Securities Industry News
November 15, 2007 www.securitiesindustry.com

GUEST COMMENT

From Outsourcing to Smart-Sourcing

By Jess Varughese

The appetite for outsourcing in today's capital markets shows no sign of slowing down. According to research firm Yankee Group, the worldwide market for financial services outsourcing will grow from $11.2 billion in 2004 to $17.2 billion next year.

With growth has come increasing fragmentation and an outsourcing vernacular that seems to grow more complicated by the day. Terms such as multi-sourcing, smart-sourcing, near-shoring, any-shoring and captive sourcing, among others, have arisen to describe approaches that attempt to answer a fairly fundamental question on the minds of financial executives: "How do I develop the optimal operating model for my various business processes?"

The outsourcing landscape has evolved with tremendous speed. Third-party providers have ramped up their capabilities, offerings and geographical reach while the end users of outsourcing services have gone through a first generation of initiatives and have modified their thinking about how to deal with such models.

Financial firms are striving to strike the right balance between cost-efficiency, client service and risk management in their business processes, and are focusing on a number of key trends as they gear up for 2008.

The "version 1.0" outsourcing model was all about using a third party on a distant shore as a way to play the labor arbitrage game. As the model evolved, and flaws became apparent, firms started to look inward to see if they could do it better. Enter captive sourcing, where firms establish offshore subsidiaries to hire and manage local talent performing business processes. Today, firms have developed a new version—multi-sourcing or smart-sourcing, where the mantra is one size does not fit all and innovative hybrid models abound.

We see continued interest in captive models for a variety of reasons: greater control, and therefore better risk management; data security and privacy issues; regulatory compliance; direct client interface; and greater flexibility in adapting to business imperatives. There is also a greater level of sophistication among financial firms, who are willing to break down functions into high-, medium- and low-value elements and employ different models for different components—i.e., retaining ownership of high- and medium-value components through captive offshore models or on-shore centralized models and outsourcing low-value processes to third parties.

Firms continue to look for opportunities to partner with up-and-coming offshore providers, particularly in the high- and medium-value process space. Consider the announcement in June that Merrill Lynch & Co. was investing $11 million in Copal Partners, an India-based analytics and research outsourcing provider to investment banks, joining Deutsche Bank and Citigroup who were already investors in the firm.

All About TOM

The current buzzword in outsourcing is TOM, or target operating model.

In first-generation models, banks looked almost exclusively at cost. The drive to reduce costs concentrated primarily on the labor arbitrage equation between proprietary on-shore operations and third-party-operated off-shore operations. While initially appealing, the evolution to captive models has come at a cost—longer time frames to launch (and resultant return on investment) and higher total cost of ownership due to lack of scale. Too often, models that seemed right as they were being contemplated and launched became outmoded quickly as business imperatives changed.

In addition to contemplating hybrid sourcing models that make the most sense, financial services organizations need to focus on developing holistic TOMs that will not only support businesses five to ten years out, but can also accommodate change rapidly.

Firms need to ask themselves, what is the right combination framework of business processes and controls, technology architecture and labor sourcing to support the long-term business plan? In that equation, labor sourcing is only one piece of the overall picture and, importantly, the interdependencies between the three components are mapped out and accommodated. Indeed, cost is now only one of the drivers in developing an operating model. Other drivers may include the need for rapid expansion, better client service or greater innovation.

Devil in the Details

As financial institutions continue to advance their smart-sourcing initiatives, there is a growing realization that upfront rigor and financial discipline pay dividends down the line. Once functions have been identified as good candidates for smart-sourcing, in addition to building detailed TOMs, firms need to perform adequate due diligence, including:

• **Portability analyses.** Functional areas should be broken down into detailed workflow components and scored across several dimensions of portability, risk and return. That level of due diligence typically separates and prioritizes process components that lend themselves to "porting" to an alternative model and those that do not, as well as those that require additional transformation before porting.

• **Detailed financial modeling.** Historically, the cost savings from outsourcing or captive sourcing were assumed and taken for granted. But with ongoing wage inflation in offshore locations, significant cost of entry for captive models, and a greater understanding of total cost of ownership, including the management oversight costs, the obvious advantages are eroding. Therefore the need for rigorous and detailed financial modeling is greater than ever before, to ensure that advertised synergies do in fact exist. Attention is shifting from immediate ROI to a model that delivers lower long-term operating costs as a result of better-leveraged business processes relative to business growth.

• **Building strong vendor-management functions.** The continued success of a firm's smart-sourcing hinges on the ability of on-shore management to oversee offshore teams, whether wholly owned, a third party or a combination of the two. A number of Milestone clients are establishing strong vendor-management functions by recruiting seasoned individuals from the provider or adviser disciplines and building world-class processes and metrics to effectively govern their smart-sourcing.

Not long ago, after a number of well-publicized failed initiatives, some in the financial services industry were rashly proclaiming the death of outsourcing. Yet outsourcing, in its different guises, is more prevalent than ever. The smart-sourcing trend looks set to increase and with it the level of innovation, focus and rigor that firms are now bringing to bear.

What did die were the misconceptions that outsourcing should be centered on cost and that functions can be devolved wholesale rather than on a case-by-case basis. Having refined its thinking, the financial services industry is poised to make smart-sourcing a success. ■

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