No Nasty Surprises

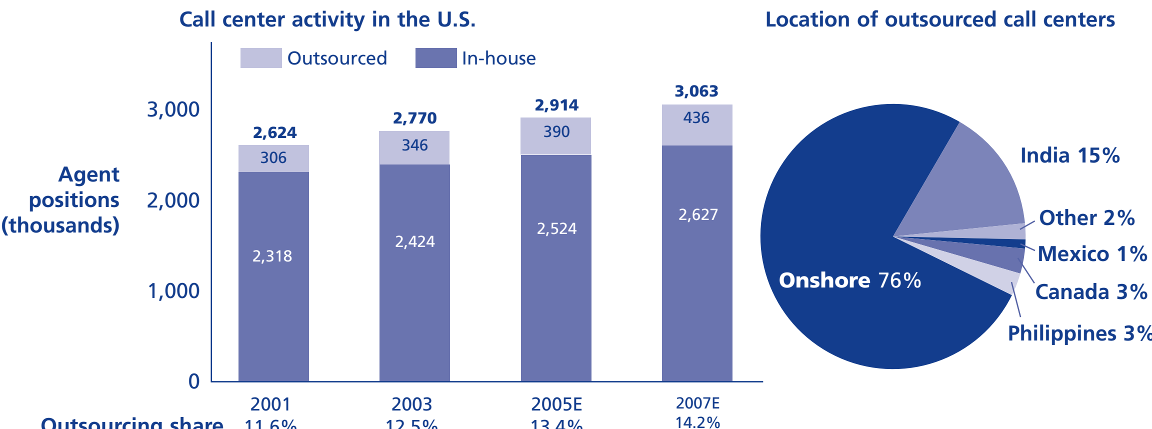
Anticipating the hidden risks of outsourcing

By Olivier Fainsilber and Andrew Chadwick-Jones

As more companies move to outsource services currently performed in-house, they'll likely encounter a slew of risks, some of which become clear only when something goes badly wrong. Managers will have to mitigate these risks in order to reap the substantial benefits that outsourcing provides.

From the U.S. Midwest to India, China, and Eastern Europe, global outsourcing is booming. More and more companies across a range of industries are discovering that the external sourcing of services traditionally performed in-house can provide significant benefits. Outsourcing gives companies the ability to leverage suppliers' scale, expertise, and systems; access suppliers' lower labor and even capital costs; provide higher quality and more stable processes; and to focus on the core business.

Exhibit 1 **Just starting to outsource?**



Source: Mercer research, Datamonitor, Gartner

We have written about the secrets of managing supplier partners adeptly ("Outsourced, But Not Out of Mind," *Mercer Management Journal 18*). This article will deal with the many risks involved in outsourcing. The risks of flawed provider selection and management are considerable, especially for critical or large activities. Millions of dollars in direct costs and lost opportunities, not to mention management time, are at stake. A recent AMR Research survey found that 80% of outsourcing deals did not meet the targeted return on investment.

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Some of these risks are relatively obvious, such as the risk of poor service quality by a provider. But other risks may not become clear until something goes badly wrong. Fortunately, there is a proven framework and an array of best practices that can help managers mitigate the risks inherent in outsourcing.

Understanding the types of risk

Outsourcing risks can be grouped into four categories. *Strategic risks* threaten the business by moving it in a fundamentally harmful direction. Most risks that arise in outsourcing, however, are *operational risks*, which encompass a range of service-related, staffing, and governance issues. *Financial risks* include the unexpected costs, regulatory issues, and liabilities acquired through outsourcing. *Hazard risks* entail potential natural disasters as well as the political and trade elements associated with offshore outsourcing. While certain risks can be insured against, many cannot and require other countermeasures by senior managers. Therefore, after reviewing some of the key risks, we will outline a practical framework for making an effective and concerted effort in planning, ongoing management, and risk mitigation.

Strategic risks
As the scope of outsourced activities has widened, outsourcing providers are more likely to affect companies' core businesses. Among the major risks are these:

- *Loss of control*. Attention to the outsourced activity may tend to lapse as knowledgeable staff depart for greener pastures or are laid off, leaving fewer people to keep up with advances in the functional area. At some point, the company has little effective control. JPMorgan Chase recently announced it would bring back in-house a major set of IT activities it had outsourced to IBM in a seven-year, $5 billion deal. The bank now feels it is critical to manage and control IT directly to gain competitive advantage. Some 4,000 IBM employees will be transferred back to JPMorgan just two years after the contract was announced. The cancellation penalties, missed opportunities, and other transition costs involved in such decisions highlight the value of careful analysis of objectives and options prior to launching any large outsourcing initiative.

- *Brand damage*. Retailers such as Nike have been tarred with the "bad practices" brush because of their choice of product suppliers in China and Central America, while Wal-Mart's brand has been tarnished by allegations of improper hiring by a subcontractor. Banks and other service businesses are just as vulnerable to perceived misdeeds by providers in distant geographies. These potential costs must be considered early to avoid costly surprises later.

- *Arrested evolution*. Business requirements inevitably change, and an outsourcing solution defined from a short-term, static perspective likely cannot respond adequately to rapid growth or new challenges. Companies thus may face a costly reassessment and complex transition of providers. This can materialize as an inability to serve new needs, to scale up, or to innovate. In one recent case, for example, Mercer helped design and execute a major re-sourcing of external strategic services for an airline dissatisfied with the incumbent provider's level of engagement and its ability to increase its scale.

Operational risks
All of the operational challenges related to in-house activities persist when outsourced, but they may be less visible and harder to correct. Operations can go awry in numerous ways:

- *Poor service performance.* This problem can defeat the most attractive cost advantage. Capital One cancelled a contract with Spectramind, India's largest call center provider, after instances of workers tempting credit card customers with unauthorized free gifts. Poorly integrated processes, language difficulties, or contextual unfamiliarity also can threaten customer service. To minimize service risks, one major retailer maintains a small team to integrate new service providers into its ongoing operations, viewing the skills for ramping up new vendors as replicable across functions.

- *Weak governance by the buyer.* At a leading high-tech company, a major operating function had been outsourced to the same provider independently by four different divisions via seven contracts worth a total of $100 million annually. Only when one of the divisions expressed dissatisfaction with the supplier's responsiveness did managers connect the dots. Not surprisingly, the provider then resisted attempts to centralize control over its activities. Success in complex outsourcing relationships demands cross-functional teams, senior management leadership, and metric-driven processes.

- *Staff resistance.* Outsourcing can profoundly disrupt staff and cause lower morale, lower productivity, higher turnover, and reduced service delivery. Employees should be actively involved in the project, with retention plans, role changes, reassignments, job shadowing, severance programs, and interviews with the provider all part of the plan.

- *Process fragmentation.* How will the outsourced processes link to other key internal activities? As one bank manager we interviewed put it, "Moving IT across the street was a disaster. How could we ever contemplate offshoring?" The CEO of a software firm that sends development offshore to its India office notes that much of the important knowledge is not committed to paper: "There's so much knowledge sitting in people's heads that even if you sit down to document things, you miss out on quite a few items that you only remember when a problem happens." Joint process analysis prior to launch and continuing close interaction with the provider are critical to ensuring that various processes function well together.

Financial risks
Through lower wage rates, economies of scale, and a specialist's expertise, outsourcing can deliver savings of 25% to 50%, after adjusting for incremental management and communications costs. But just as enterprise resource planning rarely lived up to the promised return on investment, outsourcing also holds numerous financial risks:

- *Unforeseen costs.* In the first flush of enthusiasm, managers rarely reckon the costs of evaluating vendors, managing major contracts, traveling to offshore sites, enhancing security, and paying severance for laid-off workers. In addition, standardized services rarely meet the needs of the business, and customized solutions by the vendor will likely add between 15% and 30% to the cost. Finally, exit costs can be substantial, as ending an arrangement prematurely exposes both buyer and provider to litigation. Managers should plan realistically for the full range of costs, creating detailed financial models and testing scenarios to make sure the decision will still look good if various factors go wrong.

- *Regulatory risks.* Restrictions on outsourcing motivated by protectionist instincts are appearing on state and local ballots in the U.S. and might be debated in Congress. Even without dramatic change, companies remain responsible for regulatory compliance in areas such as corporate accountability and privacy, and this clearly extends to their vendors as well. Sarbanes-Oxley, Basel II, and numerous other statutes and regulations in the U.S. and Europe require compliance by financial service and other firms, as well as by their providers. Yet not all outsourcers can assure customers that they are fully compliant. This is another reason for a comprehensive due diligence process.

Hazard risks

Natural and man-made risks can rise exponentially when crucial business services are outsourced to far-flung locations. The challenge is to identify the full range of potential issues upfront and approach them through a careful assessment of the levers available to mitigate potential problems. Among the most common hazard risks are these:

- *Workers' compensation surprises.* Depending on the wording of contracts, the vendor's employees might be considered leased employees of the client company. If so, numerous problems could surface regarding workers' compensation. Countries and states differ in their treatment of which company is the employer, with some conferring that status on both the buyer and the provider. If the buyer is not considered the employer, it may still be vulnerable to a lawsuit by an injured outsourced employee.

- *Personal injury gaps.* Commercial general liability policies generally do not cover personal injury (e.g., libel and slander) assumed under contract. Depending on the contract wording, either party may be assuming liability for which it has no coverage. For example, a vendor that infringes on a person's medical privacy may lack the right insurance despite contract language holding it responsible. The claim likely will be made against the vendor and company that collects the information.

- *Errors and omissions coverage.* Offshore outsourcers may not carry the levels of protection against errors and omissions (E&O) that major corporations expect of their vendors. In India, for example, E&O coverage is generally available only up to a $5 million limit. Those contemplating externalizing critical functions should insist on proper coverage by their suppliers. This may mean using specialist underwriters such as those in the London insurance markets.

- *Political risk.* Dealing with distant vendors gives rise to potential risks of expropriation, trade disruption, and exchange rate fluctuations that can have major impacts on a company's costs and supply chain performance. These risks are best handled via a combination of due diligence, splitting the work across several geographies, and insurance.

- *Natural disaster risk.* Fire, earthquake, and other natural disasters can disrupt activities at a vendor's location and cause the contracting company to lose income. The situation is worse if the vendor does not maintain adequate property insurance. The best response is, first, to maintain adequate amounts of "contingent time element" insurance under the property policy and, second, to have the vendor maintain adequate property insurance on an "all risks" basis, including business interruption coverage.

A framework for managing the risks

Despite the many types of risk surrounding the selection and management of outsourcing providers, there are also many successful examples of outsourcing. Of the thousands of companies that have off-loaded IT operations, for example, only 3% later took them back, according to a 2003 survey by the Gartner Group.

Mercer's research into both successes and failures has identified best practices that can help managers avoid pitfalls in planning and managing major outsourced activities and advance to strategic partner management. Our insights stem from multiple engagements helping clients think through what and why they should outsource, how to select the right partner, and then how to manage the relationship to ensure the best performance. The industries researched include banking, retailing, telecommunications, electric power, transportation, high technology, and manufacturing.

Our key findings: Successful outsourcing begins by asking the right questions, entails a substantial partner selection process, and continues with sophisticated governance arrangements. Successful outsourcers evidence a level of attention throughout the relationship that goes well beyond the usual procurement approach. An effective approach to outsourcing consists of three major phases (see Exhibit 2).

Exhibit 2 **Framework for successful outsourcing**

1. Strategy
Opportunity assessment and business case

Decide whether and what to outsource

- Define objectives and potential options, including:
  - Target functions
  - Operational control
  - Location parameters
- Assess options
  - Economics
  - Quality and service levels
  - Risks (quantified)
  - Best practices
- Recommend option and build business case

2. Launch
Partner selection and implementation

Choose best partner and launch the deal

- Develop criteria and identify potential partners
- Manage proposal process
  - Structured approach
  - Outcomes modeling
  - Process reviews
- Transfer insurable risks
- Negotiate agreement
- Design sound governance
- Plan transition and launch

3. Management
Ongoing control and improvement

Manage and improve performance

- Manage key performance indicators via robust relationship model
- Assess existing arrangements, potentially:
  - Renegotiating contract
  - Finding new partner
- Re-evaluate outsourcing approach, potentially:
  - Changing strategy
  - Extending scope
  - In-sourcing or spinning off

The first phase involves deciding whether, what, and how to outsource. A full range of options, including in-house shared service solutions, should be assessed in light of economic costs and benefits, potential service levels, quantified risks, market capabilities, and competitive realities (see Exhibit 3). We term this broad consideration "right-sourcing," since outsourcing is but one possible outcome.

Exhibit 3 **Outsourcing paths**

Typical starting point

Captive/Onshore

Advantages
• More control over quality of service • Proximity to other company operations • In-house knowledge retention
Disadvantages
• More expensive labor • Difficult to achieve 24-hour coverage

Basic outsourcing moves to consider	Advantages	Disadvantages
1 Captive/Offshore	• More control over quality of service • Knowledge retention • Lower labor costs • College-educated agents	• Cultural barriers • Weaker infrastructure • Significant training • Economies of scale needed for profitability
2 3rd Party/Offshore	• Lowest labor costs • College-educated agents • Lower startup costs	• Cultural barriers • Weaker infrastructure • Significant training • Less control over quality of service
3 3rd Party/Onshore	• Proximity to other company operations • Strong IT infrastructure • Access to experienced pool of vendors	• Higher labor costs • Less control over quality of service

Companies sometimes ignore this phase when they are intent on rapid cost shedding and have been blinded by articles about miraculous offshore solutions. Yet their objectives may be unclear and even conflicting. Marketing and Finance functions, for example, have different views on which capabilities must be kept in-house to maintain control. The understanding of current costs, processes, and the potential for improvement may be so limited that the company cannot accurately estimate potential gains from outsourcing. Thus, an objective assessment of the starting position, major objectives, and possible solutions is an essential first step.

The second phase entails selecting the best partner, reaching a formal agreement, and planning for the transition. One funds manager we interviewed who outsourced back-office transaction processing told us this is the most important part of the whole approach. We recommend a structured process progressing from a Request for Information to a Request for Proposals and ultimately the crafting of a Service Level Agreement. The process works best when conducted by a cross-functional team.

Projected outcomes should be modeled and compared across proposals and with the current situation. This should include value (defined as sales increases, customer satisfaction, up-time of critical activities, or key quality aspects) as well as costs. You should review processes with potential providers, jointly revise them, and establish performance indicators and incentives,

linked to exceeding service goals (such as percentage of questions answered on the first call) or savings targets (for example, 50-50 sharing of the first year's gains) in order to align the interests of both parties.

Penalties tend not to be useful here. One manager at a financial services company told us, "If it ever came to the fine print, we knew the relationship was over." Review the insurable risks and expand coverage as needed. Finally, negotiate the deal and prepare specific transition plans. The transition from in-house to outsourced services, or from one provider to another, may be the toughest part of the relationship and deserves extensive planning and preparation.

The third phase involves deepening the relationship structure and measurements to ensure strong performance over time. Many companies don't anticipate the complexities of managing large outsourced relationships. If services are outsourced on an *ad hoc* basis, responsibility diffuses throughout the organization. The solution is formal partner management that includes monthly or quarterly customer/supplier meetings to ensure prompt resolution of problems and ongoing check-ups on business objectives. Senior executives from client and provider organizations must meet regularly to build trust and ensure prompt issue resolution. Partner management teams should include multi-functional and cross-business unit members to properly govern complex outsourced relationships.

Annual check-ups serve to evaluate major service suppliers from a strategic perspective. As part of the check-up, ask: How are needs changing? What is the trend in vendor performance? Are there new opportunities available in the marketplace? The answer may be a move to renegotiate or seek a new partner, or to change strategy by outsourcing more activities or bringing back certain functions in-house.

Improving the odds

Throughout this process, adherence to a handful of best practices will improve the odds of success:

- *Make a "right-sourcing" decision based on strategic goals,* not just tactical urgency. Use an enterprise-wide assessment of cost- and productivity-enhancing options.

- *Invest in a robust selection process.* It's not easy to switch vendors later, so careful consideration, interviews with other clients, detailed modeling, multi-level contacts, and due diligence investigations are worth the effort.

- *Retain domain knowledge.* Keep critical strategic know-how inside the organization so that vendors don't become competitors and the company remains in control of strategy.

- *Communicate fully with current employees.* They must shift from an initial position of fear or anxiety to one of positive collaboration in transferring knowledge to the vendor.

- *Build joint company-vendor teams.* Joint transition efforts help to fine-tune and introduce new processes. Training and site visits should flow in both directions.

- *Define appropriate performance measures.* Key performance indicators should address service delivery quality and total costs, and they should be within the provider's clear control.

- *Provide the right incentives.* Baseline and stretch targets for provider payment should directly link to service levels, and supplier staff bonuses at every level should align with contract incentives.

- *Assess insurance coverage.* Determine possible gaps by thoroughly reviewing all relevant policies, adding needed coverage, and seeking suitable provider liability.

- *Design an exit strategy.* Prepare to survive a contract termination, when operations might need to be transferred to another vendor or brought back in-house.

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Strategic services outsourcing can add value through direction setting, intelligent analysis, committed management, measurement, and appropriate risk transfer. To realize the benefits, companies must anticipate and address the many risks involved in outsourcing. Developing and following a robust framework for outsourcing decisions, partner selection, and partner management provides the best assurance that outsourcing will be rewarding to both outsourcing companies and their partners.❖