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Financial Services

IS FULL APPLICATIONS OUTSOURCING BACK ON THE TABLE IN FINANCIAL SERVICES?

IMPLICATIONS FOR THE INSURANCE SECTOR

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INTRODUCTION

Few financial institutions (FIs) have comprehensively outsourced their IT applications development and maintenance (ADM). A handful of failed experiments have convinced most that the risks are not worth taking. We believe it is time to reconsider. Recent Oliver Wyman client work suggests that 80% of the typical financial institution's ADM activities can be outsourced, delivering savings of 20% to 40%.

This Oliver Wyman Perspective aims to help FI managers overcome their understandable apprehension by explaining the sources of these savings and the ways to minimize the risks associated with ADM outsourcing. In the end, comprehensive outsourcing will not be right for everyone; different FIs face different potential benefits and different risks. But the decision should be made after giving it the serious consideration that we hope this article will help to stimulate and guide.

1. THE BENEFITS OF COMPREHENSIVE ADM OUTSOURCING

By "comprehensive outsourcing" we mean outsourcing all or most applications and development functions including the people who perform them. Usually, the FI will transfer the ownership of the relevant resources and the employment of some staff to a third party and then consume ADM services on a pre-established "pay for service" basis. A combination of fixed and variable costs is thereby replaced with almost purely variable costs. This reduces "business risk" (because costs decline with volumes) and it reduces aggregate costs, because the third-party has several advantages over in-house suppliers:

- **Demand management**. Demand management is the ability to reduce or manage down business requirements to keep them better in line with supply constraints or alternative, lower-cost ways of fulfillment. Outsourcers are good at this because of the rigor and commercial discipline that they are able to enforce around requests for service, change control and pricing.
- **Productivity improvement**. Productivity in the world of ADM describes the output from a given ADM activity per unit of input (e.g., number of test scripts per person per week). Outsourcers are often better at imposing ADM performance standards, upgrading staff skills, improving utilization, reusing tools and capturing synergies across resource pools.
- **Labor arbitrage**. While outsourcing does not necessarily reduce wage costs, outsourcers can employ staff in lower cost regions, whether on- or off-shore. In fact, outsourcing is a major impetus for offshoring: unlike many of their customers, outsourcers typically like to achieve at least a 70/30 offshore/onshore ratio in a long-term outsourcing arrangement.

EXHIBIT 1: OUTSOURCING/OFFSHORING ACTIVITIES IN ADM OBSERVED AT LIFE AND PROPERTY AND CASUALTY (P&C) INSURANCE FIRMS

DEVELOPMENT

- Development and implementation of reconciliation reports for finance data
- Claims management software enhancements and customization (e.g. enhancements to track return to work for injured employees)
- Policy administration system development
- Routine internet application development and support
- Access/Oracle/Java – application development and database management services

MAINTENANCE

- Market data maintenance (e.g., monitoring system for market data utilization and capacity planning, technical support for the production market data system, resolution of outages)
- Reference data management and maintenance
- Monitoring and support of workflows
- End user support
- 2nd level trouble shooting
- File system administration

TESTING

- Client and server web application testing
- Mainframe testing
- Internet, wireless and mobile services testing
- Building of automated testing environments

PRODUCT SPECIFIC (LIFE AND P&C)

- Life
  - Development and deployment of Policy Administration software for high end policies that require complex functionality
- P&C
  - Development of mobile solutions to support field work for claims
  - Outside counsel performance monitoring
  - Re-pricing bills (finding lowest rate for given service)
  - Administrative services (reporting, further reviewing, case management)

Source: Peer interviews and indirect observations

Our research indicates that well-crafted ADM outsourcing agreements can deliver 20-40% run-rate savings against the addressable IT cost base. Most of these savings are produced through offshoring, which typically contributes 70-80% of the savings, followed by productivity gains (~10-20% of the savings), and demand management (5-15% of savings).

In interviews with leading proponents of ADM outsourcing in the financial industry, we were consistently surprised at the levels of outsourcing they claimed to have achieved and the range of applications deemed to be "in scope." Our research showed that up to 80-85% of the applications cost base can be outsourced. Even in businesses where front and middle office expertise is often considered to be proprietary, we found that most applications and associated activity were candidates for outsourcing.

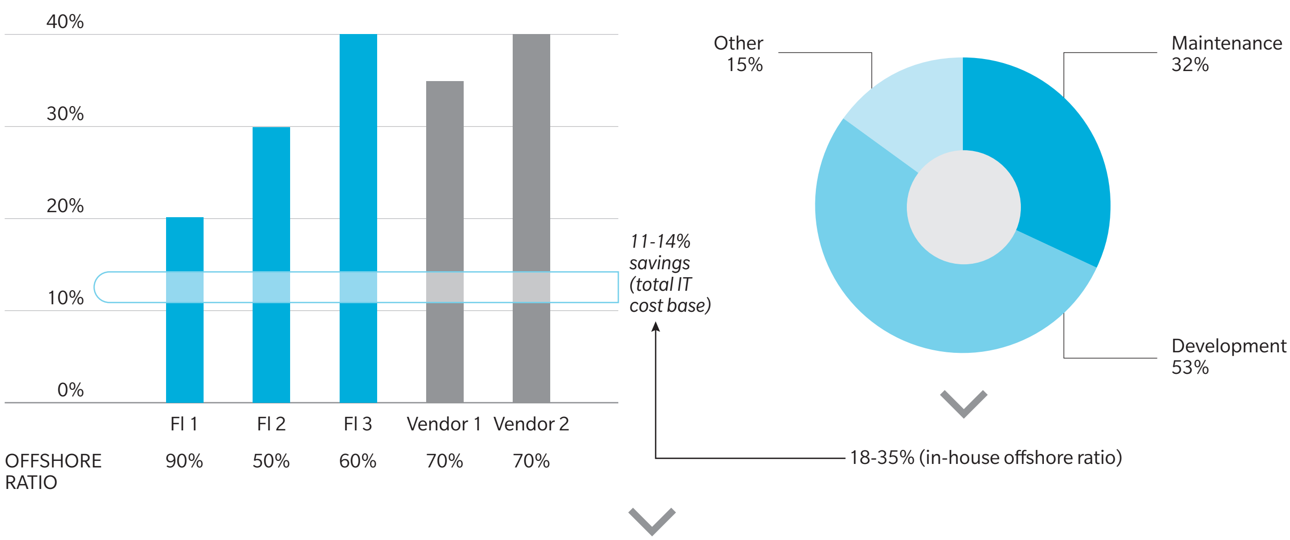
At one global institution with extensive P&C insurance operations where we analyzed ADM activity and headcount in detail, we found that 90% of the headcount associated with ADM functions could be outsourced with minimal risk; the remaining 10% would focus on business analysis and large scale program/project management. Even the retained cost base under an outsourcing arrangement, comprising functions such as vendor management, business-IT relationship, and service level management, typically emerges leaner, more responsive and more focused.

The benefits of outsourcing depend, to a large extent, on whether or not the outsourcing FI chooses to "rebadge" staff. Rebadging refers to the transfer of ADM personnel from the FI to the outsourcing company for a specified length of time. There are business as well as social reasons for preferring to rebadge rather than

EXHIBIT 2: OUTSOURCING CAN MORE THAN DOUBLE THE IMPACT OF IN-HOUSE OFFSHORING EFFORTS

REPORTED RUN-RATE SAVINGS FROM OUTSOURCING AND OFFSHORE RATIOS
Selected financial institutions and vendors

TYPICAL BREAKDOWN OF LARGE FI IT SPEND AND IN-HOUSE SAVINGS FROM OFFSHORING AND RATIO



Difference in savings driven by:

- Difference in process and productivity maturity of FI and outsourcing partner at the outset of outsourcing arrangement
- Potential for efficiency improvement
- Joint execution capabilities of FI and vendor
- IT investment cycles, i.e., levels of in-house FI investment in IT over the course of the outsourcing arrangement

EXHIBIT 3: IMPACT OF 'REBADGING' ON ADM OUTSOURCING BUSINESS CASE

SCENARIO ANALYSIS

SCENARIO	NO. OF HIRES BY VENDOR (FTEs)	SEVERANCE IMPACT	POTENTIAL SAVINGS EXCL. SEVERANCE	POTENTIAL SAVINGS INCL. SEVERANCE
All affected IT staff rebadged	2,000	N/A	5-6%	5-6%
2/3 of IT staff rebadged	1,350	650	19-24%	18-22%
1/3 of IT staff rebadged	675	1,325	31-38%	28-35%
Key IT staff only rebadged ('optimal' scenario)	300	1,700	42-52%	38-47%

Note: In all scenarios, FI's present IT contractors replaced by vendor personnel offshore.
Scenario Assumptions:
- All scenarios assume outsourced staffing mix from Day 1, but no offshoring which would significantly increase savings
- 7 year time horizon
- Severance estimate based on 3 weeks per year of service, 10 years' service average

release company employees, such as ensuring ongoing access to personnel who have in-depth knowledge of the FI's applications. However, rebadging constrains the benefits of outsourcing. We noted savings as low as five to six percent in the case of full rebadging. This is because the outsourcer could not take full advantage of offshoring (due to the obligation to retain "rebadged" employees) and because the retraining required defers productivity gains.

Exhibit 3 shows the wide dispersion in benefits under various rebadging scenarios based on typical vendor practices and FI experience.

The preferred practice of major outsourcing players is to rebadge only those IT personnel who are deemed to have the skills necessary to thrive in the vendor's organization long term, typically at two thirds their current salary. Offer acceptance rates tend to be high (> 90%) with employment guaranteed for 12-18 months. Retention rates also run high given the selectiveness of offers. Most vendors aim for a 70/30 offshore ratio, bringing retained staff levels down over time to about one third of their original level. Under most rebadging arrangements, the outsourcer cannot move staff offshore for a specified period of time, usually 12-24 months, which delays the savings. Social attitudes toward layoffs and outsourcing as well as national economic conditions and policies play an important role in the rebadging equation. It should be noted that rebadging is not really part of the proposition of Indian offshore vendors.

It takes 9-12 months to start realizing the benefits of ADM outsourcing and up to four years to achieve full run rate savings. The major factor impacting the timing of benefits other than rebadging is the speed with which support can be moved offshore (i.e., replaced with offshore staff). The case research indicates that it is possible to replace thousands of ADM staff with offshore staff within months if the move is planned correctly and the outsourcing partner has the necessary scale.

2. RISKS IN COMPREHENSIVE OUTSOURCING AND THEIR MITIGANTS

We encountered three broad categories of risk with "full" ADM outsourcing:

- **Strategic risk**: The risk that ADM outsourcing results in the FI compromising information that could eventually lead to revenue loss, e.g., compromise of proprietary intellectual capital or customer information.
- **Execution risk**: The risk that the outsourcing arrangement does not work out as planned, e.g., transition disruptions, service level degradation, financial benefits not as large or quick as anticipated.
- **Ancillary risks**: Downstream risks associated with ADM outsourcing e.g., the reputational risk that FIs may face when replacing employees with lower-wage resources in another country, the cultural compatibility and change management risk attendant with adopting a global ADM delivery model.

All of these risks are well understood by mature customers of outsourcing services and have been mitigated with varying degrees of success:

- Strategic risk is mitigated by initially limiting outsourcing to non-mission critical activities and only tackling increasingly proprietary activities (real or perceived) when the FI has established a strong framework for managing strategic risk. For example, some FIs choose never to share the source code of their homegrown applications with outsourcers. Instead the outsourcer is asked to build functionality around the source code. Likewise, some FIs don't share customer data with outsourcers. Where it is necessary to share customer data, e.g., to conduct analyses or run test scripts, the data is disguised.
- Execution risk is dealt with to a large extent by ensuring rigorous due diligence during the vendor selection phase and stipulating clear operational and commercial guidelines, including recourse, in structuring the outsourcing contract. Due diligence is fundamental to ensuring the outsourcing partner is well tuned, and its incentives successfully aligned, to the FIs' needs. Areas to investigate include: the vendor's country of outsourcing operations (country risk varies depending on political and other factors), labor rates and volatility, attrition, scale and headroom, quality of processes, etc. – the list of factors to consider should be long. Vendors that appear risky should be eliminated at the RFI phase. Residual execution risk can be handled via contract management. Contracts should spell out, in painstaking detail, the operational and financial terms of the arrangement including: transition timeframe, minimum service levels, expected benefits over time, etc. The vendor's incentives would be closely linked to the commercial terms of the contract, i.e., if the vendor performs at or above the specification, it stands to gain, if not, it gets penalized. Some of the larger, more mature vendors are even willing to stake the contract on success fees, i.e., if the FI does not achieve the promised benefits, the vendor will absorb the shortfall.
- Ancillary risks are highly contextual. For instance, some countries frown on replacing jobs in their home country with outsourced jobs. There is no right answer in such circumstances; however, rebadging does help to mitigate that risk. Transition and cultural assimilation risks are more prevalent when FIs are new to outsourcing. FIs that adapt better do so because their executives are committed to change and can push change down through the organization. Also, multinational FIs are used to dealing with time and distance challenges and have fewer issues adapting to a global delivery model. Nevertheless, adapting to a fully outsourced ADM model and truly global delivery is not an overnight proposition, it's more like a staged expedition, where the FI's retained team and the vendor's onsite resources play a decisive role in leading a smooth and successful transition.

EXHIBIT 4: FRAMEWORK TO DETERMINE RISKINESS OF IT APPLICATIONS PORTFOLIO OUTSOURCING

KEY CRITERIA	IF "LOW" THEN:	IF "HIGH" THEN:
Business criticality	●	⊕
Application complexity	●	⊕
Integration with other applications	●	⊕
Security or operational risks associated with outsourcing	●	⊕
Level of documentation	⊕	●
Functional and technical stability of application	⊕	●
Resistance from business to outsource	●	⊕

● Readily addressable ⊕ Challenging/higher risk

It should be stressed that for the vast majority of FI's the perceived or actual risks of outsourcing the bulk of their ADM activity will never be surmountable given factors as varied as:

- Concern about losing control of their mission-critical applications and giving proprietary knowledge to a third party
- Belief that the institution has better capabilities than the vendor marketplace
- Regulatory and compliance concerns
- A preponderance of in-house or highly customized applications with insufficient documentation
- Business insistence on physical proximity of IT

Nevertheless, a few financial institutions have found ways to overcome these constraints to achieve significant levels of outsourcing, even of the most sensitive types of applications. For these institutions, concerns are addressed through the high caliber and performance of their retained IT teams around critical functions (especially IT management, business analysis, architecture, and managing the business-IT interface). Strong documentation standards, architectural controls, and coding conventions and tools stemming from good governance mechanisms involving the business, IT, and third party vendors complete the requisite foundation.

3. DECISION ANALYSIS IN ADM OUTSOURCING: "...OR HOW TO GET OFF THE DIME"

Comprehensive outsourcing of systems applications is a big decision. Most financial institutions want to thoroughly assess whether ADM outsourcing makes sense for their particular situation before making a decision. A well-structured decision process can help an FI objectively determine whether outsourcing makes sense, whether the FI can successfully pull off such an arrangement, how much to outsource and whom to partner with. Exhibit 5 describes this process.

The first step is to systematically answer the questions "why are we doing this?" and "what are our options?" Typical reasons we have noted include reducing costs quickly, prioritizing the organization's strategic business focus and addressing perceived capability or quality gaps.

The second step is to estimate the benefits, costs, and risks associated with ADM outsourcing and gain internal agreement on the way forward. Many of the answers to these questions will vary depending on the FI's maturity. For example, FIs that have already offshored a significant chunk of ADM activities will benefit less. This step is all about ensuring organizational alignment around ADM outsourcing. Even assuming there is a strong business case, the FI will need unwavering support from senior business, operations and IT leaders to successfully pull off an outsourcing migration. The time to debate, ask for commitment and ensure support is at this point, before the organization launches into full-blown transformation.

Assuming the business case holds and the organization is committed to outsourcing, the next step, is to decide on the appropriate sourcing model. Here vendor sourcing options are assessed and management decides which combination will work best given the FI's particular circumstances. At this stage, a long list of potentially viable partners is identified and pared down based on characteristics such as scale, capabilities, financial health, cost, and working style (e.g., how

EXHIBIT 5: DECISION PROCESS FOR COMPREHENSIVE ADM OUTSOURCING

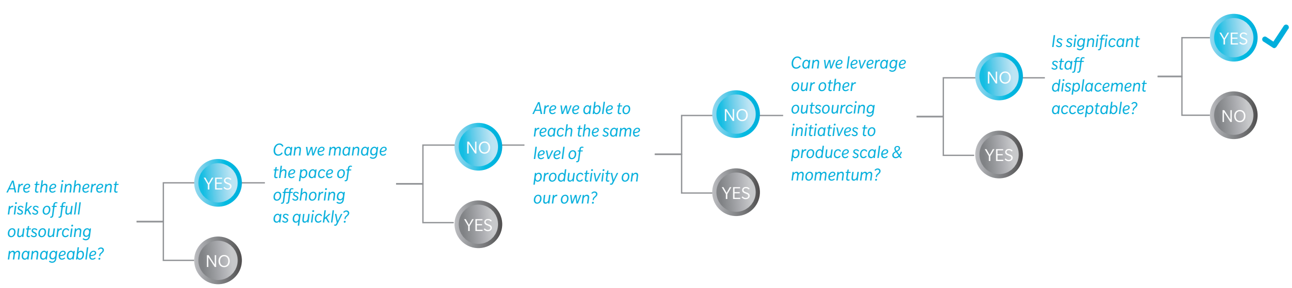
	① ASSESS STRATEGIC OBJECTIVES AND OPTIONS	② CONFIRM VIABILITY AND INTERNAL COMMITMENT	③ DEFINE SOURCING STRATEGY AND SELECT BEST-FIT VENDOR/S
KEY QUESTIONS	• What is the strategic purpose for pursuing comprehensive outsourcing (e.g., major cost reduction, strategic refocusing, address capability gaps)? • What alternatives does the organization have available to pursue the strategic objectives and how do these compare to outsourcing (e.g., internal IT productivity improvement programs)?	• Is there a viable business case for ADM outsourcing? • How much to outsource? • Should rebadging be considered and to what extent? What is the scope and timing of savings? • What are the organizational risks associated with outsourcing and can they be mitigated? • Have key stakeholders bought into ADM outsourcing?	• What is the right sourcing strategy? • Should the FI partner with one vendor or many? If more than one, should the pie be sliced by BU, application type, geography, or other? • In what sequence should the applications be migrated? • Which vendors should be evaluated for an outsourcing partnership? • Who is/are the most appropriate outsourcing vendor/s?
DESIRED OUTCOME	Outsourcing seen as best course to achieve strategic goals	Organization is committed to outsourcing	Organization decides how the outsourcing model will work and engages vendors

collaborative, how transparent). The realm of partners that can be considered is broad. Global outsourcing partners like Accenture and IBM offer comprehensive solutions and more flexible staff retention and rebadging options. The primarily India based offshoring partners feature their global delivery model. Niche vendors offer business, function or geography-specific expertise. The down-selection process is typically punctuated by a formal Request for Information (RFI) that allows the FI to develop its shortlist of vendors (usually two to four for reasons of specialization, concentration risk mitigation, and back-up choice) best able to meet its needs.

FIs should be prepared at this stage to share fairly detailed information on all the "in-scope" assets being contemplated for outsourcing, i.e., applications, people and associated functions. Outsourcing vendors use this information to come back with a comprehensive and more or less accurate bid. The FI can weigh these bids and negotiate further with a selection of the shortlisted vendors to decide on the most appropriate to partner with. The process of converging on a sourcing strategy and selecting vendors usually runs 6-12 months.

Exhibit 6 shows a successive logic of critical considerations in outsourcing strategy selection (related to the third chevron "Define Sourcing Strategy" in Exhibit 5) derived from observations of peer financial institutions.

EXHIBIT 6: CRITICAL CONSIDERATIONS IN OUTSOURCING STRATEGY SELECTION



- With the increasing maturity of ADM outsourcing, FIs find inherent risks are better understood
- A variety of techniques are now available to mitigate residual risks
- Experience with offshoring helps: outsourced ADM operates very much like offshore captives
- As a reflection, offshore captives have been spun off to third parties

- The ability to move operations offshore en masse is where most of the benefit of full outsourcing lies
- However, internally managed processes involving staff transfers or terminations can create significant disruption in ongoing ADM operations
- Also, significant management overhead is required
- Therefore, internal processes tend to be more cautious; less able to deliver the same amount of offshore transfer as vendors through long-term contracts

- IT productivity gains in ADM are a laborious, painstaking task to achieve in-house
- Typical levers include process engineering, automation, utilization/throughput and staff caliber
- IT departments can usually pull process and automation levers on their own, often with outside support
- However, utilization/throughput/caliber generate the most benefit, yet are the most challenging to achieve in-house

- Most IT outsourcing spend is concentrated in Infrastructure services as opposed to ADM
- Most common business applications outsourced among insurers include finance operations, administrative platforms, underwriting, and workflow management
- Although few vendors are world class across categories, FIs like to concentrate their outsourcing bids to build on experience and create scale economies
- Existing arrangements can provide a catalyst for greater ADM outsourcing

- Outsourcing vendors make their margin by doing the same work, or more, with fewer resources
- Typically they will opt to rebadge only those internal staff who are 'retrainable' = 60-70%
- Vendors' ability to redeploy staff also depends on local attitudes toward offshoring and overall market demand for outsourcing
- Inability or unwillingness to shed staff can dramatically impact the business case, wiping out up to 80% of the benefits
- Most often companies find it easier to use vendors to first rebadge then displace staff over time

Typical decision gates of Financial Institutions considering comprehensive outsourcing [ ]

4. CASE STUDIES

The following mini-case studies highlight some of the key factors and successful practices we found among insurance companies transitioning to a highly outsourced ADM environment. Note that these institutions would be considered very mature in their outsourcing/offshoring practices; many are pioneers, most have outsourced or offshored a major portion of their ADM activities and all have realized significant benefits by doing so.

Insurance companies that have successfully transitioned to a highly outsourced IT applications model have a clear rationale for outsourcing.

Insurer A, a major North American life insurer had two major objectives associated with their outsourcing strategy:

- Reduce general and IT expenses
- Improve the predictability and quality of IT given consistent failure to deliver on large projects historically

Insurer B, a leading European property and casualty insurer decided to pursue outsourcing for the following reasons:

- Organization was facing deteriorating financial situation
- As part of the turnaround strategy, several performance management initiatives were mobilized including outsourcing of IT activities
- Major rationale driving outsourcing decision was that a third party could drive the ADM transformation far more quickly than in-house efforts

Making an outsourced model work requires an organization to adapt to a new environment – scope of change may impact structure, governance, and performance management.

Insurer A made several changes to ready the organization for outsourcing:

- The IT organization was originally very central; as part of the outsourced model, the company pushed budgeting to the business unit level to make sure that each business was responsible for their own IT spend
- CIO group retained centralized reporting and shared IT budgets across business units – this pushed business units to analyze their budgets more carefully
- Dramatically simplified the IT charge-back model
- Instituted gate process (for each major stage of an IT project) to justify IT spend – business units owned the benefits of all projects; benefits had to be focused on tangible cost reduction

Insurers have experienced a broad range of benefits from ADM outsourcing.

Insurer A realized positive benefits both financially and on the intangible side from their outsourcing arrangements:

- Labor costs went down significantly because of resources being moved offshore and to a lower cost location onshore
- Productivity improved, primarily driven by higher utilization of staff and better training

- Intangible benefits included
  - Talent upgrade, i.e., some employees chose to leave during the rebadging, thereby "refreshing" the IT organization
  - Time zone arbitrage via offshoring, i.e., the "on" plus "off" model enabled a 24 hour processing window

Insurer B realized several benefits from outsourcing ADM activities:

- IT ADM headcount was reduced by ~30%, while adding new services and increasing service levels
- Labor costs were driven down by moving ~50% of jobs offshore
- Average number of daily productive working hours were increased from 5 to 6 by ensuring discipline around time management, time tracking and project management
- Process management was improved by deploying more robust tools and processes provided by the outsourcing partner

* * *

Many leading insurers can outsource, and already are outsourcing, more and more of their application systems' development and maintenance. We found significant potential, and in several cases, realized benefits from moving towards comprehensive ADM outsourcing – still, the managerial and transitional challenges remain daunting. In this paper, we have laid out a logical and strategic framework that insurance companies can use to test whether they have the appetite to outsource more given the size of the prize. This should include, at a minimum, a comparison of a more comprehensive ADM outsourcing approach to in-house led alternatives.

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