

outsourcing in the financial services industry

relevant to Professional Scheme Paper 3.5 and new ACCA Qualification Paper P3

make or buy?

■ **Outsourcing decisions, traditionally known as 'make or buy' decisions, have been reliant on the accountant providing a comparison of costs. More recently, there has been growing interest in the use of outsourcing as an option to reshape an organisation's resource base and therefore enable strategic development. While cost remains a key issue in outsourcing, accountants need to be aware of the wider range of factors that impact on the decision.**

This article reviews the potential benefits and problems of outsourcing, and considers the results of a study of outsourcing in a service industry, that of building societies operating in the mortgage market. The study shows that many of the societies' value chain activities – both primary and secondary – are open to being outsourced, including product development, distribution, operations, and systems development.

Outsourcing creates new, possibly critical, dependencies and requires a new mix of management skills. Clearly, the decision to outsource requires formal policy guidelines. However, the study found these to be largely absent.

OUTSOURCING AS A STRATEGIC DECISION

Outsourcing has become part of a revolution in strategic thinking, the aim of which is to develop a more competitive organisation, one in which investment and management attention can focus on a narrower set of activities, namely the organisation's core capabilities. These capabilities form a chain of activities that managers integrate in order to create a distinct type of value for the

organisation's specific customers, thereby achieving competitive advantage. For each activity in the value creation system, the company needs to question performance. Does it provide a level of performance that is as good or better than any other organisation throughout the commercial world? If not, the following question must be asked 'could improvement be achieved through outsourcing or some other form of external supply, such as a joint venture?'

The improvements which can come from outsourcing are often strategic in nature: improved performance in terms of cost, quality, and flexibility, reduced overheads, a move towards more costs becoming variable, greater access to economies of scale and to advanced technologies, increased leverage of core knowledge and skills, improved focus on the development of core abilities, and a more compact organisation. Overall, the strategic use of outsourcing can lead to a profound development in strategic advantage.

It must also be noted, however, that outsourcing failures are not uncommon. While outsourcing contracts frequently target a minimum 15% cost saving (and sometimes 20 to 25%), failure to achieve anticipated cost improvements often occurs. The level of achieved saving may average 9%, although a large proportion of outsourcing clients only break even, or sometimes find that costs increase. Such effects may arise from low vendor estimates, misunderstanding of the contract, and the costs of establishing and monitoring supply. Similarly, outsourcing can result in reduced quality, particularly where service levels are poorly specified and

monitored. More seriously, outsourcing has been accused of helping to create the 'hollow corporation'. This is the cumulative effect of outsourcing decisions which were not made to provide leverage for a firm's skills and knowledge, but to incrementally undermine those core capabilities on which the organisation relies for its competitive ability.

The outsourcing decision has traditionally been the concern of the accountant. Framed as the 'make or buy' decision, outsourcing has required the skills of the accountant to identify, evaluate, and compare the relevant costs of using an external or internal source of supply.

As the outsourcing decision has become of increased strategic importance, so the skills required of the accountant have had to develop to ensure they are fully able to contribute to the development and implementation of an organisation's outsourcing strategy.

Changes to the ACCA qualification seek to provide accountants with such skills. Paper 3.5, *Strategic Business Planning and Development*, is being replaced in December 2007 by Paper P3, *Business Analysis*. This paper maintains the focus of Paper 3.5 on strategic analysis – assessing the context of strategic decisions in preparation for evaluating the available strategic choices, followed by implementation, change, and supply chain management. However, the new paper places greater emphasis on issues concerning changing business processes, information technology, quality, project management, and monitoring the outcomes of strategic decisions – issues which, together with effective strategic analysis, are often of critical importance to successful outsourcing decisions.

The outsourcing decision has, in many instances, become more strategic requiring recognition of other strategic factors and their longer-term development, in particular supply market conditions and the effective management of the supply chain. In addition, the accountant needs to constantly bear in mind that outsourcing decisions must be consistent with achieving increased strategic effectiveness, in particular by helping to develop the organisation's particular form of competitive advantage.

OUTSOURCING IN THE FINANCIAL SERVICES INDUSTRY

Much of the recent research concerning outsourcing has focused on manufacturing industries. Service industries, such as financial services, have been relatively neglected. In order to help understand outsourcing in a service industry, I conducted a study of building societies and their approach to outsourcing decisions.

In the UK, building societies supply mortgage finance to facilitate house purchases, and also provide other personal financial products such as savings and life insurance. For the study, interviews were held with six organisations, ranging from the largest, with nationwide coverage, to the smallest, a local building society serving a specific locality through the operation of a few branches.

Building societies are experiencing the same pressures which have resulted in many industries moving towards an increased use of outsourcing. The market is becoming increasingly competitive, requiring organisations to be far more aggressive in seeking performance improvement. Industry deregulation, the continuing entry of new competition, and the customer's easy access to information through published sources and the Internet have increased competitive pressure and made building societies more critical of how they maintain and improve performance. In addition, as for most industries, there has

been a growth of service providers to the extent that (in principle) any part of the value chain may be supplied externally. The cyclical nature of the main business – mortgage lending – also argues for the use of outsourcing as a means of shifting the risk of investing in assets to an outside provider.

OUTSOURCING THE VALUE CHAIN

The widespread potential for outsourcing can be illustrated by placing some instances of building society outsourcing into Porter's value chain model. The value chain provides a useful set of headings to help gain an overview of activities and how they are sourced.

Product development

Many of the building societies bought in products from other financial service providers, which the society then customised and branded. However, this strategy was only applied to peripheral products, not to mortgage lending.

The buying in of existing products widened the product range in a rapid and flexible manner and made full use of existing experience with the product. Where products were developed in-house, product development was often assisted by using agencies to support the organisation's own development process. Similar mixed sourcing patterns are very common in design-based industries such as clothing. Again, the main benefits are speed of product development and access to expertise.

Distribution

Products require effective distribution in order to access the market. Building societies have traditionally distributed their products by means of the ownership of a network of branches – retail outlets that provide customer contact and opportunities for the cross-selling of products. Such a strategy requires extensive investment without significant additional cost. Such agency arrangements are often used in peripheral locations that would not merit a branch.

A large society may have over 1,000 agents, collectively introducing the majority of the society's mortgage business. Consequently, these activities are closely integrated into the society's lending processes and information systems.

Operations and their development

Operations concern the day to day activities of a building society. For mortgage lending, this includes vetting the application, risk assessment, the provision of legal services for the transfer of property, and the processing of transactions from existing mortgages. The recurring nature of such activities invites examination of their efficiency. All of the organisations surveyed outsourced legal services either in whole or in part. The market for legal services is made readily accessible by a society creating a list of approved solicitors to undertake the routine task of property transfer. A similar pattern of outsourcing is used for property surveying, providing geographic coverage at an economic cost.

Operations are frequently reliant on an appropriate information system. While in many industries the development of information systems is largely outsourced, the building societies often expressed a strong preference for in-house development. Reasons for this practice involved a number of beliefs: that IT was a core activity which impacted on the customers' quality of service, it involved issues of confidentiality, and it was often believed to be more cost-effective when handled in

house. IT developments were most likely to be outsourced when there was pressure on existing resources and to help meet deadlines for systems development.

Nevertheless, developments in IT have confronted all building societies with new uncertainties and potentially high investment costs. In meeting this problem, both large and small societies have benefited from developing cooperative supply arrangements. 'Link' was established as a consortium to provide members with a national network for automatic telling machines (cash machines). The consortium enabled its members to overcome problems of limited expertise and geographic spread when supplying a new service to customers. Smaller societies have also benefited from membership of software user groups that provide them with a forum for discussing information technology developments, and the joint commissioning of software projects. For a small society, the cost of software may be reduced to less than 10% of the equivalent if it had acted on its own.

SUPPLY CHAIN MANAGEMENT

External supply requires the development of new management skills. Managers need to develop skills in identifying potential suppliers and evaluating their reliability. Contracts will need to be specified and negotiated to deliver standards of performance which the buying organisation may not have explicitly recognised before. Change management is required to address changes in employment required by outsourcing, and to deal with the possible loss of motivation experienced by in-house staff. In addition, managers have to learn how to work with the supply organisation and its different culture, and to effectively monitor supplier performance. Many of the societies in the study recognised that outsourcing, and the associated need to negotiate, coordinate, and monitor suppliers, often added to management costs.

There have been a number of surveys of management opinion on whether outsourcing relationships are helpful to an organisation. Responses vary between a majority expressing dissatisfaction and, in other surveys, expressing satisfaction. However, such conclusions are often drawn from managers who have limited

evidence on which to base their opinion. Only half the surveyed organisations measure the performance of outsourced services to ensure claimed benefits are being achieved. The building society study found a widespread belief that in-house operations were more reliable, flexible, and efficient. At the same time, in many areas, in-house performance standards only received careful attention when outsourcing was being considered.

THE ABSENCE OF AN OUTSOURCING STRATEGY

Outsourcing decisions often have critical importance for an organisation. However, of the building societies surveyed, only one had a comprehensive, documented set of guidelines for outsourcing decisions. The policy defined the role that outsourcing should play in the society's development and defined the delegation of the decision to specific levels of management, according to risk of impact on service quality, brand, budgeted cost, and the impact on the society if the vendor had to be replaced. The guidelines also addressed the operation of the outsourcing relationship in terms of cultural compatibility, joint planning, and the development of a long-term relationship.

In the other building societies, formal policy guidelines frequently encouraged an active consideration of outsourcing and, within the societies, there had emerged some shared beliefs concerning the role of outsourcing.

Greater reluctance was shown when considering the outsourcing of any activity that was regarded as close to the society's core (defined by product or expertise). Outsourcing was most likely to be used in an attempt to reduce costs, although it was widely doubted that outside providers were more efficient. Outsourcing was also regarded as a way of meeting deadlines when internal resources were overstretched, and suitable for those non-core areas where expertise was lacking and issues of security and confidentiality were not significant. The respondents also preferred to avoid situations where vendors might exert their power, and where the reinstatement of in-house provision would be difficult.

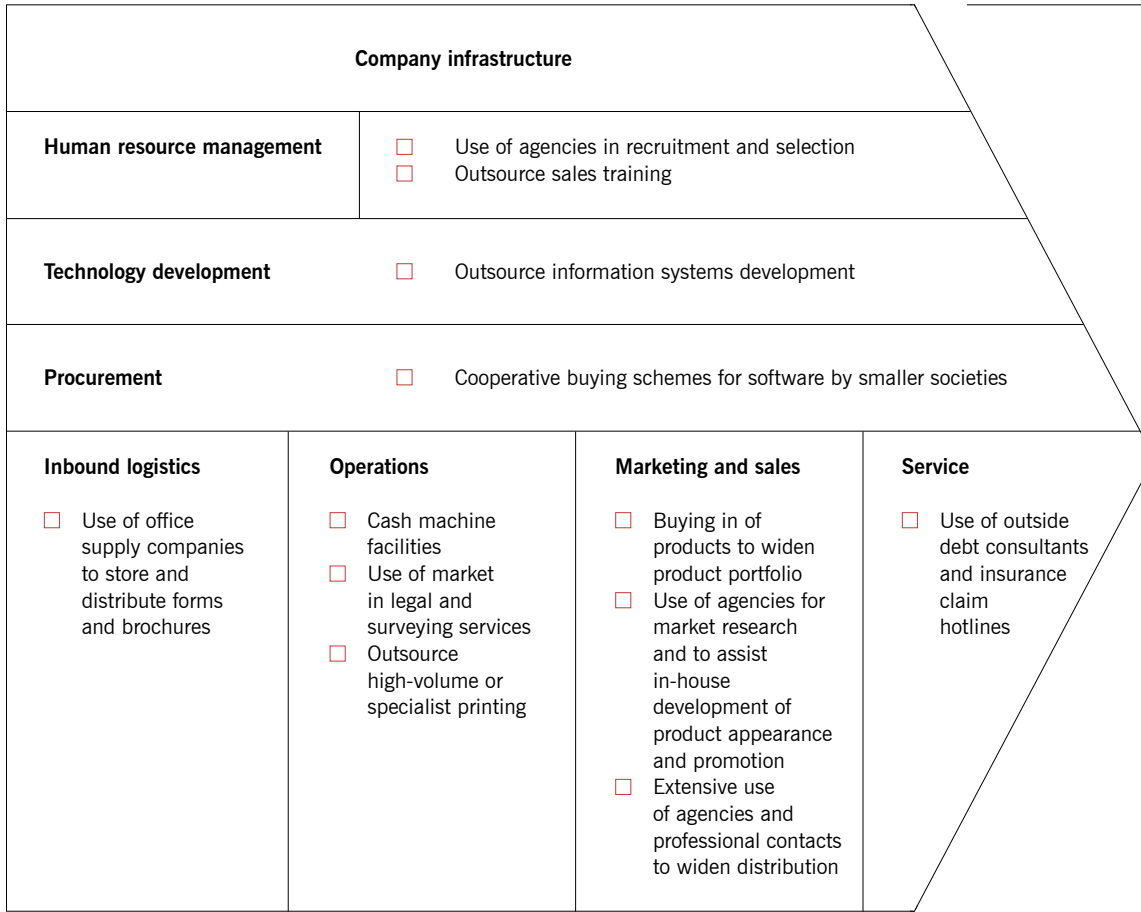


FIGURE 1: OUTSOURCING THE VALUE CHAIN
 (Adapted from Porter M E, *Competitive Advantage: Creating and Sustaining Superior Performance*, Free Press, New York, 1985)

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The above typify two approaches to policy formation – deliberate and emergent. Both approaches address the issue of risk. However, the formal approach invites a more proactive and controlled development of outsourcing decisions.

MAKING OUTSOURCING DECISIONS

Each industry and business is, in some respects, unique. Consequently, the factors that should be considered when making an outsourcing decision will differ between each organisation and its specific context. Standard analytical tools, such as PEST and SWOT, are useful when considering the context of outsourcing decisions, while the value chain model helps maintain an overview of the sourcing decisions being made by an organisation.

Cost analysis has been the traditional focus of outsourcing decisions. The study indicated that the building societies often developed a comprehensive analysis of variable and overhead costs which included all of the activities associated with the operation of the activity, its supporting assets, and its development. In addition, several respondents included the opportunity costs associated with those resources that would be made available through outsourcing, such as an alternative revenue stream that could be established by in-house staff, or alternative use of office space.

In principle, cost analysis should also be extended to include the costs of the potential supplier. To avoid the familiar disappointing cost performance of outsourced activities, any claims for a lower cost of supply must be confirmed by identifying such cost drivers as economies of scale, superior learning leading to cost reduction, and labour agreements that provide a lower cost base.

Many of the respondents in the study showed great sensitivity to conditions in supply markets, with concern for both the current and potential market power of suppliers. The relevant number of potential suppliers represents those who are available and can meet the required standard of performance for the outsourced activity. Generally, the loss of in-house supply was felt to strengthen a supplier's potential bargaining power unless it operated in a competitive market, or the building society did not face significant barriers to reinstating in-house supply.

Longer-term issues, concerning the degree of concentration in the supply market, should also be considered, as well as the financial strength of suppliers and their future stability. The willingness of suppliers to understand the organisation's particular needs and, if necessary to engage in activities that enable integration such as planning, together with the degree of cultural compatibility, were all seen as relevant supply conditions.

CONCLUSIONS

Many industries face similar conditions to the financial services industry. These include increasing competitive pressure, the need to achieve developments more rapidly, and variable demand and the consequent threat of periodic excess or insufficient in-house capacity.

Each of these factors calls for a closer examination of the outsourcing option. The accountant, through developing cost comparisons, has always had a key role to play when making outsourcing decisions. The outsourcing decision has, in many instances, become more strategic requiring recognition of other strategic factors and their longer-term development, in particular supply market conditions and the effective management of the supply chain. In addition, the accountant needs to constantly bear in mind that outsourcing decisions must be consistent with achieving increased strategic effectiveness, in particular by helping to develop the organisation's particular form of competitive advantage.

Making outsourcing decisions and managing supply relationships requires wide-ranging expertise. This requires a team approach in which all members – including the accountant – seek to develop a full understanding of what can often be a complex strategic decision. ■

David Jennings is a marker for Paper 3.5