estimated that outsourcing represented an approximately US$ 524.4 billion global industry in 2015, with significant emphasis on three broad areas:

1. Logistics, sourcing, and distribution services;
2. IT services, including the creation of software and the management of computer centers;
3. BPO areas such as call centers, financial transaction processing and human resources management.

In the Financial Services Industry, BPO was a known quantity even before the crisis, but has become prominent, growing by 3.2 percent CAGR from 2009 to 2012, reaching US$ 143 billion. In the face of increased enforcement of regulations, this is projected to increase to 5.2 percent CAGR between 2013 and 2017. However, this figure still lags behind when compared with other industries such as the manufacturing industry, which often outsources up to 70-80 percent of its finished product.

So why does the financial industry still shy away from the BPO business management practice?
We suspect the reason for this is two-fold:

1. On the one hand, BPO has a bad image and is burdened by substantial misconceptions:
   a. It necessarily results in staff lay-offs
   b. It is a complex to manage process that often fails in the details
   c. It is a statement of the firm “against” a defined, low-value activity
   d. All the math done, it is often not cheaper than in-house processing
   e. It increases vendor dependency

2. On the other hand, many players have bad experiences with BPO or failed in making it a success story for their firm as they did not take full value of BPO projects in the past:
   a. It did not consider all the potential processes in scope and only covered low value-added back-office activities
   b. It did not take value from vendor centralization and resulted in a fragmented vendor landscape
   c. It only copy-pasted existing processes and did not trigger a review of the business process and service offering in itself
   d. The project was not managed with sufficient management focus and lacked resources for implementation
   e. It failed to produce the expected financial benefits through higher-than-expected implementation cost and non-adapted pricing models

f. The financial business case did not compare to the fully loaded in-house production cost

We believe that when smartly managed, a BPO project does not necessarily have to entail these consequences. It can be of substantial value to a financial services firm by increasing margins, reducing risks, propelling innovation and enhancing value delivered to clients (whether internal or external clients).

To break with this image, let us therefore take BPO to the next level by introducing the concept of “Smart-Sourcing”.

2. What is smart-sourcing?
Smart-sourcing can roughly be understood as outsourcing business processes under the considerations that:

• The processes to be outsourced are reviewed and redesigned
• The quality of the services is significantly increased through the application of best practices
• The project entails a review (and upgrade) of the service offering
• Vendors are centralized but smartly managed to grasp additional economies of scale and provide higher processing transparency

To break with this image, let us therefore take BPO to the next level by introducing the concept of “Smart-Sourcing”.

Engaging in smart-sourcing instead of simple BPO entails (and even requires) a mindset change for many financial institutions:

### From outsourcing... ...to smart-sourcing

- Focus on cost reduction
- Streamline back office tasks
- Works well with predictable processes
- Commodity process
- Efficiency
- Vendor Management
- Tight monitoring of operational risk

### Smart-sourcing for inspiration: defying conventional wisdom, 7 large start-ups have relied on smart-sourcing for their IT development to successfully power their business

Start-up companies have very well understood the value of smart-sourcing and have relied on it to fuel their expansion plans. In the examples below, those companies have challenged traditional strategies by outsourcing what could be seen as a key asset: their IT development process.

1. **Slack**: Now valued at nearly US$ 3 billion, this company used outsourcing to develop its team communication solution in its earliest days.
2. **Skype**: They used a team of developers in Estonia to help them build out their business.
3. **Staff.com**: Serving as a company that offers outsourced talent and freelancers for other organizations; Staff.com utilized the same model to grow from a start-up into a globally successful business.
4. **Basecamp**: The same practice of outsourcing worked for Basecamp as it developed itself into a technology leader.
5. **MySQL**: From the start, the company believed and proved the success of a growth strategy that included using a mostly outsourced staff in various countries to ramp up operations in each location.
6. **Opera**: This web browser company relied on developers in other countries to create and implement its platform.
7. **Pingar**: The company helps organizations with data analytics. While establishing itself in its industry it called on outsourced talent to develop its business.

### 2.1. Characteristics of the ideal process to smart-source

One of the main root causes for a disappointing BPO process is wrong casting for the smart-sourced process. A critical step on the path to smart-sourcing is indeed understanding what characteristics make a process ideally suited to be outsourced. A good casting of the process to be smart-sourced can be achieved as outlined in the following points:

**Core process for the smart-sourcer, but not for you**—first, the outsourced process must not be a core activity of yours but it should be a core activity of the outsourcing service provider (the “smart-sourcer”). Indeed, the smart-sourcer will have developed best practice formulas and specialized systems that are proven and optimized.

**Other criteria of processes prone to smart-sourcing are:**

- **Large scale/Cyclical**—this is to allow a constant flow of work to the service provider, which is important to benefit from economies of scale and to allow the vendor’s performance to be measured in a deadline constrained framework.
• Complexity is not an issue/high value tasks—a popular misconception surrounding BPO is that the services being outsourced should usually be of low value and should be simple in nature. However, quite on the contrary, complex tasks, especially those requiring a vast array of competencies, can lead to model smart-sourcing candidates because getting the necessary expertise would be difficult, costly and risky to manage. For instance, the turbulent tax and regulatory environment has led to many processes becoming quite complex (e.g. tax reporting, marketing and regulatory compliance, risk management and reporting), requiring a multitude of experts to complete successfully. The non-compliance burden attached to them greatly increases the importance of these services: in 2014, US and European banks paid an astronomical amount of US$ 65 billion in penalties and fines.4

• Commodity services—another facet that makes a service a suitable candidate is that it is conceived as a commodity, allowing firms to compare between several outsourcing providers competing on the best and most innovative services but also on prices. In addition, commodity services allow for greater cost forecasting and budget predictability as service providers tend to follow the pay-as-you-go model, which greatly reduces fixed costs, giving the client more autonomy.

Maybe the greatest benefit of smart-sourcing fund factsheets is that it allows innovation to be captured much faster than if it were insourced.

Smart-sourcing solution: traditional and future fund factsheets
A fund factsheet is the essential marketing tool to promote fund products. Yet, today, too many fund factsheets are still produced with a rigid content and are not refreshed as often as one would want. In addition, classic factsheets today are designed to be printed and fail to satisfy the requirements of the upcoming generation of global “digital native” clients.

By smart-sourcing fund factsheet production, fund houses can differentiate themselves in many ways:

• By being assured that local compliance obligations will be met (and avoid pricy fines and public sanctions)
• By allowing rapid development and launch process for products to “go to market”
• By strengthening the data management process (this can actually benefit many other fund document productions, KIIDs, prospectus, etc.)
• By getting a faster, more cost-effective, more flexible, more scalable production solution that even large players could not afford

Maybe the greatest benefit of smart-sourcing fund factsheets is that it allows innovation to be captured much faster than if it were insourced. Current systems are indeed most often outdated and undersized. What would be the rationale of trying to replicate third-party solutions with less investment and focus than “smart-sourcers”? To illustrate this point, fund factsheet smart-sourcers are now proposing solutions that many asset managers have not yet started to dream of: factsheets can now come to life, i.e. be dynamic, generated on a real-time basis, reworked online by clients as they wish, mixing all media available today: static and daily data (like NAV per share, risk measures, news, links to other documents), video, news feeds and even social media.

2.2. Be ready to change to become faster, stronger, better
In many cases where outsourcing failed to capture its potential, the client did not see the relationship between themselves and the service provider as a partnership, thus creating innovation deficits. A typical error for an outsourcing project would consist in “copy-pasting solutions” (or “lift and shift” solutions), where the client simply asks the vendor to follow the legacy processes they were using, often defeating the purpose of outsourcing in the first place as they failed to take advantage of the vendor’s strengths.

The point is that firms must agree to transform themselves (for the better) and allow service providers to follow their own modus operandi.

This is a small cost in comparison to the potential benefits of smart-sourcing:
• **Volume resilience**—the smart-sourcing model usually comes with a gain in flexibility, which is significant in cases where there is a sudden increase or decrease in processing volume. It is easy and far more cost-effective to adapt the resources required if going through a service provider, reducing the inefficient allocation of resources and the response time to market movements – a highly useful tool in today’s turbulent environment.
• **Global reach**—especially for firms active in cross-border markets, smart-sourcing solutions would enable firms to gain immediate access to a specialized pool of resources with superior expertise and technical knowledge. Allowing vendors to use their own processing system enables them to leverage their network of expertise in different countries, leading to correct and specific solutions.
• **Innovation**—as the process being outsourced is part of the core activities of the smart-sourcer, it will continue developing and improving its services, providing you with innovative solutions that would most likely not have been on your own development agenda.

2.3. When smart-sourcing, do no “micro-outsource”. Think about the global picture.
Of course, outsourced processes must not be done independently from the big picture; the overall model must remain coherent and efficient. As a matter of fact, a number of firms address new business challenges (such as a new regulatory reporting requirement) by immediately outsourcing the issue at hand... and ultimately fail to reap the benefits of smart-sourcing. This type of strategy may lead to immediate pain relief, but does not constitute an effective solution that is sustainable in the long run.

Indeed, we have observed a number of firms that chose to outsource a multitude of problems to a multitude of specialized vendors. The objectives pursued in those cases were to quickly benefit from the expertise of specialised vendors. Such a strategy relying on multiple vendors creates in the long run a very challenging environment where the benefits gained are wiped out by the efforts necessary to coordinate the various service providers. Often, such setups lead to unforeseen delays and suffer from a lack of consistency in terms of quality. This is especially true in cases of high level of inter-dependency between vendors where the mistakes or delays of one vendor can bring the entire system to a halt.

A more effective arrangement is to select a service provider that offers a breadth of activities and skills, acting more as an integrated solution for outsourced services. This significantly cuts down the web of complex relationships to be supervised and synchronized.

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**Outsourcing to a multitude of vendors inevitably leads to inefficiencies and quality issues**

- Client
  - Vendor A
    - Extract
    - Transform
    - Load
  - Vendor B
    - Factsheet
    - Publish
  - Vendor C
    - Risk Reporting
    - Publish
  - Vendor D
    - Tax & Risk reporting
    - Publish
  - Financial statements
  - Disseminate
    - Simple vendor management model
    - Consistency of data
    - Faster production cycle
    - Cost-efficient
    - New service easy to set up
**A smart-sourcing model is synergetic by design**

In addition, the service provider is tasked to coordinate operations internally, leading to a much more cohesive process, which can often mean the difference between success and failure. Furthermore, the client is also able to receive output that is consistent, and the service vendor is able to take advantage of any synergies that may be present, creating value for both parties.

A concern related to the centralized vendor model is the risk of increased dependency on one external service provider. As the saying goes, “You should always be careful before putting all your eggs in one basket” and this is true; there is certainly a need for caution. However, issues usually only occur due to poor vendor management where there has been a lack of controls implemented at the beginning of the relationship.

### 2.4. Some risks are inherent in outsourcing and need to be tackled

While smart-sourcing offers numerous advantages transforming the way day-to-day business is conducted at a firm in the Financial Services Industry, it also comes with potential risks and drawbacks. It is worth noting, however, that most of these risks result from poor vendor management and a misalignment of expectations.

While proper management agreements and transparency with your service provider can usually mitigate these risks, there are a few considerations a firm must make before taking the decision to outsource process functions.

- **Control**—arguably, the risk most cited by organizations is the loss of control or visibility in the processes that are outsourced to BPO providers. There may be cases where the service provider carries out processes in a way that is not desired by the client, leading to unfavorable outcomes that the client has no control over without significantly renegotiating the terms of agreements. Quite often, contracts are signed with fixed terms which takes away a level of flexibility from the client if processing volumes change.

- **Dependency**—equally important is the risk of increased dependency on an external service provider. This has become even more relevant due to incoming regulations that make clients liable for the actions of their third-party service providers. Hence, clients must be fully aware of the importance of the functions being outsourced and the risks that this entails.

- **Confidentiality**—loss of confidentiality is also a considerable risk, especially given the regulations and privacy in the financial services sector. This risk also plays a role in the location of outsourcing, for example, keeping the outsourcing within the same country boundaries. Related to this are the considerations that many clients of the firm may not be comfortable with their data being in the hands of a third party and may affect the perception of the firm negatively.

- **Image**—customer perceptions in general pose a significant risk, even without the risk of underlying confidential data. For many customers, the perception of outsourcing carries negative connotations and can drastically alter their relationships with the firms if the outsourcing relationship becomes public knowledge. In cases where the customer is forced to interact directly with the service provider, it can lead to the rise of potential conflicts or a gap in knowledge which creates a negative perception in the eyes of the customer.

- **Knowledge loss**—another less common risk is the loss of knowledge and expertise that was created by keeping the functions in-house. This is especially true in cases where firms have had successful outsourcing relationships for a few years, where the in-house knowledge of these functions or processes has been eroded over time. Hence, it is important to have a few key stakeholders or knowledge repositories that are capable of having a nuanced view of the outsourcing relationship between vendor and client.

- **Cost**—last, but not least, the business case behind outsourcing business processes may be rendered invalid as firms are unable to realize the cost advantage that was one of the main factors behind the reason to outsource in the first place. This is mainly due to poor management of the vendor relationship but can often be a costly mistake, forcing the firm to backtrack and insource the function back, or spend further resources to find a new service provider.
Last, but not least, the business case behind outsourcing business processes may be rendered invalid as firms are unable to realize the cost advantage that was one of the main factors behind the reason to outsource in the first place.

Key objectives pursued by an effective vendor management function

1. Manage successful completion of transition
2. Ensure service providers’ adherence to commitments
3. Manage budgets and unknown costs
4. Control scope through structured processes
5. Ensure invoicing accuracy.
6. Perform necessary financial planning
7. Ensure improvement by implementing industry leading practices
8. Proactively manage issues, risks and disputes
9. Build vendor governance processes and controls
10. Maintain an independent and unbiased approach to service providers
11. Ensure service providers meet process improvement and innovation expectations
12. Effectively improve collaboration and reduce conflict of interest among service providers

3. Conclusion

Firms operating in the financial services industry are seeing their business models squeezed and profitability pressurized. These challenges are compounded due to many reasons such as the fast-paced changes in client expectations, the complex regulations at local and global levels, the disruption caused by the digital revolution, and lastly, the forces of globalization.

Reducing costs through outsourcing is possible and remains a valid business objective. Nevertheless, this should not be the only motivation for outsourcing.

Financial firms should reject conventional wisdom and use smart-sourcing to delegate non-core but high-value processes while mitigating global compliance risks and reducing costs.

Smart-sourcing definitely offers great opportunities for working more efficiently, proposing innovative services and standing out in the competitive landscape; globalization-driven processes in the fields of tax, compliance, risk management, and regulatory affairs are just a few of those processes ideally positioned to be smart-sourced.