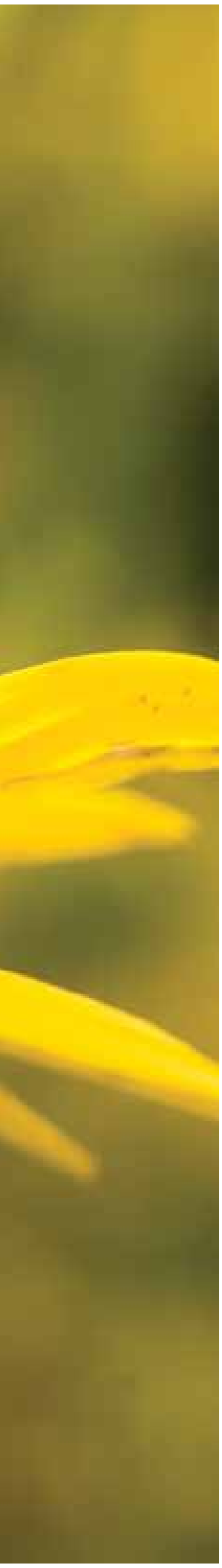

Outsourcing trends and risk implications

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One might be forgiven for thinking that anything that could be said, learnt or considered about outsourcing has already been said, learnt or considered one hundred times over. Outsourcing in all manner of domains has been with us for some time now, nowhere more so than in the realm of the financial industry.

The 'third party administrator', the global custodian, the 'value-added' service provider, the call centre and the whole battery of service offerings are familiar and recognised parts of the market infrastructure, and have been tried and tested over the years. And yet, something that should by now be a standard process still has the power to surprise, to confound, to challenge, or to put it bluntly, to go horribly wrong.

The logic for outsourcing is impeccable and frequently repeated, encompassing specialisation, economies of scale, critical mass, the cost of investment, a focus on core business, global reach and many, many other factors. After a certain hiatus following the financial crisis, when most actors in the markets were more preoccupied with achieving stability and focus rather than undergoing change, activity is once again picking up in the sector. Institutions that hitherto held firm to the 'in-house' only concept are in some cases looking for potential outsource service providers; institutions that have already outsourced are reviewing their partner relationships and matching them to expectations; and service providers, still reeling under the costs of investments they have needed to make to keep pace with regulatory change, are once again on the quest for new clients.

It would therefore seem opportune to reflect for a moment on the whole experience of outsourcing, its successes, pitfalls and 'dos and don'ts', and to try to understand why a subject that is so familiar can prove so complex and often so challenging.

If business models were truly able to readily accommodate such a range, either the whole outsourcing sector would be a place of joy and happiness or the whole industry would be beating a path to a single provider

The process starts with the decision to outsource, or to consider outsourcing. Even in cases where an institution that has already outsourced decides to review its relationship with the service provider and its model, that first premise is still valid, because somewhere along the line in the process of revalidation or questioning, there should be a return to first principles: why was the decision to outsource originally taken? Have the goals that were set then been met? Have those goals changed, is there a new dynamic in the equation, and is there a better service proposition than the one currently to hand?

It may come as something of a surprise, but the problems that can bedevil outsourcing often commence at this initial stage. For the starting point must always be a clear and precise idea of what the objective is. There are no such things as bad objectives, or wrong objectives. If the ultimate goal is simply one of saving money, that in itself is an objective. Risk arises when that rationale or that objective is not fully understood or shared, or more importantly, accepted. There can of course be many reasons to consider outsourcing: savings on the cost of system upgrades or new systems, time to market, the scope of investment strategies or cross-border development. All are valid. Problems may arise in the first case where political correctness or the 'sub-conscious selling pitch' starts to affect how the objective is articulated, and secondly, where consensus is achieved through parallel but not necessarily converging visions.

Executive committees and boards frequently seem to have issues with accepting cost as a major driver. At the back of the collective consciousness there often lurks a feeling that the decision to outsource will not necessarily be a popular one, that in some way it may appear disloyal to staff who will be impacted, and subconsciously the 'selling' process has begun. This can be a cardinal error, because if cost is the driver, by allowing it to be obscured by the fluffier elements that may well have a role in 'selling' the process at a later stage, the criteria used for the appraisal, the decision and how the project is run may also be clouded. If, however, the major impetus is another factor—extending global reach for example, acquiring more varied language skills in distribution support or extending the product range—then the whole process of evaluation is different, as are the ultimate selection criteria. As a blunt example, if cost is the object, the ideal partner is a lean, mean processing machine; if client facing is paramount, then the appropriate service provider will need a strong client service focus and culture. Asking for one and looking for the other will almost always ultimately result in disappointment. There are service providers who can score highly at both ends of this scale, but they are rare, and if the ultimate aim is to find a 'five-legged sheep' (to borrow the beautifully evocative French expression), then before embarking on the quest one should be prepared for a long and arduous search. If business models were truly able to readily accommodate such a range, either the whole outsourcing sector would be a place of joy and happiness or the whole industry would be beating a path to a single provider.

Do

- Ensure that outsourcing positively responds to at least one of the firm's five main strategic issues (profitability, geographical coverage, etc.)
- Consider the impact on the service delivered to the client–and the client's reactions
- Will the firm's key differentiators be preserved?
- Remember that something must be left on the table for all partie

Don't

- Lose sight of the business impacts of a single strategic objective
- Sacrifice clarity for consensus
- Underestimate the task being undertaken

Transparency and direct communication is essential in overcoming that hurdle, which means in turn it should not be a benchmarking exercise—there are consultants for that!

Equally, in coming to a decision to outsource, agreement is essential. And, at the risk of upsetting more consensual cultures, agreement is not the same thing as consensus. There may well be collateral advantages that allow differing visions to converge, a cost-based initial logic may well offer possibilities for more efficient data models, a global footprint, time-zone leverage and so forth, but these will remain add-ons and should not be confused with the primary objective. Conversely, if they are important in themselves, then that needs to be articulated and accepted as such. An excellent way of creating future problems is for this to be buried in consensus. Different stakeholders in the decision-making process will have different objectives—the world seen from the perspective of business development or client relationships is very different to that seen through the eyes of the CFO. It is not unknown for a board or an executive committee to arrive at an agreement on outsourcing based on each stakeholder accepting that in his or her case there are sufficient advantages to be had, without that agreement extending to what the primary drivers should be.

The first prerequisite is that the criteria are understood and agreed. They may be multiple, but in that case it should be remembered that the greater the number of criteria, the less likely it is that a single service offering will satisfy all of them.

The section of the RFP concerning fund accounting alone ran to over a thousand questions. When the mounds of paper came back with detailed answers, some in whole paragraphs, the institution in question was left scratching its collective head as to what to do with all the data

In the tumultuous late Middle Ages and Renaissance in Scotland, when rebellious lords or other dissenters plotted to assassinate a rival, the practice was to draw up a written bond to which the conspirators would sign their names. This apparently suicidal process, should the plot be discovered, did have certain advantages. In the first instance it tended to favour confidentiality, as no-one had an incentive for it to be disclosed, but above all it focused minds admirably on collective responsibility. It would indeed be far-fetched, if sometimes tempting, to suggest that there is any more than a fleeting similarity between the decision-making process of an executive committee or board and the blood-soaked anarchy of bygone Caledonia. Nevertheless, there is much to be said for things that are written down in simple words. Provided the pitfall of political correctness is avoided and once again the need to 'sell' the decision internally does not begin to obfuscate the true objective, something in itself which is not necessarily a simple exercise in larger entities with mandatory staff delegate participation in governance, a clear, minuted statement of the agreed objectives both clarifies intent without equivocation and serves as a useful point of reference throughout the selection process and for progress review over subsequent years in the new configuration.

Having taken the basic decision to outsource, the next question to be answered is *"now what do we do?"* and in general the reply is *"issue an RFP"*. There are cases where a strong connection already exists with a service provider, which may be a related company, for example. In circumstances where there is a natural affinity and the conditions proposed are in line with the statement of intent and tick all the right boxes, such a short cut may have advantages. One should also be aware of the inherent disadvantages. It is an almost universal experience that very few 'in-house' clients feel themselves to be fairly treated by the in-house service provider. Sometimes this is solely a matter of perception; sometimes it is more than that. It is also difficult as an in-house client to obtain the keenest pricing within a set series of parametres, as the relationship is often confused by shared resources—profits generated in a shared dealing room or execution facility, etc. Thus, in some respects, the short cut may not necessarily be the only solution, especially in an environment where pricing, even internal pricing, of all aspects of fund charges is coming increasingly under scrutiny. However, when looking elsewhere, it is often difficult to convince potential bidders that their offer is invited for serious consideration and not merely as a benchmarking exercise. Transparency and direct communication is essential in overcoming that hurdle, which means in turn it should not be a benchmarking exercise—there are consultants for that!

The RFP is where the first step-difference in the process arises; in the majority of cases the RFP on the 'buy' side (the outsourcer) is a new experience. For the service provider, it is closer to a sales exercise. The scope for misunderstanding between the two is rich indeed.

It is essential that—before the RFP is drafted—the outsourcing party defines exactly what it needs to know, what the key drivers are (back to the written statement of intent) and how, at least in the broadest terms, the whole project will be structured. As an illustration,there was one case in which a highly consensual approach was taken across several locations, with all stakeholders having their say in what should go into the RFP, including several levels of in-house staff. It was felt that not only would this give the necessary level of detail to be able to formulate a judgement, but would also increase the 'buy-in' on the part of the staff who would be part of the outsourcing deal. The section of the RFP concerning fund accounting alone ran to over a thousand questions. When the mounds of paper came back with detailed answers, some in whole paragraphs, the institution in question was left scratching its collective head as to what to do with all the data. It eventually came up with the idea of using graduated 'smilies' on a scale of 1-5—which was quickly reduced to 1-3, as it was impossible to agree the nuances between just two positive or two negative results, as an expedient aimed at achieving a meaningful result before early retirement began to kick in as an additional factor. The case is extreme, but it is a good illustration of the over enthusiasm that is sometimes allowed to cloud the issue. Typically, the institution will have one or two people who may have been involved in an RFP in a former life, although it is rare to have someone who has actually run an RFP. Collectively the 'project team' will spend hours agonising over the subtleties of a few questions that it believes to be important, and leave whole swathes in such general terms that the possible replies are almost too numerous to contemplate, or too vague to use, such as "*Do you do this?*"—to which the inevitable answer is –"*yes*".

Do

- Ask the right questions in the RFP Will the RFP give you insight into the alignment of strategy and values?
- Assess compatibility in terms of corporate culture
- Ensure that all of the firm's relevant departments are involved in reviewing the RFP answers
- Ensure that the RFP is reviewed by employees/ consultants with good market knowledge
- Due diligence, due diligence, due diligence

Don't

- Limit the RFP questions to technical issues and pricing considerations
- Limit the RFP review to a restricted number of people within the firm
- Skip the due diligence process, as this is a unique opportunity to assess outsourcer values
- Forget that the service provider is in 'sales mode'

On the sell side, this RFP will be one of many; in a lot of cases, replies will be a 'cut and paste' of those used previously to answer similar questions (for innocent entertainment it is always amusing to scan an RFP response to see if anyone has been careless enough to leave in a former client name!) and the risk that a response is given that answers a question other than the one that was intended is significant. Moreover, each service provider has its own approach to answering RFPs. Some are very slick, commercially oriented and well organised, leveraging RFP databases and other such tools. The risk with this approach is that the operational departments of the service provider may not even see the RFP—or will probably see it without having enough time to go through it in detail, and may be consulted by the RFP team on a couple of difficult questions taken out of context. A slick RFP is no guarantee of a slick operational process.

A key question to ask in RFP review meetings is: *"How exactly has the RFP been handled?"*. The response may not be 100% accurate but the way in which the service provider responds to that question will be indicative of its corporate culture.

The potential pitfalls are numerous. In all outsourcings there comes a moment when the frustrated institution decides to go back to the RFP to see how the service provider replied to a specific point with the intention of resolving a difference 'by force'. Forget it. If an outsourcing project has reached that stage it is time to get both parties together for a heart-to-heart before relationships are permanently damaged.

The important points to be remembered are that an RFP is a tool and nothing more: it requires skill and experience to interpret it accurately, including knowing how to look beyond it and understanding which service providers have good processes but less flashy RFP responses and vice versa; realising that no two RFPs are alike; accepting that at this stage in the process the RFP constitutes a selling exercise for the service provider, and looking very closely at the executive summary, which is often the most important part of the RFP as it should allow the institution to gauge the service provider's commitment to this particular deal.

There is no right or wrong way to go about this process. It is, however, time-consuming and fraught with risk for the institution to seek to start the process from scratch when there are consultants available who can not only guide them in building a solid approach and process, but also bring experience and insight that can in the long run prove invaluable. At the same time the RFP is not a poisoned chalice to be dumped on the consultant and left well alone. The key to success is to remain involved in the process, but to recognise value and experience and to remember why a third party has been retained to help with the exercise. And the RFP is no substitute for and, at the end of the day is much less important than, due diligence.

It will probably come as no surprise, given these reflections on the theory and practice of an RFP, that it is only the first step on a long and complex path.

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There remains the evaluation of the responses, the selection of a short list, due diligence on potential service providers, project planning for lift-out or transfer, contract negotiations, setting up KPIs and service reviews, establishing a vendor management function—to name just some of the things that are high up on the 'to do' list once the mammoth task of the RFP has been completed. In the face of this complexity, it is hardly surprising that most outsourcers turn to external professionals for assistance.

What is perhaps a little more difficult to understand is the use that outsourcers sometimes make of the professional help that they retain. There are several levels where a professional may be of assistance. Few institutions that embark on an outsourcing project have the luxury of a permanent PMO and project team, and consultants may be a useful source of qualified and experienced staff in such roles. Yet to stop there is to deprive oneself of the real value-added expertise that an experienced consultant with practical hands-on experience can bring to the whole process. It can make the difference between success and a very pale version of success, or even a result that feels and leaves an aftertaste that seems very similar to failure.

This can be demonstrated in many facets of an outsourcing initiative. Due diligence is a good example. In some cases, to perform any sort of due diligence before a short list has been drawn up may seem an unnecessary use of time and resources, especially where—for relationship reasons—the initial list of bidders invited is extensive. However, given the difficulties inherent in the RFP process (as discussed above), a degree of flexibility might sometimes avoid missing the most appropriate service provider. Another example is in the due diligence itself. Contrast the following: example one is a due diligence exercise that consisted of sitting in the service provider's boardroom looking at a PowerPoint presentation and a repetitive chant of 'yes we can'—an exaggeration (but not by much). Example two, considered to be more thorough, involved a visit to the operational floors. Unfortunately—either by accident or design—the start of the floor visit had been so delayed that the day's activity had in effect already been completed, and the 'in depth' visit became a walking version of the PowerPoint scenario in the first example, but without the presentation and with scenic stops at various unlikely corners of a rapidly emptying office. Example three saw the relevant team from the outsourcing institution follow the NAV process from start to finish (including to the enjoyment of the visitors and the embarrassment of the service provider identifying an error in the process!). It does not take much thought to see which due diligence version was beneficial; the planning and orchestration was the work of a consultant, but one with a strong business background.

Key challenges

1. The decision process–confirm that outsourcing meets the strategic objectives
2. Selecting the right service provider
3. Transition and implementation
4. BAU–KPIs and vendor management

When it comes to evaluating the financial proposals, many institutions, beyond a simple number crunching exercise to apply quoted rates to known volumes for which they use their consultants, disappear into a huddle to make their final decision. Clearly, that decision is theirs and theirs alone. However, an experienced consultant may be able to guide them through the evaluation exercise. When something seems too good to be true, it usually is; but a low offer, especially where the key RFP criteria are a mix of cost savings and bespoke functionality, can make sense. A service provider may be looking to strengthen its credentials and client list; it may wish to acquire a specific geographic footprint, or it may be seeking diversification away from concentration in a specific segment. The skill required in judging such a proposal is the ability to weigh up just how far the service provider is going to achieve that aim, how relevant that aim may be tomorrow when the heat of the competition for today's RFP has faded, and how likely it is to influence ongoing relations. It is also essential to remember that for a successful deal, there has to be something on the table for both parties.

A suitably empowered consultant has a key role to play in pointing out to an outsourcer when the decision makers are being unreasonable. The service providers know their business; they have proven operating models and demonstrable results. At times when they are unwilling to accommodate a request there can be very good reasons for it. Facilitating this dialogue—and avoiding the dreaded recourse to the RFP—is an important task for the consultant. But to achieve this effectively, the terms of reference and the scope of the consultancy engagement should be as clearly agreed and defined from the outset as the objectives of the outsourcing itself.

Do

- Recruit a project team with extensive experience in outsourcing in the same industry
- Adopt a collaborative approach with the outsourcer–this will strengthen the relationship and facilitate successful management of the transition
- Engage with clients from the outset–a successful transition is pointless if you have lost all your clients in the process

Don't

- Underestimate change management activity, especially HR issues in the event of a lift-out
- Make assumptions about client reactions
- Go back to the RFP every time you hit a problem–it is too late for that and you will only sour relations
- Ignore any danger signal, however small
- Cut corners or fudge difficulties
- Forget that if things go wrong, there are only losers

The purpose of this article is not to seek to provide the definitive A to Z of outsourcing—that would require a book, and still be incomplete. What it has attempted to do is give a flavour of the complexities, the variable geometry and the challenges that outsourcing poses. It has concentrated on the initial phases to illustrate just how early on in a process key issues are faced—and how mistakes may be made.

But after this initial phase the challenges go on and on. They encompass the successful and appropriate handling of staff lift-outs, TUPE regulations and the more subtle but equally important psychological and motivational change that will inevitably impact the staff lifted out as they make the transition. In many cases, experience challenges conventional wisdom, for example on the merits of trying to keep an out-lifted team together for a protracted period after the transition. In order to determine the success of the outsourcing endeavour, the outsourcer will require adequate and appropriate KPIs and reporting; the art is to get the balance right between meaningful and useful information, and creating a cottage industry through unrealistic demands.

So what conclusions may be drawn from this brief review? In a nutshell they may be summarised as: know, define and agree on the objectives of the strategy. Retain control but be prepared to listen to advice and implement that advice. Build a robust plan with adequate resourcing throughout the project lifecycle and start with the control framework, KPIs and reporting designsooner rather than later.

Outsourcing is neither a black art nor an occult science. It does however have its arcane byways that require experience and expertise to be navigated successfully. That experience and expertise cannot be found in a book—it has to be acquired the hard way, on the ground.

Do

- Identify the right KPIs to accurately assess the outsourcer's service quality and business profitability
- Build open and informal communication channels as well as formal ones
- Organise regular service reviews with the outsourcer

Don't

- Ask for so much information you will be overwhelmed
- Ask for information you have no clear idea how to use–just because 'it might be useful'
- Forget that now the hard part starts!

A service provider may be looking to strengthen its credentials and client list; it may wish to acquire a specific geographic footprint, or it may be seeking diversification away from concentration in a specific segment