# Financial Services Strategic Offshoring

## An Australian Road Map

**Co-authors:** *Sriraman ("Sri") Annaswamy*
*Michael Pain*

**Date :** *December 2003*

## Table of Contents :

# Introduction

## a. Foreword

In recent times, one interesting aspect of Financial Services has been the increasing globalisation of the 'operations' of the industry. In effect, this represents the adoption of global business models that have been in place in other industries such as automotive for over a decade.

In particular, the trend in Financial Services has been to establish operations in locations where there are cost and skills advantages, and potentially to outsource activities where an organisation lacks scale or competency in specific areas. These are typically, but not exclusively, in non-core activity areas.

This paper was commissioned to guage the progress of the Australian industry towards the implementation of global sourcing models, discuss candidates for global sourcing/outsourcing and identify the risks and challenges of making and implementing decisions in this arena. Domestic Financial Services institutions are seeking to maintain cost profiles competitive with global Financial Services players and the use of global business models is likely play a critical role in achieving this outcome.

I would personally like to thank all the participants in this study for their valuable time and assistance in supporting this study over the last few months.

***Douglas Snedden***
***Accenture - Head of Financial Services, Australia and South East Asia***

## b. About the Co-authors

### *Sriraman Annaswamy*

Sri is an Australian who was born and educated in India and is a Financial Services Strategy and Technology specialist. He has spent the first half his life in three major cities in India including two major Strategic Offshoring hubs – Chennai (Madras) and Mumbai (Bombay) and the second half of his life in Sydney, London and the San Francisco Bay Area.

Sri has an engineering degree from the Indian Institute of Technology (IIT) and an MBA from the Indian Institute of Management (IIM) – two institutions that have played an internationally acclaimed role as the cradle of India's Technology and Knowledge-based service industry phenomenon.

Originally trained as an engineer, he has spent the last 15 years in the global financial services industry in a variety of organisations - the Financial Services / Strategy and M&A group at Coopers & Lybrand, the Group Strategy, Planning & Development area of Commonwealth Bank of Australia, the International Strategy & Development group of **eLance (**www.elance.com) - a Silicon Valley based Business Services Outsourcing start and as a Project Director on a Strategic Services & Operations Offshoring project in India involving the BPO subsidiary of a major UK global financial services group .

### *Michael Pain*

Michael Pain is a Sydney-based Partner of the Financial Services practice of Accenture. He has a B.Sc.(Hons) in Pure Mathematics and Computer Science, and an MBA from INSEAD.

In recent times, Michael has recently led major on-shore and offshore IT implementation programs for Financial Services clients based in Australia, South East Asia and Europe.

Within Accenture, Michael currently holds several roles including functional leadership of the Finance and Performance Management Service Line, and Asia Pacific responsibility for the Accenture/SAP alliance in Financial Services. Previous roles include leadership of the Industry Solutions practice, the Technology competency, and the IT Strategy area.

## c. Project Methodology

The intention of this project was to focus on the following three important aspects:

- summarise an Australian financial services industry viewpoint on Offshoring as opposed to a general global overview, despite the nascency of Offshoring here in Australia

- Create a study that looks at Strategic Offshoring from an "inside out" perspective i.e. from the viewpoint of a Financial Services industry practitioner having to make informed and often, difficult decisions about Offshoring activities

- Consider key implementation aspects of Offshoring without losing sight of the underlying conceptual and strategic underpinnings

To achieve these objectives and produce a document that can act as an ingredient in the Offshoring debate within Financial Services organisations here in Australia, we conducted in-depth and focussed discussions with approximately 45 key executives across six major banking and insurance organisations based out of Sydney and Melbourne over a period of about 4 months.

Given the sensitive nature of this topic, these organisations and the associated executives participated under conditions of strict confidentiality and we remain grateful to each one of them for sparing their valuable time towards this exercise.

These executives were drawn from across the various functional groups within these organisations with one major factor in common – they are, or would be, key contributors to the Strategic Offshoring agenda and business case within their organisations.

Typically, they were:

- Group level executives in charge of functions such as Group Strategy / Strategic Planning, Group Finance and Risk Management, Group Technology

- Owners of Domains and Processes directly impacted by Offshoring for eg. Banking Operations, Insurance – New Business and Administration, Program and Project Management, Insurance – Claims management and Underwriting, Funds Mgmt operations

The views and top-of-mind concerns from these discussions have been synthesised and summarised, and combined with Accenture's point of view of global BPO/Offshoring issues and trends to produce this discussion paper.

## Executive Summary

- Almost every participant in our study (about 90%) focussed on the Environmental factors driving Offshoring on such a global scale as well as the factors driving Offshoring here in Australia and this has been addressed this in detail in **Section 1 : Environmental factors (Global and Australian)**

  In summary, the major environmental factors driving Offshoring globally are – Demographics and Skills shortage, Social Transformation and the International "Hyper Services" economy, the need to Leverage global Intellect and People capabilities and the presence of an opportunity for Labour cost arbitrage and Productivity.

  In addition to these factors that are driving Offshoring globally, the study highlights several additional Australian concerns/factors, including community impacts (also see Section 2), the need to benefit from global scale and standardization, and the need to manage business continuity planning including disaster recovery through geographically distributed platforms.

- Every participant was concerned about the impact Offshoring would have on the Australian community (positive and negative) and this has been addressed it in **Section 2: the Great Australian Debate.**

- Every participant was concerned about the Reputational risk associated with Offshoring, the need for internal management capabilities to oversee Offshoring, the Business Continuity and Operational Risk aspects and the ongoing stability of the Strategic Sourcing model. This has been addressed this in **Section 3 : The Offshoring Option – Key Business Model issues.**

  Further, the case has been made in **Section 3c** for a change in organisational mindset around operations and processes, from an "Operations Management" mindset to a "Strategic Sourcing" mindset.

  Also, Business Continuity and Operational Risk has been addressed in **Section 3e** with the System requirements discussed in **Section 5b.**

- Most participants (about 75%) wanted to know the key considerations involved in domain selection, how they should be Offshored, in what order and over what time frame. This is clearly institution specific, but a general view has been set out in **Sections 4 - Which Financial Services Domains can be Offshored** and **Section 5 – Making it Happen**

- About half the participants (50%) wanted a comparison of how Offshoring has progressed globally vs in Australia. Also, they wanted a view on which Domains are likely to be moved Offshore by Australian institutions over the next 12 months. This has been addressed in **Section 4c - Global vs Australian Expected progressions**

- About half the participants (50%) wanted to know if there was any unique and innovative strategy for Australian banks and insurers lacking the size and scale or the people capabilities, to still benefit from the Offshoring phenomenon. This has been discussed as the industry wide "Co Sourcing" consortium structure in **Section 5a – The Structure for Offshoring**

- A few of the more experienced participants (about 25%, typically from Australian banks and insurers that have commenced Offshoring, or are actively pursuing) wanted to understand the options and players in the various Domains and this is summarised in **Section 6: Geographic Locations and Offshoring Players.**

- Although very few (only 2 out the 45 interviewees) were significantly interested in the developments on the 'cutting edge' i.e. domains such as Analytic capabilities and Dispute resolution systems and processes, **Section 7: Future Developments** – addresses their interest.

- About half the participants were interested in obtaining a good understanding of the scope and size of the activities of the more advanced financial services players and this has been profiled in **Section 8 – Case Studies of Advanced Financial Services Players**

- Lastly, about two thirds of our participants wanted to get an idea of "what was happening in the market, of late" and has been addressed in the **Appendix – Latest Financial Services Announcements**

## Section 1: Why Offshore Business Processes– Summary of Global and Australian Environmental Factors

In the global financial press in the last 18 months, not a week passes without a global financial services organisation, typically based in the US or the UK and, increasingly, on the Continent announcing a significant Offshoring venture.

Almost every participant in this study has referred to the sudden rush of UK and US based banks and insurance companies making public announcements about their Offshoring strategies (a sample of these announcements has been included in the Appendix) and was interested in the Global and Australian factors driving this trend.

Typically, these announcements involve the setting up of a specialized overseas subsidiary – a wholly owned Business Process Offshoring ("Captive BPO") vehicle – with the stated purpose of undertaking a variety of activities currently done in the "home" geographies. These overseas subsidiaries would be based in India, China or Philippines and the announcements would state an intent to recruit hundreds or thousands of staff in those locations to perform these activities.

The activities themselves fall into one of the following five categories :

- IT – Maintenance and Applications Development
- Customer contact centre activities – including in-bound call centres for customer queries, out-bound telemarketing centres, mortgage broker and advisor contact centres
- Transaction Processing functions – including those supporting credit cards, cheques, mortgages, car insurance claims, funds mgmt investor service, pension and super fund back office processing
- Administrative and Back Office functions - including HR , Payroll processing, Accounts Payable and Receivables processing, Group Legal back office activities
- Analytics functions including Data Warehousing and Data Mining functions, Group Finance and Audit and Accounting functions, Risk Management analytics, Treasury and Corporate Bank analytics

This section summarizes the overall environmental factors driving offshoring, globally and in Australia – in effect, the 'strategic rationale' for Offshoring.

If it were merely restricted to routine, boring and mundane tasks then why is there an increasing tendency to offshoring complex and "core" value added functions such as Group Finance, Auditing and Accounting, Group Risk Management as well as Equity Research and Valuation ?

If it were merely the productivity and abundance of low cost labour then why are countries such as India, China and Philippines preferred to say Pakistan, Bangladesh and Indonesia ?

Clearly. neither the 'mundane' nature of the tasks nor the existence of labour cost arbitrage driven by low cost domestic labour can fully explain the Offshoring phenomenon.

In our view, there are four factors that are driving the global financial services Offshoring phenomenon (which are also relevant to Australia). These factors are not necessarily independent, and in some cases overlap and reinforce each other. The factors are:

- Economics, Labour Cost Arbitrage and Productivity
- Social Transformation and the Dawn of the "Hyper Services" economy
- Leveraging Global Intellect and People Capabilities
- Demographics and Skills shortage

In addition to the above, there are several Australian-specific views that were highlighted in this study:

- Need for Scale and Standardization
- Geographic Risk, Business Continuity and Operational Risk Management

**Labour cost arbitrage, Economics, and Productivity**

All participants echoed this factor as the most obvious in the Offshoring debate, and this has been the oft-cited reason for Offshoring – the "upfront" existence of Labour cost arbitrage between the source and the offshore locations and the strong impact on the productivity/output levels of the organisation.

However, given the experience that has now accumulated in relation to Offshoring, there are additional issues that need to be taken into account to provide a complete picture of this "upfront" advantage, in the context of Australian offshoring decisions.

- Focussing solely on labour cost arbitrage restricts a typical financial services organisation's view of the domains and activities that can be offshored, beneficially. It results in a myopic view of Offshoring as "shipping away the manual labour intensive tasks" and therefore, limits an Offshoring strategy to the rapidly commoditised parts e.g. back office activities and call centres, IT legacy systems maintenance and software application development.
- Even if the focus is primarily on labour cost arbitrage, Australian organisations now recognise that the "upfront" labour cost differential is potentially lower than previously and, in any case, will be volatile over

time depending on the domain, specific activity being offshored and the supply / demand factor for that skillset depending on the actions of other scale based competitors.

For example, in a commoditised domain like software application development, the salaries for Indian software professionals based in India have risen by almost 20% p.a. over the last three years, considerably reducing the labour arbitrage between Australian and Indian software rates. (However, this has been offset in recent time by the strength of the Australian dollar.)

A recent survey (dt: Nov 11, 2003) by the HR consulting firm Hewitt Associates has pointed out that the Indian software industry had the highest average pay rise in the Asia Pacific region over the last three year period (about 18% p.a. for that period).

At these compounded rates, labour cost arbitrage can evaporate quickly depending on the sophistication of the skillset needed and the availability of that skillset . Australian banks and insurers must be cautioned against assuming static CPI plus cost assumptions in looking at offshoring decisions.

- Lastly, experience is now showing that given the very good quality and high motivation levels of people working at Offshoring facilities, there is a significant risk of high turnover levels amongst experienced staff (e.g. 50% turnover levels currently experienced amongst call centre managers by some players). This can significantly affect the economics, expected productivity and 'internal knowledge' of the offshore capability. Whilst this risk can be mitigated (and passed on to some extent) through contractual SLAs with third party vendors, it demonstrates that Australian organisations cannot afford to treat Offshoring as a low cost "ship it and forget about it" solution.

**Social Transformation and the International "Hyper Services" economy**

Globally, Offshoring is regarded as consistent with, and a driver of, the emergence of a true international economy in Services – referred to as the Hyper Services economy. This factor was not highlighted by many of our interviewees, as the impacts are strategic and typically longer term. Nevertheless, this factor is applicable to the Offshoring debate in Australia.

Historically, societies move through phases such as the Agragrian and Farming phase and the Manufacturing and Mining phase. The current transition, from the late 80s onwards, can be regarded as the Services and Technology phase.

Consistent with this social transformation, employment has moved from farming and agricultural industries to the miners and manufacturers on to the banking, funds management, telcos, tourism and leisure and other services companies.

Having created and established 'traditional' domestic services markets and demand for services in general, we see Offshoring as bringing about the

International “Hyper Services” economy. This is characterized by the creation and growth of significant new businesses and opportunities providing Offshoring as a core component, and also by strong ‘global workgroup’ and vendor management capabilities emerging in domestic organisations.

At a more local level, technology, social trends and economic imperatives have enabled “Remote Working” and “Working from Home” concepts, which have increased the familiarity of society with remote provision of services. Offshoring, in some cases, can be seen as a natural extension of this concept i.e. Working from home for a company in a different geography across a different time zone.

However, despite the relevance of this global trend to the Australian services-based economy, this transformation will not happen smoothly, and Australian executives are concerned by the inevitable challenges of the transition phase. Executives are expecting the transition phase to be characterized by communitywide concern at potential loss of jobs, intense union concern including potential for erosion of the domestic member base and significant public and stakeholder scrutiny. This is opposed to the opportunity to transition organisations to more value-added activities, or to growth objectives.

Several interviewees confirmed the need to address this transition challenge. Potential strategies to help address this include:

- creation of innovative growth strategies, utilising offshoring capabilities in pursuit of these strategies
- communications strategies and stakeholder management
- strategic partnering/capability partnering rather than ‘lift & drop’ approaches

**Leveraging Global Intellect and People Capabilities**

One of the most important and often-neglected factors about Offshoring is the beneficial impact it can have on organisations that have traditionally depended on talent and intellect from within restricted or potentially shallow markets.

This factor is now recognised by global organisations who are active in global sourcing as a key potential strategic benefit of offshoring.

Only two participants in our study mentioned this factor as a consideration in Australia, and only one pointed out the implication that this has for Analytics Offshoring analytics as a key activity Domain in future.

Some interesting background in support of this factor includes:

- For the last 20 years or so, the top “one tenth of 1%” of talented Indian graduates – the 2,000 odd graduates of the the internationally recognised Indian Institute of Technology (“IITs”) have been directly or indirectly recruited by front ranking American technology, consulting, banking and insurance organisations to create, lead and manage successful global businesses ***(source: 60 Minutes program feature presentation on the IITs, CBS television network, January 2003 ).***

- John Reed, the former Citigroup co-CEO highlighted this factor as the underlying rationale for the Indian operations of Citibank as early as the 1980's - " The profit (from India) will pay for our stationery in New York. What we truly need from India are 15 global managers every year to run our global operations" ***(source: Fortune Magazine, Dec 2003)***

The 2,000 graduates mentioned above represent a very small portion of the talent and intellect available in India and other Offshoring destinations and highlight the talent pool that represents significant potential in an Offshoring strategy.

The Appendix on latest announcements shows evidence of the significant recent increase in Offshoring knowledge-based work as opposed to routine and mechanical work (e.g. Risk Management and Data Analytics vs Data Entry work, Equity Research and M&A Valuations vs Call Centre work, Accounting and Audit vs Accounts Receivable / Payable Management).

Clearly, organisations globally have started to transform their business models to help leverage the "untapped" pool of intellect and talent in key Offshoring locations.

Given this trend, we believe that a forward-looking Offshoring strategy should be driven as much by the organisation's considered strategy to leverage Global Intellect as by its need to cut its processing cost base.

**Demographics and Skills shortage:**

One factor supporting the Offshoring trend globally is the need to access larger workforces via international markets rather than being constrained by domestic markets.

In Australia, this is a long-tem factor and was not highlighted in our interviews.

It is a well known and well researched trend that increasingly the populations in the OECD economies including Australia are ageing and heading towards retirement age and beyond.

Whilst this trend has led to the rapid growth and sophistication of the Wealth Management, Leisure and Travel industries in these nations, there is a potential gap emerging to replace the rapidly ageing populations with capable and suitably skilled younger people.

Historically, the gap has been met through "physical" immigration of people from other nations as well as improvements in process automation technologies including various online tools, which has delivered increased productivity whilst necessitating fewer people to perform these processes. The United States of America and Australia are two nations that are prime examples of this historic trend.

In the longer term, Offshoring could be a significant solution to these trends and constraints wherein:

- Physical immigration of young and capable people to perform various jobs is replaced by the 'migration' of jobs to overseas locations for these prospective migrants to perform them very close to their homes

- Process automation and workflow management technologies enable employees to no longer be restricted to workgroups within geographic boundaries and therefore, allow domestic skill shortages to be met by overseas skilled staff in different time zones.

In addition to the above, several **Australian-specific** views on these factors emerged during our study as potential drivers of Offshoring in Australia:

**Need for Global Scale and Standardization**

Many of the participants (about 60%) confirmed that their organisations are looking to take the next step towards improving the productivity of the various processing and group level support functions such as technology, human resources and finance and accounting.

Interviewees were also fully aware of the potential for productivity benefits through standardisation of processes, platforms and technologies that could result from Offshoring initiatives.

- For example, one participant pointed to an organisation-wide initiative underway to geographically consolidate the Origination, Documentation, Settlement and Servicing functions in various geographies to act as an economy of scope enabler for other future initiatives including Offshoring .

- Another participant, from a more advanced organisation currently pursuing Offshoring, pointed to an initiative underway to disaggregate various processes that go into an Australian wealth management product, in order to evaluate which of the sub-processes that support this Australian product could be Offshored.

This is a natural consequence of looking to maintain the performance on Australian organisations at or near global performance levels. From a global perspective, active sourcing/offshoring strategies are now well understood by leading global Financial Services organisations and commonly pursued.

In the Australian context, this quest for consolidation and standardization to achieve global economies of scale and scope, could be an equally important driver towards Offshoring .

**Geographic Risk, Business Continuity and Operational Risk Management**

Only a few participants referred to this as a factor in their Offshoring thinking.

Historically, these issues have been seen as potential risks/barriers associated with Offshoring. However, in the context of current Australian decision-making, the converse view is widely held.

Geographic risk is potentially now more widely understood, and Australian institutions are benefiting from this experience.

Australian banks and insurers typically have well developed BCP and disaster recovery strategies, often based around multiple facilities in one of the other Australian or NZ cities (e.g. Sydney and Melbourne or Sydney and Adelaide). Consequently, business continuity issues are well understood and the challenges of Offshoring business continuity are relatively manageable.

As discussed in Section 3 when discussing BCP and Operational Risk, there is an increasing awareness of the improved rigour and transparency achieved by reducing the reliance on paper based systems, as well as improving the quality of process documentation and exception monitoring. Every participant in our study who has an Offshoring program currently underway pointed out that there is an increased level of discipline and transparency due to better process understanding, documentation, training and automation resulting in reduction of "work arounds". Overall, the impact of Offshoring is to enable a very clear understanding of processes and their risks, which assists with meeting the increased monitoring and management requirements for Operational Risk emerging under Basle II.

This additional transparency and rigour could prove to be an important driver of Offshoring in the Australian financial services institution context.

## Section 2: The Community Impact -The Great Australian Debate

In almost every discussion on this project, the 'Community Impact' of Offshoring has featured prominently. In fact, most participants in this project have indicated this as the single most important risk factor to be assessed and evaluated, as part of the overall business case.

In addition, given the prominent role that Australian banks and insurers play in the community, it is inconceivable that they would be able to embrace Offshoring in any strategic manner without clearly having this debate, internally within their organisations as well as externally with various stakeholders.

This debate is summarized below via the pros and cons that emerged from these discussions.

| Issues with Offshoring | Responses/Benefits of Offshoring |
|---|---|
| • Large scale job losses due to cheap overseas labour force impacting wages, salaries and lifestyle<br>• Contributes to community unrest and tensions | • Offshoring should be correctly viewed as "Remote Immigration" enabled by technology.<br>• Like physical immigration creating opportunities for the Australian community, so too will Offshoring.<br>• Ideally, offshoring should be underpinned by business growth. |
| • Significant "Hollowing out" of the Australian services industry capabilities and therefore, the Australian community<br>• Makes Australia a "branch office" economy with just branding and marketing activities being performed in Australia | • Embracing Offshoring leverages global intellect and people capabilities.<br>• Offshoring replaces the old domestic services model with the new "Hyper Services" economy model and builds international capabilities of Australian organisations<br>• In some cases, Offshoring creates the possibility of Australia as an Offshoring location for Analytics and other "high end" activities |
| • Reduces Australian jobs, wage levels and salaries and negatively impacts value of Australian assets – property prices and stock prices including banking and wealth management stock prices and retail stocks | • Enables Australian organisations to make the next "quantum leap" in productivity and therefore, improves capital efficiency. |

| | |
|---|---|
| • Reduces value of the typical Australian superannuation investment as it is dominated by Australian assets | • Increased capital efficiency translates into higher stock prices, more foreign investment, and higher wage levels |

**Job losses due to Offshoring vs. Offshoring as Remote Job Migration**

The key community themes emerging as a result of Offshoring are quite similar to those felt by the Australian and American communities during the various waves of immigration – from Europe in the 60s and 70s and later on, from Asia in the 80s and 90s.

The key concern then and now is – "Will this pool of cheap overseas labour take over our jobs and either make us redundant or force our salaries and wage levels down and impact our lifestyle?"

The key difference between now and then is that the physical "inward" migration of skilled labour from various geographies has been replaced by the remote "outward" migration of skilled jobs to a variety of offshore geographies.

The key factor causing this difference is technology, especially the rapidly increasing sophistication of internet based workflow and workgroup management systems that make remote services offshoring a feasible proposition.

The Australian community is concerned about the impact of Offshoring just as it was concerned about the impact of immigration, a few decades ago.

A correct and foresightful approach for Australian organisations and the Australian community, is not to give in to populism and/or isolationism but map out in a structured fashion the changes that Financial Services organisations in Australia can and need to achieve, recognise the impacts that society needs to deal with, and then go ahead and master Offshoring, including mastering the internal transitions required within organisations such as individual personnel management.

In fact, just as the physical immigration waves contributed to the emergence of the Australian multicultural society in terms of international awareness, openness and innovation, so too it is anticipated that Offshoring will expedite internationalisation in the Australian business environment and community at large.

**Incremental improvements vs. Creating strong Australian-based FS institutions**

A review of recent media and equity analyst reports, and the discussions undertaken as part of this study, indicate that Australian banks and insurers are pursuing incremental productivity enhancements such as workflow automation, reduction of headcount through streamlining and simplifying of operations and Straight Through Processing, better customer service through improved systems

and sales staff training as well as basic IT and process outsourcing arrangements.

However, analysts continue to be cautious in their reaction to announcements from these organisations regarding the “transformational” nature of these programs.

Further, overall organic growth in the system - the one important driver of the profitability of the banking and wealth management sector throughout the last two decades is beginning to show signs of tapering off.

The key questions therefore, are:

- how can these organisations continue to be maintaining their positions as “investments of choice” amidst international and domestic fund managers?

- where will the next **quantum leap** in productivity come from to push these organisations back to the top of the heap?

There are two major options:

***‘Do Nothing’ and continue with incremental productivity strategies*** - In this case, there is a risk that the relative stock prices of Australian banks and insurers would trend downward with the possibility that an organisation might be acquired by a global Financial Services player. In this scenario, it is highly likely that any sizeable global institution would objectively decide to rationalize a sizeable proportion of jobs by sending those functions to their established Offshoring facilities. (This would have a potential knock on effect of highlighting different performance to Australian institutions with purely onshore facilities).

***Master Offshoring strategies*** – Whilst this may result in a proportion of jobs lost upfront during the transition phase, these Australian banks and insurers would be able to benefit from the quantum leap in productivity and innovation that Offshoring is capable of providing.

In addition, they would also become capable of being successful at managing international operations and hence, stand a realistic chance of remaining Australia based and Australian owned organisations.

In the longer term, should any institutions in Australia aspire to be global Financial Services operators, management and effective leverage of international sourcing and/or facilities would be a necessary organisational capability.

**‘Hollowing out’ of Services vs. Australia as an Offshoring Centre**

As stated before, Offshoring within experienced global institutions is increasingly becoming an exercise of leveraging global intellect and people capabilities and is no longer purely a cost arbitrage equation.

Given this, there are several significant potential benefits for Australian organisations and the wider community as a result of embracing Offshoring willingly:

- First, Australian organisations could benefit immensely from the transparency, rigour and discipline that Offshoring brings with it.

  Almost every time that we spoke to an executive with "first hand" experience of Offshoring, we have heard the general theme that "post-Offshoring they understood their own processes better as the quality of rigour and documentation improved substantially" often accompanied by the decline in the number of workabouts and similar workflow hindrances.

- More importantly (and as pointed out by one participant in our study), given the quality of infrastructure and the strong emphasis on legal, finance and accounting activities that Australia has, there is a distinct possibility of Australia itself becoming one of the handful of "high end, value added" Offshoring destinations for a variety of global financial services organisations.

  The functions that we see where Australian skillsets would be suited to Offshoring would be around legal, finance, audit, taxation and accounting services as well as research, business valuations and business performance analysis.

These benefits are clearly not a 'given' and depend on how enthusiastic Australian organisations are in reworking their strategies and their business processes to embrace an Offshoring strategy and culture (both inbound and outbound). Equally, it would also depend on how receptive the wider community is to Offshoring.

## Section 3 : The Offshoring Option – Defining the Business Model

During our discussions, particularly with the Group level participants, we tested hypotheses regarding the 'business model' issues when Offshoring is being considered as a major option on the strategic agenda. That is, in pursuing an Offshoring option, what issues are most relevant from a business model perspective?

Based on the responses from the participants, we have set out below the top-of-mind issues in considering the decision to offshore.

a. **Scope and Profile of Activities to be Offshored**

During the preparation for this project, we anticipated that time would be spent informing some participants regarding the state of Offshoring, and to discuss that Offshoring had gone **beyond** the first wave of traditional "IT application development, back office administration, transaction processing and call centres" outsourcing.

However, most institutions, and the executives interviewed, have gathered significant knowledge, including monitoring the current state of Outsourcing and have an understanding of the potential impacts for Offshoring within their own organisations.

Virtually all institutions have formed a preliminary view of the first areas that are likely to be Offshored, and that the initial areas would be the conventional "back-office processing and administration activities". However it was recognised that Offshoring is a significant decision with major implications across many business units within the traditional banking and insurance organisation, and that navigating this decision was complex.

At the more detailed level, many interviewees identified specific banking or insurance functions which were being targeted or discussed for Offshoring. A summarised version of these views is provided in Section 3.

The factors most frequently mentioned in relation to this selection included the visibility of the function, and the efficiency of integrating the function with onshore activities. Issues around the linkage and integration of 'first wave' functions such as IT and administration functions were felt to be well understood (despite the limited offshoring activity to date in the Australian market).

One area of discussion in relation to Offshoring was the viability of real time (offshore) transaction processing.

To date, offshoring has frequently operated with captives and third party vendors working on duplicated customer information and data. This is principally driven by reliability, privacy and technology issues. Moving to a real-time processing model has the potential to improve the efficiency significantly if 'live' customer data can be manipulated and transacted

offshore, and need for manual onshore intervention (as in most current cases) in removed. Instead of the current Offshoring practice of hosting the customer data onshore and quarantining data handled by offshore vendors including captives, the organisation's customer data centre including the customer information files are accessed in various offshore geographies.

The barriers to this model or risks posed to an organisation, including privacy and regulatory issues are becoming fewer, with the relatively advanced American institutions currently collaboratively setting up the protocols to enable real time approaches.

b. **Reputational Risk**

Reputational risk was pointed out by almost every participant in our discussions as one of the key risks of Offshoring.

Several participants drew our attention to the uniqueness of Australian banks and insurers, being their significant reliance on two customer markets (Aus and NZ) when compared to their market capitalisation. (The closest parallels would be the Canadian banks as well as some of the UK banks that grew out of building societies.)

Given the 'national icon' status and 'local employer' image that these organisations possess, any Offshoring move will potentially attract adverse reaction from a variety of stakeholders – the finance sector union, the government, the regulators and the wider community.

Recent media articles in the UK have shown the significant reaction from the unions directed at Lloyds TSB, HSBC and Abbey National for their recent announcements. Further, the vigorous adverse reaction to a national icon in the UK – the British Rail – also points to this trend.

An open and constructive communication strategy to allay key community concerns as well as outlining the reasons for Offshoring, as mentioned in Section 2, would have to be an integral part of any successful Offshoring strategy.

**c. Need for a Strategic Sourcing function and mindset**

Only three participants in our study pointed out this aspect of Offshoring. Financial Services in Australia contrasts with other (global) sectors such as manufacturing, and increasingly Financial Services, where global strategic sourcing is accepted practice. In these sectors, an internal strategic sourcing capability ***for business processes*** is in place. This issue is one unknown" issues of this wave of Offshoring and therefore, needs an appropriate priority.

Most Offshoring strategies implicitly initially assume a 'lift and drop' model of Offshoring i.e. identify functions / tasks performed onshore, locate a suitable offshore destination geography and transfer functions for at least 5 -10 years. Experience now shows that this is a rare case, and that

factors such as required skill sets, the average quality and the cost of these skillsets can change significantly over time in any one particular location.

Given the typically higher skilled staff employed in services Offshoring as opposed to manufacturing and the scale at which major players are pursuing these strategies, it is likely that all three factors – availability, quality and cost – can exhibit significant volatility even in the space of a 5 year period.

This implies the need for an active group-level Strategic Sourcing function operating across all the relevant domains and one that is constantly performance managing existing arrangements, identifying newer geographies, newer domains to be offshored and newer vendors for already offshored domains.

Ideally, the Strategic Sourcing function would have a strong business development focus and work very closely with the various business unit heads to identify, evaluate, negotiate, contract and manage Offshoring opportunities for their businesses.

One participating organisation in our study already has a dedicated team that reports to a group executive and operates very similar to the “in house” corporate development / M&A teams with the exception that it would deal with the Offshoring agenda.

Whilst the need for having senior level resources with a good understanding of the relevant geographies was easily recognised in these discussions, the need for a change in the type of staff consistent with a change in overall organisational mindset – the movement from an “Operations Management” mindset to a “Strategic Sourcing” mindset did not emerge readily.

Financial services organisations that go into Offshoring with a Strategic Sourcing mindset i.e. with a proactive, multilocational, multivendor-based, workflow and performance-managed approach are likely to be more successful than organisations that pursue it from a routine ‘operational optimisation’ perspective.

Such a function would typically have a multinational and multicultural composition and outlook, it would have (integrate access to) a combination of various relevant skillsets – lawyers and dealmakers, researchers and business intelligence professionals, business and financial modellers and risk management analysts, engineers and technology staff and operations centre managers.

For example, organisations such as GE Capital International Services, eServe International, SCOPE, Axa Business Services perform such a strategic sourcing function for their parent organisations (GE, Citi, Stanchart and AXA, respectively)

d. **Control (the 'Pecking order' issue) / Captive BPO vs. pan - Australian Co Sourced BPO structure**

One clear strategy to date in Offshoring is the creation of captive centres. Most major UK and US based financial services organisations – HSBC, Citigroup, GE Capital, Lloyds TSB, Abbey National, Standard Chartered et al are driving this trend by establishing 100% owned so-called Captive Business Process Offshoring centres.

This brought forward a major concern from our participants, the 'pecking order' issue. This arises because 'onshore' in Australia, Australian banks and insurers are large scale players and are therefore able to control and manage vendors very aggressively (be it domestic vendors or even local arms of global vendors).

The apprehension is that, in offshore geographies, Australian organisations are unlikely to be the largest players in any major domain and would experience a significant loss of the control that they would not experience at home.

In addition, while UK and US based organisations have significant experience in operating in specific offshore geographies and can therefore manage captive BPO centres, Australian organisations have limited experience controlling and managing similar entities.

These are valid concerns, and this lack of control can be mitigated in two significant ways:

- First, this can be to some extent be addressed by rigor, transparency and discipline in the Service Level negotiation, documentation and reporting process (arms-length, 'legal' control)

- Second, as discussed in Section 7 – Structural Issues, this could be addressed in some cases by adopting 'Co Sourcing' consortium / partnership approaches wherein organisations enter into a limited collaboration arrangement, structured and managed by a reputed Strategic Sourcing organisation and are thus able to use the increased scale to obtain significantly more control than on their own

  Such an Australian 'Co Sourcing' approach may also help in the geography evaluation and vendor selection process as the consortium would have a better mix of "on shore / off shore" skills than each of the component entities.

e. **Business Continuity and Operational Risk**

Most of the participants pointed out the need for more robust BCP and Operational Risk-based systems than those currently enabled in their organisations for two important reasons:

- The transformational nature of Offshoring on operational processes and
- the “emerging market” nature of the typical offshoring geographies

The effectiveness of a BCP and Disaster Recovery Plan for an Offshoring strategy is driven by three primary factors:

- Paper based and manual process fallovers vs Online and automated processes
- Sophistication of imaging, rules based workflow and workgroup management systems and reporting technologies
- Use of in-house / multilocational / multiple vendor capability with queuing and load balancing flexibility

As discussed above, from an Operational Risk perspective (including the current issues of Basle II OR incidence and impact), Offshoring, if properly implemented, is typically seen as alleviating many OR issues and a means of defining appropriate management OR approaches.

Several participants in the study who currently offshore administrative processes confirmed that the rigour, transparency and discipline governing the underlying processes goes up significantly when these processes are “disembedded” and housed separately in an offshore location. This is accompanied by better documentation of processes, improved reporting and monitoring systems, elimination of work-arounds and better quality and higher skilled staff.

Assuming that Basel II objectives are recognized from the outset, this leads to more robust Operational Risk Incidence data and hence, more scientific OR assessment and, eventually, better OR capital management.

Overall, in the process of addressing the emerging market nature of the locations, organisations that offshore would realise a benefit of significantly improved and sophisticated BCP systems and OR systems that are created in the process of undertaking Offshoring.

f. **Impact of Privacy Act and associated legislation**

Only three participants in our study mentioned privacy legislation concerns in the context of Offshoring, however this remains a significant risk even in an advanced market like the US.

This risk has been mitigated, currently, in three ways:

- through predominantly captive or controlled entities that are risk managed and covered as a part of the parent unit’s global operations. Customer contact activities are then carried out as part of the “existing business relationship” provisions in privacy legislation
- where third party offshore application development vendors are involved, by providing only “dummy data” to these vendors and then user testing the applications on real live customer data, on shore

- by hosting the customer information files onshore and allowing only broadband access to the data from offshore, subject to strict and pre agreed guidelines. One Australian organisation in our study currently follows this protocol, as a risk mitigation measure.

This has been reinforced by other recent legislative measures such as the Federal Trade Commission's nationwide "Do Not Call" list and associated rules directed at offshore contact centre vendors including those previously covered under the "existing business relationship" clause.

g. **Support for cross-border M&A and global consolidation**

Although very few participants currently see this as a 'top of mind' implication of Offshoring (potentially due to the limited track record of cross-border M&A deals within the Australian banking and insurance industry), this is a potential long term benefit of Offshore capability.

One of the key challenges with crossborder consolidation and M&A deals in the financial services industry has been the inability of the acquiror organisation to realise the level of cost synergies required.

This is frequently the result of inability to standardize and consolidate operational and group level processes across geographically distributed units (typically exacerbated by paper based manual processes and 'work-arounds', and multiple workflow and workgroup management systems)., which meant that expected productivity and economies of scale were difficult to achieve.

This has three implications for the Australian banks and insurers that participated in our study:

- Internal global consolidation within the organisation

  Several Australian banks and insurers have back office processes hosted in multiple geographies (or indeed in multiple business units within a country). Offshoring could prove to be a means of tackling cross-border/cross-BU process standardization issues and achieving the rapid dissemination of global Best Practice benchmarks and compliance.

  Further, co-location and consolidation of global group-wide processes in a handful of Offshoring facilities brings increased transparency and rigor to the performance management of relevant processes.

- Global aspirations of Australian banks and insurers

  Should any FS institution in Australia aspire to achieve global presence, a global sourcing/offshoring strategy would typically be an important element of this strategy.

- Take over by a global financial services institution

  If Australian banks and insurers are not able to productively pursue Offshoring due to community concerns, then it is possible that an overseas financial services institution would see them as potential 'high cost base' targets, and the paucity of such 'high cost' targets globally could make Australian targets more attractive to a global acquiror. This is obviously subject to the practical political constraints on foreign takeovers of Australian financial services institutions.

  It is highly likely that any acquiring institution would seek to consolidate functions currently performed onshore in its existing offshore facilities to drive acquisition synergies.

  Conversely, should Australian institutions achieve global parity via offshoring/global sourcing, any cross border acquisition based predominantly on cost based drivers would potentially become difficult to justify as the incremental cost benefits over what is already delivered by the Offshoring facility would be more difficult to achieve.

## Section 4 : Which Financial Services Domains can be Offshored ?

This section discusses the the financial services domains that can be successfully Offshored as well as some of the key considerations involved in the domain selection process.

In the last 20 years (the baseline being 1984-85 when Citibank set up COSL - its wholly owned global IT and application development arm at SEEPZ, Mumbai), we have seen Offshoring move from "purely" IT and software application development through the labour- intensive routine "back office" transaction processing work such as call centres and credit cards processing to, the knowledge based analytics functions.

### Typical activity Domains that can be Offshored

For a typical Australian banking and insurance organisation with a currently limited Offshoring program, there are fundamentally five relevant activity Domains that are impacted by Offshoring :

- IT application development and maintenance functions such as Core Banking System re-platforming, database and application development

- Administrative and "Back office" services activities such as HR and payroll, Accounts Receivables / Payables, routine General Ledger updating and reporting

- Transaction Processing work including Real Time Transaction Processing (RTTP) for mortgages, institutional and investment bank settlements, insurance and funds management administration activities

- "High end" Analytics capabilities such as Data warehousing and Data mining analytics, Group Finance, Auditing and Accounting functions, Group Risk Management analytics, Group Actuarial and Dynamic Financial Analysis function, Institutional bank credit proposal preparation, pricing and valuation, Corporate portfolio review analytics

- Customer facing processes such as customer contact centres, broker and advisor contact facilities

Many of these activity domains are often owned by a number of functional / business groups within these organisations and consequently any successful Strategic Offshoring program must be undertaken by the institution at a group level (multiple operational units + IT + Finance).

For example, as one study participant pointed out, the current Offshoring program was commenced and is being monitored by a project steering team involving the CEO, Head of operations, the Head of program management and the Head of retail marketing.

**Key Operational considerations in Domain Selection**

There are four major considerations involved in the domain and eventual process / subprocess selection:

- **Transaction volume driven vs. Relationship driven process (steps)**

  Any process / sub process that is driven by high frequency transaction volumes and is a repeatable process is an obvious candidate for Offshoring. Processes such as credit card processing, mortgage and personal loan processing, collections, new business administration, FX and derivatives settlements feature in this category and are good examples of processes that can be Offshored, in the first instance.

  Conversely, a process that involves a "complex or critical" customer relationship needs to be looked at with greater care. Consequently, processes need to be broken down into the individual subprocesses that are volume driven can be Offshored, to begin with.

  For example, in the case of life insurance claims management (as a major UK life company does) – whilst the claims manager needs to be onshore, the sub processes that make up the claims assessment, evaluation and settlement process can be Offshored.

  The customer's completed claims application can be imaged and allotted to a workgroup offshore and things like completion of the claims data screen, verification of the certificate of demise, confirmation of premium paid status, verification of pre-existing conditions can be done in that offshore.

- **Back office work vs. customer and intermediary contact**

  Any process / sub process that is predominantly back office with little or no customer contact especially voice contact is suitable for Offshoring, in the first instance.

  For example, employees at SCOPE International (the StanChart Captive BPO) based in Chennai currently settle, validate and revalue FX derivatives positions for the Global Institutional Bank in several other onshore locations.

  Conversely, where there is significant customer or intermediary contact especially voice contact, the process needs to be reviewed for identification of sub processes that can be Offshored, initially.

  This is particularly applicable to Australian banks and insurers that are looking at Offshoring customer and advisor contact centres based on precedences in the UK or the US. We believe that that is not the ideal initial function, as currently in Australia there is relatively limited familiarity with Offshore call centre models and a perception of poor service quality and query handling.

  A lower risk approach would be to, as one of the entities that participated in

our study currently does, retain voice contact for both customers and advisors onshore but send out the subprocesses such as updating data screens, actioning on letters and mail to customers, sending out policy renewal statements, fund transaction confirmations Offshore.

- **Elimination of Paper based processes vs. Remote and online processes**

  Several participants pointed out that paper based processes concern them significantly from a Business Continuity Planning and Operational Risk perspective and almost always necessitate manual intervention and action resulting in significant loss of economies of scale in most processes.

  Paper based processes need to be reworked and limited significantly as part of the preparatory phase for Offshoring. In our discussions, we found most Australian organisations have already made significant investments in imaging and image manipulation as well as reworking current workflow management systems. This investment obviates some of the typically steps required as part of the preparation for Offshoring.

  For example, as one insurance participant in our study confirmed, their organisation has automated the telephone claims process to an extent where nearly 85% of their claims go from lodgment through to repairer selection, assessment and repair to settlement without the customer meeting a company person.

  This is an excellent example of preparation for Offshoring. However, it should be recognised that successful Offshoring does require more sophisticated workgroup management, load balancing and reporting systems. In fact, the level of sophistication of these technologies provided by any third parties involved should be a key criterion in any selection process for an Offshoring initiative.

- **Repeatable, analytical capabilities vs. 'Instinctive' processes**

  Only one participant across our study pointed out the fact that the degree to which a process / sub process is repeatable and analysis-driven as opposed to an instinctive process is a key indicator of its Offshoring potential.

  Increasingly, analytics Offshoring is becoming the area of interest amongst the most experienced and successful organisations.

  For example, the recent announcements from three successful offshorers – HSBC, JP Morgan and the World Bank (profiled in the "latest announcements" section of this report) show the increasingly Analytics driven nature of Offshoring.

  Also, based on recent media, GE CIS is currently engaged in significantly broadening its Offshoring facilities at Hyderabad and Gurgoan in India to include risk management and financial accounting and management reporting analytic activities.

There has been a recognition that Analytics functions such as finance, audit, accounting and business performance analysis or data warehousing and mining or credit risk, equity research and M&A due diligence and valuation analysis have the inherent advantage of being currently performed in a globally standardized manner - by similarly qualified staff operating on standardized platforms using relatively standardized processes and relatively standardized rules and evaluation criteria.

To some extent, the speed of harmonization of global accounting and regulatory standards and approaches further enhances this trend.

For example, budgeting and management reporting processes for an Indian bank performed by CPA qualified accountants already reporting on US GAAP are similar to an Australian bank operating on Australian or UK GAAP.

Conversely, 'instinctive' or ad hoc processes need to remain at least partially onshore. For example, deal-making and ad hoc sales activities can be supported offshore, but will remain substantially based onshore close to end clients.

In the next 2 tables the expected progression of Global financial services Offshoring with the expected progression of the Australian financial services Offshoring.

In the Global table, the shaded areas represent activity Domains that are currently Offshored in at least 1 global financial services organisation and the non-shaded areas represent Domains that will emerge over the next 12 – 18 mths (based on publicly available information).

In the Australian table, the darkly shaded areas represent activity Domains where Offshoring is currently underway in at least 1 organisation in our study, the lightly shaded areas represent priority Domains over the next 12 months for at least 1 organisation in our study and the non- shaded areas, represent Domains that will emerge after that timeframe at least 1 Australian organisation.

***(note: Direct customer and advisor voice contact activities have been excluded as that has been cited as a "No Go" area for the next 12mths by most participants in our study)***

| FS Offshoring Matrix (Global – Current & Expected Progression) | Retail Banking including SME banking operations | Institutional and Investmt. Banking operations | General Insurance operations | Life Insurance and Wealth Mgmt. operations | Group and Corporate Cntre. |
|---|---|---|---|---|---|
| **IT and Systems** | • Core Banking re-platforming support, maintenance and upgradin<br>• CIF database related application development and maintenance | • Capital Markets and Tradin settlement systems support an mtnce.<br>• Middleware mtnce. and applcn. devpmt. | • Legacy policy admin systems mntnce. and support<br>• Customer database applcns. support and devpmnt. | • Legacy policy admin systems mntnce. and support<br>• Superannuation and Mastertrust platform devpmt. and support | • Groupwide HR and payroll systems maintenance and application development<br>• Group Finance and Accounting system maintenance and support |
| **Administrative Back Office services activities** | General ledger and MIS updating<br>Divisonal HR, payroll and accounting support<br>Marketing and advertising support and campaign management | • Marketing and HR support | • HR and accounting support<br>• Marketing and advertising support and campaign<br>• New business admin activities<br>• Policy renewals, confirmations and issuance mgmt. | • Fund accounting, MIS and reporting functions<br>• Investor database query handling and portfolio services<br>• New business admin support activities | • Payroll processing function<br>• Employees Superannuation and pension fund accounting and administration<br>• Groupwide Accounts Receivables / Payables processing |
| **Transaction Processing** | Day 1 and day 2 processing<br>Collections handling<br>Mortgage and credit card processing (other than Exceptions)<br>Trade Finance and Letter of Credit advice and processing | FX and Currency ops – deal settlement, documentatic n and end of day validations<br>Derivatives ops – ISDA doc preparation and reporting | • Car and Home and Contents policies claims assessment and management | • Life policy claims assessment and management | |
| **Analytic Capabilities** | Home loans, business and personal lending portfolic pricing<br>Home loans an personal lending MIS analysis, accounting and reporting<br>Data warehousing and data minin analytics | Credit proposal preparation including ROEE calculations and pricing<br>Divisional accounting and reporting<br>Portfolio review, repricing and revaluation | • Customer segmentation and marketing data analytics functions<br>• Policy Underwriting algorithms – development and support<br>• Actuarial / Dynamic Financial Analysis support | • Data warehousing and Mining analytics<br>• Dynamic Financial Analysis and Actuarial support | • Group Finance and Risk Mgmt analytics - management and financial accounting and budgeting analysis, shareholder value based performance analysis, credit risk EDF and LGD analysis<br>• Strategic Business case preparation and due diligence support services |

| FS Offshoring : Australia – Current & Expected Progression | Retail Banking including SME banking operations | Institutional and Investmt. Banking operations | General Insurance operations | Life Insurance and Wealth Mgmt. operations | Group and Corporate Cntre. |
|---|---|---|---|---|---|
| **IT and Systems** | • Core Banking re-platforming, support, maintenance and upgrading<br>• CIF database related gapplication development and maintenance | • Capital Markets and Trading settlement systems support and mtnce.<br>• Middleware mtnce. and applcn. devpmt. | • Legacy policy admin systems mntnce. and support<br>• Customer database apps. support and dev't. | • Legacy policy admin systems mntnce. and support<br>• Super and Mastertrust platform devpmt. and support | • Groupwide HR and payroll systems maintenance and application development<br>• Group Finance and Accounting system maintenance and support |
| **Administrative Back Office services activities** | • General ledger and MIS updating<br>• Divisonal HR, payroll and accounting support<br>• Marketing and advertising support and campaign management | • Marketing and HR support | • HR and accounting support<br>• Marketing and advertising support and campaign<br>• New business admin activities<br>• Policy renewals, confirmations and issuance mgmt. | • Fund accounting, MIS and reporting functions<br>• Investor database query handling and portfolio services<br>• New business admin support activities | • Payroll processing function<br>• Employees Superannuation and pension fund accounting and administration<br>• Groupwide Accounts Receivables / Payables processing |
| **Transaction Processing** | • Day 1 and day 2 processing<br>• Collections handling<br>• Mortgage and credit card processing (other than Exceptions)<br>• Trade Finance and Letter of Credit advice and processing | • FX and Currency ops – deal settlement, documentation and end of day validations<br>• Derivatives ops – ISDA doc preparation and reporting | • Car and Personal injury policies claims assessment and management<br>• Home and contents routine claims processing and payment | • Life policy claims assessment and management<br>• Disability claims mgmt. | |
| **Analytic Capabilities** | • Home loans, business and personal lending portfolio pricing<br>• Home loans and personal lending MIS analysis, accounting and reporting<br>• Data warehousing and data mining analytics | • Credit proposal preparation including ROEE calculations and pricing<br>• Divisional accounting and reporting<br>• Portfolio review, repricing and revaluation | • Customer segmentation and marketing data analytics functions<br>• Policy Underwriting algorithms – development and support<br>• Actuarial / Dynamic Financial Analysis support | • Data warehousing and Mining analytics<br>• Dynamic Financial Analysis and Actuarial support | • Group Finance and Risk Mgmt analytics - management and financial accounting and budgeting analysis, shareholder value based performance analysis, credit risk EDF and LGD analysis<br>• Strategic Business case preparation and due diligence support services |

## Section 5: Making it Happen

## Preparation for Offshoring

A critical success factor, confirmed in our discussions, for any Australian bank or insurer seeking to go offshore is the preparatory phase preceding the Offshoring itself.

The preparatory process comprises three important sets of decisions:

- Structure for Offshoring
- Systems capabilities
- Phasing and Tiering of activity Domains

### The Structure for Offshoring

A critical consideration in any Offshoring strategy is the actual legal, management and control structure of the Offshoring entity.

The three fundamental options that were considered in our discussions were:

- Captive Business Process Offshoring entities ("Captive BPOs")
- Third-party entities
- Industry wide "Co Sourcing" arrangements

Historically, the Captive BPO has been the preferred path of Offshoring for most UK and US based global financial services firms. Prominent examples are SCOPE – the Standard Chartered vehicle, e-Serve – the Citibank vehicle, GE Capital International Services (GECIS) – the GE vehicle.

At that time, given the infancy of the Offshoring industry and the lack of vendors with specific process expertise, captive BPOs were the risk optimal route for pioneers to establish and manage processes offshore.

Given the control issues that concerned these organisations, their ability to drive scale on their own and their strong multiple geography presence and people capabilities, the 'captive' path was feasible and appropriate.

Lastly, these organisations also had the necessary scale and process volumes as well as the inhouse "re-platforming" experience to drive the productivity gains that were needed to make Offshoring work.

Consequently, a key issue our study participants discussed was whether a Captive BPO organisation was an appropriate structure for Australian banks and insurers.

A majority of respondents responded by discussing the following issues as key in evaluating the Captive model:

- Competitive scale and Brand strength

  Whilst these Australian organisations are typically large, scale-based players with strong brands domestically and thus able to recruit quality staff and dominate vendors, they would be relatively small players

compared to global institutions such as HSBC, Citibank or ING and would be constrained in their ability to both recruit quality people as well as get keen pricing and service levels from vendors.

- Continuous offshoring supply chain mgmt. experience

  Successful Offshoring is a continuous supply chain management process of identifying newer locations, newer vendors, newer domains to be offshored and performance managing existing ones.

  Whilst the pioneering global organisations would clearly possess this capability, most of the Australian organisations would find it quite challenging to develop and manage this function on an ongoing basis

- People capabilities in emerging markets

  Most of the prominent financial services Offshoring destinations are based in emerging market locations such as India, Malyasia or China.

  Managing these operations based in those locations and interfacing with the customer markets in Australia or NZ on a day to day basis necessitates the need to have significant capabilities at Group Executive levels to commit time and oversee these initiatives. Again, this poses considerable challenges for our participating organisations

- Uniqueness of Australian products

  Whilst not as major an issue as the above three, it must be noted that several Australian products especially in the Mastertrust / Wrap product space as well as the home loan space are quite advanced and unique with very little comparable elsewhere in the US or UK. The associated processes are also quite unique and would pose sizeable training and ongoing management issues during their Offshoring phases.

  The training costs of these unique processes can be quite substantial especially given their individual scale and would reduce the economic attractiveness of Offshoring.

On balance, given the special challenges that Australian banks and insurers would face, we do not believe that a Captive BPO is as attractive an option as it was for many of the global, early movers in Offshoring.

Although politically complex, an alternative model for Australian model of Offshoring which takes into account the unique complexities of Australian banks and insurers is an Industry-wide “Co Sourcing” Consortium approach.

Fundamentally, this model would be a legal structure owned by a few Australian banking and insurance groups with a “master” Offshore Services Manager – a global entity with delivery capabilities in various key offshore locations as well as a good understanding of “best of breed” vendor management in those geographies.

The banking and insurance groups would, in conjunction with the master Services Manager, jointly create a shortlist of key activity Domains across each of the individual organisations that have the highest potential for Offshoring at any point in time. Domain selection process would be carefully undertaken to anticipate and avoid Trade Practices and anti-competitive behaviour concerns from the ACCC.

The "master" Offshore Services Manager would work across the various geographies and use its own delivery capabilities as well as those of its partner organisations, to optimally structure and deliver the required activities to rigorous SLA standards.

This has the following advantages for the Australian banks and insurers:

- Community backlash and Reputational risk of Offshoring is spread across several organisations
- Relatively high degree of control (though not sole control like a Captive)
- Benefits of combined scale comparable to scale-based global players
- Rigorous and transparent Domain selection process
- Rigorous and disciplined initial and ongoing geographic selection process
- Rigorous and transparent vendor selection and delivery management
- Ease of ongoing performance management across multiple Domains, multiple vendors and multiple geographies

**Systems Capabilities**

The systems capabilities needed for Offshoring revolve around three important groups of technologies:

- Imaging systems

  Paper, as we have said before, represents a very big hurdle to successful Offshoring. It makes BCP quite challenging and increases the need for manual intervention. Further, it makes process related operational risk incidence data quite difficult to collect, monitor and analyse and thus, complicates OR measurement and management.

  Thus, Imaging systems constitute one of the basic building blocks for successfully Offshoring any group of processes and a significant number of participants recognised this. As mentioned above, most Australian institutions have already invested extensively in this technology which reduces the impact of Offshoring in some cases.

- Efficient workflow and workgroup management / load balancing systems

  Effective “remote” workgroup management is an equally significant part of any process Offshoring exercise. Most participants in our study pointed out the need for rationalization of existing workflow management systems and effective workgroup management tools.

  One banking participant pointed out how, as a preparatory step, they were focussed on bringing together the loan Origination, Documentation, Servicing and Settlement / Drawdown functions in various domestic geographies together to create multi-location workgroups.

  Another participant pointed out how a current initiative involving a rules based queuing system for personal loans and mortgages across various geographies had simplified BCP significantly by limiting manual intervention to just the “end of day” validation processes such as GL updating, fixings and rate resets.

- Reporting systems

  Across the various organisations there was a clearly articulated need for more sophisticated performance reporting systems especially considering the Offshoring agenda.

  We believe that the adoption of a standardized and well understood multiple stakeholder system like a Balanced Scorecard is a crucial ingredient of the goal setting and performance management of workgroups across remote locations.

  Such systems would allow workgroup managers to clearly identify “trade offs” that might need to be made such as flexibility for certain customer groups versus process unit cost and more importantly, quantify and communicate them across the workgroups.

**Phasing and Tiering**

Phasing and Tiering form a core axiom governing the Offshoring process.

Phasing implies the actual phasing of Offshoring Domains starting with more traditional transactional / back office domains and slowly progressing towards the middle office and customer contact domains.

In the case of an life insurance claims management process, the claims evaluation and assessment process would be Offshored in the first instance before moving the entire claims management process including the “physical” claims managers, offshore.

Tiering refers to the staggering of the complexity of the process / subprocess being Offshored. This means that even after deciding on a particular Domain to be Offshored, the simpler and more automated elements would be Offshored before the more complex, regulation and exception driven elements.

For example, in the case of a general insurance claims management process, the car and home and contents claims processes would be Offshored before the CTP and other personal injury claims which tend to be more manual in addition to being governed by state based legislation. For example, in the case of a life and disability insurer, claims only upto a certain pre specified limit (say $ 250K or only 12 mths cover) would be Offshored, in the first instance.

## Section 6:The Geographic Locations and Offshoring Players

Almost half the participants were familiar with at least one major Offshoring geography. We also came across a 'top of mind' dominance of two Indian cities – Bangalore and Mumbai- amongst participants.

While this is not an exhaustive list, our view is that any serious Offshoring geography selection by an Australian bank and insurer should consider at least four major geographies:

- **India – Bombay (Mumbai), Bangalore, Madras (Chennai), Hyderabad, Gurgaon (near Delhi) and increasingly, Calcutta (Kolkotha)**

  Clearly, India is one of the oldest and most developed financial services Offshoring geographies.

  Although Bangalore, once a 'retiree's haven' for South Indian pensioners, now captures the global media spotlight on India, Chennai, Hyderabad (located relatively close to Bangalore) and Gurgaon are increasingly popular destinations with global financial services firms.

  Standard Chartered's entity SCOPE commenced its processing operations in Chennai as did the Citibank entity, e-Serve, when it commenced retail processing in 1999 whilst GE CIS started in Gurgaon in 1998 and now has large transaction processing, shared services and risk management and finance analytics centres at Hyderabad, Gurgaon and Calcutta.

  These locations are recognised for the availability of high quality skills across the entire spectrum of skill bases in the single location – from good graduates for low value administrative and support functions through sophisticated engineers and MBAs for the "high end" analytic functions such as Dynamic Financial Analysis, M&A valuation and Equity Research to "rocket scientist" Ph.D's for specialised functions like super- catastrophe insurance pricing, options and derivatives modelling, Data Mining and Consumer behaviour modelling.

- **China – Shanghai, Shenzhen and Beijing**

  Increasingly, China is becoming an IT and processing hub of choice :
  - amongst "pan Asian" global financial services majors for e.g. HSBC which has now large IT and processing operations based out of Shenzhen and its Regional HQ based out of Shangai.
  - for Japan/Korea focused Offshoring via the unique language and service positioning of locations such as Dalian.

  Whilst the perceived attractiveness for an Australian bank and insurer might be currently hampered by language barriers, the rapid emergence of an English-based quality education system including the advent of

engineering and MBA programs with global affiliations would make it imperative to consider China as a serious alternative to India in the near future.

- **Malaysia – Kuala Lumpur**

  Kuala Lumpur, given its proximity, infrastructure and economics should be considered as an Offshore destination. The relatively recent Multimedia Super Corridor which acts as the IT and systems hub for KL enhances the attractiveness of KL as an Offshore destination.

  However, the relatively shallow pool of skilled staff especially in the higher end Analytic capabilities driven functions could limit the range of domains that can be based in KL.

- **South Africa and Namibia – Johannesburg, Cape Town and Windhoek**

  Despite the media highlighted problems with Africa, in general and South Africa and Namibia specifically, there is significant medium to long term Offshoring potential. In fact, South Africa's first technology and IT hub is slowly emerging on the outskirts of Johannesburg and Old Mutual is in the process of setting up the region's first Offshoring facility close to Cape Town.
  Given the specific industry skill base in the financial services industry, (Standard Bank and Old Mutual are probably quite advanced by global standards) the relatively large English speaking populations and the cheap real estate and labour costs, it would not surprise us if these two countries became significant offshore process locations, in the future

In addition to these locations, there are other established locations such a Philippines which have been providing services in some IT and other domains to large markets such as the US for more than 10 years.

For Australian financial services organisations, there are three locational alternatives that can be considered:

**a.** On shore in Australia e.g. Tasmania
**b.** Near shore - NZ or Fiji
**c.** Offshore – India, Malaysia, China etc.

There are also two strategic options that could be adopted:

**1.** Individually - each organisation on its own through Captives

**2.** Individually – each organisation but through Third Parties

**3.** Collaboratively, in some sort of a consortium arrangement

Putting these two together, we get this matrix of nine alternatives, below:

| | | |
|---|---|---|
| Offshore Captive BPOs | Offshore Third Party BPOs | Offshore "Co Sourcing" Consortiums |
| "Near shore" Captive BPOs | "Near shore" Third Party BPOs | "Near shore" "Co Sourcing" Consortium strategies |
| Onshore individual productivity strategies | Onshore Third Party productivity strategies | On shore "Co Sourcing" Consortium strategies |

Based on our discussions, over the next 12 mths, we expect 1 organisation to pursue a Near Shore Captive BPO strategy, 2 organisations to pursue Offshore "Co Sourcing" strategies and 2 organisations to continue pursue their current Offshore Captive BPO strategies

## Offshoring Players

One point of interest in most of our discussions was the capabilities of the various vendors and the activity Domains / functional groups in which they specialize.

As we have stated before, one of the specific challenges for an Australian bank and insurer looking to Offshore processes is the need for a detailed understanding of the capabilities of the various vendors across the relevant Domains and then contracting and performance managing those vendors.

The various vendors currently operating in the financial services Offshoring realm typically fall into six major categories:

- **IT and consulting enabled services providers** (for e.g. Accenture, Wipro Spectramind, Satyam, TCS, HCL Infosystems, Infosys, Mphasis)

- **Transaction processing entities** – usually entities fully or minority owned by other financial services groups (for e.g. e-Serve International (Citibank), SCOPE (Stanchart), GE CIS, HSBC's processing centres, World Bank's centre, ICICI OneSource).

  However, third party vendors such as Progeon and Msource have commenced transaction processing activities, as well.

- **Domestic customer contact specialists** (for e.g. Daksh, 24/7, vCustomer, Msource)

- **US contact centre specialists with large offshore operations** (for e.g. Convergsys, Spherion, ICT, TeleTech)

- **Finance and Accounting, HR, Pension / Super fund shared service providers** (for e.g. Accenture, India-Life Hewitt (40% owned by Hewitt associates), Nittany-Life India, Progeon

- **Analytics specialists for financial services** (for e.g. Quintant, Office Tiger, Evalueserve)

As can be seen from the above very few of the vendors possess all three attributes required – IT and systems integration skills, detailed Process knowledge for the relevant Domains and multiple geography / global scale.

Therefore, an Australian organisation looking to adopt a Strategic Sourcing approach might need to go through a carefully managed "Co Sourcing" arrangement involving a master Sourcing Partner who would assist and manage the multivendor / multi locational delivery process.

## Section 7 : Future Developments

Going forward, existing Offshoring functions/activities will continue to expand and be refined. However, there are several areas that are likely to emerge and therefore potentially impact the participants and their organisations:

- **Analytic capabilities emerging as a large activity Domain**

  As mentioned before, analytical activities are potentially suited to Offshoring given that most of them are not customer interfacing and that many analytical platforms, processes, practices, qualifications and skillsets are becoming globally standardized.

  Also, given the availability of high-quality skillset across the entire spectrum of skill bases in locations like India and China, we see analytical activities become a very large process Domain for Offshoring.

  Recent announcements by the World Bank, Morgan Stanley, HSBC and JP Morgan (included as part of the latest announcements section in the Appendix) who are setting up finance and accounting, equity research and analytic centres clearly point towards this increasing trend towards analytics Offshoring.

  The increasing popularity of venture capital backed third party analytic specialists such as Evalueserve, Quintant and Office Tiger is another indicator of this trend/.

- **Dispute resolution systems and BPO Insurance policies**

  We have not yet witnessed a major media showcased dispute between a client and an Offshorer or even, between client groups and Captive BPO entities within the same global group, as yet.

  Nearly 10% of participants in our study were concerned about the framework required to resolve significant disputes, as and when they occur, as well as the speed with which such disputes could be resolved. So far, any dispute has merely resulted in the client entity sourcing services from another vendor or negotiating more demanding SLAs.

  Although the current practice of specifying that disputes will be resolved by arbitration might still happen, we see this area changing quite significantly and more sophisticated and perhaps, industry specific dispute resolution systems being developed especially in the Offshore locations.

  BPO Insurance policies are another area that has slowly emerged as a risk mitigation measure for organisations planning to Offshore activities and processes. In recent weeks the first BPO insurance policy was brokered by AON (the UK based insurance broker) in the Lloyd's market for an undisclosed UK client.

## Section 8 : Financial Services Offshoring case studies

Whilst almost three quarters of participants had heard of or talked to someone associated with Offshoring entities such as GE CIS, HSBC…etc, there was an articulated need to understand more about these entities – their locations, the nature of processes and people involved, so on and so forth.

To help our study participants get a good "end to end" view of the full potential of Offshoring, we have chosen two specific financial services case studies – e-Serve International which is ***partly owned by Citibank*** **but a publicly listed** entity and SCOPE International which is a Standard Chartered controlled entity.

Both these entities have been in existence for a significant period of time; both have made the transition from IT and application development operations to complex transaction processing and shared services activities and increasingly, analytics outfits.

Further, both of these outfits and or their parent groups have publicly revealed sizeable target cost savings which we are confident would interest most of our participants.

Lastly, there is a significant body of publicly available information as well as analyst reports that enable us to profile them without in anyway infringing on confidentiality sensitivities.

In fact, we would like to emphasise that all the information in these two case studies has been restricted to information present in the public domain.

### Case Study 1: e-Serve International (the Citibank processing entity based in Chennai and Mumbai )

### Background information

e-Serve International is partly owned by Citibank but publicly listed entity and was formed by the merger of Citicorp Securities and Investments Ltd (CSIL) and Citicorp Credit Service India Ltd (CCIL).

In 1998, it changed its strategic mission from a finance company to an internal BPO organisation for various Citibank / Citigroup businesses around the world. It is a financial services focussed entity and is fundamentally managed and run by ex-Citibankers who have worked with Citi in various areas around the globe.

It currently services diverse Citibank entities in about 25 countries including the US, UK, India, Poland, South Africa and UAE.

**Size and Services offered**

It is the largest non-captive Offshoring entity in India and operates of 100,000 square feet of offices in Chennai (Madras) and Mumbai (Bombay) with a staff strength of about 4,000 as of June 2003.

Typically, the entity has processesed an average of around 70 million transactions and about 20 million calls, per annum, for the last 3 year period and revenue of about USD 40 million, for the last 12 month period.

It has specialized in three fundamental types of services for various Citibank entities:

- Transaction Processing services
- Technology Services
- Customer contact centres focussed around financial services products

Some examples of typical services that it offers various Citigroup entities under each of these categories:

Transaction Processing services

- Corporate cash management and Trade Finance processing
- Credit cards and Mortgages processing
- Insurance policies and claims processing

Technology Services

- Software Verification and Validation
- Customer Data warehousing and mining
- Application development services

Customer contact centres

- Collections for personal loans, credit cards and mortgages

**Strategic rationale and Impact on Citigroup**

In an SSB investor presentation at the beginning of the year (28th Jan 2003), Citigroup's CFO outlined the "Big Picture" impact of Offshoring by pointing out that over the last 5 years, Citi's costs have grown by USD 12 billion while its revenue base has grown by USD 30 billion!

Whilst no breakdown was provided as to the cost reduction contribution by entity, clearly, partly owned entities such as e-Serve International have played a part in that transformation !!

**Case Study 2: SCOPE International**
**(the Standard Chartered vehicle based out of Chennai and Kuala Lumpur)**

**Background Information**

SCOPE International is the Standard Chartered BPO entity based out of Chennai in India and Kuala Lumpur in Malaysia. Stanchart is an emerging market financial services specialist based out of London in the UK with a majority of its business in Asia and the Middle East.

**Size and Services offered**

SCOPE currently has about 2,000 employees based in Chennai in a 20,000 square feet office premises. The company expects to scale that up to about 5,000 employees to be based in three locations, over a 18mths to two years time frame (source: CEO presentation, Dec 2002).

SCOPE currently services Standard Chartered businesses in about 14 countries and plans to scale it up to servicing entities in about 40 countries in an 18 mths to two years time frame. SCOPE is relatively unique in that it offers substantial services to the Global Institutional Banking group of Standard Chartered in addition to the Retail Bank.

It currently provides services that fall in the following categories:

- Transaction Processing operations
- HR, payroll and shared services
- Finance and Accounting services
- Technology services

Some typical examples of these services are:

Transaction Processing operations
- Trade Finance, Cash Mgmt and Payments processing
- Credit cards processing
- Derivatives and FX settlement
- Custodial services

HR, payroll and shared services
- Payroll
- Employee Benefits administration
- Expat Management
- Pensions and employee share scheme administration

Finance and Accounting services

- Financial Accounting and Reporting
- Taxation and Reconciliations
- Management accounting and Budgeting
- AR / AP management
- Group Finance and Risk analytics such as group credit and market risk, portfolio VAR analytics…etc

Technology Services

- Insititutional bank IT help desks
- Software applications development
- Global IT sourcing and vendor management support

**Strategic Rationale and Impact of SCOPE on Stanchart**

The strategic rationale of SCOPE was recently outlined as “Cost reduction, Consolidation and Process redesign and replatforming” of Standard Chartered institutional and retail banking businesses. The expected impact of SCOPE is forecast to around USD 80 million per annum in steady state cost savings realisable over the 18 mth period.

## Appendix: Summary of recent financial services announcements (Sept 2003 to Nov 203)

1. **Aviva plc – UK and Canadian businesses** Date: 02 Dec 2003

   Domains: Car and Home insurance claims processing
   New business and administration back office
   IT and application development
   Customer and adviser contact centres

   Geographies: Bangalore (India) or Chennai (India) – decision awaited

   No. of jobs : 3,000 jobs over the next 12 months

2. **Lloyds TSB – UK** Date : 29 Sep 2003

   Domains : Call centres and Transaction processing

   Geographies: Hyderabad (India) and Bangalore (India)

   No. of jobs : 2,000 over the next 12 month period

3. **HSBC – UK and Asia** Date : 6 Nov 2003

   Domains : Analytics and research, Finance, audit and accounting

   Geographies: Shenzhen & Shangai (China), Chennai (India), Colombo (Sri Lanka)

   No. of jobs: 4,000 (no specified time period)

4. **Abbey National – UK** Date : 23 Sep 2003

   Domain: call centres and transaction processing

   Geographies: not disclosed

   No. of jobs: not disclosed but media reports place it around 1,500

5. **JP Morgan Chase** Date : Sept 2003

   Domain **:** Global Equity research, analysis and valuation support

   Geographies: Mumbai (India)

   No. of jobs : not disclosed but media reports place it at around 50

6. **Morgan Stanley – US** Date : 16 Sep 2003

   Domain: Fund accounting , Portfolio services, Equity Research, analysis and valuation support

Geographies: Mumbai (India)

No. of jobs : about 1,500

7. **World Bank group – global** Date: 18 Nov 2003

   Domain: Portfolio review, valuation, auditing and back office processing

   Geographies: Chennai (India)

   No. of jobs : around 200

8. **Bank of America / Fleet Boston – US** Date: 13 Oct 2003

   Domain: IT and systems development, Finance & Accounting and Risk Mgmt analytic support

   Geographies : not disclosed but media reports point to Chennai (India)

   No. of jobs : not disclosed

9. **ING Group – IT, Systems development and Data Analytics**
   Date : 27 Oct 2003

   Domain : IT and systems development, customer contact, new business and administration, life claims processing and management,

   Geographies: not disclosed but media points to Chennai (India) or Hyderabad (India)

   No. of jobs : not disclosed