IBM Global Business Services

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The value of relationship and services assets in outsourcing

Few who entered into multi-year outsourcing relationships over recent years could have predicted the recent economic turmoil, the series of bank failures, acquisitions and bailouts or the current cost pressures in the banking sector. As banks seek greater efficiencies from their current outsourcing contracts and also consider the potential for further efficiencies from a new wave of outsourcing, how can value be measured and assured?

Value in any outsourcing arrangement is a combination of business value (the level of IT alignment and customisation to directly support and drive business outcomes as well as the level of service to ensure certainty of business outcomes), economic value (the cost savings and efficiency derived from more efficient IT management) and relationship value (a far less tangible and often overlooked dimension).

Research by the IBM Institute for Business Value shows that 90% of financial markets executives and government officials believe the returns of the past are over. Operational expenditure is therefore expected to be under real pressure for the foreseeable future. A consequence of this, which was also highlighted by our research, has been a dramatic increase in the number of firms considering outsourcing.

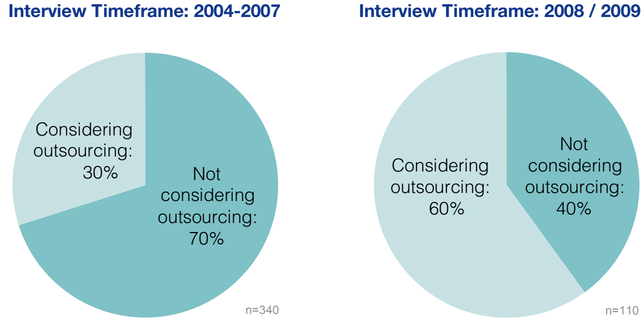
Evolution of outsourcing:
In the past such a swing to outsourcing might have been purely in pursuit of economic value, but the outsourcing sector has matured and evolved over recent years and business dynamics have changed dramatically.

Initially the sector saw a host of 'mega-deals' in which clients invested in large long-term contracts, often on an exclusive basis, in order to achieve dramatic cost-efficiencies. While this was primarily in pursuit of economic value, it also represented a significant investment in relationship value with a long-term commitment to a single supplier, which some saw as potentially restrictive.

This was followed by a swing towards 'multi-sourcing' where clients shared work across a host of smaller vendors, each of which typically exploited labour arbitrage to offer siloed cost efficiencies. Clients were free to switch vendors, but usually failed to capitalise on cross-silo efficiencies and found that labour arbitrage offered only short term efficiency gains. Furthermore their lack of investment in relationship value carried an unexpectedly high overhead in supplier management, governance and complexity.

90% of executives interviewed believe the returns of the past are over, and are searching for ways to cut costs; 60% of firms surveyed are considering outsourcing

Question Asked: Is your Firm Considering Outsourcing?
(Percentage of Executives Interviewed)



Source: Primary interviews; IBM Institute for Business Value analysis

We now appear to be entering a third phase in which relationship value is again being recognised, just as we are starting to see economic value being realised in a whole new way - through greater automation of both processes and labour. Finding someone to do the same job for less reduces your labour costs only so much, but automating the task can completely reduce labour costs to zero.

The Pursuit of Economic Value through Services Assets

This trend has the power to change the IT services industry completely. Previously each services engagement might have employed an army of IT and business consultants to create a unique solution for each client. However, the continual need to increase efficiency and productivity is driving a move towards the creation of service assets. These service assets embody the essence of service functionality and can be used across engagements. This move towards reusable service assets can reduce the cost of the design aspect of services, because it is less labor-intensive cutting down on the need for particular service professionals. Use of proven assets also helps to reduce project risk.

The trend is blurring the lines between software and services. Software is inherently technology-based, whereas services are historically people-based, with people, interactions, and relationships at the core of the discipline. These distinctio however, are becoming less important as a spectrum of n options emerges.

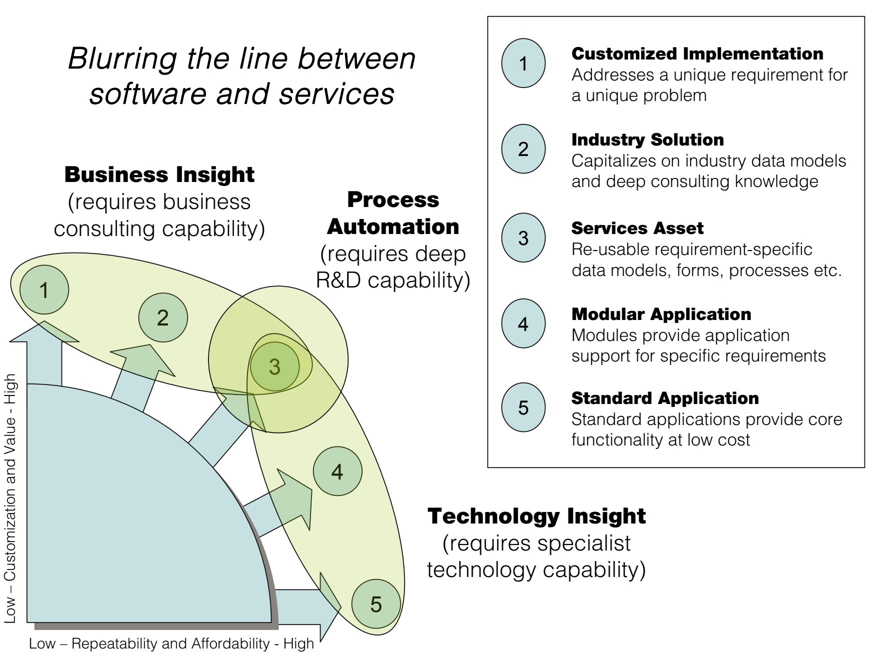
While technology plays a pivotal role in services, the development of services assets requires the right balanc between people and skills (which implies customization, business value and differentiation) and service asset reus (which implies standardization, commoditization, repeata and affordability).

The development of services assets typically requires an understanding not only of technology, but also of the particular business processes inherent in a particular business area. Developing such assets, however, is a far from trivial challenge and it requires a complex combination of capabilities:

- **Specialist technology capability:** process automation requires terrific software expertise. Forward-looking services business will ensure that they have a strong, complimentary software business as effective automation is impossible without it.

- **Business consulting capability:** process automation requires in-depth industry expertise and deep business consulting capabilities. This is essential for the development of industry-specific frameworks, along with requirement-specific data models, forms and process maps.

- **Research and development capability:** using process automation and services assets to solve some of the most complex problems facing business and government will require the application of advanced analytical methods and optimization techniques (such as behavioral modeling). These will require significant R&D capabilities, particularly in the detailed refinement of requirement-specific optimization.



IBM aims to offer world-class expertise in consulting, technology and research to automate labor-based processes and to create repeatable software-like assets.

There are many approaches to process modeling from traditional business process re-engineering techniques to IBM's own Component Business Modeling methodology, but real process automation requires extensive investment in the development of a detailed underlying information framework (including data models, function models and workflow models) as well as a robust industry architecture.

IBM has already made this investment, using industry standards including ISO message formats and Service Oriented Architecture (SOA) to underpin its Information Framework (IFW) which has been proven in use over recent years by over 250 banks and 150 insurance companies worldwide.

This ability to develop services assets in order to automate processes will enable services firms to break the historical linear relationship between headcount and revenue. It can also help to dramatically alter the economic value of all services or outsourcing relationships.

Appreciating Relationship Value

The scale of the investment required to automate processes as well as the complex combination of capabilities required to do so is narrowing the field of potential suppliers, at a time when relationship value is again being recognised in the outsourcing equation.

Few if any outsourcing contracts survive unaltered for the duration of any outsourcing relationship. Inevitably cost pressures and changing business requirements lead to mid-term renegotiation. Indeed there may be many phases of renegotiation during the life-cycle of any relationship. Most contracts start with a focus on economic value in an effort to drive down costs.

Subsequent changes in business requirements, possibly following acquisition, expansion or a drive for growth or customer service improvement can lead to a swing towards business value orientation in the outsourcing relationship. In the current climate however many companies are looking to cut costs over and above any savings already achieved. This is leading to a renewed focus on capitalising on relationship value.

In any outsourcing arrangement value needs to be realised by both parties in order for the relationship to be fruitful over the long term. Where this is the case and where a close relationship exists, there are opportunities to extend the relationship value in order to gain further economic value:

- Extending the scope of a contract can offer significant savings: going from a desktop outsource to a full infrastructure outsource can provide scope for greater efficiencies and enable the supplier to pass further savings on to the client. Likewise extending a regional contract to include additional regions or even a global remit can also provide scope for additional savings.

- Extending the length of a contract can also offer significant savings: likewise going from a five to a ten year outsource, not only allows a longer period for start-up costs to be offset, but can also provide scope for greater long term efficiencies and enable the supplier to pass additional savings on to the client.

In the current climate we are seeing banks use both of these techniques to seek savings. Indeed we have seen a definite trend recently for banks to look for longer term contracts, with extended scope, where greater commitment and investment in relationship value are used to achieve increased cost efficiency over the long term.

This return to relationship value orientation not only offers scope and scale efficiencies but also cross-silo integration efficiencies and reduced supplier management, governance and complexity. However such long term contracts require great consideration:

- Relationship alignment: any attempt to capitalise on relationship value depends on a shared relationship orientation and a close alignment at executive level to ensure that the relationship works for both parties over the long term.

- Flexibility: clients must ensure that contracts terms allow for convenient adaptation, extension or termination as required, allowing for developing business requirements.

- Breadth of capabilities and geographic footprint: scale and scope efficiencies can only be obtained from an outsourcing provider that has the necessary breath of capabilities or geographic footprint to allow for such contract extensions.

- Financial longevity: while clients focus on cost savings to ensure their own survival during the current downturn, recent corporate defaults and the troubles with Satyam have shown that they must also consider their outsourcing provider's ability to survive over the long term.

In the current economic downturn we are definitely seeing renewed interest in outsourcing, and indeed the return of larger deals, but these will take a new form. Process automation offers a potential step-change in cost savings and a new dawn for outsourcing – this is potentially the start of a very fruitful era for both clients and suppliers.

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