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Outsourcing in a brave new world

An international survey of current outsourcing practice and trends

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A NORTON ROSE GROUP PUBLICATION
2011

Contents

01

Foreword

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I am pleased to present the second Norton Rose Group international survey of outsourcing practice. Our 2008 report on international best practice in outsourcing and procurement – *A Smart Approach to Sourcing* – highlighted the differences in approach to sourcing across various industry sectors. We found that customers needed to improve three areas of their procurement processes if they wanted to achieve the maximum benefit from outsourcing:

- Management buy-in: procurement should be placed firmly at the core of corporate strategy and have proper resources allocated to it.
- Good supplier/customer relationships: if suppliers are to deliver technology and services which meet the needs of business, customers need to be far more open about their objectives with suppliers and to share information with them. Good relationships cannot be built on ignorance and misunderstanding.
- A more sophisticated approach to risk: both customers and suppliers need to take a more considered approach to identifying the risks associated with projects and a more realistic approach to the allocation of risk between supplier and customer.

The world has experienced a period of profound economic dislocation since our 2008 survey. Western economies have suffered severe recession and austerity measures have been introduced. Cutbacks in both public and private sector have increased the focus on outsourcing as a means of achieving cost reductions. The rate of growth of emerging markets (and developed countries who are major commodity exporters) has been slowed and affected by inflation. We wanted to find out how the changing global economics of the past few years have affected outsourcing strategy and practice.

This report is one of a series prepared by Norton Rose Group on the effects of the global financial crisis. It supports the findings of other surveys. In particular, our recent 2011 report *Financial Institutions – the Changing Perspective* found that cost cutting featured in 47 per cent of financial institutions' business plans. Outsourcing is one perceived method of delivering such cost cutting.

We look at current trends in outsourcing deals; examine whether customers are placing an increasing emphasis on the identification and management of risk in outsourcing projects; and the tools they are using to mitigate risk. We also address major current trends – cloud computing, offshoring and multi-sourcing – and we consider the perennial challenges of capturing innovation and contract management.

This survey shows that:

- cost reduction is the most important driver for outsourcing
- customers want flexible solutions
- customers have tightened their due diligence processes – apart from those applied to key incoming personnel

The Norton Rose Group sourcing team has grown rapidly since our 2008 survey. We have specialist outsourcing lawyers in our offices in Asia, Australia, Canada, Europe, the Middle East and South Africa. All these teams were involved in the preparation of this survey, which has enabled us to interview customers and suppliers across the globe. As a result, many of our findings are broken down by region which allows readers to see how outsourcing practice varies.

Finally, we asked our specialist lawyers and some of the international consultancies with whom we work on a regular basis to share their thoughts on current trends in outsourcing and technology. We are very grateful to all our participants for their time and assistance. We agreed to treat contributions anonymously, encouraging openness and honesty. All quotes were given on an unattributable basis.

I hope you find this report both thought provoking and helpful. If you would like to discuss any issues raised, please do not hesitate to contact us.

Mike Rebeiro
Partner, Norton Rose LLP
Head of Technology and Innovation

02

Executive summary

Executive summary

The global economic crisis has clearly impacted on outsourcing strategy and deals. The survey shows that:

- 87 per cent of customers cited cost reduction as the motivating factor for outsourcing
- 86 per cent of suppliers cited cost reduction as the motivating factor for their customers' outsourcing
- 62 per cent of suppliers expressed a view that the global financial crisis had resulted in harder price negotiations
- 69 per cent of respondents mentioned flexibility as a motivating factor for outsourcing, in contrast to less than 10 per cent in the 2008 survey
- 65 per cent of both suppliers and customers said customers did not do detailed due diligence on the key personnel involved in an outsourcing project
- 66 per cent of customers – and 61 per cent of suppliers – thought that due diligence processes had tightened in the last two years

Cost reduction as the most common driver for outsourcing

Cost reduction was cited as a motivating factor in outsourcing by 87 per cent of customers and 86 per cent of suppliers. This was a slight increase on the figures in the 2008 survey. After cost reduction, the reasons most often reported by customers were: access to new technologies; flexibility; and business transformation. Suppliers cited flexibility, business transformation and access to specialist expertise.

It is clear that outsourcing has been affected by the economic downturn. The need to implement austerity measures may have encouraged both the private and public sectors to outsource. There is an increased focus on value for money and flexibility.

This presents an opportunity for suppliers. They need to persuade customers that outsourcing can deliver cost reduction. Cloud computing and offshoring are two ways of reducing cost. However, customers have concerns about both of these. The challenge for suppliers is to reassure customers that the risks relating to cloud computing and offshoring can be effectively managed.

Nevertheless, customers need to be careful not to push their suppliers too hard. This could lead to a decrease in service quality and potentially less competition in the market. Successful outsourcing arrangements have to be win-win for both parties.

It is clear that outsourcing has been affected by the economic downturn.

The importance of flexibility

A big change since our last survey was the increased importance of flexibility as a motivating factor for outsourcing. In 2008, flexibility was mentioned by less than 10 per cent of customers, compared to 69 per cent in this year's survey. This change is a direct consequence of the economic downturn. Suppliers have also noticed this development. A general counsel at a European telecoms provider commented: "Customers want total flexibility: the ability to flex on [services] and flex off. That is the biggest trend I have seen in all my 25 years in the IT industry; the trend towards flexibility and the reluctance [of customers] to invest money up front."

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Conducting due diligence on key personnel

Nearly two-thirds of customers (65 per cent) do not conduct detailed due diligence on the incoming key personnel of the supplier. Some suppliers thought that customers assumed suppliers would have done the necessary due diligence on their own staff and so there was no need to repeat the exercise.

Indeed, some suppliers actively sought to discourage this kind of investigation and also were unwilling to name key personnel in the contract.

We were surprised at these results. A project manager who has 'misrepresented' his qualifications might fatally damage a project. In light of the prevailing economic climate and the fallout from rogue employees at Satyam and EDS, we think that customers should review their processes to ensure they are properly protected.

Due diligence – capability analysis and financial checks

Broadly speaking, customers and suppliers had the same views on due diligence. Both agreed that capability analysis and financial checks were the most important due diligence activities. A majority of both suppliers (61 per cent) and customers (66 per cent) also thought that due diligence processes had tightened in the last two years. A variety of factors influenced this. In the financial services sector there had been increases in regulation and corporate governance requirements. More generally, customers were concerned about the solvency of potential suppliers. Reputational risk was also key, with customers very concerned that outsourcing arrangements should not adversely affect their brand.

Selecting the most appropriate supplier for a project can reduce risk substantially. It is incumbent on a customer to devise a due diligence process that will properly test and evaluate potential suppliers.

Reputational risk was also key, with customers very concerned that outsourcing arrangements should not adversely affect their brand.

03

About this survey

About this survey

Introduction

In carrying out the survey, Norton Rose Group interviewed 74 businesses. These interviews were almost all carried out at face-to-face meetings or by telephone by partners and senior lawyers in Norton Rose Group's sourcing team. Most interviews were carried out face to face, with each interview lasting about one hour.

The customers and suppliers interviewed were asked detailed questions about their view of the market and outsourcing strategy and processes. The aim of the interviews was to gain their perspective on the effectiveness of outsourcing processes and the latest trends in outsourcing and procurement strategies. For the purposes of analysing responses, we divided the results between suppliers and customers, and between the customers' industry sectors and their geographic location.

The participants

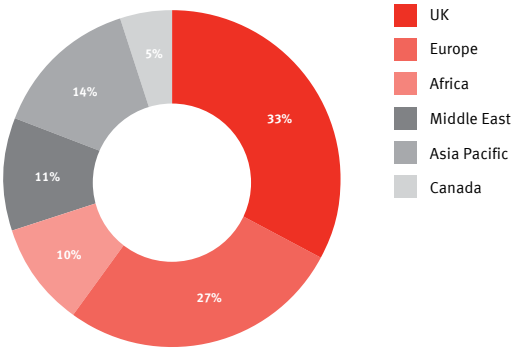
The in-depth interviews were conducted with chief information officers, general counsel, heads of procurement and other senior executives at outsourcing suppliers and their customers. The participants were located in the UK, other countries in the European Union, Canada, South Africa, the Middle East and Asia Pacific.

The aggregate market capitalisation of public listed companies interviewed (36 of the total) is over US$1550 billion.

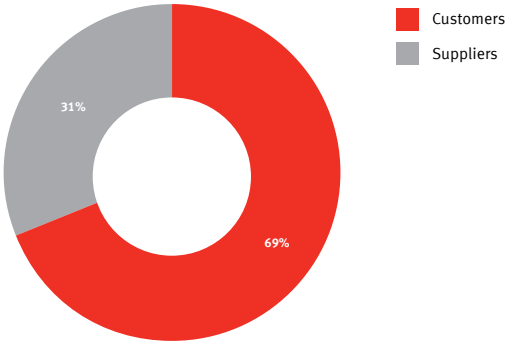
The customers interviewed came from a variety of sectors including technology and life sciences; retail and brands; financial institutions (including banks, insurers and fund managers); transport, energy and infrastructure; and professional services.

The suppliers interviewed comprised a mixture of both onshore, near shore and offshore providers in IT outsourcing (ITO), business process outsourcing (BPO), HR outsourcing (HRO) and data centre services.

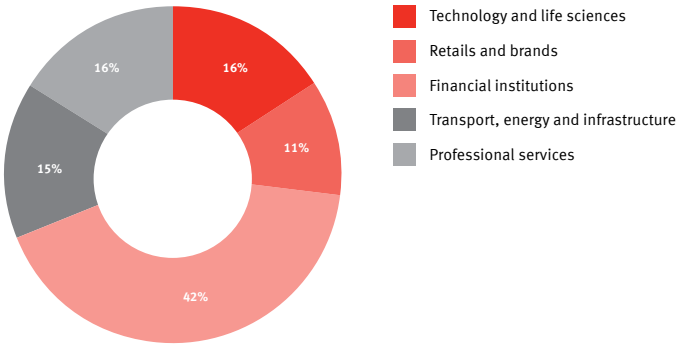
All participants by region



Participants – customers and suppliers



Customer participants by sector



The aggregate market capitalisation of public listed companies interviewed (36 of the total) is over US$1550 billion.

04

'The new world': an exploration of current trends in outsourcing deals

'The new world': an exploration of current trends in outsourcing deals

Background

The world has experienced a period of profound economic dislocation since the bankruptcy of Lehman Brothers in September 2008. Economic activity fell sharply and confidence collapsed in developed economies as the credit crisis unfurled. The continued weakness of the eurozone and the indebtedness of many developed countries, mean their economies are in a prolonged period of low growth (if indeed they are growing at all). In contrast, economic growth has continued in many developing economies led by the rising economic powerhouses of China and India. However, even in these economies, growth has slowed of late as a consequence of higher inflation and reduced demand in their key export markets.

Notwithstanding the turbulence in the world economy, recent estimates state that US$100 billion worth of new outsourcing contracts are signed every year. At the same time it is estimated that the global IT services industry has grown to a US$1820 billion giant.

We wanted to understand what differences (if any) the economic crisis has made to outsourcing deals and the deal process.

The impact of the global financial crisis on deals

We asked participants whether the global financial crisis had made a difference to their outsourcing deals and the deal process. A minority of customers said that the financial crisis had not affected their existing outsourcing strategy; they felt their outsourcing strategy had been accepted as the correct business model prior to the crisis and they had not deviated from it. This was particularly true in the UK and North America where outsourcing as a business model has been established for many years.

In some countries where outsourcing is not so well established, such as France and Germany, both customers and suppliers thought that the crisis had accelerated the adoption of outsourcing. Previously, for cultural and social reasons, outsourcing had not been viewed favourably. The crisis had forced many companies to reconsider their view and to think about outsourcing even though it was not viewed favourably by trade unions and employees. One French outsourcing consultant said: "French corporates (especially larger ones) overcame their fear of change to proceed with outsourcing. The French were historically not so keen on outsourcing. The global financial crisis has been an excuse for change." The head of business development of a German outsourcing service supplier commented: "Outsourcing is in general still a good deal, particularly as the German market is underdeveloped. There is still high potential."

Notwithstanding the perceived growth in outsourcing as a business model, many of the participants told us that the economic crisis had made a difference to deals and the deal process. Of suppliers who expressed a view, 62 per cent thought that the crisis had resulted in harder price negotiations. This contrasts with just 41 per cent of customers. The difference may be accounted for by the fact that a sizeable number of customers insisted they had always been tough on price. In any event, the suppliers have noticed this trend, with 29 per cent of them (and 20 per cent of customers) also reporting reduced margins.

In Australia, the experience of customers was that the financial crisis had not led to significant price reductions but had led to two very significant results:

- Suppliers were far more prepared to partner with third parties to provide a full service to the customer than was the case before the crisis.
- The offshore suppliers were building up their local presence and doing more work onshore.

Overall, suppliers seemed to view the effects of the crisis more negatively than their customers, with greater numbers feeling that the contracting process had slowed down and contracts were being awarded for shorter terms.

In some countries where outsourcing is not so well established, such as France and Germany, both customers and suppliers thought that the crisis had accelerated the adoption of outsourcing.

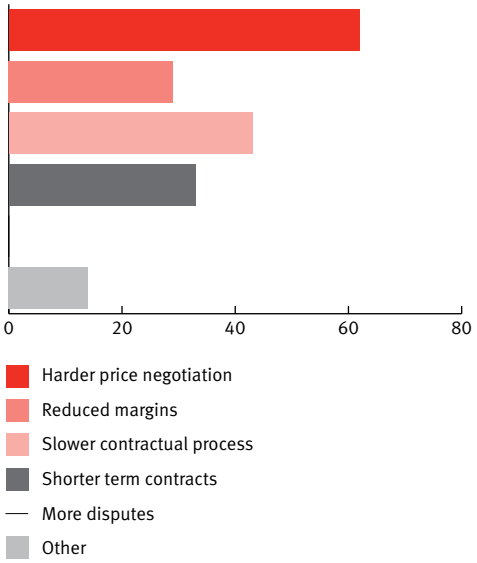
Pricing structure

We asked suppliers whether they disclosed their profit margins to customers. Thirty-five per cent of suppliers said they were prepared in some cases to disclose their margins, although most did so reluctantly. As one general counsel at a major European telecoms supplier said: "I still think the major players would like to keep their margins privy and confidential to themselves." Customers were divided as to whether they should see their suppliers' margins. However, even if they received the data, many were sceptical as to its accuracy. One partner at a French professional services firm said bluntly: "Even if they disclose the margins we don't believe them." The CIO of a South African bank concurred: "I insist on seeing margins, although the accuracy of what I see is another question." He also noted that: "Margins are very low but it is not good practice to drive them as low as possible. When someone takes over a part of your business you do not want their margins to be so tight, it does not make business sense for them."

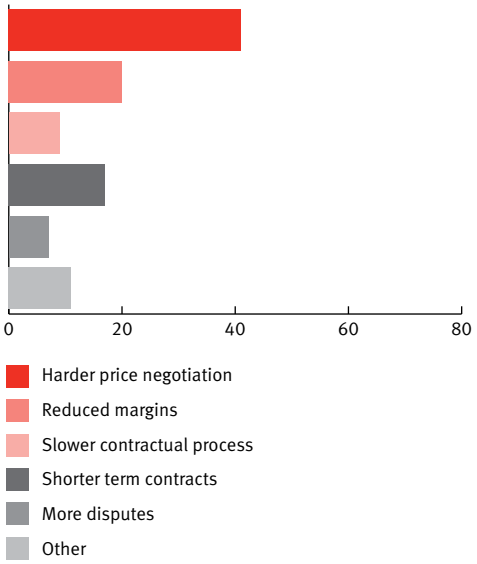
We asked suppliers how they could help keep costs down. Suggestions ranged from greater use of cloud computing to more offshoring. Many suppliers suggested customers needed to help keep their own costs down. A Canadian supplier said: "More often than not, clients ask for the world. They think they need something they don't necessarily. Clients should ask themselves 'what do we actually need'? There may be an off-the-shelf solution instead of a more costly customised solution."

Customers also had ideas on how suppliers could help them save money. One head of procurement

Impact of economic crisis on deals and process: suppliers



Impact of economic crisis on deals and process: combined customers



at a UK financial services company said: "Suppliers should tell customers how they can improve. For example, they won't need to charge for overtime if customers plan their workflow better."

"Margins are very low but it is not good practice to drive them as low as possible. When someone takes over a part of your business you do not want their margins to be so tight, it does not make business sense for them."

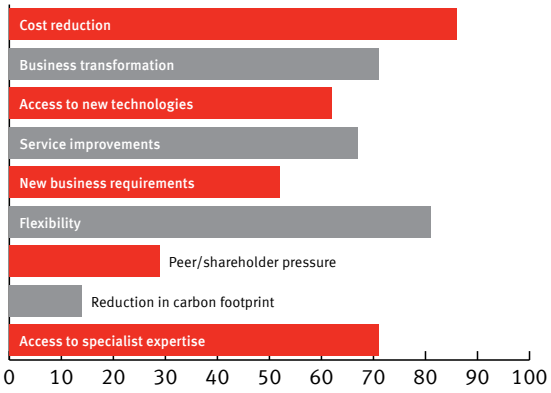
Commercial drivers for outsourcing

We wanted to understand what influenced customers to engage in outsourcing. We asked customers which factors motivated them. We also asked suppliers what factors they thought motivated their customers. Eighty-six per cent of suppliers and 87 per cent of customers cited cost reduction as a key factor for outsourcing. This is slightly up on the figure in our last survey. As the South African senior contract manager at a US technology supplier said: "Price is and always has been the number one factor." Other participants said they were now less focused on cost reduction. Instead, they were placing greater emphasis on value for money. Even customers who were hoping to achieve cost reduction said this alone would not be a reason to outsource. One head of procurement at a UK professional services firm put this as follows: "I will outsource if I can make a function more efficient or if I don't have skills. I wouldn't simply outsource because it is cheaper." After that, the reasons most often cited by customers were: access to new technologies; flexibility; and business transformation. Suppliers cited flexibility, business transformation and access to specialist expertise. Languishing at the bottom of the list in each case was a reduction in the business's carbon footprint.

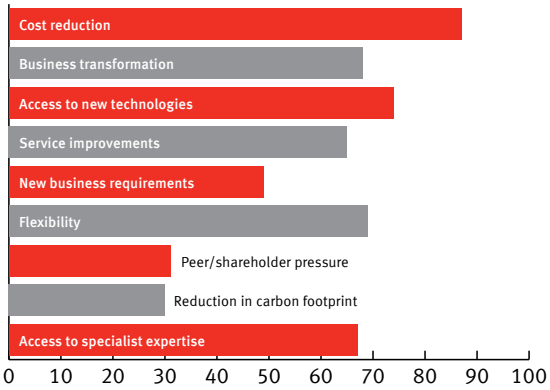
As the South African senior contract manager at a US technology supplier said: "Price is and always has been the number one factor."

The survey revealed some interesting regional disparities, especially in light of the downturn. In Europe, cost reduction featured less frequently as a motivating factor. In the UK it was 72 per cent, in the rest of Europe 63 per cent. In Asia Pacific, customers tended to have multiple reasons for outsourcing. Whilst 100 per cent were seeking cost reductions, they also wanted service improvements and flexibility: three tough criteria for suppliers to achieve simultaneously. In Asia, the attitude to outsourcing varies. Some customers view outsourcing as a partnership, looking for a win-win situation. At the other extreme, other customers view outsourcing as a supplier/customer relationship. Australian customers in particular are

Motivating factors for outsourcing: suppliers



Motivating factors for outsourcing: combined customers

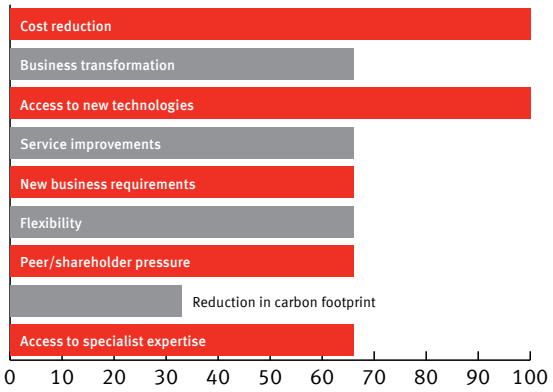


constantly fighting a tight labour market and often outsource in order to obtain access to skill sets that are not available locally.

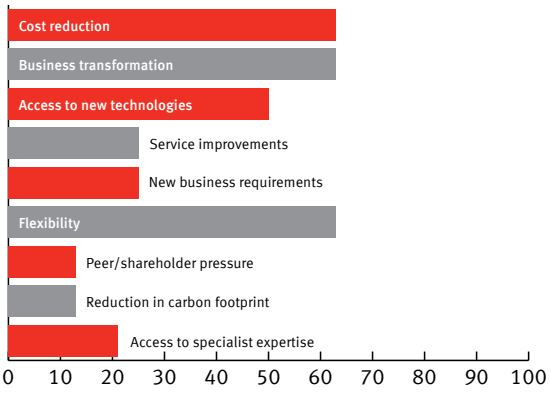
Although cost reduction topped the charts in the Middle East, in interviews many customers also said outsourcing gave access to skills that were sometimes in short supply in the region. A Middle Eastern customer said: "My perspective is that crisis or no crisis, we would have look to [outsourcing] because we actually want to improve in terms of scale, access to new technologies and ideas. People thinking about outsourcing solely from the perspective of cost cutting miss some of the other things... the efficiency and scaleability, improved cost control, consistency in reporting etc." The chief strategy officer at Japanese technology company in the Middle East thought outsourcing provided access to deep skills without the overhead.

A big change since our last survey in 2008 was the increased importance of flexibility as a motivating factor for outsourcing. Last time, less than 10 per cent of customers mentioned it. This time it was 69 per cent. This change is a direct consequence of the economic downturn. As one German management

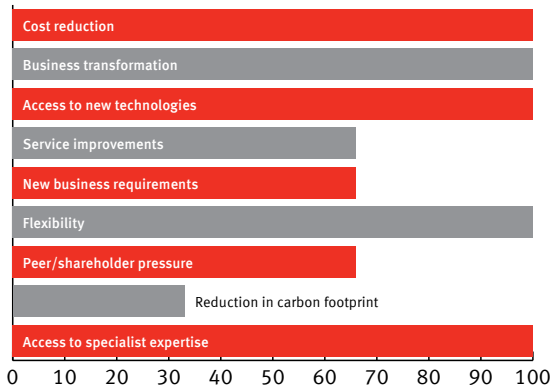
Motivating factors for outsourcing: Canadian customers



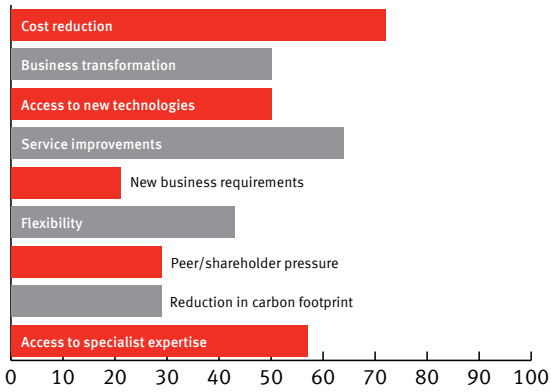
Motivating factors for outsourcing: European (ex UK) customers



Motivating factors for outsourcing: South African customers

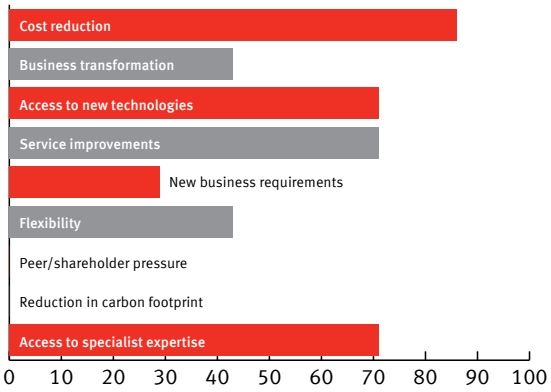


Motivating factors for outsourcing: UK customers

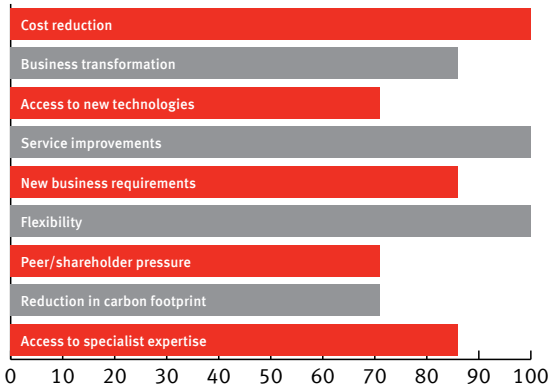


consultant said: "While businesses managed to cut their costs by 30 per cent in the direct value chain during the economic crisis, their IT costs were only 10 per cent variable and 90 per cent fixed. Therefore, flexibility is the key requirement for up-to-date outsourcing agreements." Suppliers had noticed this change too. A general counsel at a European telecoms provider commented: "Customers want total flexibility: the ability to flex on [services] and flex off. That is the biggest trend I have seen in all my 25 years in the IT industry; the trend towards flexibility and the reluctance [of customers] to invest money up front."

Motivating factors for outsourcing: Middle Eastern customers



Motivating factors for outsourcing: Asia Pacific customers



Norton Rose Group view

It is clear that the outsourcing sector has been affected by the economic downturn. Whilst the need to implement austerity measures may have encouraged both the private and public sectors to outsource, they have tightened the purse strings focusing, increasingly on value for money and flexibility. However, customers need to be careful not to erode their suppliers' margins too much; this could lead to a decrease in service quality. This view was shared by the deputy CIO at an Australian insurance company who said: "We always want a great price but not at the risk of compromising quality and service. We have learnt our lesson." Lower prices may also lead to a round of consolidation amongst suppliers; an outcome not necessarily to the customers' benefit if there is a corresponding decrease in competition. It is also clear that both suppliers and customers want more transparency. Customers want to know if they are getting the best price and service. Suppliers want to know they can provide the desired service at a decent margin.

This view was shared by the deputy CIO at an Australian insurance company who said: "We always want a great price but not at the risk of compromising quality and service. We have learnt our lesson."

"Be open and honest about delivery and your plans. Unrealistic plans cost money. We do not want unrealistic tenders just to win work." ***Commercial manager at a Dutch energy company***

"It has to be a win-win situation for both parties. It does not work when the customer tries to squeeze every little bit out of the supplier without getting something back." ***South African Contract Manager for a US technology supplier***

05

Finding the right partner

Finding the right partner

Background

The collapse of the Indian supplier Satyam in 2009 and HP's takeover of EDS created shockwaves in the outsourcing sector. Customers wanted to know more about their supplier's business and whether it was financially stable. We wanted to explore whether factors such as the collapse of Satyam and the prevailing economic climate had affected the due diligence processes that customers employed when selecting a new partner.

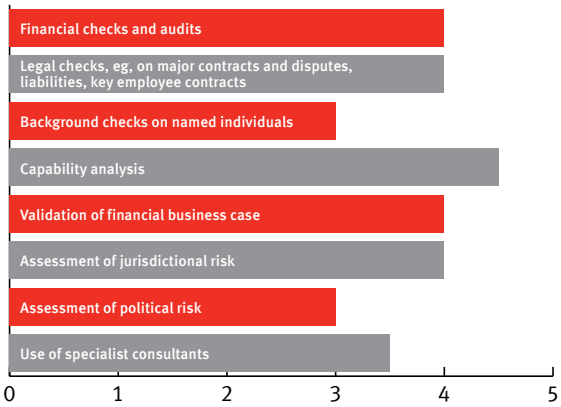
Due diligence strategy

We gave customers a list of possible due diligence activities and asked which activities they routinely undertook when selecting a new partner. Where they undertook an activity, we then asked how useful and important they regarded it. We also asked suppliers how they rated the usefulness of the due diligence their customers carried out on them.

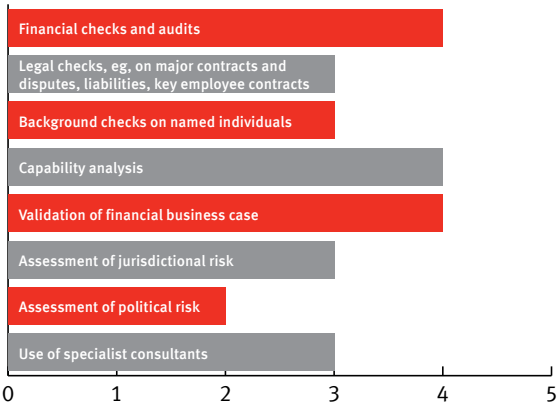
Broadly speaking, the views of the customers and suppliers were the same. Both agreed that capability analysis and financial checks were the most important due diligence activities. A majority of both suppliers (61 per cent) and customers (66 per cent) also thought due diligence processes had tightened in the last two years. A variety of factors influenced this. In the financial services sector there had been increases in regulation and corporate governance requirements. More generally, customers were concerned about the solvency of potential suppliers. Others had been affected by bad choices in the past and were improving their processes. There were also regional factors at play. A bank in Hong Kong had tightened its processes following the Japanese earthquake.

A majority of both suppliers (61 per cent) and customers (66 per cent) also thought due diligence processes had tightened in the last two years.

Usefulness of due diligence activity: combined customer view



Usefulness of due diligence activity: supplier view



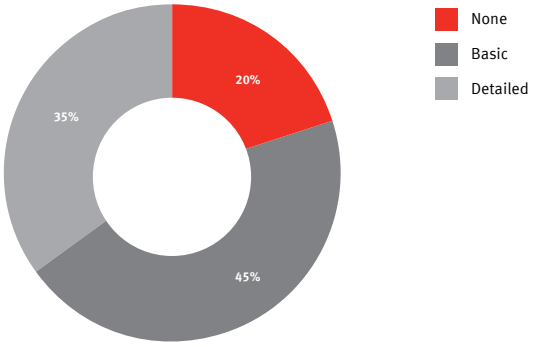
The only region which did not have the same process-driven view on due diligence was the Middle East. Outsourcing is still relatively new, and perhaps the general business culture there which favours personal relationships, means due diligence is not necessarily based on a purely factual or financial analysis. One Middle East financial services company said: "We always work with large firms, so the market is the due diligence. Where there is somebody who is brand new... we will get recommendations from people they have worked for." The chief strategy officer of a Japanese technology company in the Middle East said: "Regionally, the analysis of capabilities and taking up references is more important than a detailed financial/legal audit. We have moved towards basing decisions on relationships rather than bare facts."

The supplier view of due diligence

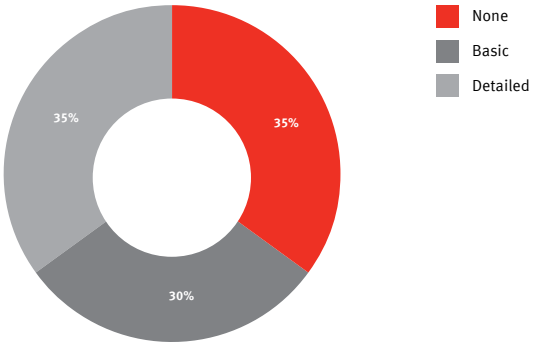
Suppliers tended to have mixed views on the due diligence conducted on them. These ranged from those who thought due diligence could be "adversarial" or "useless", to those who thought customers generally focused on the correct things. One Canadian supplier thought: "Due diligence tends to be done to a rigid one-size-fits all template. There is not a good connection between the level of engagement in the due diligence process and the actual solution that may be required. Customers often cast the net out wide to see what they can catch, as opposed to more focused due diligence that would elicit the kind of information that the customer needs to make the right decision."

As to how customers could improve, one general counsel of a European telecoms provider summed it up: "If I was a customer I would first satisfy myself of the financial viability of the supplier to make sure it is well structured, well managed and financially stable. I would then want to understand the capability of that supplier versus the services I wanted it to perform."

Due diligence on key personnel: suppliers



Due diligence on key personnel: combined customers



A project manager who has "misrepresented" his qualifications might fatally damage a project. In light of the prevailing economic climate and the fallout from rogue employees at Satyam and EDS, we think that customers should review their processes to ensure they are properly protected.

A few suppliers were keen to stress that due diligence was a two-way process. One general counsel at a pan-European supplier said: "One of our real frustrations is the lack of respect from customers that we have got to do proper due diligence [on them]. It is in both our interests to do proper due diligence." In South Africa, the executive director of technology at a large international supplier said: "Both parties now see due diligence as a process to assess whether this is a good deal. The clients want to know that they will get 'bang for their buck' and that the supplier can actually do what is promised. The supplier wants to ensure that the project will be profitable and that they understand all the risks involved. The due diligence is the opportunity for both parties to define accurately the baseline from which they will be operating."

Due diligence on key employees

We wanted to understand more about the level of due diligence customers conducted on the incoming key personnel of the supplier. We believe there are three different levels of due diligence: none; basic (CV check); and detailed (full background checks, verification of qualifications etc).

Around one-third (35 per cent) of both suppliers and customers said detailed due diligence was conducted on key personnel. At the other end of the spectrum, 20 per cent of suppliers and 35 per cent of customers said no due diligence at all was conducted on key personnel.

The collapse of Satyam

On 7 January 2009, the chairman of Satyam Computer Services (Satyam), one of India's largest software companies, admitted that he had been manipulating the company's accounts for several years and had inflated the value of the company by $1 billion. This corporate fraud dented the confidence both of investors and of companies generally who outsourced their services offshore.

The first sign of trouble appeared in December 2008, when Satyam's directors unanimously approved the purchase of two companies owned by the chairman's family. The transactions were stopped but the incident significantly damaged Satyam's reputation nationally and internationally. When the value of Satyam shares dropped, lenders began liquidating the family stake to realise their collateral, forcing the chairman to admit his fraud.

Eventually Tech Mahindra bought a stake in Satyam and re-branded it. Meanwhile, global customers of Indian IT suppliers began to question the transparency of their suppliers.

BSkyB v EDS

In January 2010, the UK High Court found that the IT supplier Electronic Data Systems (EDS) (now part of HP Enterprise Services) had fraudulently misrepresented its ability to meet the timescale stated when it pitched for a £48 million project to build and implement a customer relationship management system for BSkyB. The contract capped EDS's liability at £30 million, in stark contrast to BSkyB's original claim for damages, which was in excess of £700 million. In February 2010, EDS was ordered to pay BSkyB interim damages of £270 million, which indicated that the final damages figure would be at least equal to that sum. BSkyB and Hewlett-Packard subsequently settled this case in June 2010, with Hewlett-Packard agreeing to pay BSkyB £318 million to settle the action. This sum took into account the February 2010 interim payment.

Hewlett-Packard acquired EDS for around $13.9 billion in May 2008, in order to strengthen Hewlett-Packard's servicing business and improve EDS's finances.

Some suppliers thought customers assumed that suppliers would have done the necessary due diligence on their own staff and so there was no need to repeat the exercise. Indeed, some suppliers actively sought to discourage this kind of investigation and were also unwilling to name key personnel in the contract. One UK general counsel of a European supplier said: "Our philosophy is that if a service is outsourced, we control the personnel delivering it. It is service functionality/performance that is the test of whether we are delivering, not who is delivering." Another general counsel of a UK supplier said: "We never name individuals in contracts – I don't see the point. What happens if they leave? We don't allow [clients] to get involved in succession planning either. We need the ability to move our guys around if we need to."

We were surprised at these results. A project manager who has "misrepresented" his qualifications might fatally damage a project. In light of the prevailing economic climate and the fallout from rogue employees at Satyam and EDS, we think that customers should review their processes to ensure they are properly protected.

Norton Rose Group view

Selecting the most appropriate supplier for a project can reduce risk substantially. It is incumbent on a customer to devise a due diligence process that will properly test and evaluate potential suppliers. A successful due diligence exercise should not just be a paper exercise; it should involve visiting potential suppliers, testing technology and speaking to other customers of the supplier. It is also important for customers to consider soft issues such as cultural fit. All too often outsourcing goes wrong because it was not possible to create an effective working partnership between customer and supplier.

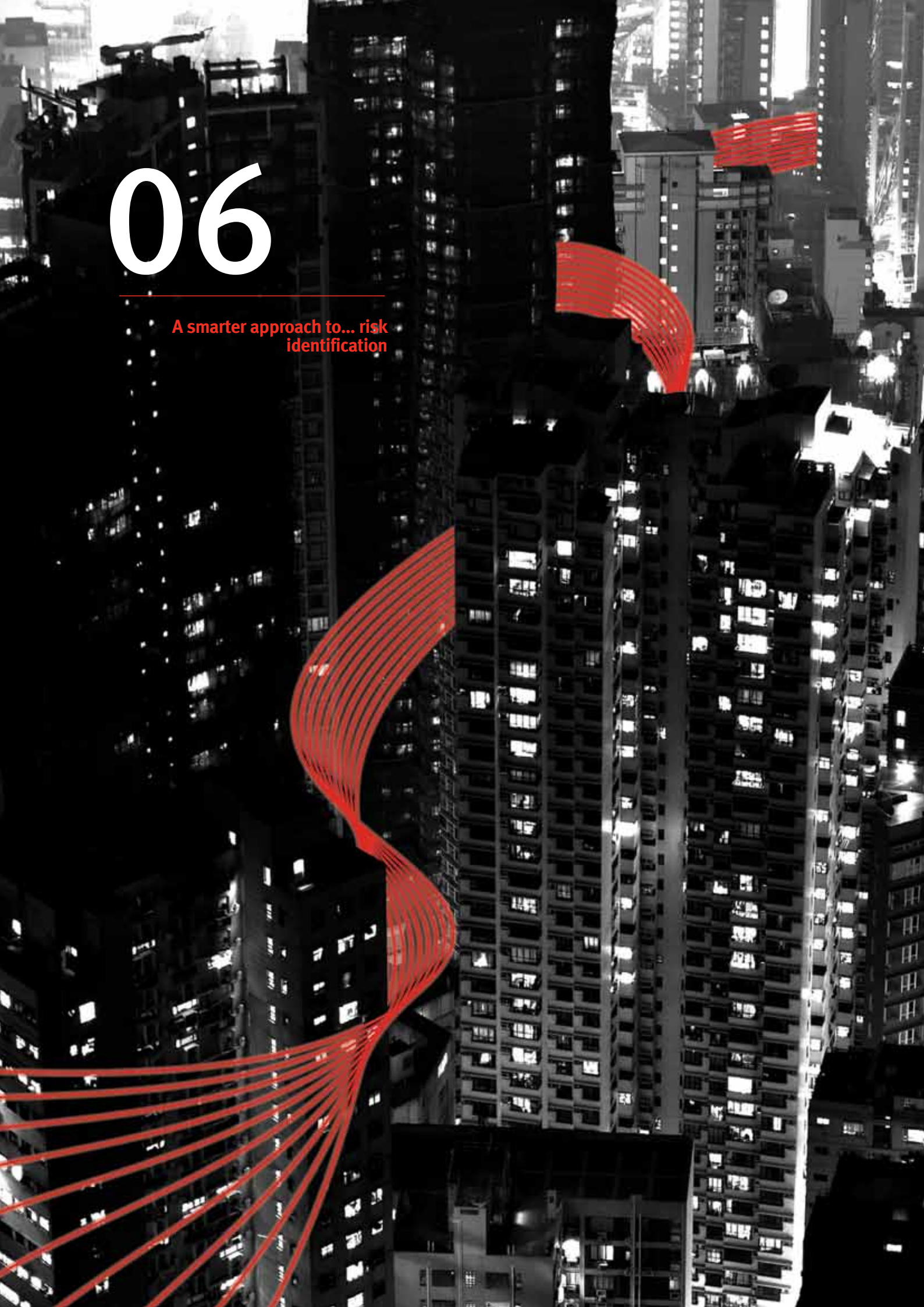
The financial aspects of due diligence are also important. This should not only involve looking at accounts but also reviewing the financial viability of the supplier's business case for the project and the ownership structures. It is important to remember that this financial due diligence needs to be repeated regularly after the contract has been entered into. Circumstances can change quickly and customers need to be aware of any deterioration in their suppliers' solvency situation.

A successful due diligence exercise should not just be a paper exercise; it should involve visiting potential suppliers, testing technology and speaking to other customers of the supplier.

Finally, as one of our participants noted, due diligence is not a one-way process. It is equally important for suppliers to review their customers' financial situation and to gain a full understanding of the business being outsourced.

"Invest in learning to understand the business of the client. Suppliers must understand their clients' business processes to provide a good quality service." ***CEO of Global CIO advisory group, French professional services firm***

"We've done an overall risk assessment of our supplier base. Those that are business critical are the ones we need to know a lot more about, so we are doing an audit of them. The more critical the service, the more due diligence we do." ***Head of procurement, UK financial services firm***



06

A smarter approach to... risk identification

A smarter approach to... risk identification

Background

There are many types of risk which should be addressed in any outsourcing. It is important that the customer has a full understanding of the risks associated with an outsourcing project. The customer needs to identify relevant risks and draft the contract with the risks facing the business in mind. Risk should be considered holistically by the legal, operational and project management team. Once identified, the customer should evaluate how likely it is that the risk will arise and what loss will be suffered if the risk materialises. Customers need to consider how risks can be minimised and whether they are best placed to manage such risk. The risk profile should be shared with suppliers before they can attribute a proper cost to carrying such risk.

In our 2008 survey we asked customers how they approached risk in outsourcing projects and how they identified risk. The survey revealed that industry sectors rated and evaluated risks differently. We decided to repeat this exercise. We asked customers to rate the importance of certain risks to outsourcing. We then asked suppliers how important they thought their customers rated these risks. We have categorised risks as Tier 1 risks (extremely important to the business); Tier 2 risks (important to the business) and Tier 3 risks (less important to the business). As in the last survey, an analysis of customer views on risk by industry sector provided some interesting comparisons and reiterated the conclusion of the last survey that a uniform approach to risk evaluation and hence commercial, operational models is not possible.

Analysis: project risks – consolidated customer view/supplier view

As in the last survey, a comparison of supplier and customer results showed a worrying mismatch of understanding. For example, customers rated reputational damage as a Tier 1 risk; suppliers rated it as a Tier 2 risk. In the current economic climate, suppliers should be more aware of the importance their clients place on reputation. Even entering into an outsourcing deal may adversely affect a customer's brand. For example, in Western economies consumers can be hostile to companies who offshore jobs. Indeed, this hostility has led to the repatriation of some customer-facing functions. Suppliers need to appreciate this. Suppliers also rated service performance failure as a Tier 1 risk; customers rated it Tier 2. Suppliers can be too focused on the operational services they deliver and fail to look at the big picture. Finally, suppliers rated insolvency risk as a Tier 3 risk. In the current economic climate, this has moved up the customers' list of concerns to Tier 2.

In Western economies consumers can be hostile to companies who offshore jobs. Indeed, this hostility has led to the repatriation of some customer-facing functions.

Consolidated customer view
Tier One
Breach of security/data loss
Reputational damage
Business disruption /service availability
Tier Two
Service performance failure
Regulatory risk
Supplier insolvency
Loss of revenue
Tier Three
Project delay
Political/jusrisdictional risk
Employee issues

Project risks – financial institutions

As in the last survey, financial institutions ranked breach of security/data loss, reputational damage and regulatory risk as Tier 1 risks. The demise of Lehman, increased regulation (or the threat of it) and the damage to the reputation of many financial institutions in the last three years, have all reinforced their view that these risks are key to their business. This is not surprising. It is not just data privacy regulators who can impose fines on financial institutions, financial regulators can too. For example, the UK FSA imposed a £2.75 million fine on Zurich Insurance plc when its captive outsourcer in South Africa lost customer data.

In Singapore, the Monetary Authority of Singapore, which has always had stringent oversight over outsourcing in the sector, has recently ramped up the level of oversight. Since August 2011, all financial institutions wishing to enter into material outsourcing arrangements (which would cover any IT outsourcing) have to complete a detailed technology questionnaire explaining, amongst other things, what the outsourcing contract entails, policies, board approval and whether legal advice has been obtained.

The risk which has become of much greater importance is that of the supplier's insolvency.

Financial institutions, like many other businesses, have a far greater awareness of the solvency of their key suppliers, with many only prepared to deal with large suppliers with good credit ratings. The importance placed on this risk suggests they believe the economic situation will not improve any time soon.

Risks relating to the outsourced function such as service performance failure/business disruption were regarded as important but were thought to be more easily managed and so were relegated to the second tier. This is in sharp contrast to the suppliers' view.

Political/jurisdictional risk was the lowest rated. This was not because financial institutions were not cognisant of political/jurisdictional risk but rather that they tended to have lists of approved territories which met the approval of their board. If a territory was not approved it wouldn't generally even be considered.

Commenting on the approach he thought his suppliers should take, the head of vendor governance at a German bank said: "Vendors need to realise that they should add value in long-term relationships rather than living on a yearly P&L. They should have a five-year plan. They also need to understand the clients' business objectives and risk and provide proactive support."

Supplier view on customer risk
Tier One
Business disruption/service availability
Service performance failure
Breach of security/data loss
Tier Two
Project delay
Reputational damage
Regulatory risk
Loss of revenue
Tier Three
Supplier insolvency
Employee issues
Political/jurisdictional risk

Financial institutions
Tier One
Breach of security/data loss
Reputational damage
Regulatory risk
Tier Two
Supplier insolvency
Service performance failure
Loss of revenue
Business disruption/service availability
Tier Three
Project delay
Employee issues
Political/jurisdictional risk

"Vendors need to realise that they should add value in long-term relationships rather than living on a yearly P&L. They should have a five-year plan. They also need to understand the clients' business objectives and risk and provide proactive support."

Project risks – transport, energy and infrastructure

This sector is not as heavily regulated as the financial services sector, nor has it been as uniformly badly affected by the global financial crisis. As a consequence, regulatory risk and reputational damage were not considered so important. Rather, participants tended to focus on risks such as service performance failure and business disruption/service availability which would impact directly on their customers. Also of key concern to those retail energy customers with big consumer client bases was the issue of breach of security /data loss. Data privacy is increasing in importance around the world with more pro-active regulators enforcing the law.

Once again political/jurisdictional risk was rated low. In part we think this is because these companies are used to dealing in countries regarded as less stable and have well developed mechanisms for assessing and managing risk of this sort.

Project risks – professional services

Whilst not subject to the same regulatory regime as the financial services sector, professional services firms are required to deliver a discreet, secure and timely service. A failure to do so could cause irreparable damage to their reputation. As a consequence breach of security/data loss, reputational damage and business disruption/service availability were classed as Tier 1 risks, just as in the last survey. As the UK head of procurement at a global professional services firm put it: "Our reputation is pretty much our licence to operate."

Perhaps by nature conservative businesses, participants tended to shy away from risky countries and wanted to contract with large credit-worthy suppliers, with the consequence that they did not have to assess political risk or insolvency very often.

Transport, energy and infrastructure
Tier One
Service performance failure
Business disruption/service availability
Breach of security/data loss
Tier Two
Project delay
Supplier insolvency
Reputational damage
Regulatory risk
Tier Three
Political/jurisdictional risk
Loss of revenue
Employee issues

Professional services
Tier One
Breach of security/data loss
Reputational damage
Business disruption/service availability
Tier Two
Service performance failure
Loss of revenue
Project delay
Regulatory risk
Tier Three
Political/jurisdictional risk
Employee issues
Supplier insolvency

Project risks – technology and life sciences

As consumer focused businesses, those in the technology and life science sectors were concerned about breach of security/data loss and business disruption/service availability which all impact directly on their reputation. Only some businesses in this sector, for example, those in telecommunications and life sciences, are regulated. Those that were tended to regard regulatory risk as key; its ranking is lowered by the views of non-regulated businesses.

Alone of all the sectors, supplier insolvency was regarded as a Tier 1 risk. Perhaps technology companies are just more aware of how difficult it would be operationally to unwind an outsourcing in an insolvency situation.

At the bottom of the list they ranked employee issues, political/jurisdictional risk and loss of revenue.

Project risks – retail and brands

The consumer facing industries were, not surprisingly, focused on business disruption/service availability, reputational damage and breach of security/data loss. They are completely focused on the service/product provided to consumers and their key aim is to maintain the customer's positive view of their brand.

We were surprised to see that this sector ranked supplier insolvency last. Given their dependency on their supply chain we thought they would have scored it more highly.

Regional differences

As one would expect, the approach to risk is influenced by the legal and political framework in which a business operates. This has a great impact on the risk assessment process.

In the Middle East, damage to reputation was the risk of most concern, a reflection of the particular importance placed on reputation in Middle Eastern countries.

Europe (excluding the UK) and Asia Pacific (excluding Australia) were the only regions who rated employee issues as an important risk. In countries such as Italy, France and Germany this can be explained by the power of trade unions and work councils and considerable employee protection laws. In Australia there are relatively few laws that impact on the employment relationship as a result of an outsourcing arrangement. However, in Asia the situation varies from country to country. Some such as Hong Kong and Singapore are lightly regulated and offer employees little protection. Others such as Japan have tough employee protection regulations.

Technology and life sciences
Tier One
Supplier insolvency
Breach of security/data loss
Business disruption/service availability
Tier Two
Regulatory risk
Reputational damage
Service performance failure
Project delay
Tier Three
Employee issues
Political/jurisdictional risk
Loss of revenue

Retail and brands
Tier One
Business disruption/service availability
Reputational damage
Breach of security/data loss
Tier Two
Project delay
Service performance failure
Regulatory risk
Loss of revenue
Tier Three
Political/jurisdictional risk
Employee issues
Supplier insolvency

Accordingly, a company looking to outsource in Asia would need to do a country-by-country analysis of the laws that apply.

Processes for identifying risk: the supplier view

In addition to asking suppliers to rate risk, we also asked what processes, if any, they followed to identify and evaluate risk. Seventy per cent said they kept a written risk register. Forty-three per cent allocated a risk manager to the project (although this person might also have another role). This means that three out of ten kept no written risk records and half had no dedicated risk manager; a result which we found very surprising. It also runs counter to what the largest suppliers said happened in their organisations. One European general counsel at a US supplier said: "Risk identification was fundamental to getting the bid signed off." Another general counsel of a European supplier agreed risk had become more important. There was now a formal checklist of risk items and various review boards before a bid could be submitted. There was a further review before signing the contract. These risks registers were often maintained post-signature.

Processes for identifying risk: the customer view

Just 42 per cent of customers allocated a risk manager to the project (although as at suppliers, this person may also have another role). Only 51 per cent kept a written risk register. Once again we were surprised by these results and think customers should improve their processes and invest more resource in identifying and evaluating risk. Whilst in North America, Europe and parts of Asia Pacific there was an awareness of best practice (even if they did not adopt it) the situation was different in the Middle East. In the Middle East, no participants had a risk manager and only one kept a register. They preferred a less formal approach to risk management. One financial services institution explained this lack of formal process as follows: "You must recognise that corporatisation in this part of the world is only 20 years old. When we start comparing that with Europe, North America and some parts of the Far East [the comparison] is just unfair. Different stages of evolution, different culture, different needs and wants. Nobody in the world – whether it is in the Middle East or North America – wants to get ripped off; but they manage it in different ways."

Norton Rose Group view

We do not think that enough customers and suppliers are placing risk assessment high enough on their agenda. There can be no "one-size-fits-all" attitude to risk. It is important that customers identify risks at the outset of any project, even before issuing an invitation to tender. Every outsourcing project will have different risks associated with it, so even using risk registers from previous deals as templates can be dangerous. Once identified, the customer should evaluate the likelihood of the risk arising and the damage caused if the risk materialises. Then, the customer should decide what level of risk is acceptable in the context of the project. In our view, it is important that customers share their risk profile with suppliers, alerting them to the risks which are of most concern to their business. Customers and suppliers need to have an open and honest conversation about risk. Only then can they best decide how to manage it. Finally, we recommend that a risk manager is included in the project team, even if this person also has another role.

"I will trust you for as long as you can prove you can be trusted. I want to treat you as a team member, but you need to be honest and straight. It's all about transparency and trust." ***Head of procurement, UK insurance company***

"I think risk has become a much more critical factor in the decision-making process. Aligned with this it is critical to understand what is critical to your competitive advantage... Anyone can outsource grass cutting. However, if you are a lawn company then that's your core business and critical to your success as an organisation. So understand what you are doing and what is core to your business. Anything that isn't [core] can go." ***Head of procurement, UK financial services firm***

07

A smarter approach to... risk allocation

A smarter approach to... risk allocation

Background

When deciding how to allocate risk, customers should consider whether risk can be best managed by the customer or the supplier; they should take a realistic view. They should focus on those risks which are real and important to the business. They should not get into a deal-breaking position on risk, if the overall risk profile of the arrangement is low. They should also remember that risk will be priced into the contract. As one Canadian supplier said: "If clients try to shift all risk to the supplier, we must price accordingly."

Having ascertained what risks parties face, we asked which party should take responsibility for managing the risks associated with an outsourcing project. When we talk about managing risk in this context we are talking about managing risk from an operational point of view. We are not talking about accepting legal liability for risk. Participants were asked whether it was the supplier, customer or both parties who were best placed to manage specific risks. We asked the same question in our 2008 survey and we wanted to find out whether the approach to risk allocation had changed in the intervening period.

"If clients try to shift all risk to the supplier, we must price accordingly."

Supplier view

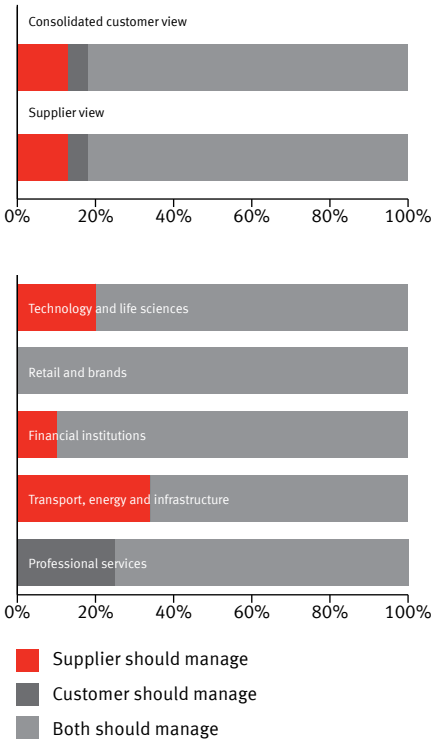
Suppliers wanted to get a clear message across: outsourcing is not about the customer abdicating its risk and responsibility. They thought customers should accept their fair share of risk or at least acknowledge that the amount of risk accepted by the supplier must be tied to the amount of its reward. The European general counsel at a US technology supplier summed this up: "Outsourcing is not about divesting responsibility."

Customer view

Customers described a variety of rationales for deciding whether the customer or supplier should take responsibility for managing risk. Risk allocation could follow liability under law or regulation. Risk allocation could be allocated to the party with the best practical means to manage risk. The CIO of a South African bank said: "Risk allocation to the party with the best practical means to manage risk, is the only option to ensure regulatory compliance and limit risks to reputation."

One UK professional services firm said: "We go with the flow. At the cheap and cheerful end of the spectrum you accept some risks and you try and manage them yourselves. At the top of the scale you might expect someone to take on more risk. You pay for what you get."

Who should manage risk: project delay



Many participants adopted a pragmatic view. A technology company in the Middle East said, "If the risk is imbalanced, the parties will act in ways that are not beneficial to the relationship."

Analysis: allocation of risk

Project delay

Suppliers and customers were in agreement: 82 per cent of each party thought this risk should be managed jointly. This is a big change since our last survey when over half of customers thought this risk was for the supplier alone. In our view this is a sensible approach. It may also reflect a change in attitude amongst customers who have come to realise that they cannot outsource responsibility for project delay. In fact this attitude has gone so far in the professional services sector that 25 per cent of customers thought they should manage project delay.

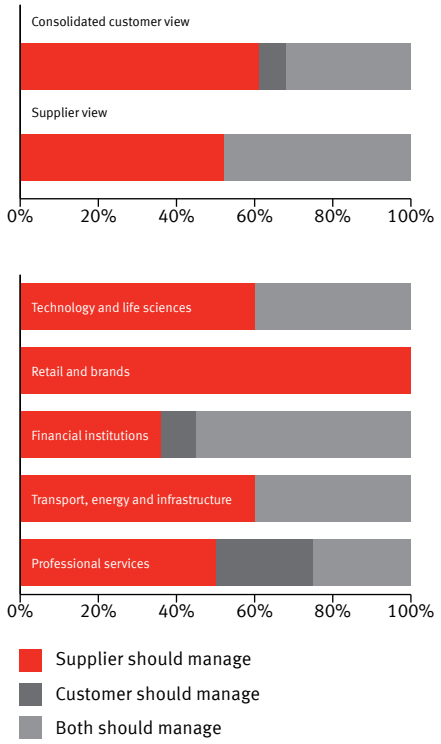
Service performance failure

More customers (61 per cent) than suppliers (52 per cent) thought service performance failure was a risk for suppliers alone. This view is broadly in line with the results of our last survey. However, this figure was distorted in part by the aggressive stance taken by those in the retail and brands sector. Given that, like financial institutions, the retail and brand sector is consumer facing we expected their views to be similar. Perhaps the retail and brands sector does not have the same sophisticated approach to outsourcing and is therefore more risk averse. In our view, from an operational perspective, there is probably good reason for regarding this as a risk which should be jointly managed; the customer will need to manage its retained functions effectively to minimise disruption caused by the failure.

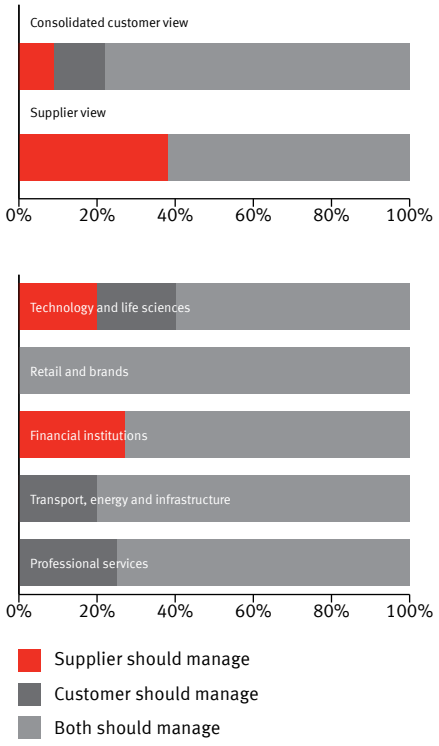
Breach of security/data loss

The great majority of respondents (78 per cent of customers; 62 per cent of suppliers) thought managing this risk should be a joint effort. Only

Who should manage risk: service performance failure



Who should manage risk: breach of security/data loss



13 per cent of customers thought this risk could be left to suppliers alone. This is an enormous change in attitude from the last survey, when 80 per cent of suppliers and 60 per cent of customers thought this was a risk for suppliers. The participants' view this time is pragmatic. In most jurisdictions, customers are responsible to regulators and their data subjects even if the data loss is caused by the supplier. Regulators do not take kindly to data owners attempting to abrogate their responsibilities and have made their views clear to industry. The increasing awareness of data privacy issues (and the fines that may be imposed) within organisations probably accounts for the change in attitude since the last survey.

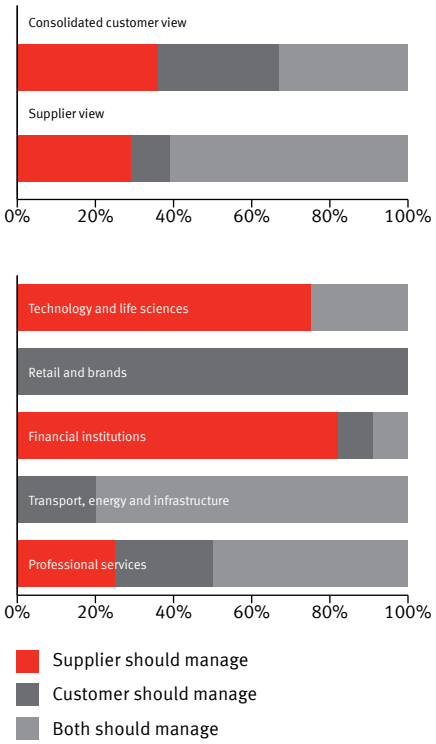
Employee issues

Customers were split three ways on this issue (about the same as the last survey). Of suppliers 71 per cent thought this was an issue for the customer or both parties together. The financial services sector and the technology and life sciences sectors took a different view to others, believing the supplier should manage this risk. It is difficult to see how this can be achieved because in many countries the customer is liable for its employees up to the point of transfer. There were some strong regional discrepancies, with customers in Europe (excluding the UK) saying they would carry the responsibility for all employee issues as they were legally obliged to.

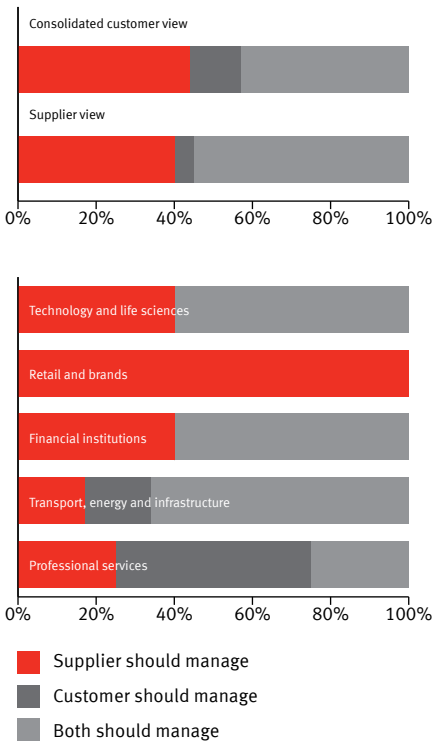
Business disruption/service availability

Forty per cent of both suppliers and customers thought this was a risk for the supplier to manage; most of the remainder thought it should be jointly managed. Standing out from this trend were professional services firms who thought they, as customers, should take responsibility for managing disruption, acting as an interface between the supplier and end user. This may be because they are so dependent on IT and other outsourced services to deliver services to their own customer base that they need to put in place back-up services to ensure continuity of service.

Who should manage risk: employee issues



Who should manage risk: business disruption/ service availability



Reputational damage

As we have seen above, reputation is key for many customers. It is therefore no surprise to see that only 12 per cent of customers thought they could leave this risk for suppliers to manage (down from 40 per cent in the last survey). Indeed, in the retail and brands and professional services sectors where the "consumer is king", no-one thought the supplier should have a role to play. Most customers take the sensible view that if their reputation is suffering they need to have some involvement in salvaging it. This could include PR, customer relationship management or, in extreme situations, customer helplines. Customers also wanted protection in the contract if they could be affected by a decrease in the supplier's reputation. A technology procurement executive at an Australian bank told us: "We insist on having a Satyam clause in all our outsourcing arrangements." (A Satyam clause is one which lets the customer terminate upon the occurrence of any event which could adversely affect the supplier's reputation.)

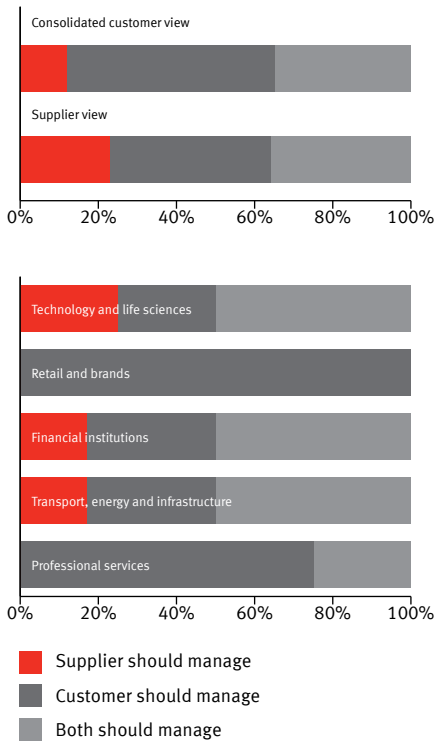
Regulatory risk

Only 13 per cent of suppliers and 16 per cent of customers thought the supplier alone should manage regulatory risk. It was only in the lesser regulated technology and life sciences and transport, energy and infrastructure sectors that a sizeable number of respondents believed this risk should be left with the supplier. In more heavily regulated sectors, participants believed their regulators would not let them outsource this risk. In the UK, for example, the FSA will not allow financial institutions to outsource risk. "In Australia, we cannot outsource regulatory compliance. We are very aware of our obligations and we look for suppliers that acknowledge these obligations and work with us to fulfill them," said a technology executive at an Australian financial services company.

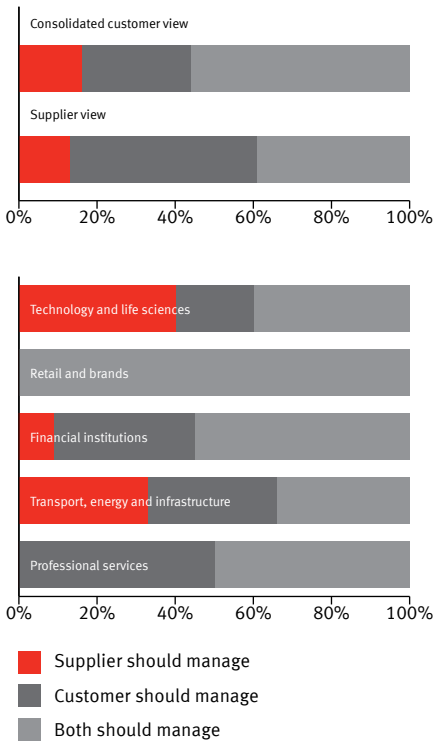
Loss of revenue

Not surprisingly, only 10 per cent of suppliers thought they alone should manage the revenue loss risk. Most customers thought this was a risk for them or should be shared. Standing out from this trend was the transport, energy and infrastructure sector where 40 per cent of participants thought this risk should rest with the supplier. In reality, it is difficult to see how a supplier can be fully responsible for managing this risk. It has no control

Who should manage risk: reputational damage



Who should manage risk: regulatory risk



over the customers' relationships with end users and so is not in a position to mitigate losses.

Political/jurisdictional risk

There was a wide discrepancy in responses: only 8 per cent of suppliers thought they should manage the political/jurisdictional risk compared with 49 per cent of customers who wanted suppliers to manage this risk. The customers' attitude appeared to be that if suppliers have chosen a jurisdiction, they should have satisfied themselves they could operate successfully there. Suppliers did not appear to share this confidence. This could lead to problems if the outsourcing does not go well. Suppliers need to have an open conversation with customers about the risks of doing business in certain jurisdictions. For their part, customers need to consider how they will manage an offshore project and how they could repatriate it if things go wrong.

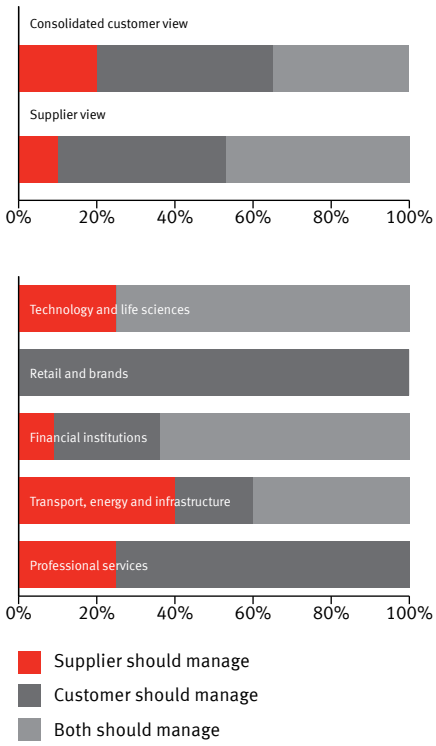
Norton Rose Group view

Customers should understand that asking suppliers to accept a greater proportion of risk will have a direct impact on the level of charges payable under the contract. For example, the transfer to the supplier of risk which would be best managed by the customer will lead to an increase in charges. We think customers need to take a realistic approach to risk allocation; there are some risks which cannot simply be "outsourced" to suppliers. Indeed, attempting to do so could damage their core business and potentially put them in breach of their regulatory obligations. In negotiating contracts, customers should focus on those risks which are real and important to their business. Where the risk is not important, they should take a pragmatic and commercial view in negotiations.

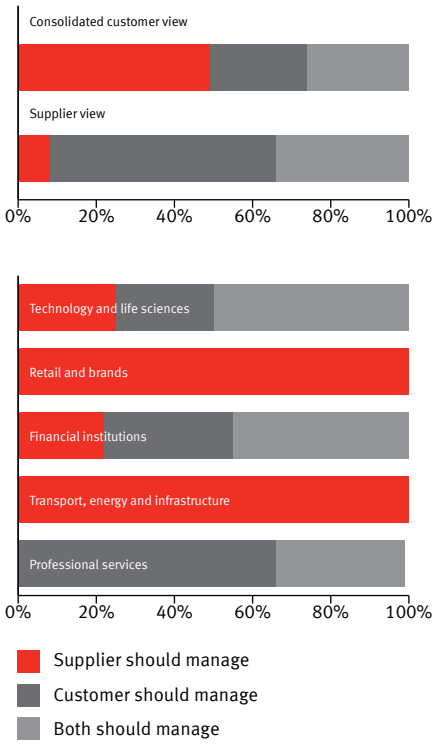
"You need a complete breakdown of price and costs. It all goes back to understanding the margin. If you can do this it opens up a whole different conversation around risk." ***CIO, global professional services firm***

"Be realistic about the allocation of risk. A contract is about the allocation of risk; not the abdication of risk. Outsourcing is not a means for abdicating responsibility." ***UK general counsel for a US technology supplier***

Who should manage risk: loss of revenue



Who should manage risk: political/jurisdictional risk



08

A smarter approach to... risk management

A smarter approach to... risk management

Background

Risk cannot be eliminated; however, it can be properly managed. Once customers have identified potential risks and assessed the likelihood of their arising and the damage they would cause, the next step is to consider what steps can be taken to manage those risks. Customers have a variety of risk management tools available to them and they need to consider which are most appropriate. These tools can be both contractual and operational. However, it is only by working together with the supplier that risk can be managed effectively.

We asked participants to score a variety of risk mitigation tools on the basis of whether a tool was not very useful, useful or extremely useful. We asked a similar question in our 2008 survey and we wanted to know whether views had changed.

Analysis: strategies for mitigating risk

Insurance

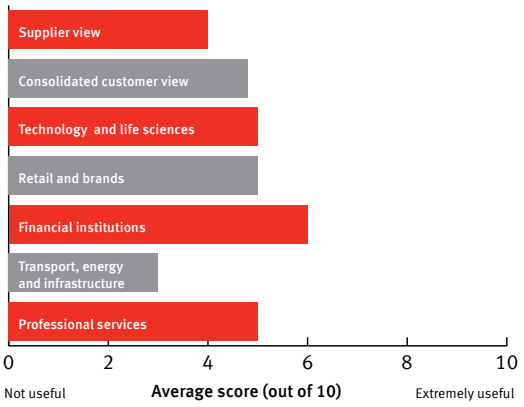
With the exception of financial institutions, no sector rated insurance more than useful. There was a similar outcome in the last survey. It is not surprising that financial institutions ranked insurance highly; in part, they are demonstrating a belief in their products. Other customers tended to take the view that even if they insisted on the supplier taking out professional negligence insurance, it may not adequately protect them. This may be right. If the main risks to a business cannot be adequately compensated by a financial payment, for example loss of reputation, insurance may not be a viable risk management tool.

Key performance indicators (KPIs), service credits and liquidated damages

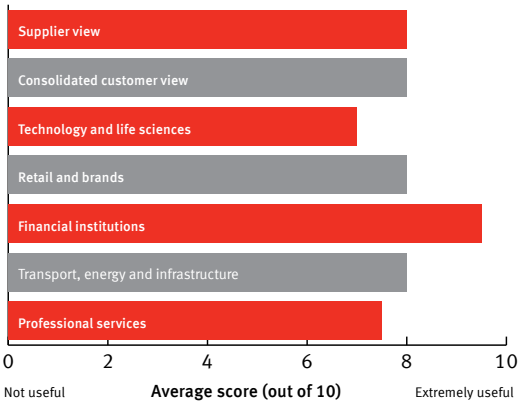
Both suppliers and customers regarded KPIs, service credits and liquidated damages as effective risk management tools. Many customers were anxious to stress that KPIs and service credits would only be effective if they were focused on key outputs and deliverables. Too many KPIs focused on minor outputs and deliverables were considered at best to be an administrative burden and at worst a costly waste of time. Suppliers agreed. One lawyer at a European financial services supplier said: "Put in four or five key things [into the service level agreement] and make sure they can be properly measured and reported on. Not 50 pages of 'deliver this report by 4pm and that report by 5pm.' If they are drafted properly they are a good way of keeping suppliers on their toes."

In Australia, there is an example of a very large transaction that has one major KPI and just a few smaller KPIs (after the parties spent months unsuccessfully trying to negotiate upward of 50 separate SLAs). However, the major KPI has been carefully chosen as it is the KPI that really causes the customer pain if it is breached. In the case of KPIs, less can be more.

Risk mitigation strategy: insurance



Risk mitigation strategy: KPIs, service credits and LDs



Technology

Suppliers had a more positive attitude to using technology to minimise risks than customers. This is perhaps not surprising; most are in the business of selling technical solutions to problems. However, there were some unusual outcomes. Three sectors only gave technology an average score: technology and life sciences; retail and brands; and professional services. It is difficult to know why the technology sector rated their own products so low.

The selection and use of the correct technology may serve to reduce risks. One example of a common problem is data loss. If this is a serious risk then a technical risk reduction solution would be to back-up data on a regular basis. Then, if data is lost, at least recent back-up discs will be available. Similarly, where security breaches are considered a threat, the customer should ensure that it has state of the art protection systems in place.

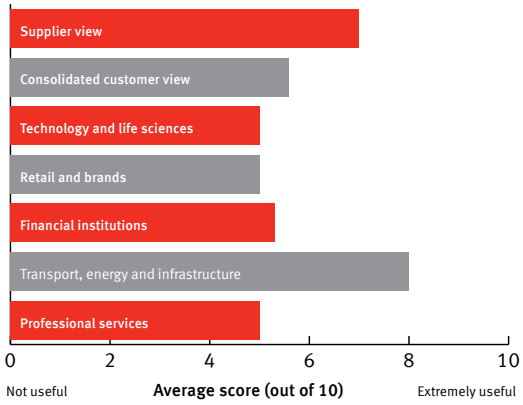
Project management

Most participants considered project management a useful risk management tool. The only exception was the retail and brands sector. At the other end of the scale, the transport, energy and infrastructure sector considered it the most effective tool. This is probably due to the value placed on project management in this sector generally and the skills of their personnel. However, some customers were dissatisfied with their suppliers' project management. A Middle Eastern retail business said: "Project management is a key weakness of offshore suppliers. Generally they do not understand the principles of project management and the lead project manager will tend to be a technical person who has been promoted after several years' service, but that person may not be the most appropriately skilled to make a good project manager." The head of procurement at a UK professional services firm agreed: "Improve the quality of account management. The difference [in suppliers] is not in price but in the way contracts are managed. I am more likely to renew if I am happy with the account manager."

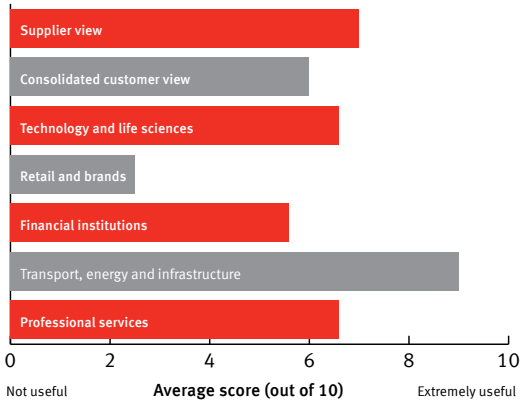
Training

Of participants, only those in technology and life sciences and professional services sectors scored training above average. Suppliers only gave it a score of 4. We are disappointed to see participants rating training so low. As those participants above

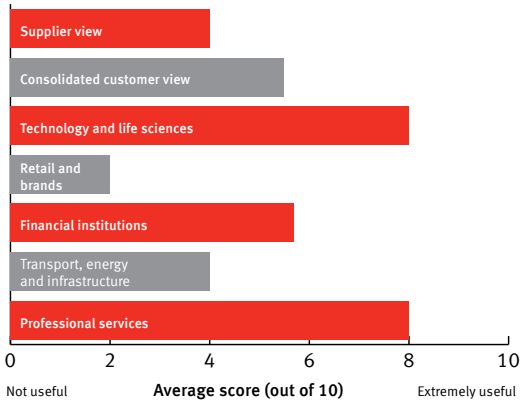
Risk mitigation strategy: technology



Risk mitigation strategy: project management



Risk mitigation strategy: training



noted, poorly trained staff are a problem and may ultimately lead to suppliers losing work. All too often human error is the cause of project failure. Both suppliers and customers should invest in training their staff. Staff need to be properly trained so that they can work effectively. The procurement team should be properly trained in current best practice to ensure their processes and contracts meet industry best practice. Project staff need to be properly trained in relationship management, to ensure they properly manage their suppliers and projects so that outsourcing delivers the promised benefits.

Multi-sourcing

Most customers thought multi-sourcing was of average use; suppliers thought it less useful. Perhaps suppliers were concerned about losing business or having to work in partnership with their competitors. If the functions being outsourced are business critical, customers may wish to diversify and appoint more than one supplier. Many suppliers think this problem is best solved by appointing a main contractor and letting them appoint sub-contractors. PA Consulting Group sets out its views on the challenges of multi-sourcing and how these can be overcome at the end of this chapter.

Due diligence

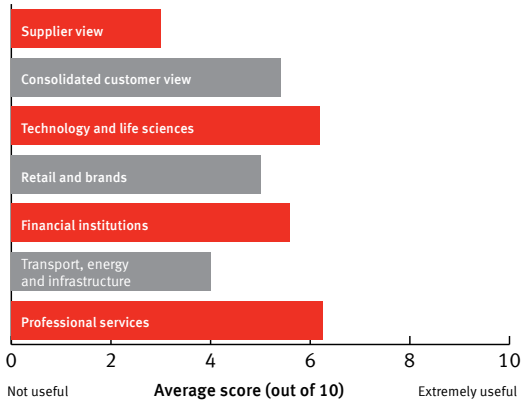
Suppliers and all customer sectors rated due diligence highly (in line with the results of our last survey). This ties in with the finding that most participants have tightened their due diligence processes in the last two years, spurred on by the economic crisis and the collapse of some prominent suppliers.

Selecting the supplier who is most appropriate for the outsourcing can reduce risk substantially. It is therefore incumbent on a customer to devise a due diligence process that will properly evaluate and test potential suppliers. This should include visiting potential suppliers, trying out their systems and speaking to their other customers.

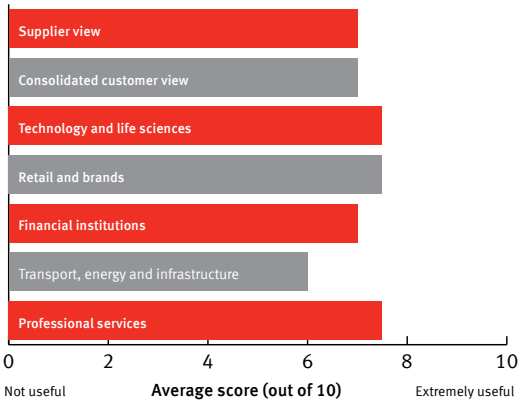
Step-in rights

With the exception of the transport, energy and infrastructure and professional services sectors, participants did not consider step-in rights a useful tool. A step-in right is the right for a customer to step in and manage the contract in place of the supplier. It is normally exercisable as a precursor to termination for breach. If the supplier is not

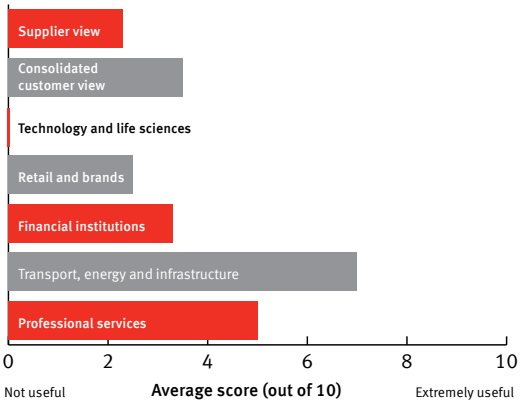
Risk mitigation strategy: multi-sourcing



Risk mitigation strategy: due diligence



Risk mitigation strategy: step-in rights



performing, then a customer may wish to consider step-in to try and salvage the contract and reduce the fees payable. Most participants thought in reality step-in rights would not work and rated it low as a result. In particular, no-one in the technology and life sciences rated it of any use at all; presumably because they were all too aware of the potential difficulties in enforcing it, and/or they did not have the skills required to manage the contract themselves. The general counsel at one UK ITO provider said: "Clients don't have the skills necessary to exercise step-in rights." Notwithstanding the practical difficulty in enforcing them, in our experience they are usually included in major contracts as a remedy of (almost) last resort.

Reporting

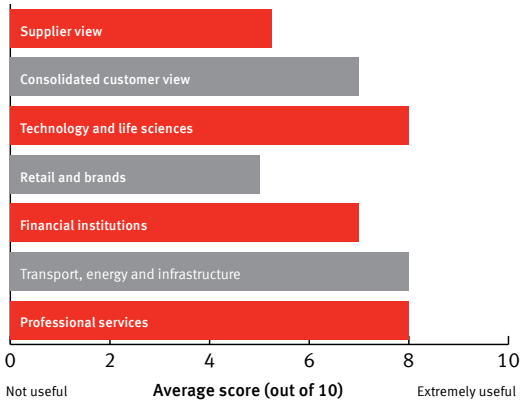
Customers believed reporting to be an effective risk management tool; suppliers were less convinced of its effectiveness, rating it of average use. However, customers in the technology and life sciences, transport, energy and infrastructure and professional services sectors all rated it highly.

For a customer to be able to mitigate risk in an outsourcing project it needs to have full visibility of its supplier's performance. To this end, the supplier should report regularly on problems and performance against targets. The customer should consider carefully what information it requires. The supplier will factor in the cost of reporting into its fees, so customers should beware of incurring unnecessary costs through requesting the production of superfluous reports.

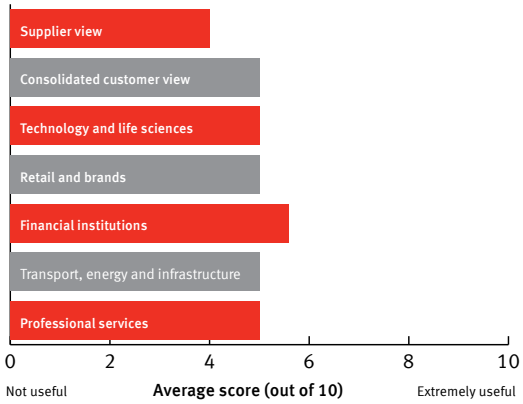
Audit rights

Audit rights did not rank highly as a risk management tool. This is surprising, especially so in the financial services sector given the requirement of many financial services regulators to include extensive audits in outsourcing contracts. The right to audit entitles the customer to carry out its own investigations as to the supplier's compliance with the terms of the outsourcing contract. It may also extend to other matters, such as supplier's compliance with relevant regulations or the supplier's solvency. Given the importance of these latter two issues, we think participants should rethink their views on the usefulness of audit rights.

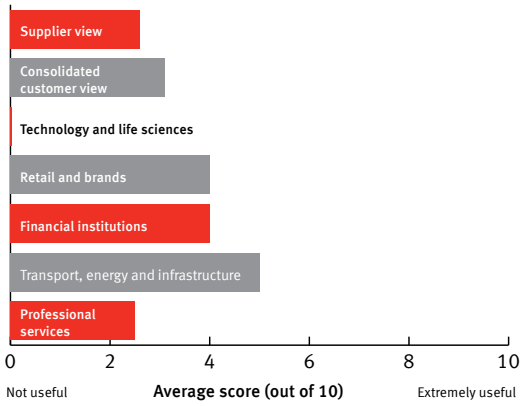
Risk mitigation strategy: reporting



Risk mitigation strategy: audit rights



Risk mitigation strategy: benchmarking



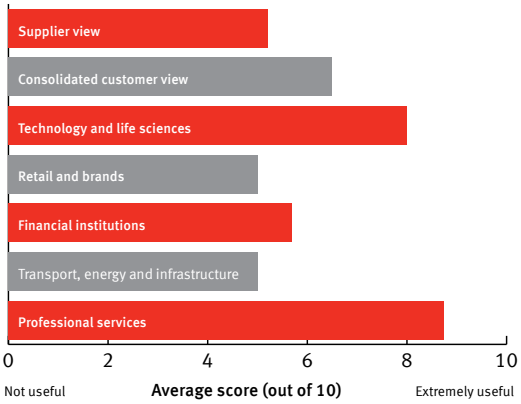
Benchmarking

Benchmarking is the comparison of the supplier's offering against others in the market place. Neither customers nor suppliers rated benchmarking highly, with no-one rating it useful. One UK general counsel of a US technology supplier was dismissive: "I'm happy to go through the process but if customers don't like the results they can go elsewhere!" This view is understandable; suppliers don't want to decrease their prices. Customers believe that benchmarking has limitations too. It can be difficult to find true comparators and data, and embarking on a contested benchmarking can profoundly damage the relationship. Some Canadian participants thought that as, in their view, benchmarking was costly, inefficient and time consuming, it would be preferable to have shorter term contracts with the possibility to ask for tender prior to renewal.

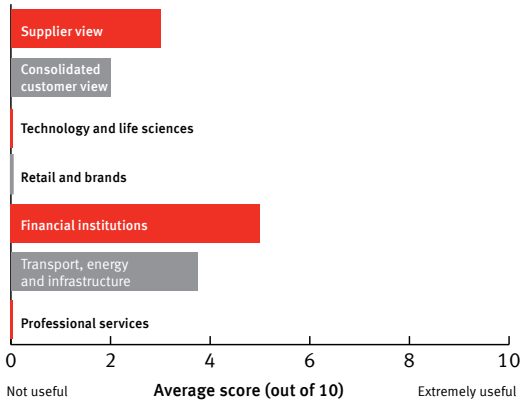
Exit planning

With the exception of the technology and life sciences and professional services sectors, exit planning was not highly rated. This is concerning given that so many participants were worried about supplier solvency but reflects the reality of contract negotiations; everyone is excited about doing the deal, rather than focusing on what will happen if it all goes wrong. The solvency of the supplier should not just be considered prior to signature of the contract; it should be an ongoing consideration. Allied to this, the customer needs to understand how it would extricate itself from the contract with minimum disruption if the supplier became insolvent. This is one of the core functions of exit planning. The exit plan should be renewed regularly and kept up to date.

Risk mitigation strategy: exit planning



Risk mitigation strategy: third party guarantees



Third party guarantees

No group of participants rated third party guarantees highly. In the main this was because many customers insisted on dealing directly with large, well-funded suppliers. Other customers had concerns about the practicalities of enforcing guarantees. This is a particular issue when there is no reciprocal arrangement between the country where the judgment is given and the jurisdiction where the guarantor is established.

However, given the concern so many participants had about solvency, this tool should always be considered. In particular where customers have concerns about dealing with subsidiaries of corporate groups, customers may wish the parent company to stand behind its subsidiary and guarantee performance and/or financial compensation.

Norton Rose Group view

In our view, customers should focus on those risk tools which they regard as effective for their business. They should not waste time, money and resources negotiating contractual provisions relating to tools which will not be used. On several occasions in interviews, customers told us they routinely asked for inclusion of clauses, for example step-in rights, which in reality that had no intention (or capability) of implementing. This led to more protracted negotiations and can sour relations with suppliers even before the deal is signed. To avoid this we suggest that on each deal, customers consider which risk management tools would be most effective and concentrate on implementing them.

In addition, parties should never underestimate the importance of good project management and be prepared to invest in it. It is in the interests of both parties to ensure good governance and project management is in place with appropriately trained project managers taking the lead.

We have seen outsourcing projects fail because when a problem arose the risks were poorly managed. In this way problems turned into a crisis. The crisis then developed a life of its own and neither party was able to manage it successfully. Consequently, the projects failed.

"Outsourcing is a collaborative situation. You need to work together to find solutions." ***Head of strategy, French outsourced service provider***

"Customers don't expect to pay more for risk management tools." ***European general counsel, US technology supplier***

Making multi-vendor sourcing work

PA Consulting Group (PA) suggests strategies to avoid the pitfalls of outsourcing to more than one supplier

When it comes to sourcing, are two heads – or more – better than one? At the risk of appearing to sit on the fence, the answer is "it depends." PA is often asked to help its clients decide between single-vendor and multi-vendor sourcing, and to help them make their chosen solution work. In this article, we focus on the challenges of multi-vendor sourcing.

The multi-sourcing trend

During the 1990s and early 2000s, single-vendor sourcing was usually the preferred choice for large-scale strategic sourcing solutions. Having the majority of supply issues handled by one entity meant that the client needed only a relatively small retained organisation (ie, unit responsible for interfacing with and managing the supplier).

The past five to six years have, however, seen a shift towards multi-vendor sourcing ("multi-sourcing" for short). Among other reasons, single vendors had been failing to deliver, or at least had been perceived as doing so. Multi-sourcing has the additional attraction of offering access to best-of-breed solutions, instead of getting everything from one vendor.

Past sourcing experience is not an adequate foundation

In an ideal world, the move towards multi-sourcing would have been a natural, evolutionary step for most clients. The necessary service management capabilities, supported by maturing governance arrangements, would have developed as a consequence of managing the original outsourcing arrangements. These disciplines would also have supplied the integration capabilities required in a multi-sourcing environment.

Unfortunately, past sourcing experience has not always provided such a sound foundation for multi-sourcing as might have been hoped.

One problem is that outsourcing business cases predicated largely on achieving cost reductions have left little scope or appetite for investing in the quality and skills of the retained organisation.

There has also been too little recognition of the value of supplier management. A single supplier can paper over the cracks of the client's failure to hold it to account, but in a multi-sourced environment those cracks are all too evident and it is no longer in the supplier's commercial interests to fill them. The onus is now on the client to fill the void.

Improvements to consider when multi-sourcing

Now those years of underinvestment need to be redressed. Any organisation that is considering, or has embarked on, multi-sourcing should review, and if necessary improve, three main areas which experience shows are problematic. These are service management, integration, and governance.

Service management

The retained organisation needs a practical understanding of the disciplines of service delivery – disciplines which should already be embedded in any blue-chip supplier's approach. With this understanding, it becomes possible to knit multiple independently delivered services into a single seamless service to the customer or end-user.

Integration

To meet service and performance commitments to customers and end-users, it's necessary to negotiate the appropriate service levels and performance criteria for each individual service, and then make sure each supplier meets their commitments. This means clearly understanding the interface points between the various services that comprise the overall supply chain. The skills and capabilities required to achieve integration are typically drawn from service management and technical architecture. Since many organisations find it difficult to attract and retain such skills, it may be worth considering the use of a service integrator.

Governance
It is obviously important to define the rules of engagement to be followed when working with suppliers: how and when the service is to be delivered, reported, reviewed and managed, and how exceptions and changes are handled. Many of these rules also have implications for the client side, but it is here that governance has tended to be weakest. All too often, attention is focused on contract terms and the implications for the client organisation are neglected. Governance of the retained organisation should therefore be given special attention.

Is multi-sourcing worth doing?

Clearly, there are significant costs involved in managing a multi-sourced solution properly. Do these costs negate the benefits? This is a question that every business must evaluate systematically before deciding to pursue multi-sourcing.

If the business decides to go ahead, there is a strong argument for building the competence of the retained organisation, since managing suppliers will be a core activity of the business.

It is feasible to use a third party to manage the integration aspect of multi-sourcing. Before doing so, it is important to be aware that a core business competence is being outsourced. The contract must be written in such a way as to ensure that responsibilities and accountabilities are aligned right along the supply chain.

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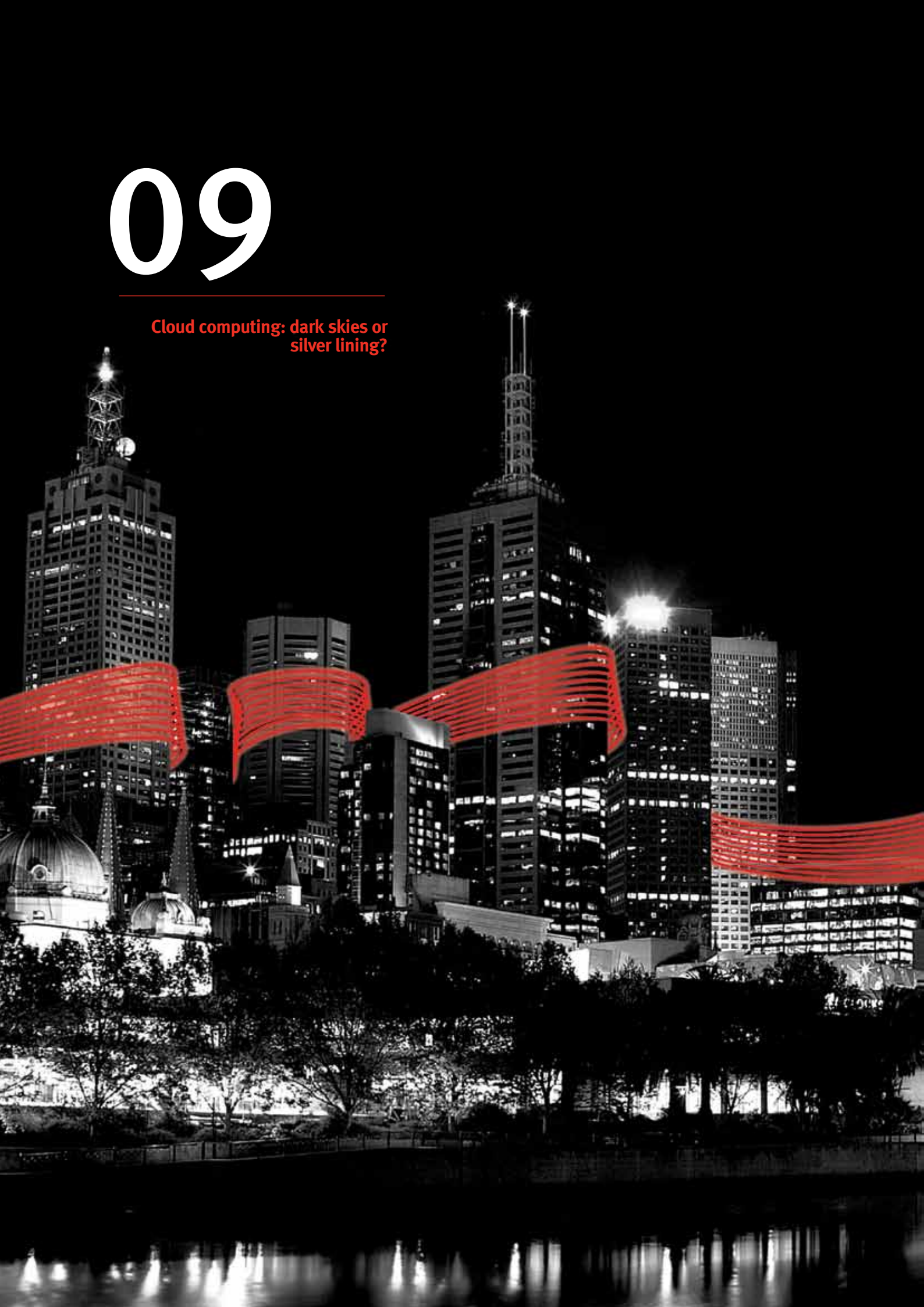
09

Cloud computing: dark skies or silver lining?



Cloud computing: dark skies or silver lining?

Background

Cloud computing is currently the subject of much media hype. In the outsourcing field the perceived upside is that its use can lead to tremendous cost savings. Several suppliers told us that they were beginning to see cloud computing take off and they thought there was a potential for huge growth. However, one supplier wanted to dismiss the idea that cloud computing was new. The UK general counsel of a data centre provider said: "The way I look at it, if you've got a hotmail account then you've been living in the cloud for many years. [The cloud] has been around for a long time but I think it is now reaching people that it didn't reach in the past because of the way it has been marketed."

Several suppliers told us that they were beginning to see cloud computing take off and they thought there was a potential for huge growth.

When we refer to cloud computing, we usually mean computing services with the following characteristics:

- the storage and network infrastructure used to store and process data and applications is shared amongst users;
- that infrastructure is in different locations; and
- the cloud service provider is able to move the data between locations in order to make best use of latent capacity in its infrastructure.

There are a number of different types of cloud:

- Private cloud – this usually refers to clouds where all the data and infrastructure is owned by and controlled by the same organisation.
- Public cloud – this refers to where the infrastructure is owned by a service provider and made available/rented to a customer to put applications and data into.
- Hybrid cloud – this is where an organisation combines a private cloud with a public cloud, perhaps for disaster recovery purposes or to deal with demand peaks where its private cloud has insufficient capacity.

The cloud's defining characteristics mean that an organisation putting data into a cloud service may not know where the data is and who has access to it.

Ernst and Young Advisory Services sets out its view on the opportunities offered by cloud computing at the end of this chapter.

We wanted to find out whether the hype was justified or whether the risks associated with cloud computing were a deterrent to its widespread use. We started by asking participants whether or not they used cloud computing as part of outsourcing. Overall 70 per cent of suppliers said they used the cloud, compared with just 45 per cent of customers. Some sectors were more averse to the use of cloud than others. In particular, the financial institutions sector (25 per cent use) and transport, energy and infrastructure sector (25 per cent use) made least use of it. There were also some big regional differences. Our South African participants stressed that cloud computing was in its infancy there, with insufficient infrastructure to support its wide use. Some parts of the Middle East North Africa region were also thought to be three to six years away from a data and telecommunications infrastructure able to support cloud computing.

Analysis

We asked interviewees to consider a number of risks associated with cloud computing and to indicate in each case whether they considered the risk to be "not very significant" or "very significant."

Supplier view

Suppliers thought the greatest risk in using cloud computing was a security breach. There have been a number of high profile incidents of hacking recently. In next place they ranked loss of data. Suppliers

thought customers needed to understand the risks before signing up to cloud computing. One UK general counsel of a US technology business said: "If you are buying into cloud, you are buying into a standard delivery model not a bespoke service. If that is not adequate then you shouldn't buy the service."

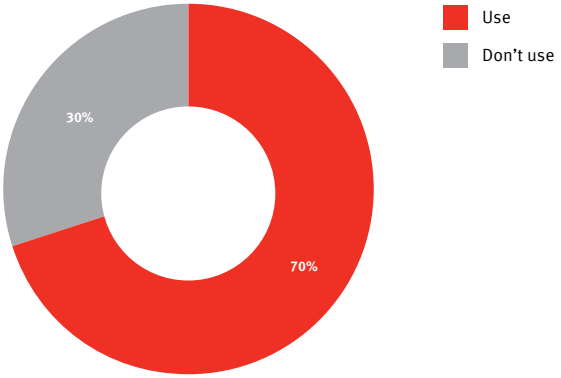
Combined customers' view

Like suppliers, customers thought the greatest risk was a security breach. In second place they put compliance issues. As we note in other parts of this report, regulators (whether sector specific regulators or data privacy regulators) have increased their focus on the protection of consumer data, in some cases imposing significant fines for loss. Customers cannot contract out of their legal obligations to regulators so it is no surprise to see them rating it so highly. They were not as concerned about losing data or losing control of data, perhaps placing more faith in disaster recovery/data retrieval systems than suppliers. Those participants who used the cloud had adopted a variety of controls to manage the risks set out above. Many had visited the data centre as part of their due diligence. They even insisted in the contract that only those data centres be used. They then only permitted the cloud to be used for less sensitive data and/or used encryption technology. Some were only prepared to use private clouds.

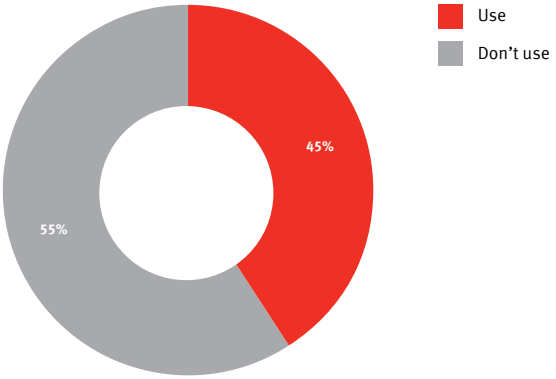
Technology and life sciences

Seventy-five per cent of customers in the technology and life sciences sector used the cloud; a reflection of their greater ease with new technologies. Customers in this sector tended to score the risks associated with cloud computing highly. The only risk which they regarded as not significant was

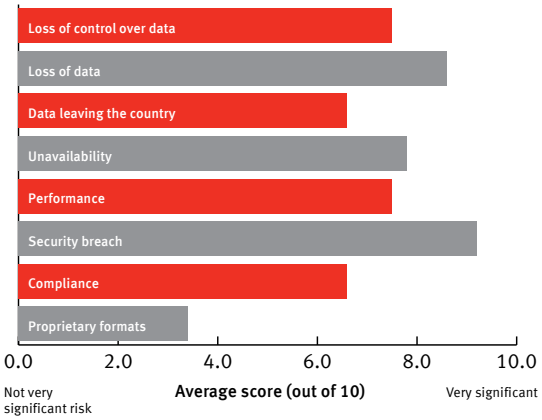
Use of cloud computing: suppliers



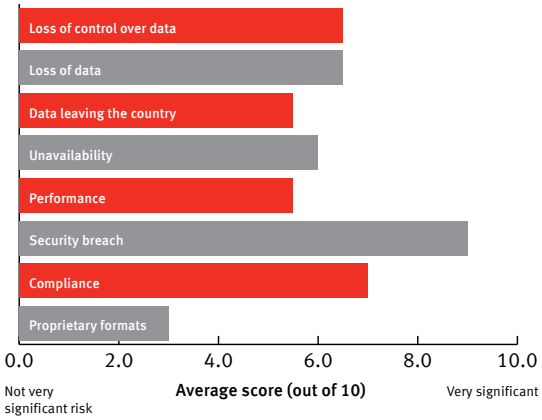
Use of cloud computing: combined customers



Risks: suppliers



Risks: combined customers



proprietary formats. Proprietary formats is the use by suppliers of their own formats to store data once it has been transferred to them. It can be difficult to migrate data back to a customer at the end of a relationship as these formats are not compatible with the customers' systems.

Notwithstanding their attitude to risk, companies in this sector made great use of cloud computing. They were satisfied that these risks could be managed by a mixture of contract, technology and operational procedures.

Retail and brands

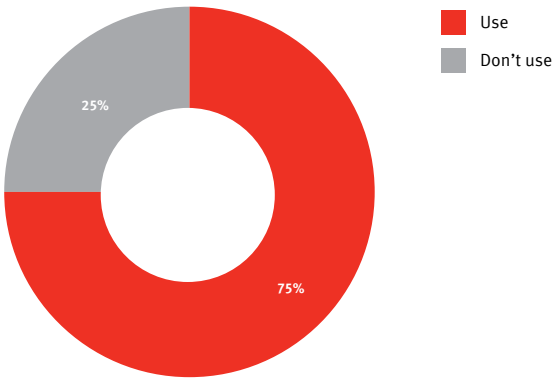
In the retail and brands sector, 40 per cent of customers used the cloud. Notwithstanding this low take up, they scored risks lower than other sectors.

Respondents in the sector were only concerned by security breaches and a loss of control over their data. Otherwise they rated risks low. It may be that they were more prepared to live with risk if the upside was reduced costs. In the areas of data leaving the country and compliance they were far less concerned than other sectors, reflecting the fact that they are not as regulated (at least not by industry specific regulators).

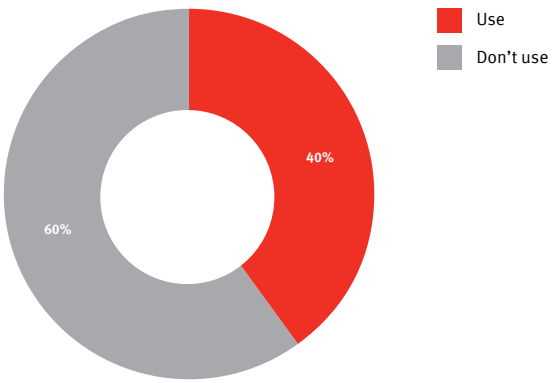
Financial institutions

Only 25 per cent of customers in this sector used the cloud. This probably results from the risks that posed the greatest concern. As expected, security breach and compliance were the key concerns for customers in this sector. They gave both the highest possible score. Indeed, they were concerned about all risks except proprietary formats. The deputy CIO

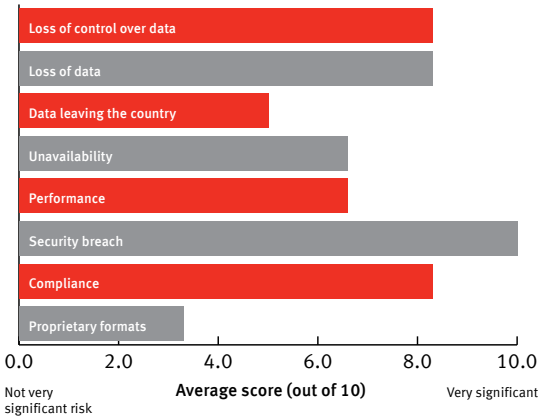
Use of cloud computing: technology and life sciences



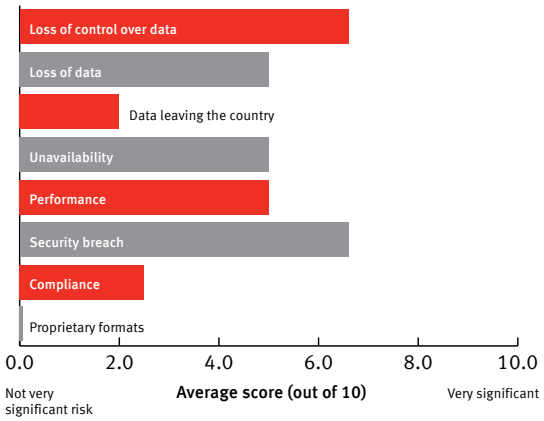
Use of cloud computing: retail and brands



Risks: technology and life sciences



Risks: retail and brands



at an Australian insurance company said: "We use the cloud but we have backup of all important data just in case the cloud goes down." Some financial institutions also doubted whether they could put in place sufficient controls to manage these risks, resulting in a low rate of adoption of cloud computing. Even those who had adopted it tended to favour private clouds.

The deputy CIO at an Australian insurance company said: "We use the cloud but we have backup of all important data just in case the cloud goes down."

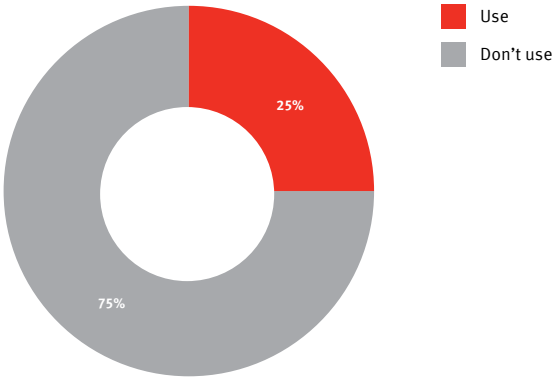
Transport, energy and infrastructure

Only 25 per cent of customers in the transport, energy and infrastructure sector used the cloud. Indeed, amongst participants this sector had the least familiarity with the cloud. One manager at a Dutch energy firm told us he had barely heard of it. The general manager of an Australian energy firm said: "Cloud providers have a lack of understanding of our needs and our difficulties with legislation." In common with other sectors, the participants' greatest concern was a security breach.

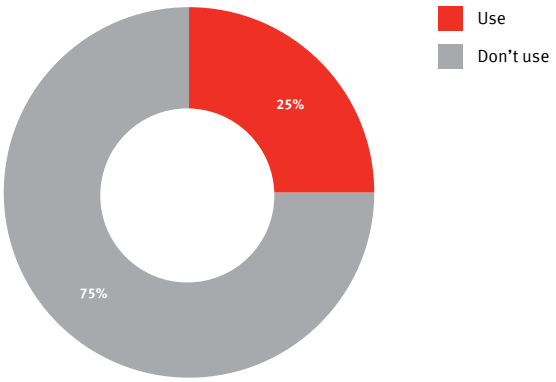
Professional services

In the professional services sector, 40 per cent of customers used the cloud. Just like the financial services sector, this sector awarded the risks around security breaches and compliance the highest

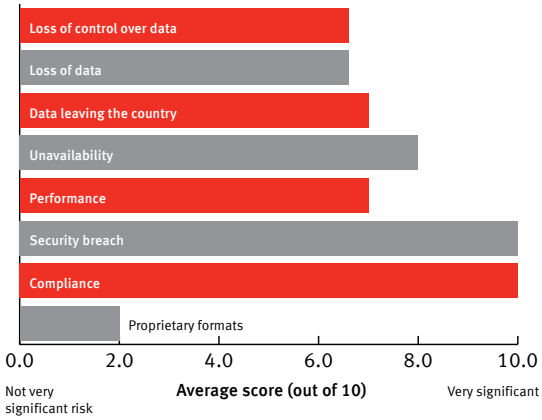
Use of cloud computing: financial institutions



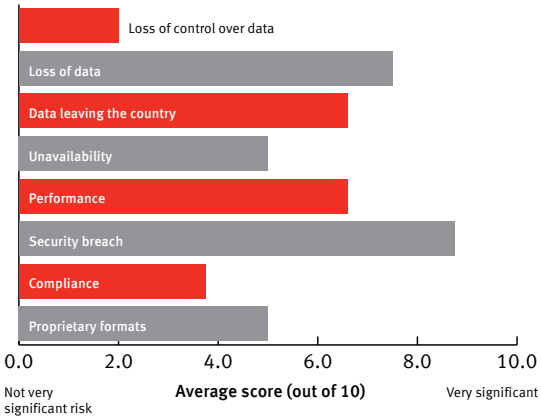
Use of cloud computing: transport, energy and infrastructure



Risks: financial institutions



Risks: transport, energy and infrastructure

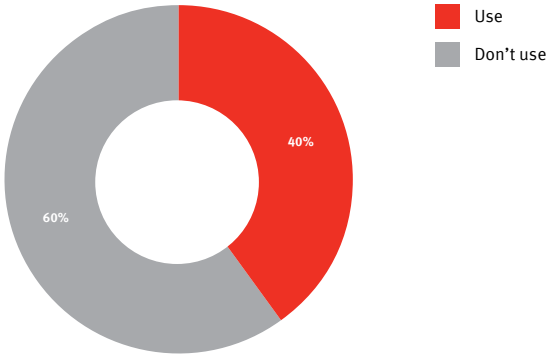


possible score. Customers were also very concerned about data leaving the country and losing control of data. Like the financial services sector, professional services firms are very focused on maintaining their brand and reputation. Any adverse publicity caused by a data breach could be very damaging. Those who had used cloud computing had done a great deal of due diligence on suppliers and their facilities.

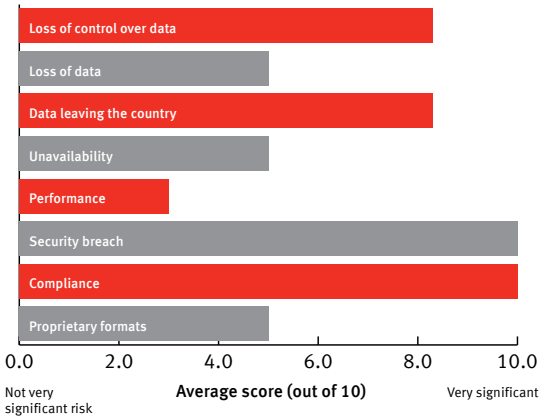
Norton Rose Group view

It is clear that cloud computing presents opportunities in the outsourcing field. The use of shared infrastructure enables providers to reduce their costs and presents customers with an opportunity for cost savings.

Use of cloud computing: professional services



Risks: professional services



There are, however, risks involved. Customers need to be aware of these risks and decide how material they are for their business. Businesses, for example, which do not process personal or sensitive data may be far more willing to use the cloud as a solution than those whose business involves the processing of highly confidential personal or financial information. Ultimately, customers need to balance the risks against the potential cost savings. It may be the case that they decide certain information may be stored in the cloud but other data should not. Once a decision to use the cloud has been made, customers should conduct rigorous due diligence on the supplier and their site before committing to a contract. Customers should also consider whether a public, private or hybrid cloud would best suit their needs.

It is clear that cloud computing presents opportunities in the outsourcing field. The use of shared infrastructure enables providers to reduce their costs and presents customers with an opportunity for cost savings.

"We have had a cloud service offering for a while. Previously it has not gone strongly despite a couple of relaunches. But in the past year it has got traction and we have seen much larger, strategic deals."
European general counsel, US technology supplier

"I consider whether I am prepared to store information in the cloud. If so, then I insist on access to named data centres, a strong contract (not one off-the-shelf like a licence) and due diligence. I may also want to use a private cloud."
Head of vendor governance, German bank

Cloud computing

Ernst and Young Advisory Services

Today, many routine, low-value services can be outsourced using traditional outsourcing offerings. Looking ahead, we expect higher-value business process services to evolve, that will ride atop multiple underlying cloud computing services. These new services will be based on the ability of business experts in different domains to optimise a process and deliver it via cloud-based IT services. Ultimately, future organisations may create flexible and innovative offerings by combining such optimised services for themselves and for external users. That is why cloud computing is referred to as "the next generation of outsourcing."

Cloud computing services are already available across the entire computing spectrum; however, various interpretations exist of what "cloud computing" is. The US National Institute for Standards and Technology has published a definition of cloud computing that has been adopted and referred to internationally. This definition contains five essential characteristics of a service in order for it to be a cloud-based service. These characteristics are: on-demand self-service; broad network access; resource pooling; rapid elasticity; and measured service. The definition further includes the three service models: "Infrastructure as a Service" (raw computing power, storage and network bandwidth); "Platform as a Service" (databases, development tools and other supporting components for custom applications); and "Software as a Service" (both general applications such as word processing, email or spreadsheet and specialised applications such as customer relationship management (CRM) and enterprise resource management (ERM)).

Additionally, we believe a fourth service model is evolving: "Business Process as a Service", combining multiple components of each of the primary three to deliver an entire business process. The market is evolving at different speeds around the globe, but the trend is that you can buy as a service just about any slice of the computing "stack" within these service models.

Many factors are causing momentum to build for mainstream adoption of cloud computing. For example, very attractive for business organisations are the core elements of cloud service provider (CSP) business models: pay-as-you-use instead of install-and-own and inherently greater flexibility in IT. Cloud computing services generally shift major up-front capital expense from the buyer of IT to the provider of IT services — a strong incentive in a world that continues to struggle with economic uncertainty and more restricted access to capital. Of note, this shift enables organisations to further manage their investment risk by rapidly implementing and trialling new solutions before making long-term commitments.

Even more alluring for businesses, however, is the promise that cloud computing will increase their business agility in at least two dimensions. First, clouds can free companies from the drudgery of building and maintaining IT infrastructure so that they can focus on value-creating differentiation to ride atop that infrastructure. Second, clouds provide flexibility in the form of highly elastic scalability, enabling organisations to rapidly increase or decrease their IT infrastructure costs as fast as their business needs change. That flexibility dimension is the primary way in which cloud services differ from traditional IT services. These factors combine to lower IT barriers (and risk) to business change, including barriers to entry for start-up businesses, whether entrepreneurial or inside an established organisation. The same factors also enable small and medium-sized businesses (SMBs) to take advantage of sophisticated applications and a breadth of functionality that previously could only be afforded by large enterprises, and can do so at much lower cost. As a result of these factors, SMBs appear to be migrating to the cloud more rapidly than larger companies, and start-ups are virtually all cloud users.

Adding fuel to the interest in cloud computing is that cloud services advance "green" agendas: they allow fuller utilisation of shared infrastructure capacity, thus consuming less power and lowering the carbon footprints of their users versus alternative IT approaches.

But cloud services add complexity to the businesses of established companies entering the cloud computing market, whether as users or service providers. The delivery of cloud services is leading to new, multi-layered revenue streams with increasingly complex and uncertain security, privacy, tax and related compliance and control consequences for cloud computing users and providers alike. With regard to compliance issues, some CSPs provide limited or no transparency about where data is being processed and stored within their network (the "global cloud" approach). More often, however, cloud service is provided by a group of interrelated but distinguishable data centers in different locations (the "network" approach). Cloud users may be subject to all or some of the compliance regulations in all the jurisdictions through which the cloud network passes. The key issues for cloud users are determining which compliance regulations need to be addressed as a result of where a CSP's data centers are located, and the level of support their CSP provides in meeting those compliance requirements.

However, none of these challenges are impenetrable obstacles, and many of these inhibitors can be turned into cloud adoption accelerants by cloud service providers that address them with leading practices. For example, the Service Organisation Controls (SOC) framework was launched in 2010 by the American Institute of Certified Public Accountants that includes a reporting framework called "SOC 2", which provides internationally accepted independent assurance based on standardised Trust Services Principles and Criteria (including, among others, privacy, confidentiality and availability) on processes not necessarily related to financial reporting.

Despite the certainty expressed in many predictions regarding the growth of cloud computing, the transition to cloud computing from in-house IT infrastructure and traditional outsourcing is really just beginning. There is a long, hard road of difficult transitions and adoption decisions still ahead.

Right now, however, CSPs need to position themselves, their offerings and their future development strategies for the rapid changes to come. Likewise, business users of cloud services require immediate insight into the benefits and risks of cloud computing — along with how to exploit the former, while avoiding the latter — as they adopt this "new mainstream" IT approach. Finally, both technology and other businesses need to understand how cloud computing is changing consumers' habits and expectations.

As the vision of IT delivered with the same reliability, flexibility and scalability as a public utility service takes hold, the implications are enormous for businesses and consumers worldwide. Despite lingering concerns about security, privacy and regulatory, legal and compliance issues, as well as the fundamental need to transform existing corporate and IT cultures, we believe the success of cloud computing is inevitable, because companies will be attracted to its flexible, pay-as-you-use business model. That model allows companies to manage their technology costs more efficiently, enables deployment of new technology faster and easier than other models, and allows management to focus on delivering business value.

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10

A small world: the challenges of offshoring

A small world: the challenges of offshoring

Background

The growth of offshore outsourced service providers, particularly those from India, has been one of the big business success stories of the last two decades. However, these traditional locations are now under threat as their low cost base is eroded and there are fewer benefits in labour arbitrage. They are facing increased competition from near shore centres such as Eastern Europe or even secondary locations in developed countries. To mitigate these threats to their core business, offshore service providers are seeking to move up the value chain. We wanted to examine what barriers they may face.

We asked participants what they thought were the advantages and disadvantages of offshoring. The advantages included cost savings, resource availability, expertise and productivity gains (particularly if it allowed the adoption of a "follow the sun" business model). The principal disadvantages were a loss of control, different time zones, difficulties in resolving disputes, language and cultural differences, politico-legal risks and the difficulties in managing an offshore supplier. Some participants said insofar as they used offshore providers, they were always captive organisations.

We asked participants to tell us what they considered to be the single most significant risk associated with offshoring.

In the current economic climate many consumers in the developed world are unhappy with the offshoring of jobs to lower cost countries and make their dissatisfaction clear when selecting service providers. This has led to some companies bringing customer facing functions back onshore.

Analysis

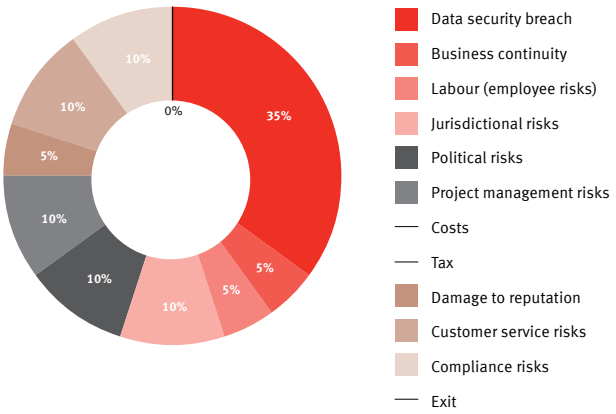
Suppliers

A substantial minority of suppliers (35 per cent) thought that data security breach was the greatest risk associated with offshoring. A data security breach can occur in a number of ways, such as:

- determined hackers, blaggers or others circumventing a generally well organised security system from outside the organisation
- employees and insiders deliberately circumventing internal controls, for example, to defraud customers
- inadequate security procedures that allow access to the information
- a supplier's own inadvertent posting of information on a website or sending it to the wrong address or loss of unencrypted media

Globally, there is an increasing legal obligation to notify regulators and individuals when their personal data is compromised. Very few suppliers were primarily concerned about business continuity, employee risks or damage to reputation and exit. Yet all these issues matter to customers. We would highlight damage to reputation as a concern to

Risks associated with offshoring: suppliers



which suppliers should pay more attention. As we note below, in the current economic climate many consumers in the developed world are unhappy with the offshoring of jobs to lower cost countries and make their dissatisfaction clear when selecting service providers. This has led to some companies bringing customer facing functions back onshore.

Technology and life sciences sector

A significant minority (36 per cent) in the technology and life sciences sector thought that data security breach was the greatest risk associated with offshoring. There have been lots of scare stories in the media about unscrupulous workers in offshore centres selling confidential information. In reality, this may be mere perception but it does create a perception, that there is a risk and this needs to be managed. The constraints imposed on the export of data from the European Union also cause data exporters from this region to focus on the issue.

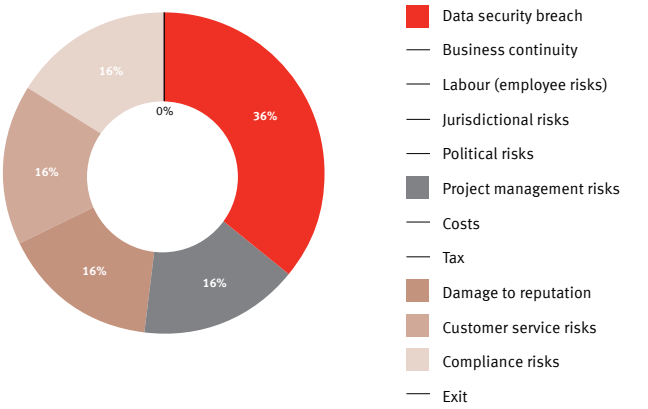
Retail and brands

A majority (66 per cent) in the retail and brands sector identified data security breach as the most significant risk; with the remainder believing exit was the most significant risk. It can be very difficult to repatriate a function once it has been offshored. It will probably be impossible to relocate the relevant staff and, without the staff, it can be impossible to replicate the service. Many customers believed the only viable option would be to transfer the outsourced function to another offshore provider.

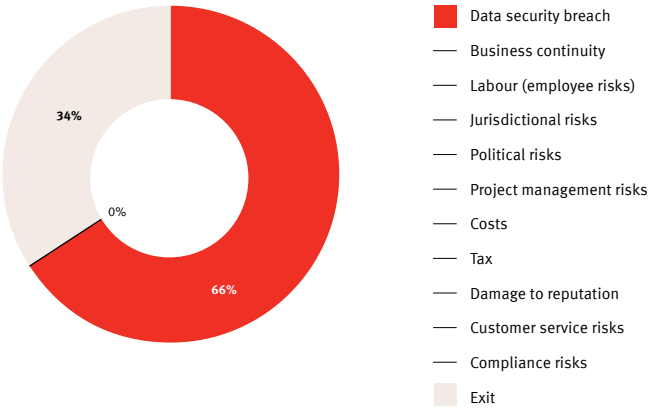
Financial institutions

Half of all respondents in the financial institutions sector considered data security breach the most significant risk; a further 18 per cent thought compliance risks were the most important. Regulators tend to hold customers liable for the acts and omissions of their outsourced service providers. As a result, if the offshore supplier defaults on its obligations the regulator will pursue the customer. Regulators also impose rules such as those surrounding the transfer of data outside the EU which need to be complied with when offshoring.

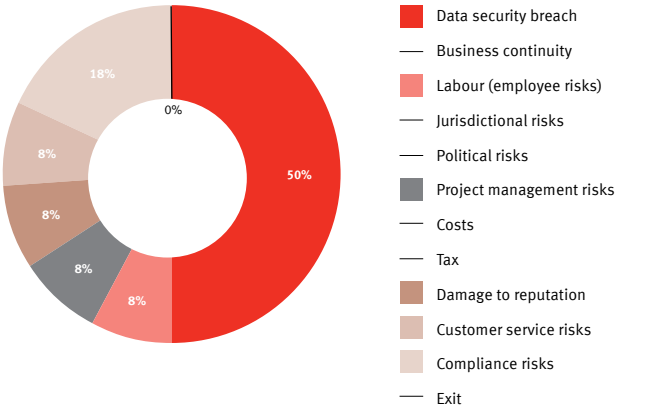
Risks associated with offshoring: technology and life sciences



Risks associated with offshoring: retail and brands



Risks associated with offshoring: financial institutions



Transport, energy and infrastructure

Opinion was divided in the transport, energy and infrastructure sector with a quarter of all respondents identifying data security breach, political risks, customer service risks and compliance risks as the most significant. The sector tended to view offshoring favourably, especially for non-customer facing services. With regard to political risk, it is important for any customer thinking of using an offshore location to consider the political situation carefully: is the country stable; is corruption an issue; does the rule of law prevail? Customers may want to engage a specialist country risk advisor to help them with their assessment.

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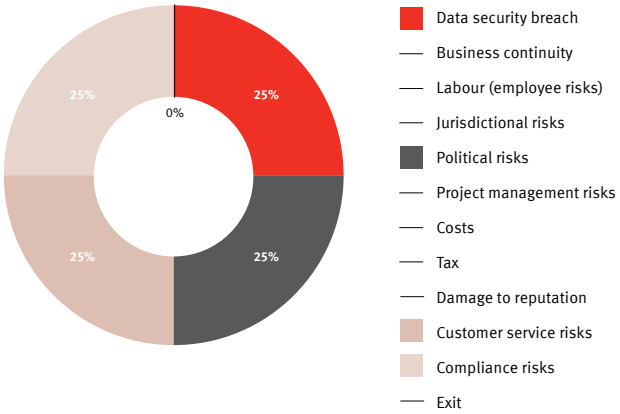
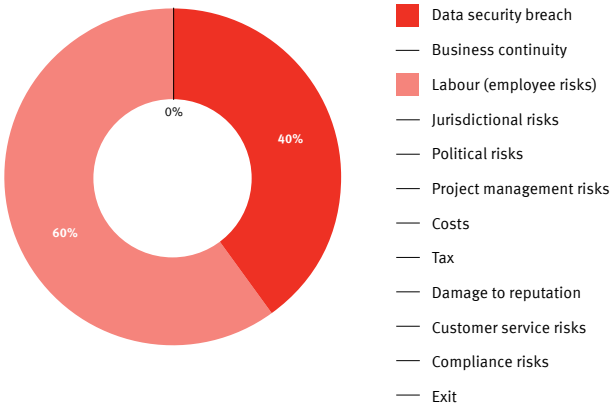
Professional services

Interestingly, professional services was the only sector which did not identify data security breach as their key concern. Instead employee risks were considered key by 60 per cent of respondents. Given that these businesses trade on the intellectual capital of their employees, this result is perhaps not surprising. There are two risks posed which can cause concern. First, if staff are made redundant in the home country and services are performed abroad, this will result in a lack of competency at home. It can be difficult (and/or very expensive) to recreate this competency at home in the future. Second, if intellectual capital is created abroad it can be more difficult to capture it and if employees of the outsourced service provider leave, this knowledge can be lost forever (or end up in the hands of a competitor).

Risks associated with offshoring: transport, energy and infrastructure



Risks associated with offshoring: professional services



Regional differences

South Africa, as a developing country, is itself a destination for offshore service providers. Consequently participants there tended to make less use of offshoring (although one or two did). One global technology company in South Africa explained the difficulty of selling offshoring as a business model: "Clients do not trust offshoring as they cannot see the infrastructure or the people think they have no control over it. Also companies are concerned about giving jobs to foreigners instead of South Africans especially if they have signed the 'Proudly South African Charter'."

Participants in other regions had more experience of offshoring. In deciding which country to offshore to, the most important factor was language capability. As a result Canadians and the UK often chose India; the French chose Morocco and Tunisia; the Middle East chose Egypt and Morocco and so on.

Australian customers commented that offshoring was sometimes the only option due to skills shortages in the local market. Australians are increasingly looking to China and the Philippines as offshoring jurisdictions.

Customer concerns

We talked to customers about the business functions they would not be willing to offshore.

Customer service

Most customers were unwilling to offshore customer service. The reasons commonly cited were language ability and cultural differences. Participants felt the provision of customer service was key to their brand; they did not wish to risk damaging this by offshoring. Particularly in the UK, Europe and Canada there was often a perception that their end customers wanted to deal with suppliers in their home country. Offshoring this function could cause bad publicity, especially when their home economies were in difficulty. One Canadian financial institution said: "We would not offshore customer facing functions. There is a reputational risk and we are not sure how our customers would take it." A Japanese technology company went further: "A Japanese company would not easily relinquish control of customer service." We have seen recent evidence of this in the UK where several banks have repatriated call centres because their own customers were unhappy about talking to people abroad.

Research and development (R&D)

Many participants felt R&D should be a core competency and should not be outsourced (let alone offshored). They felt that if a third party did their research and development, this would lead to a loss of their intellectual capital and a hollowing out of their own core ability to innovate. The head of procurement at a US life sciences company in the Middle East said he would be wary of offshoring growth enabling functions: "There is more need for a supplier to be embedded and to have knowledge of the business for these."

Human resources (HR)

Many customers did not want to outsource, let alone offshore their HR function. In France, it was felt it would be impossible to outsource payroll; there were too many complexities surrounding it. One French legal counsel at a well known consumer goods company said he would never outsource payroll as he would not be able to get sufficient warranty protection to cover all his risks.

Accounting and finance

In some countries, law and regulation prevents the outsourcing of accounting and finance. A Canadian financial institution said it could not offshore these functions for regulatory reasons. A French professional services firm said cash management and treasury could not be offshored under French law.

Norton Rose Group view

The days when offshoring was considered an easy way of saving money are drawing to a close. The increase in wages in developing economies (particularly in skilled professions) means the cost differentials are not as pronounced. In addition, customers have realised that it can be very expensive to project manage an offshore supplier. These "hidden" costs can quickly mount up.

As a result, offshore providers are increasingly looking to move up the value chain. As we have seen above they face barriers which, whilst not insurmountable, do need to be addressed. They need to assuage customer concerns around issues such as cultural differences, effective project governance and, most importantly, explain to the customer how the function could be repatriated if the relationship does not work out. The European general counsel at a US technology supplier told us that some of their customers have demanded a hot onshore facility as part of offshore exit planning.

"With offshoring I think the risks are security and protection of data and political and reputational risk. There are also significant issues bringing [it] back in-house. If customers feel they have made a mistake it is going to be very difficult for them to bring it back." ***General counsel, European telecoms supplier***

"The biggest issues are cultural alignment and time zone differences and the delays that creates in terms of being able to resolve things. Rather than ring someone up to have a chat to resolve [an issue], you send them an email, they send you a question back and it's taken three days before you get the feedback." ***Head of procurement, UK financial services firm***

Outsourcing human resources? Don't just 're-up' with your current provider

A.T. Kearney

Today's HRO service providers can deliver 35 per cent or more in savings

The next generation of human resources outsourcing (HRO) is upon us as the first long-term deals – signed between 2001 and 2004 – begin to expire. Nearly 50 contracts will terminate this year alone. Buyers might be tempted to take the easy option and renew their existing contracts. But the advantages of reassessing those contracts and re-evaluating market capabilities are too big to ignore. Today's HRO providers have improved capabilities and new technologies that could bring cost savings of 35 per cent or more. And they are hungry for deals.

Resistance to change is understandable when it comes to outsourcing contracts. After years getting accustomed to processes, the costs and hassle of sourcing and then switching suppliers can seem like needless trouble. It's little surprise that in the market for HRO – where more than $7 billion worth of contracts will expire by 2013 – most buyers are choosing to renew with existing vendors.

This could be a big mistake, however. In today's market, the upside benefits of a competitive sourcing exercise cannot be ignored. Vendors with vastly improved offshore delivery teams can offer better service and savings of up to 35 per cent.

Why now?

There are several reasons why buyers have more options and leverage in the HRO market.

Improved capabilities and talent
Major acquisitions have allowed HRO vendors to broaden their capabilities. Many business process outsourcing (BPO) leaders and best-of-breed niche players have invested in expanding their HRO portfolios, and Six Sigma and continuous improvement programs have reduced the number of manual and redundant processes. More HRO providers now have self-serve and automated solutions that improve efficiency and reduce costs. Additionally, offshore delivery centres have matured and stabilised to include best-in-class talent at lower prices.

HRO providers are 'hungry' so prices are negotiable
Providers are willing to bid aggressively for services, to fill capacity and to forge new relationships. With investment and capacity outpacing recent growth, many vendors have dropped prices to draw customers. Several niche players have emerged, giving buyers access to a broader range of vendors and a greater opportunity for lower prices.

Reduced switching costs
HR information technology (IT) has advanced, with software as a service (SaaS) and cloud architecture reducing switching costs and improving the viability of IT solutions. Switching providers is now easier and cheaper than in the past.

Revamping old contracts

Buyers that overcome their "incumbent" bias and go with a new provider have an opportunity to address the major issues with their first-generation contracts.

'Clean up' obsolete contract terms
A new contract is a good time to clean up years-old contract terms – matching contracts with current market standards, refining key processes, identifying new ways to streamline HR operations, and removing underperforming or obsolete services.

Take advantage of improved IT capabilities
Upgrading IT can be expensive and time-consuming. But many HRO providers today have more efficient, user-friendly and flexible HR IT systems than ever before. The competitive bidding process can help determine the future scope of HRO, compare the costs of ongoing maintenance with one-time implementation, and benchmark IT costs and technology trends among many providers.

Revamp service level agreements (SLAs) and key performance indicators (KPIs)
SLA and KPI values can be misleading when it comes to selecting HRO solutions. Achieving a level of service does not guarantee satisfaction, and scoring well in a KPI does not necessarily mean that long-term business objectives will be met. Phased SLAs, in which buyers and vendors regularly review meetings results, will ensure that all standards are being met with an eye toward business objectives.

Invest in governance
Despite rigorous vendor selection, many deals fail when HRO buyers or providers underestimate the complexity of moving to a next-generation solution. A solid transition process is vital to avoid surprises – including setting realistic timelines, developing business continuity plans, and establishing strong change management structures.

A critical juncture
With HRO at a critical juncture, buyers have an opportunity to create new, more strategic and longer-term relationships with their providers – while getting better service, more capabilities and lower costs.

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11

Transformation and innovation

Transformation and innovation

Background

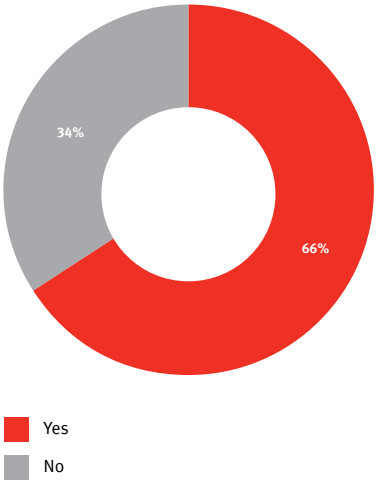
Successful outsourcing can transform a customer's business, enabling it to benefit from technological and process improvements it would not have been able to create itself. It can also free up the customer's internal resources to deliver innovation itself. For suppliers, transformation and innovation can be a key sales offering. In order to move up the value chain, they want to focus not just on cost reduction but on how their services can transform, or at least improve, their customers' business processes. Deloitte gives us its view on how outsourcing can deliver innovation at the end of this chapter.

As discussed in chapter 4, business transformation is an often cited reason for outsourcing. We wanted to understand how effective outsourcing is in delivering innovation.

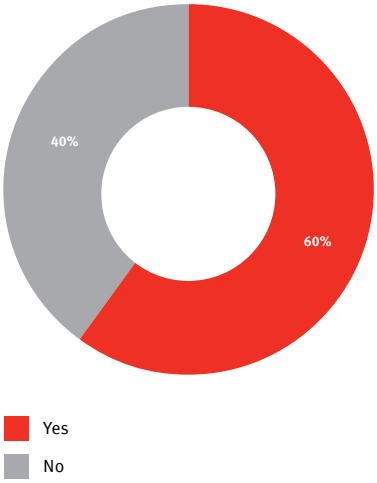
Analysis

Sixty-six per cent of suppliers and 60 per cent of customers said that business transformation was at the heart of their outsourcing strategy. There were mixed views on the extent to which outsourcing had delivered the hoped for transformation. Some customers thought if business transformation was not delivered this was ultimately their fault. They felt customers were not starting off the project with business transformation as the main aim. As one French professional services firm expressed it: "Customers tend to see transformation as a consequence of outsourcing. It should be the driver for the project." Another head of IT at a UK retailer was of the opinion that top level stakeholder support was very important if transformation was to be achieved.

Is business transformation at the heart of outsourcing strategy: suppliers



Is business transformation at the heart of outsourcing strategy: combined customers



As one French professional services firm expressed it: "Customers tend to see transformation as a consequence of outsourcing. It should be the driver for the project."

Some suppliers were cynical about their customers' stated aims. One general counsel at a French supplier commented: "Customers say business transformation is at the heart of their strategy but I am not convinced they want to pay for it." Other suppliers questioned whether they could deliver business transformation. The CIO of a South African supplier said: "Suppliers can deliver technology transformation. They can't deliver business transformation. This lies with the customer – it is the customer's business."

Barriers to innovation

Many customers expected outsourcing to deliver innovation. However, often they said they were disappointed. The chief strategy officer of a Japanese technology company said: "I always have the expectation that outsourcing will deliver innovation and I am always spectacularly disappointed." A French professional services firm was even less impressed: "Talk of innovation is sales puff on the part of suppliers." Another French professional services firm agreed, but thought customers should share some of the blame: "Customers don't care how [outsourcing] is done, as long as the job gets done. Talk of innovation is part of the supplier's sales puff. This may fool CEOs but not CIOs." Other customers, however, were happy and thought their outsourcing had delivered innovation. To understand where things went wrong we asked all participants what they thought were the barriers to innovation.

Resistance to change

Customers and suppliers thought one of the main barriers was the customer's own staff who were not open to innovation. This was a global problem. In South Africa, a bank said: "The biggest problem to innovation is always the customer's internal resistance to change or the customer has "not invented here syndrome" where the customer rejects the innovation as being inferior to their own." In the UK, a head of procurement at a financial services firm said: "The main barrier to innovation is people saying they're too busy to take innovation on board."

Poor contracts

Some customers thought they were neither good at contracting for change, nor for mapping its delivery. There was no consensus as to which type of contractual incentive would be the most effective to encourage innovation with payment to supplier, supplier sharing upside and supplier owning intellectual property and customer owning intellectual property all getting a mention.

Insufficient financial rewards

As the CIO of one South African bank succinctly put it: "I don't believe innovation is possible, especially with the lower margins that suppliers work with. At most suppliers are only interested in innovations which will boost their margins."

"Customers don't care how [outsourcing] is done, as long as the job gets done. Talk of innovation is part of the supplier's sales puff. This may fool CEOs but not CIOs."

Norton Rose Group view

It is disappointing to find that many customers did not feel that outsourcing was delivering transformation and/or innovation. We think one of the main reasons for this is that customers are not prepared to pay enough to incentivise suppliers. If they insist on keeping charges to a minimum, they should not be surprised if suppliers do the bare minimum to achieve SLAs. This state of affairs will probably prevail until the economic situation improves and cost reduction stops being the principal driver for outsourcing.

For those customers who are serious about outsourcing delivering change and innovation, we suggest they capture the desired changes in their business case and share this with the supplier. Taking a more holistic view of what should be included in the business case, can lead to greater benefits being derived from the outsourcing relationship.

"Treat the supplier as a partner so that there are not two IT departments. Let the outsourcer interact directly with the business so that it can truly understand the environment and drive innovation." ***South African technology supplier***

"I think one of the biggest barriers is people saying they are too busy to take up innovation. There is a cartoon on the wall [on boss's office] of General Custer with a machine gun salesman behind him. The General is saying can't you see I'm busy. And that is the way it is [in the work place]." ***Head of procurement, UK financial services firm***

Innovate or die

Deloitte Canada

That title was given to me by the good folks at Norton Rose. It's a great title, and something that I often say to my own clients. But after thinking about it a little longer, it is both true and untrue … in some interesting ways.

First, although it sounds profound, it is a truism. All companies, to some extent or another, innovate. As a hypothetical example, the company that sold buggy whips manufactured with coal steam engines to the armed forces of the Ottoman Empire has made of lot of changes in the last century!

The definition of innovation that we use at Deloitte is "fresh ideas that create value". Making new products, services or technologies; improving your business processes; or finding new ways to manage or interact with your employees or customers are all innovation strategies – and no company does none of those things.

If innovation is something that everyone does, is doing more of it better than doing less? More specifically, is spending on R&D the only – or even the best – way to innovate?

Not always. Even in the high technology world, companies that spend more than 25 per cent of revenues on R&D tend to be much riskier than average, and often under-perform. The tech company that is currently seen as the most successful – and is close to being the most valuable company in the world – spends only 2 per cent of its revenue of R&D. That's right: Apple is where it is, despite spending less on traditional research than many of its computer, smartphone or tablet peers.

One other great example would be Netflix. Although it is currently experiencing strong growth due to technology-enabled on-demand video streaming of movies and television, that was not actually their first major innovation. Although the company took full advantage of advanced logistics and supply chain technology, the principal tool of the company's success in 1998 was the cutting edge technology provided by the US Postal Service, founded in 1775. Delivering DVDs by traditional "snail mail" was the breakthrough innovation!

When people look at innovation they tend to focus too much on new technology and new devices. The reality is that the most important levers for innovative companies tend to be process oriented.

And one of the most common forms of process innovation revolves around outsourcing. Although generally or popularly seen as purely a way of lowering costs, outsourcing can in fact be innovation driven.

Recent examples include the offshore manufacture of consumer goods like smartphones and tablet computers, or the onshore utilisation of content delivery networks to allow over-the-top streaming video. In each case, the primary provider made the explicit decision to focus exclusively on their core competencies, while relying on trusted partners to make or deliver high quality goods and services.

What differentiates innovative outsourcing?

In Deloitte's view, the key is in identifying the proper goals and metrics for an outsourcing program. From the outset, the company must decide whether it's looking for continuous improvement, ground-breaking innovation or something in between.

If a company's goal, for instance, is to win awards and establish a reputation for delivering an innovative customer service experience, this goal must be explicitly stated in the outsourcing agreement. But simply stating the goal won't be enough to make it happen; the two sides must also define precisely what needs to be done differently and how they'll measure success.

Sounds simple, right? Well, there's one caveat: companies must remember that, although outsourcing can certainly lead to cost savings, there's no such thing as a free lunch. If a company is expecting to have the outsourcing provider's most

innovative minds working on their behalf, higher calibre comes at a higher price. You can't expect champagne service on a beer budget.

The bottom line is that survival in business really does require some level of innovation. But innovation isn't about having the biggest budget: it's about making innovation investments wisely.

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12

The importance of good governance

The importance of good governance

Background

Our 2008 survey highlighted the importance of good governance in ensuring a successful outsourcing relationship. In our view, if good governance models are adopted:

- customer and supplier performance is managed
- disputes are avoided or managed without legal recourse
- common objectives are understood
- a genuine partnership is fostered.

We wanted to find out how the parties approached the management of their relationships and what management tools they found effective.

Managing outsourcing relationships

We asked suppliers whether they adhered to contract governance procedures or whether they evolved over the life of the contract. Thirty-nine per cent said they adhered strictly to the procedures; 61 per cent said they were more fluid. Amongst customers who expressed a view, 46 per cent strictly followed the contract and 54 per cent let it evolve. Some of the general counsel of customers expressed some concern that the business did not adhere to the governance processes in practice even though they were meant to. In-house legal teams only found out about this when there was a dispute. There are clearly advantages and disadvantages to each approach.

Whatever method is adopted, we cannot stress enough the importance of project governance in maintaining a good relationship. Customers frequently underestimate the amount of effort (and expense) that will be required to manage the relationship (especially if the supplier is offshore). As a consequence often they are not able to monitor the supplier's performance or work with the supplier to achieve the desired results.

Suppliers were uncertain whether their customers made sufficient allocation for the cost of governance in their business case (if they made any allocation at all). They were also unsure whether their customers had sufficient board level support. The European general counsel of a large US technology and outsourced service company told one "horror story" of a whole negotiation being carried out before the customer's negotiation team found there were no funds available!

Customers struggled with estimating the costs of supplier management (even if they attempted to do so). The director of supply management at a bank in Singapore said whilst project governance was priced into the cost of the project, this could vary from project to project. One head of procurement at a UK insurer highlighted the risk: "It all links back to the vendor management for me. And what I've seen is that the volume (the demand side) is out of control. So although we feel from a unit price perspective we're making great savings, from a volume demand perspective I think we're actually being fleeced. So things that would have previously taken a week to do now take a year."

One head of procurement at a UK insurer highlighted the risk: "It all links back to the vendor management for me. And what I've seen is that the volume (the demand side) is out of control. So although we feel from a unit price perspective we're making great savings, from a volume demand perspective I think we're actually being fleeced. So things that would have previously taken a week to do now take a year."

Management tools

We asked participants what processes they had in place for managing outsourcing relationships.

Training for managers

As we have noted several times in this report it is essential that all project managers (whether acting for the supplier or customer) are properly trained and have the necessary skills. It is therefore disappointing to see too few participants encouraging this (52 per cent of suppliers and 54 per cent of customers). Only South African and Canadian customers appeared to treat this seriously. We would repeat our advice that customers and suppliers need to invest in training their staff. As the head of procurement at a UK professional services firm put it: "The difference [in suppliers] is not in price, but in the way contracts are managed. I am more likely to renew if I am happy with the account manager."

Involvement of managers in negotiation

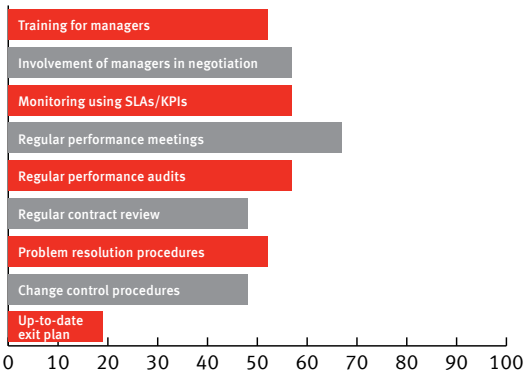
Only 57 per cent of suppliers and 59 per cent of customers involved managers in negotiations. In Europe this fell to 38 per cent. In our view, it is essential that the person responsible for implementing the project should be on the team from the outset. If they are not, they inherit a contract with which they are unfamiliar and may not have an understanding of the underlying business case. As one European general counsel of a US Technology firm said: "Make sure the negotiation team understands what is going on in the backroom." Even better in our view is to put someone from the backroom on the team. A Canadian supplier went further: "Engage your business team in the development of the requirements, the assessment of the vendor proposal, negotiation of vendor contract and ultimately in the contract management process."

"Engage your business team in the development of the requirements, the assessment of the vendor proposal, negotiation of vendor contract and ultimately in the contract management process."

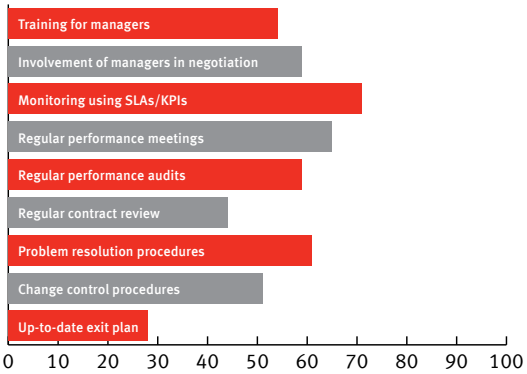
Monitoring using SLAs/KPIs

Sevety-one per cent of customers and 57 per cent of suppliers used SLAs and KPIs. We were surprised the figures weren't higher, especially as they scored so well as risk management tools. We would repeat the advice given earlier that in drafting KPIs customers should focus on key outputs and deliverables. Customers should not include unnecessary SLAs and KPIs as they may lead to higher charges.

Processes used to manage outsourcing relationships: suppliers



Processes used to manage outsourcing relationships: combined customers



Regular performance meetings

The suppliers' preferred management tool was regular performance meetings with 67 per cent using it; almost corresponding with 65 per cent of customers. Only European customers seemed unwilling to meet with their suppliers. We think customers and supplier should set out in their governance procedures how often they will meet and how they will deal with issues arising at these meetings. The attitude of those attending these meetings is also very important. Honesty and transparency are essential.

Regular performance audits

Fifty-seven per cent of suppliers and 59 per cent of customers used audits, although they were less favoured in the UK and Europe. Regular performance audits can be a valuable risk management tool and we would encourage more customers to make use of them. One head of procurement at a UK financial services firm graded all his suppliers either "critical" or "low risk". He proactively managed and reviewed those marked "business critical". This included updating his risk register on a regular basis.

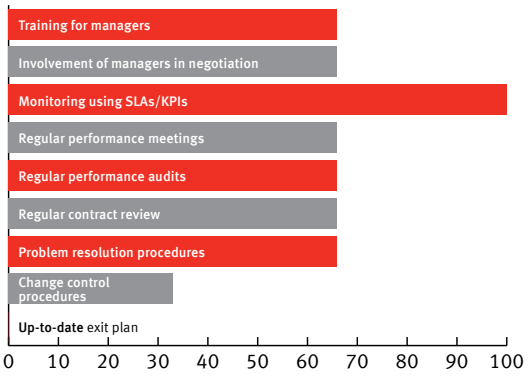
Regular contract reviews

Only 48 per cent of suppliers and 44 per cent of customers conducted regular contract reviews. This fell to an extremely low 15 per cent in Europe and 23 per cent in the UK. We think in respect of major contracts the parties should review them on a regular basis to ensure they reflect what is happening operationally on a day-to-day basis and are fit for purpose.

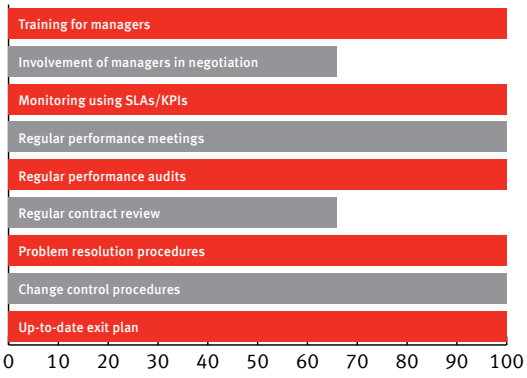
Problem resolution procedures

Fifty-two per cent of suppliers and 61 per cent of customers followed defined problem resolution procedures. Once again the UK and Europe were behind the pack. It is important the parties have defined problem resolution procedures and that these are adhered to. Too often in practice we are instructed by clients who have encountered problems and either not dealt with them until they become critical or have tried to reach compromise solutions outside the framework of the contract, ultimately prejudicing one party. Transparency and honesty are key to resolving disputes effectively; a good project governance process should encourage openness in resolving problems.

Processes used to manage outsourcing relationships: Canadian customers



Processes used to manage outsourcing relationships: South African customers



Change control procedures

Forty-eight per cent of suppliers and 51 per cent of customers followed defined processes, falling to just 23 per cent in Europe and 33 per cent in Canada. All outsourcing contracts should contain a mechanism for managing contractual and operational change. Customers should consider from the outset the likely causes of change, and agree with the supplier how any change will be implemented and at what, and whose, cost. Both the supplier and the customer should then manage change by adhering to the process set out in the contract.

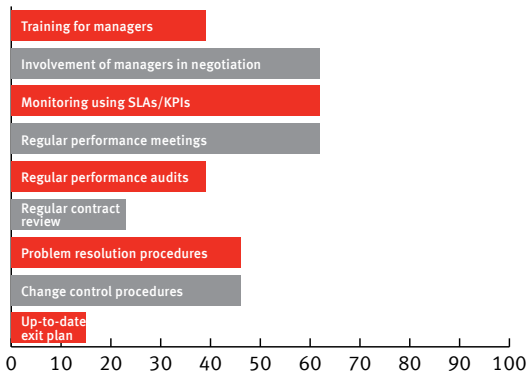
Up-to-date exit plan

Only 19 per cent of suppliers and 28 per cent of customers admitted to keeping their exit plans up to date. Worryingly, no-one in Canada and Europe prioritised this. Given that so many rated supplier insolvency as a key risk, these figures are disappointing. All customers should have contingency plans in place, so that damage is minimised if a supplier ceases to trade. Part of this plan should include an up-to- date exit plan. The plan should set out the steps which customers need to take to secure the services and/or technology of the supplier, if it is no longer able to perform or has become insolvent.

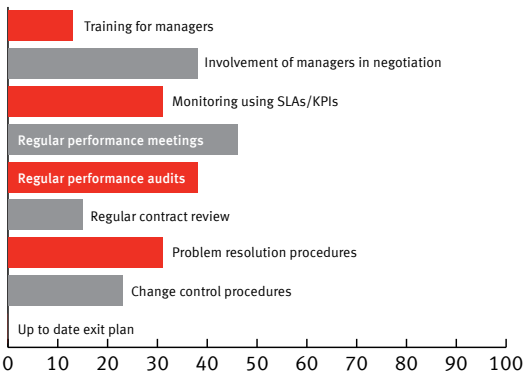
Norton Rose Group view

Good project management and governance are vital for a successful outsourcing arrangement. In practice we often find the resources and skills required to ensure good governance are often seriously underestimated. The results of the survey back this up. The effectiveness of project management as a risk management tool is wholly dependent on the quality and the calibre of the individuals tasked with project management or governance responsibilities. The survey results suggest that neither suppliers nor customers are making the necessary investment in training their staff to manage projects effectively. It is also essential that in working with each other, suppliers and customers are open and transparent. Only by adopting these traits can successful partnerships be formed.

Processes used to manage outsourcing relationships: UK customers



Processes used to manage outsourcing relationships: European (ex UK) customers

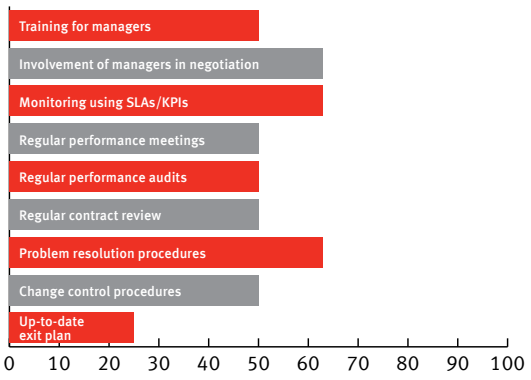


The effectiveness of project management as a risk management tool is wholly dependent on the quality and the calibre of the individuals tasked with project management or governance responsibilities.

"Be more honest about problems. Don't hide until they come out of the woodwork." ***IT director, UK energy firm***

"Every client will make some provisions for governance, but it is often necessary to educate clients on the importance of good governance and to ensure that they make sufficient [financial] allocation [for it] and to ensure that their expectations of the process are accurate." ***Executive director, global technology supplier***

Processes used to manage outsourcing relationships: Asia Pacific customers



13

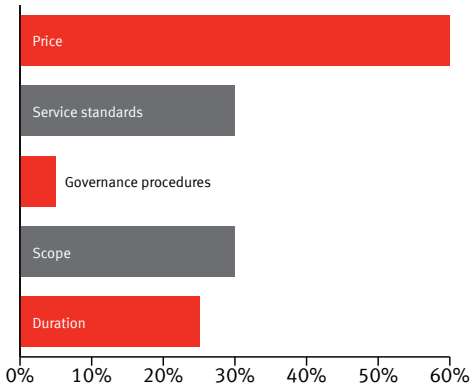
Taking stock – the role of renegotiation

Taking stock – the role of renegotiation

Background

Against the backdrop of the global financial crisis we have experienced an increase in the number of our clients seeking to renegotiate their outsourcing arrangements. Many of them are looking to reduce costs or move onto more flexible pricing arrangements. This trend is not confined to the private sector. The UK Government caused a storm last year by unilaterally requiring its principal suppliers to reduce their charges. KPMG sets out its views on how outsourcing arrangements can adapt and meet change at the end of this chapter.

Reason for renegotiation: suppliers



Analysis: reasons for renegotiation

We asked our participants what were the primary reasons for seeking to renegotiate outsourcing contracts.

Suppliers

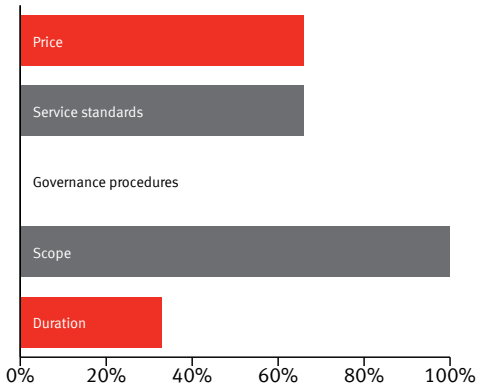
Sixty per cent of suppliers who were involved in renegotiating, were renegotiating price. Thirty per cent were also negotiating service standards and 30 per cent scope. This ties in with comments made elsewhere by suppliers that their margins were under pressure. One US supplier said it was a very aggressive market, leading to requests from customers to renegotiate. A European telecoms provider complained that customers did not want revenue commitments and were seeking flexibility.

One US supplier said it was a very aggressive market leading to requests from customers to renegotiate.

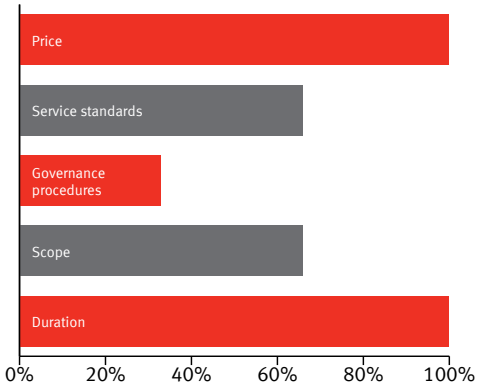
Canada

Of Canadians involved in negotiation, 100 per cent were reviewing scope and two-thirds were negotiating price and service standards. Some of these requested changes were due to changes in regulation. Others were taking advantage of more competition in the market place to improve their deals.

Reason for renegotiation: Canada



Reason for renegotiation: South Africa



South Africa

All South Africans who were involved in renegotiation were looking to amend price and duration. Some of those interviewed in the financial services sector said they conducted annual due diligence of all their outsourcing contracts against the business case and also used benchmarking to ensure their deals were still competitive.

UK

Only 39 per cent of UK customers were renegotiating price as against 46 per cent who were renegotiating service standards. One participant in the brand and retail sector said his business has grown recently and they were using this to their advantage to get volume pricing. Another customer in the technology sector was trying to improve terms with the supplier as part of the contract renewal process.

Europe (ex UK)

In Europe, 62 per cent were looking to renegotiate price. The head of vendor governance at a German bank said its risk profile had changed and as a consequence it needed to renegotiate contracts. A change in regulation had caused one Italian financial services business to renegotiate its contracts.

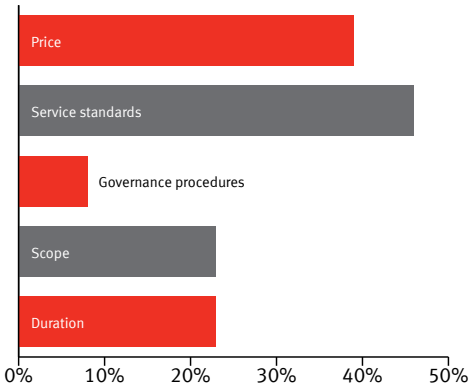
Middle East

There was in general less renegotiation taking place in the Middle East. It had the lowest percentage of customers (28 per cent) looking to renegotiate price. However, there seems to be a tendency to shorter term contracts in this region (see below). This perhaps means that customers will live with agreed prices for a short while and then seek to get a better deal by re-tendering.

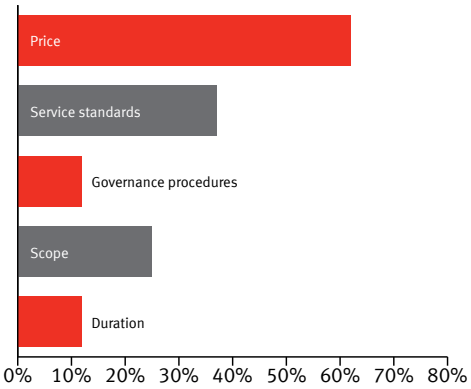
Asia Pacific

Price, service standards and scope were the terms most frequently being renegotiated (all with 43 per cent). In Australia the key driver that initiates negotiation, however, is significant changes to scope. Customers looked to scope changes as a way to improve pricing. In Asia, where pure Asian outsourcing has only taken off in a significant way in the last decade, most of the renegotiation we have seen tends to be around price. As more deals mature this may change.

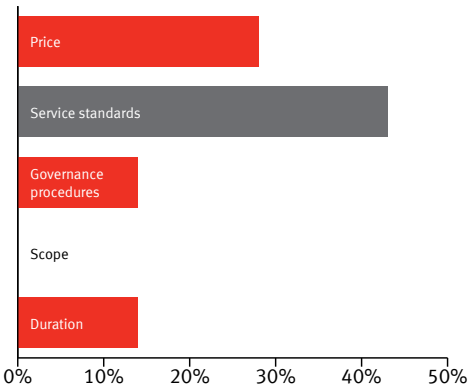
Reason for renegotiation: UK



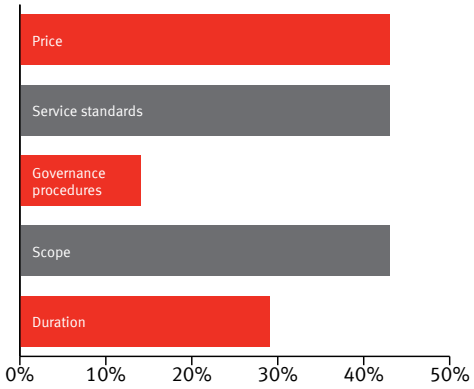
Reason for renegotiation: Europe (ex UK)



Reason for renegotiation: Middle East



Reason for renegotiation: Asia Pacific



Does outsourcing meet its objectives?

We asked both customers and suppliers what processes (if any) they had in place to verify that the outsourcing continued to meet its commercial objectives.

On the whole, suppliers were far more organised than their customers. This was to be expected. In the main the suppliers' objective for a transaction will be to make a profit. Their finance team will monitor and report on a profit and loss basis whether this objective is being met. In addition, suppliers told us that they employed regular project reviews, risk analysis and performance metrics as methods of assessing performance.

In contrast, many of the customers had no structural processes for review in place. One Canadian supplier who was also a customer admitted that they were better at reviewing their contracts when they were acting as supplier than when they were acting as customer. When acting as a customer there was not the same level of oversight and projects tended to take on a life of their own.

A South African supplier thought the customer's difficulty in measuring performance revolved around project management: "The processes are there ie, KPIs etc but they are not very effective. Most KPIs are meaningless because there is not enough clarity on exactly what is being measured or what is critical. Ninety-nine per cent uptime is a common KPI but what exactly does it mean?"

Customers who had processes in place for verifying that outsourcing met its commercial objectives recommended the following: annual due diligence against the original business case; benchmarking; use of KPIs; budget analysis; and taking regular feedback from the business.

In some regions, such as the Middle East, contracts were for a shorter term which customers thought kept suppliers on their toes. The need for constant re-tendering allowed for regular benchmarking against the marketplace.

Norton Rose Group view

It is clear that whilst the general economic situation remains difficult, customers will continue to be under pressure to reduce their costs and will look to their suppliers to help them do so. When it comes to entering into new arrangements customers should draft their contracts to allow for the maximum possible flexibility. No business or business environment remains static – change is inevitable. The contract should therefore contain a mechanism for managing contractual and operational change. Once again, good governance is key. The contract should include processes for requesting and pricing change. The pricing mechanism should include the costs of investigating and implementing change. Central to the issue of change are the dynamics at play between customers and suppliers. The customer will want flexibility, no restrictions and the ability to tender. Against this, suppliers want fixed processes, restrictions and exclusivity of provision.

"You need to review comprehensively all outsourcing deals every three to five years. The deal always becomes more beneficial for the supplier over time." ***CIO, South African bank***

"The contract is a living document, especially the schedules. We audit our contracts as a whole every year to ensure that they continue to be current and relevant to the clients' needs and expectations." ***CTO, South African supplier***

Renegotiating your outsourcing contract: succeeding in partnership with your provider

KPMG

Change is the only constant in business today and, as a result, being able to adapt effectively to change is an increasingly important characteristic for organisations. This is especially important when structuring long-term commitments, such as IT outsourcing (ITO) or business process outsourcing (BPO) arrangements.

Well-structured outsourcing contracts are now specifically designed to accommodate change and as a result are better "future-proofed" – expect to see tools that both facilitate adjustments to pricing in response to technological and workforce advances of the service provider and that allow client levels of demand (both volumes and scope) to fluctuate. However, older contracts were not constructed with this type of adaptability; they were forged at a time when the outsourcing market was less mature. These legacy agreements, which can include contracts negotiated 10, five or even three years ago, are generally more rigid. In this situation, both clients and service providers may face the challenge of renegotiating their arrangements.

Why renegotiation is important

In order to bring ITO or BPO arrangements back into alignment with the client's changing needs, with evolving market practices and with current market pricing, the client and service provider should engage in renegotiation. Historically, this has often been a painful process, although it doesn't have to be. If both client and service provider come to the negotiating table prepared for a fact-based discussion and with respect for each other's needs and economic imperatives, renegotiation can be a mutually beneficial process and a positive experience.

Renegotiations are typically initiated by the client because of a belief that the service provider is underperforming. They may also be driven by a client that feels the value of the services provided have drifted away from where other providers (the market) would provide them if the contract was set aside and the arrangement was reopened to competition. Typically, the triggers of renegotiation fall into five categories:

Expiration
Because the term of the contract is looming, renegotiations are driven by the calendar.

Performance
The client experiences or perceives performance failures, non-responsiveness from the service provider or instability in the provider's management or delivery team.

Economic
The client or provider believes that some or all elements of pricing are out of line with the current marketplace.

Events
A significant change on the client side impacts the client's business operations and requires contract adaptations. These include a merger, acquisition, divestiture, restructuring, bankruptcy, management change or a significant volume increase or decrease.

Contractual
Negotiations may simply be built into the contract at certain dates.

Renegotiations undertaken proactively are likely to be the most successful. To be proactive, a client should thoroughly analyse its needs without the pressure of an expiring agreement, understand all the elements of the outsourcing engagement and identify where needs are not being met.

Once complete, the outsourcing client should document the changes that it considers necessary to the agreement to bring it into full alignment with its objectives. It should also invest real effort in researching and anticipating their service provider's ideal outcome, so that it can be prepared to make accommodations that are fair and reasonable to create an outcome where both parties are satisfied. The next step is to gain the consensus of the entire stakeholder community (everyone affected by the outsourcing agreement, including the executive team). That consensus should be carried in to the renegotiation process by a strong team, with the necessary support of advisors and lawyers, all committed to a mutually beneficial agreement.

Renegotiation offers a great opportunity for both the client and service provider to "get it right" for the future. The proof will be in the long-term results, which should include a refreshed relationship where governance processes operate effectively to maintain alignment continuously between the parties on the scope, performance, price and value of the services being delivered.

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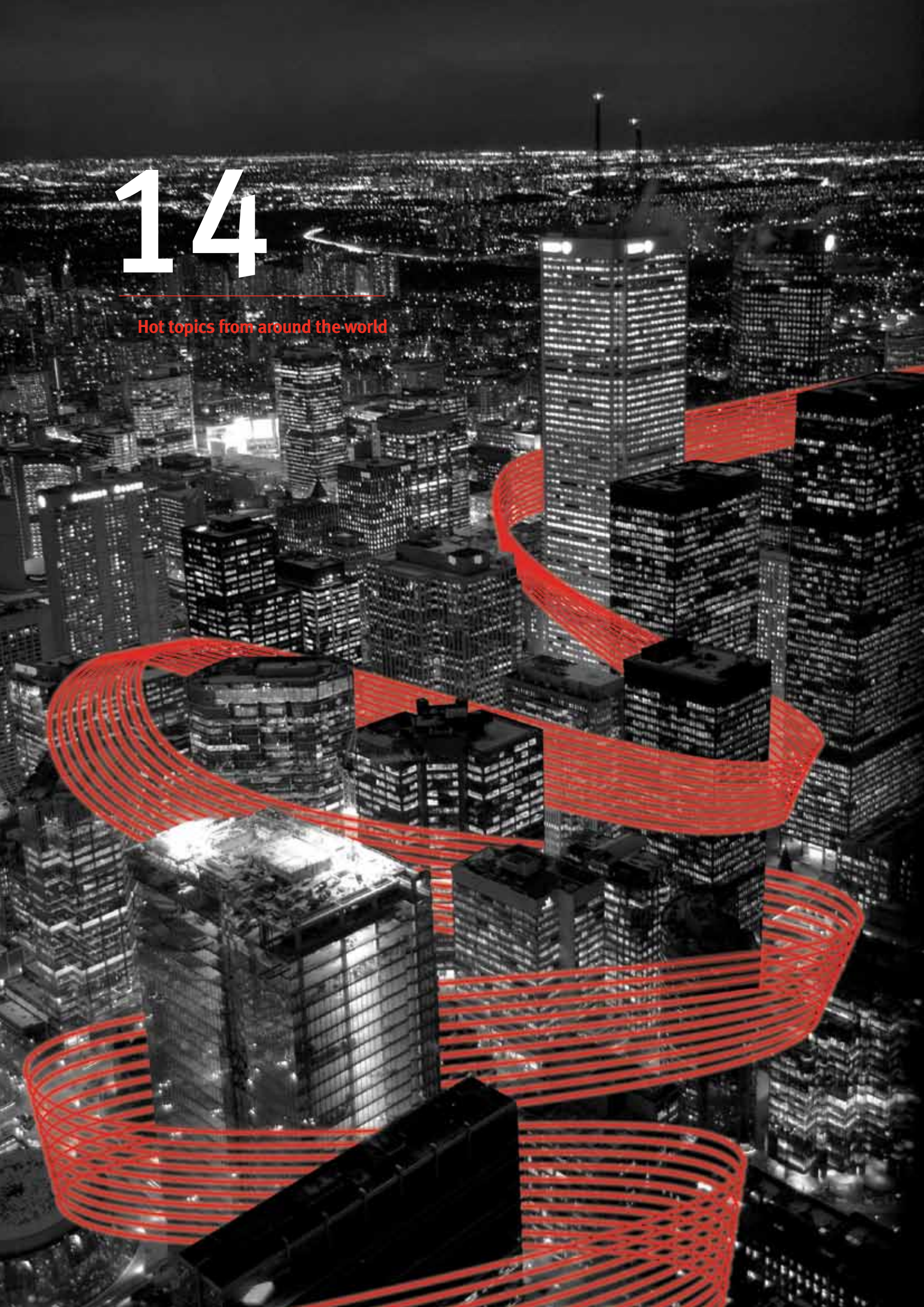
14

Hot topics from around the world



Asia

Gigi Cheah

Technology and sourcing trends

Asia is now seen as the "hot" growth market for launching technology products and services. Although it is difficult to provide a broad view of all markets in Asia, given the diversity and different stages of development of countries within this region, there are some general technology and sourcing trends that are worth noting. Companies looking to launch IT products and services in Asia have to deal with the challenge of ensuring they meet the legal, commercial and cultural requirements of this diverse region. Issues that companies have to consider include the following:

- Standardisation of contract and website terms – for compliance with mandatory requirements, including language requirements.
- Tax – structuring the distribution channels for maximum tax benefit and administrative ease.
- Tender processes – compliance with laws relating particularly to government tender processes (and the practicalities and laws surrounding marketing; anti-bribery and kick backs).
- Import/export – considering issues relevant to the import and export of products, including payable customs and duties.
- Licences, permits, consents – obtaining all relevant approvals.
- Encryption technology – obtaining, where relevant, licences to permit import of such technology as required, for example, in China and Hong Kong.
- Labelling requirements – ensuring compliance with local laws regarding labelling of products, particularly as regards safety issues and "made in" statements.
- Payment systems – particularly in relation to online sales of products and services, considering how these are logistically implemented and how funds are repatriated.
- National security – ensuring compliance with the usually tight regulatory controls over products or services that may be seen as affecting national security, eg, mapping products that provide information about the location of sensitive sites; encryption technology which might enable access to prohibited information or prevent regulatory oversight of sensitive information; and products that provide the general public with access to content that might be prohibited.
- Privacy – looking at how customer databases may be used in the region to maximise market penetration.
- Language – determining when it is mandatory to use local language in contracts, website terms, instruction manuals, product information and technical specifications.
- Cultural issues – assessing and accommodating sensitivity in relation to certain products, eg, particularly those that are content-rich and provide access to information that may not otherwise be freely available in a country or which may be prohibited, eg, online gambling.
- Advertising – differences between jurisdictions for regional advertising campaigns, these can overlap with cultural sensitivity issues.

Companies looking to launch IT products and services in Asia have to deal with the challenge of ensuring they meet the legal, commercial and cultural requirements of this diverse region.

In assessing how to manage these issues when expanding their businesses into Asia, companies need to be aware that whilst IT trends in Asia share many common characteristics with IT trends globally – that the IT market has been impacted by the global financial crisis, that open-source, mobile and wireless solutions are on the ascendancy, that piracy continues to be an issue, that hiring trends are volatile – there are some important differences.

Whilst affected by the financial downturn, Asia's IT industry has still shown growth. The Network Readiness Index (NRI) published annually by the World Economic Forum measures the ability and likelihood for countries to exploit opportunities offered by information and communications technology (ICT). It is interesting to note that Singapore, Taiwan, China and South Korea are all in the top 10, either holding steady (Singapore at No. two just behind Sweden) or climbing (China and Taiwan from No.11 to No. 6; and Korea from No. 15 to No. 10 with Hong Kong following closely at No. 12).

Countries in Asia are devoting effort to creating commercial, regulatory and infrastructure environments conducive to encouraging IT businesses to flourish, including establishing IT parks and providing tax incentives. This, together with the readiness and ability of individuals, businesses and governments to utilise growing IT affluence in sizeable populations and the increasing availability and usage of IT, has sustained growth over the last couple of years and will likely support continued growth.

Any company looking to expand its IT business in Asia must, in considering the operational hurdles relevant to launching products and services in this diverse region, bear this significant growth potential in mind.

Australia

Nick Abrahams

Michael Park

Australia's current driving force within the technology sector is the roll-out of the new national broadband network (NBN). The new $46 billion network will provide fibre services to 93 per cent of Australian premises, with the remainder to be provided on the internet via a mix of wireless and satellite technology. However, this is not the only current technology issue in Australia.

Investment in technology companies globally is very active, prompting many tech journalists to describe current conditions as "Bubble 2.0." We have seen significant upturn in tech M&A deals in Australia. The "daily deals" market is enjoying exponential growth in Australia as it is in other countries. US coupon powerhouse WhaleShark Media has recently acquired relatively unknown Melbourne company Retailmenot for $90 million, Yahoo7 acquired Spreets for a significant amount and a consortium of investors has acquired a 40 per cent stake in Scoopon/ Catch of the Day at a valuation of $200 million. US companies are also showing great interest in obtaining Australian developed technologies. Accel Partners recently purchased a minority stake in collaboration software company Atlassian for $65 million, Vodafone Plc purchased telecoms expense management software provider Quickcomm for an undisclosed sum and Infosys has purchased software solution specialist Gen-I. These deals have all been completed this year and we are constantly discussing new opportunities with our clients.

Cloud computing has been billed in the global media for the past few years as the "next big thing" in sourcing, and the take up in Australia is increasingly significant. The Australian Government recently published a Cloud Computing Strategic Direction Paper titled *Opportunities and applicability for use by the Australian Government*. In the paper, the Government described cloud computing as a "new way of delivering computing resources, not a new technology", and stated that "agencies may choose cloud-based services where they demonstrate value for money and adequate security." This strategy enables Australian Government agencies to gain the benefits of cloud computing, but ensures that sensitive information is not put at risk. The cloud model set out in the paper promotes availability and comprises on demand self-service, broad network access, resource pooling, rapid elasticity and measured service. Benefits of cloud such as scalability, efficiency, cost containment, flexibility, availability and resiliency are noted, as well as the prospect of using private clouds for sensitive data. Agencies will investigate opportunities and implement cloud solutions through a risk-managed approach. Some larger agencies have already commenced cloud computing trials, including the Australian Taxation Office and the Australian Bureau of Statistics, to evaluate the potential of application, platform and infrastructure cloud computing. The Australian Government Information Management Office is now working to develop a cloud computing framework that will include cloud principles, better practice guidance, checklists and governance arrangements. A cloud service provider certification program will be investigated, and the Government will explore whether a whole-of-government service provider panel for public cloud services should be established. Whilst the Government encourages rather than mandates the use of cloud technologies in the public sector, an increase in the procurement of cloud services in the public sector is expected as a result of this paper.

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Privacy issues are also constantly in the headlines, as they are in much of the world. The *News of the World* scandal reached Australia and the Government is considering introducing a statutory right to privacy. Many consider this to be a knee-jerk reaction that will in the end only protect celebrities from paparazzi cameras. Similarly, the Australian public were affected by the Sony Playstation privacy breach. Mandatory privacy breach notices are being considered by the Government, but again Australian commentators are sceptical given that such notices can penalise secure companies in that they become aware of breaches, where those without the relevant processes in place will not. Privacy issues surrounding cloud computing and offshore clouds are also near the top of the legislative agenda.

Convergence is also a key issue in Australia. The Government is currently conducting a full scale review of convergence issues. Traditionally print media, television, radio and telecommunications have all been subject to different rules and regulations. The line between these traditional distinctions is now somewhat blurred and radical changes to regulation are being considered.

This brings us back to the NBN, which will become Australia's national wholesale broadband network. A number of trial areas are now in service, and full commercial services will be offered in September. This is a massive project, with the rollout scheduled for completion in about 2020. At its height, over 4,000 premises per day will be passed by fibre. There are substantial opportunities for all companies in the technology supply chain and also to the construction sector. Significant opportunities also exist for retail service providers who will be able to provide a full range of services (telephone, internet, IPTV, etc) via network. We expect that this project will keep anyone involved in the technology sector busy for a considerable period.

This brings us back to the NBN, which will become Australia's national wholesale broadband network. A number of trial areas are now in service, and full commercial services will be offered in September. This is a massive project, with the rollout scheduled for completion in about 2020.

Australia's technology sector is as busy as it has ever been, and we expect this to continue for the foreseeable future.

Canada

Robert Percival

Marc Tremblay

Canada's new anti-spam law and its impact on the outsourcing of marketing functions

Canada has introduced measures to address problems of unsolicited emails (spam), phishing, spyware and malware through legislation known as the Fighting Internet and Wireless Spam Act (FIWSA)[1] which, when proclaimed, will significantly affect internet and email marketing efforts of Canadian companies. FIWSA is likely to have significant implications to technology industry sector participants. FIWSA will have an impact on those businesses that have engaged in business processing outsourcing (BPO) activities that have resulted in the outsourcing of their marketing and other customer communications to third party outsourcers.

The restrictions in FIWSA are far reaching as they cover all forms of telecommunication, including email, instant messaging and telephone, and all forms of messages, including text, sound, voice or image, and apply to any message sent or received by a computer in Canada. Unlike privacy legislation, FIWSA applies not only to marketing to individuals but also to businesses.

The sending of commercial electronic messages (spam) to an electronic address by means of a computer system located in Canada without the recipient's prior consent will be prohibited. All electronic messages designed to encourage participation in a "commercial activity" are considered to be spam. Further, an electronic message that contains a request for consent to send spam would itself be deemed to be spam.

While this might appear onerous, FIWSA gives businesses certain marketing opportunities that do not currently exist under Canada's privacy legislation. This is because under FIWSA the recipient's consent will be implied under certain circumstances. For example, implied consent exists where there is an "existing business relationship" between the recipient and the sender. An existing business relationship arises, among other things, where the recipient is a customer or has a contract with the sender that is in effect or has been terminated within the preceding two years. Similarly, consent is implied where a person has made an inquiry or application to the sender within the preceding six-month period.

Implied consent also exists where a person discloses his email address to the sender (for example, on a business card or in an email) or conspicuously publishes it (for example on a website) without specifying that he does not wish to receive spam and where the message relates to his business or employment activities. Similar rules also apply to "existing non-business relationships" which are defined to include relationships arising from a donation or gift to not-for-profit organisations or membership in associations and clubs.

All spam must contain an unsubscribe mechanism. The mechanism must permit the recipient to unsubscribe using the same electronic means by which the message was sent or, if that is impracticable, another electronic means by which an unsubscribe directive can be given. Spam that fails to comply with this and other specified requirements would violate the law

1 An Act to promote the efficiency and adaptability of the Canadian economy by regulating certain activities that discourage reliance on electronic means of carrying out commercial activities, and to amend the Canadian Radio-television and Telecommunications Commission Act, the Competition Act, the Personal Information Protection and Electronic Documents Act and the Telecommunications Act, SC 2010, c 23. FIWSA has been passed and is expected to be proclaimed into force in Autumn 2011.

as soon as its transmission was initiated, whether or not the message was actually received.

There are a few circumstances where consent would not be required under FIWSA, including where there is a "personal or family relationship" between the recipient and the sender, as defined by regulation.

A private right of action will be created for persons affected by contraventions of FIWSA. Applications exercising a private right of action could be made to the Federal Court of Canada or the superior court of a province. Upon demonstrating a violation of FIWSA, an applicant would be entitled to compensation for damages suffered as a result of the violation and, depending on the specific violation, a maximum of $200 for each contravention, not exceeding $1,000,000 for each day on which one or more contraventions occurred.

Given the circumstances under which consent is implied under FIWSA, companies should review existing email and internet marketing practices and begin putting in place mechanisms to track how they obtained email addresses and the date of their last transaction with a customer or the date their contract with a customer ended, since the onus will rest on the sender of a commercial electronic message to demonstrate compliance. Affected companies also need to ensure that clients and contacts receiving these messages are provided with opt-out mechanisms that comply with FIWSA and, where they wish to rely on express consent, they need to develop forms that comply with the requirements of FIWSA. In circumstances where affected activities and business processes have been outsourced, companies should work with their third party service partners in order to develop and implement necessary compliance programs and strategies and amend existing contracts appropriately.

Czech Republic

Milana Chamberlain

Outsourcing labour

The term "outsourcing" has two different meanings under Czech labour law. It can be either interpreted as the performance of work at a client's site while the employee is still employed by the original employer on the basis of an unmodified employment agreement, or as agency employment.

Agency employment

Agency employment has become very popular in the Czech Republic in recent years.

Agency employment is a temporary assignment of the agency's employees to the other employer (ie, the client undertaking) in order to perform work for the employer on the basis of an employment agreement entered into between the employee and the agency. The employer (client) does not employ the employees, but merely "rents" them from the employment agency on the basis of the agreement entered into between the employment agency and the employer.

Under Czech law, agency employment is reserved for agencies that fulfil certain statutory requirements and have obtained the appropriate permissions from the Ministry of Labour and Social Affairs of the Czech Republic. However, this might be changed by an amendment to the Labour Code, currently being discussed in Parliament. If passed this amendment would allow for the short-term assignment of employees even by entities other than employment agencies.

The employment agency employs the employees itself and then assigns them to clients, where the employees perform the same or similar work as regular employees of the client. The client assigns work and tasks to the agency employees and manages them. However, such employees are still employed by the employment agency, which pays their salary.

Relevant agreements

Agency employment is based on two bilateral agreements:

- An agreement relating to the temporary assignment of the employee (the Assignment Agreement) entered into between the employment agency and the client.

  The Labour Code lists the essential requirements of such an agreement. The Assignment Agreement and any subsequent instruction relating to the employee assignment must be in writing. The employment agency may assign the employee to one client for a time period of no longer than 12 months, and the duration of the assignment must be stated in the instruction. The duration of the assignment may be longer under special conditions, for example, upon the request of the employee or for a temporary replacement for an absent employee (eg, during maternity leave).

- An employment agreement entered into between the employment agency and the employee under the Labour Code.

Advantages and disadvantages of agency employment

Advantages

The main advantage of agency employment is its flexibility. It is not easy to dismiss an employee in the Czech Republic and agency employment might be the best solution for temporary employment under Czech law. It is therefore often used for seasonal jobs and emergency work flows.

Disadvantages

Agency employment might be seen as providing less security to employees than usual forms of employment. The client cannot avoid labour law

by using agency employment or disguised employment of sole traders instead of regular employment (in Czech this is often called *švarcsystém*); such behaviour might be considered to infringe the law and is therefore invalid.

The other disadvantage under current legal regulation is the requirement to have the status of an employment agency in order to assign employees. However, this condition might be removed by the proposed change to the Labour Code before Parliament.

It is also unclear what happens if the employment agency loses its permission or goes bankrupt. The possibility of terminating the agreement is governed solely by the Assignment Agreement. The liquidation of the employment agency or its loss of the permission itself is therefore not a reason for termination of the assignment. It could be that in such case the assigned employee would continue its assignment under the Assignment Agreement for the agreed term regardless of the situation of the employment agency.

France

Marc d'Haultfoeuille

Outsourcing issues under the French Data Protection Act (DPA) and French employment law

When implementing outsourcing contracts in France, various regulatory issues may cause concern, delay and costs. Whether these issues arise will depend on the type of the deal, its parameters and the function being outsourced. Two areas are particularly critical in France: data protection and employment.

Data transfer offshore under the French DPA

Outsourcing projects with an international dimension might run into difficulties if a transfer of data offshore is not properly addressed in accordance with the French DPA.

With regard to the regime on transfer of data abroad, the French DPA does not impose any restrictions on export to EEA countries or other EU Commission whitelisted countries (currently Canada, Switzerland, Argentina, Guernsey, Jersey, Israel and the Isle of Man). Export to US entities covered by the US safe harbour privacy regime is also permitted.

Otherwise, transfer of data offshore (especially sensitive data) is subject to restrictions (such as consent, EU model clauses, Binding Corporate Rules, etc) or to a prior authorisation of the Commission Nationale de l'Informatique et des Libertés (the CNIL) which is issued on a case-by-case basis.

Non-compliance with the French DPA can be subject to a criminal fine of up to €300,000.

Transfer of employment contracts under French employment law

Given that the outsourcing operation often leads to a transfer of related employment contracts of the concerned employees from the client to the service provider, one of the most fundamental aspects of the regulation of outsourcing contracts relates to the employment regime. It should be noted that any outsourcing operation, which is poorly prepared or managed from this perspective, is likely to be curbed and/or may incur additional costs or even be contested from an employment law perspective.

Given that the outsourcing operation often leads to a transfer of related employment contracts of the concerned employees from the client to the service provider, one of the most fundamental aspects of the regulation of outsourcing contracts relates to the employment regime.

The core employment issues involved in setting up an outsourcing project revolve around two main questions:

Does the outsourcing project result in an automatic transfer of employment contracts that cover employees assigned to the outsourced function?
Although the term "outsourcing" is not exactly defined by the French Employment Code, outsourcing operations are likely to constitute a "modification of the current legal position of the employer." This modification will result in an automatic transfer of employment contracts relating to employees assigned to the operation if two principal criteria, ie, the transfer of an autonomous economic entity (an organised group of people as well as tangible and intangible assets enabling a business activity to be conducted for pursuing a particular objective) and the continuity of the entity's identity within the new organisation, are jointly satisfied in compliance with the Employment Code. If that is the case, three situations can be envisaged depending on the nature of the transferred employment contracts:

- The transfer of employment contracts concerning employees that are exclusively or essentially assigned to outsourcing activities is deemed to be automatic and obligatory in accordance with European and French law. It is important to note that this transfer, viewed as a matter of public order, is imposed not only on employees but also on the customer and the supplier, excluding any possibility to "choose" employees that are to be transferred.

- The transfer of employment contracts covering employees that are partially assigned to outsourcing activities is subject to a voluntary application of the Employment Code for the employees.

- The transfer of employment contracts relating to protected employees (eg, staff representatives) is subject to the prior authorisation of the labour protection inspector (l'inspecteur du travail). The authorisation request must be addressed to the competent authority at least 15 days before the transfer.

However, if the two criteria are not both satisfied, the application of this article is subject to the parties' willingness, in which case the express consent of concerned employees is required before the transfer and the transfer recipient will be bound by the clauses of transferred employment contracts.

What impact will engaging employee issues have on the timetable for the implementation of the project?
The procedural constraints resulting from notification to and consultation with relevant entities must be fully considered when setting the timetable for the implementation of outsourcing contracts. For example, the working council of the transferring company must be consulted with as soon as the outsourcing project is sufficiently moved forward but not yet definitive or in principle established. The outsourcing contract can only be concluded after the completion of this consultation procedure under which the working council will give its opinion on the project (which is either positive or negative). The procedural delay might be increased according to the context of the operation (eg, the complexity of the project and the number of transferred employees), especially when the working council requires an expert to intervene in the process or demands further information or documents relating to the project or even an emergency interim proceeding is initiated. Additionally, other specific consultation procedures might be required under certain circumstances and consultation with the committee on hygiene, safety and working conditions may be necessary.

The procedural constraints resulting from notification to and consultation with relevant entities must be fully considered when setting the timetable for the implementation of outsourcing contracts.

In view of the essential importance of these two particular topics, outsourcing contracts that are implemented in France need to be drafted very precisely so as to comply fully with the French data protection and employment regimes.

Germany

Flemming Moos

Jamie Nowak

Outsourcing in the insurance sector – implementation of the Solvency II requirements

In accordance with the current status of the Solvency II Directive, a new regime for outsourcing contracts in the insurance sector will apply from 1 January 2013.

Currently, the Solvency II Directive provides for the following key points:

No transitional arrangements for existing outsourcing contracts

Solvency II does not grant protection or transitional arrangements for existing contracts. If an outsourcing contract does not comply with the Solvency II requirements it has to be amended.

This has to be done using existing mechanisms for the amendment of contracts (change requests) or by mutual agreement. If there are no provisions facilitating amendment, the question concerning the assumption of additional costs is of great importance. A simple guarantee by the supplier, under which it confirms compliance with the Solvency II requirements, will not suffice.
We recommend that customers start talks with their suppliers in good time in order to ensure implementation by the due date. Under the Solvency II Directive it is also possible that non-compliant outsourcing transactions will be deemed an operative risk and lead to a capital add-on to the insurer's solvency capital requirement.

Solvency II does not grant protection or transitional arrangements for existing contracts. If an outsourcing contract does not comply with the Solvency II requirements it has to be amended.

Critical and important functions

The current German catalogue of relevant functions will cease and will be replaced by a system of self-assessment by customers. Under the new regime, risk management, revision, corporate compliance and actuarial functions are important and critical functions that will be subject to stricter requirements as far as their outsourcing is concerned. The draft extends this to all functions and activities fundamental for the core business of the customer.

General principles

The outsourcing may in no case:

- endanger the governance system (currently risk management and proper business organisation)
- disproportionately increase the operational risk
- interfere with the management board's control and the regulatory authority's ability to supervise the outsourcing company's compliance with its obligations
- endanger the permanent provision of satisfactory services for the insurance holder

The Directive also clarifies that:

- the supplier shall cooperate with the supervisory authorities with regard to the outsourced function or position
- the customer, its auditors and the supervisory authority must be given access to all data in connection with the outsourced function or activity

- the supervisory authority must be given access to the business premises of the supplier

Minimum requirements of the outsourcing contract

The following minimum requirements apply to every outsourcing contract, irrespective of whether it concerns critical or important services:

- The rights and obligations of the parties have to be set out fully and unambiguously.
- The supplier has to comply with all statutory provisions, supervisory requirements and directives and cooperate with the supervisory authorities.
- The supplier has to report all developments which affect its ability to perform the outsourced function or activity.
- Termination periods have to be agreed in a way that leaves the customer sufficient time to find an alternative supplier or an alternative solution.
- The customer has to be granted the right to demand all information in connection with the outsourced functions and activities.
- The outsourcer has to be granted the right to issue general guidelines for the performance of the service and individual instructions.
- Any confidential information of the customer and its insurance holders, the beneficiaries, employees, contracting partners and any other persons have to be protected.
- The customer, its external auditors and the supervisory authority have to be granted effective access to all information in connection with the outsourcing of the function or the activity. This includes the right to carry out audits on the business premises.
- The supervisory authority needs to have the right to ask question directly to the supplier's employees.
- The conditions and regulations for the activities of subcontractors have to be set out.

As far as important and critical functions and activities are concerned, the customer also has to ensure that the risk management function and the internal control system of the supplier are appropriate and that the outsourced functions and activities are reasonably integrated in the risk management and internal control system of the customer.

Finally, the customer has to:

- verify that the supplier has appropriate financial resources to perform the services reliably and that its employees are sufficiently qualified and reliable.
- ensure that the supplier prepares appropriate contingency plans

Outsourcing to service providers outside the EU

The current draft of the implementation guidelines does not (yet) provide for additional requirements for outsourcing to non-EU countries. However, it cannot be assumed that there will be uniform requirements for EU suppliers and non-EU suppliers. While the supervision of outsourced activities and functions within the EU can be effectively implemented through the cooperation of the supervisory authorities, this is generally not feasible if the supplier is outside the EU.

Italy

Nicolò Juvara

Outsourcing in the financial services sector

Outsourcing has become a common practice in the financial services sector in Italy. Outsourcing may involve business functions or specific activities carried out by banks, insurers, investment firms and collective undertakings. Rules implemented at legislative and regulatory levels have regulated this activity. The rules aim to secure the integrity of the financial markets and protect consumers.

In particular:

- In respect of banks and other financial intermediaries, the Bank of Italy issued Supervisory Instructions and Guidelines which provide that all main banking operations can be outsourced to third parties, provided that certain safeguards are included in the contract. However, any activity relating to the assessment of the bankability of the transaction and the creditworthiness of the borrower cannot be outsourced.

- In respect of insurers, Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo (ISVAP), the insurance industry regulator, issued a regulation in 2008, aimed, in part, at anticipating the effects of Solvency II requirements. Under the 2008 ISVAP Regulation, Italian insurers can outsource all their main functions and activities, except underwriting activities, provided that specific safeguards are included in the outsourcing agreement and, if certain essential or important functions are outsourced, the relevant contracts must be notified in advance to ISVAP.

- In respect of investment firms and collective undertakings, in implementing the Markets in Financial Intruments Directive (MiFID) the Italian lawmaker delegated Italian financial market regulators (respectively Commissione Nazionale per le Società e la Borsa (CONSOB) and the Bank of Italy) to issue a joint regulation (which resulted in the 2007 Joint Regulation) setting out the requirements which investment firms and asset managers must comply with in outsourcing their business functions or phases of their activities and investment services to third parties.

Notwithstanding the different sources of such regulations, we highlight below some key features relating to outsourcing in the financial services sector. Unlike the banking and insurance industries, legislation applicable to the investment services and collective undertakings sector provides that the supplier must be a regulated entity.

One of the most distinctive aspects of the regulation of outsourcing applicable to the financial services sector, unlike other industries, relates to the regime concerning the liability of the supplier.

Outsourcing contracts must be entered into in writing and must provide for certain minimum protections, including, inter alia: the right of the client and the regulators to gain access to the information and data concerning the outsourced function or activity as well as to the premises of the supplier; the right of the client to terminate the contract at any time, without endangering the continuity of the business and the quality of the services; and the right of the client to set out parameters and SLAs for the assessment of the performance of the supplier. In addition, it is generally provided that neither the outsourcing contract nor its actual implementation can result i n the client being deprived of the outsourced function and activity.

One of the most distinctive aspects of the regulation of outsourcing applicable to the financial services

sector, unlike other industries, relates to the regime concerning the liability of the supplier.

To this end, a distinction should be made between the liability of the outsourcer to end customers and liability of the outsourced service supplier to its client:

- Applicable laws and regulations expressly state that the relevant bank/insurer/investment firm remains fully liable for the performance of the outsourced services vis-à-vis its end customers and, contrary to the principle generally applicable under Italian law, it cannot be contracted out by the parties to the outsourcing agreement. Therefore the liability of the client cannot be excluded or limited even when outsourcing the function or the activity is necessary for the performance of the relevant service or when it has been disclosed to, and accepted by, the end customer. The latter situation entails that the supplier is also jointly and severally liable with the relevant bank/insurer/investment firm.

- Applicable laws and regulations do not contain specific provisions regulating the liability of the outsourcer vis-à-vis its client. Thus, in this respect the general principles of Italian law regarding contractual liability apply.

In particular, it should be noted that, contrary to the idea prevailing in the market, the liability of the external supplier can be excluded or limited only insofar as it is caused by negligence. Any contractual provision or other arrangements between the parties aimed at excluding or limiting such liability in case of gross negligence or wilful misconduct would be void. In practice, considering the high degree of professionalism and expertise which is required from a supplier operating in this industry, it would be very difficult for such a party to be excused from liability by pleading that the breach was caused by negligence.

In addition, under Italian law, the contractual liability of a party generally includes both the actual loss or damage and the loss of profits suffered by the other party, to the extent they can be proven and quantified as a direct and immediate consequence of its breach. While this principle cannot be derogated from (unless the breach was caused by negligence), in order to avoid that the liability of the party in breach be construed broadly by the courts to cover other damages or losses (such as, for example, reputational damages or consequential losses), it is recommended that such types of additional liability are expressly excluded in the outsourcing contract.

Middle East

Dino Wilkinson

Shariah compliant outsourcing

Islamic finance institutions seeking to outsource technology or business processes to third party providers must ensure that the outsourcing contract complies with Shariah principles.

Contract structuring

An "output-based" agreement – where the customer outlines its desired requirements and all design and delivery risk is placed on the supplier – may create tensions with Islamic principles, which include a rule against Gharar (uncertainty). Accordingly, the services description would have to be drafted with suitable clarity.

An outsourced services supplier will probably be keen to ensure that it is not appointed on a Wakala (ie, agency) basis. This type of arrangement may be terminated at will by either party and, for the supplier, there is the additional risk that acting as an agent (rather than a mere service provider) materially increases the level of fiduciary duty it owes to the customer.

Liability and remedies

It is common for customers to impose liquidated (ie, fixed and agreed in advance) damages if the supplier is late in delivering aspects of a solution. Under English law, sums specified to be payable upon a breach of contract must be a genuine pre-estimate of loss. Under Shariah principles, compensation for failure to perform contractual obligations based on clearly defined amounts imports certainty into a contract and liquidated damages would generally be considered permissible (as would penalty clauses and limitations on liability). However, the prohibition on Gharar would mean that damages for loss of anticipated profits or loss of business, reputation or goodwill would not ordinarily be recoverable due to their speculative nature.

The concept of Riba (usury) will prohibit the supplier from imposing interest on late payment (a common commercial remedy). The charge could instead be imposed as a liquidated late payment charge. The supplier would be allowed to deduct direct costs and expenses from such amount with any surplus donated to charity. This encourages the customer to pay on time and compensates the supplier for expenses without delivering a hidden profit when the customer may be in distress.

Shariah governance issues

In the case of an outsourcing arrangement within an Islamic finance institution, the governance model will have to take account of the requirements or recommendations of the Shariah supervisory board. The ongoing inputs of this body should be incorporated as part of the decision-making process.

Project management and contract governance processes may also have to comply with the principles and standards issued by the likes of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). Banks, insurers and other businesses regulated by such bodies must ensure that incoming services are supplied in accordance with their guidelines.

The outsourcing agreement may have to be submitted to a scholar for the issue of a fatwa establishing its conformity with such principles. This important stage will have to be incorporated into the contract negotiation timetable.

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Monitoring supplier performance

If a supplier fails to meet contractual key performance indicators (KPIs) and/or service level agreements (SLAs), this can often trigger an obligation to pay service credits (deductions from the contract price) to the customer, or give the customer the right to terminate. The contract could also provide that liquidated damages will be payable by the supplier in the event of project delay (these have been considered above in a Shariah context). Critical to all such arrangements from a Shariah perspective will be the ability to demonstrate with certainty the reason why any such credit or deductions have arisen if objections based on the principle of Gharar are to be overcome.

Shariah service issues

Suppliers should take steps to design their delivery of services and products to take into account the unique operational characteristics of Islamic financial institutions in order to comply with Shariah principles. By way of example, a customer call centre servicing an Islamic bank is likely to experience different peaks of activity compared to a conventional bank. Prayer times and Islamic holidays will have a strong influence on call volumes. Equally, it is likely that many staff may be Muslim and will wish to work in an environment that caters for their religious requirements. The service provider will have to cater for those within the workforce that wish to participate in daily prayers and take other leaves of absence for religious reasons while ensuring it does not breach local laws preventing discrimination against employees.

South Africa

Rohan Isaacs

Black empowerment and the transformation of South Africa's outsourcing industry

Apartheid prohibited black people from having any meaningful access to the South African economy. Since the advent of democracy in 1994, a driving force within South African society has been transformation through the economic empowerment of black people. Aside from the moral imperative, it stands to reason that a social order in which the majority of the population cannot break into the higher levels of the economy is unsustainable. Changing the economic order is no simple task. How can people from disadvantaged backgrounds without experience and money be empowered so that they are able to compete with established players in the economy? This is the ongoing work of South African society through a combination of legislation and alteration of the social discourse.

Black empowerment in the information technology and outsourcing industry is governed by the Information and Communications Technology Sector Charter (ICT Charter) which is expected to become law in the near future. It is one of a number of industry charters covering various portions of the South African economy. The ICT Charter scores companies' levels of black economic empowerment against a range of factors including ownership, management, skills development, procurement policies, and socio-economic development.

Broadly, there have been two approaches to the entry of black people into ownership of South Africa's economy. Either black controlled consortia have acquired stakes in established companies or black entrepreneurs have started their own companies. Both models have been used in the information technology industry with varying levels of success.

Established outsourcing service providers have generally issued around 25 per cent of their shares to black shareholders in accordance with current guidelines. The latest version of the ICT Charter stipulates a requirement of 30 per cent black ownership. If this requirement becomes law it will impose tough additional requirements on most of the established service providers in the ICT industry as many of their black empowerment transactions will need to be restructured.

This model of black economic empowerment has been criticised by some for empowering only that segment of black business which has access to capital. Proponents of this argument suggest that real black empowerment is to be found in the smaller black owned start-up companies. The difficulty faced by these companies is that they find it virtually impossible to compete equally with large, established competitors. The procurement obligations under the ICT Charter should go somewhere towards alleviating this difficulty.

Start-up black owned companies are often used as subcontractors by larger service providers on outsourcing transactions. Whilst this has given opportunities to many smaller suppliers, it is often difficult for customers to ensure that black owned subcontractors are being given a fair share of the work on large outsourcing transactions by the prime contractor. One solution is multisourcing arrangements where smaller black owned companies are awarded portions of the project instead of being used as subcontractors.

Like all multisourcing transactions, this has its challenges. Multisourced contracts and relationships do not take care of themselves. Cooperation between the group of suppliers needs to be developed and someone needs to manage the relationships between the suppliers themselves, as well as between the suppliers and the customer. This is particularly so where experienced suppliers are working with newer market entrants, such as the smaller black owned companies. The project governance structure required is therefore more elaborate than usual.

It has also been argued that multisourcing adds cost to an outsourcing transaction. The experience in South Africa, however, has been that multisourcing has reduced the need for subcontracting so the mark-up charged by prime contractors, particularly the large risk premium charge for working with lesser known subcontractors, is avoided.

The ICT Charter will underpin the transformation of the information technology and outsourcing industry in the coming years. If its aims are achieved, the industry will be very different within one to two decades, comprising a mix of large well established participants and a vibrant group of smaller competitive service providers capable of delivering the complex services that modern outsourcing projects require.

United Kingdom

Mike Rebeiro

An holistic approach to risk in outsourcing transactions

As illustrated by several recent high profile cases, including Electronic Data Systems' (EDS) (now HP Enterprise Services) failure to successfully deliver BSkyB's customer relationship management system (see further page 21), outsourcing can be a risky business. So how can businesses manage the risks inherent in outsourcing transactions?

We advise our clients that there are six stages in a successful risk management process.

Stage one – identification of risk
It is essential to identify potential risks in an outsourcing as early as possible. There are many types of risk which can arise on an outsourcing. These risks can arise at each stage of the tender, negotiation and delivery and can be either legal or commercial. In assessing risk, it is essential to identify those particular risks which are associated with the outsourcing project and to decide what level of risk is acceptable. Risks for customers include: service failure; project delay; business disruption; regulatory risk; breach of security; data loss; damage to reputation; employees' liabilities; supplier insolvency; damage to business relationships; damage to property; and loss of revenue. We suggest these risks are identified at the outset, before the invitation to tender is issued. We also recommend that customers share their risk profile with suppliers as they need to understand their customers' business and motivations.

In assessing risk, it is essential to identify those particular risks which are associated with the outsourcing project and to decide what level of risk is acceptable.

Stage two – likelihood of risk
Once risks are identified customers must gauge the probability of the risks occurring.

Stage three – impact of risk
The next stage is to assess what damage the risk would have on the business if it materialised. Even if a risk is highly probable, its effect on the business may be negligible. The risk needs to have a value attributed to it and that value needs to reflect a business judgement. Managing this process can be difficult, but maintaining a risk register will help. Sophisticated electronic risk registers, such as Norton Rose Group's Risk Manager can be used to identify risks and record mitigation strategies, to link risks to relevant clauses in the draft contract and to produce reports for management review. If the first three stages are not completed properly then a customer may pay a premium for unnecessary "gold standards", suppliers are focused on non-critical aspects, reporting and monitoring become irrelevant to the customer and the service fails to meet expectations. The end result is that both the supplier and customer are unhappy.

Stage four – allocation of risk
Having ascertained what risks the customer faces, the parties must agree during negotiations who will be liable if a risk materialises and damage is suffered as a result. Customers need to adopt a realistic approach to risk; there are some risks which simply cannot be "outsourced" to suppliers. (For example, where the risk is within the customer's control, such as the risk of infringing a third party's intellectual property rights in respect of materials provided by the customer, or loss of data where the customer retains responsibility for its storage and back-up). Therefore, customers need to decide which risks are better managed internally and which by the supplier. Questions around the type and level of liability to be accepted by the parties are ultimately commercial questions that cannot be divorced from the issues of risk and price.

Customers need to adopt a realistic approach to risk; there are some risks which simply cannot be "outsourced" to suppliers.

Stage five – management of risk
Risk cannot be eliminated, but it can be properly managed. Risk management strategies may be operational or contractual or a combination of both. Customers need to consider which are the most appropriate risk management tools. By defining a preferred risk management strategy in advance of drafting the contract, the customer is able to create an agreement that does not "over-engineer" the risk management tools and should produce a more reasonable basis for discussion with the supplier.

Stage six – tracking risk
Finally, the people element of an outsourcing should not be underestimated. A project team comprising supplier and customer representatives is best placed to monitor and manage the outsourced services. Comprehensive governance procedures should be put in place to help them identify and resolve problems. Risk reporting should be an integral part of project governance. Training of relevant staff on the project team is important for both technical matters such as compliance, and soft skills including relationship management. Good project management is a vital risk management tool.

Once the deal has been signed we recommend a user-friendly deal manual and training and annual deal health checks. In addition, customers should keep appraised of what is going on in the supplier's industry/location. There is much to be said for cultivating strong, local contacts. Customers should also regularly audit the suppliers' financial position and check that exit plans are up to date and asset registers are accurate.

15

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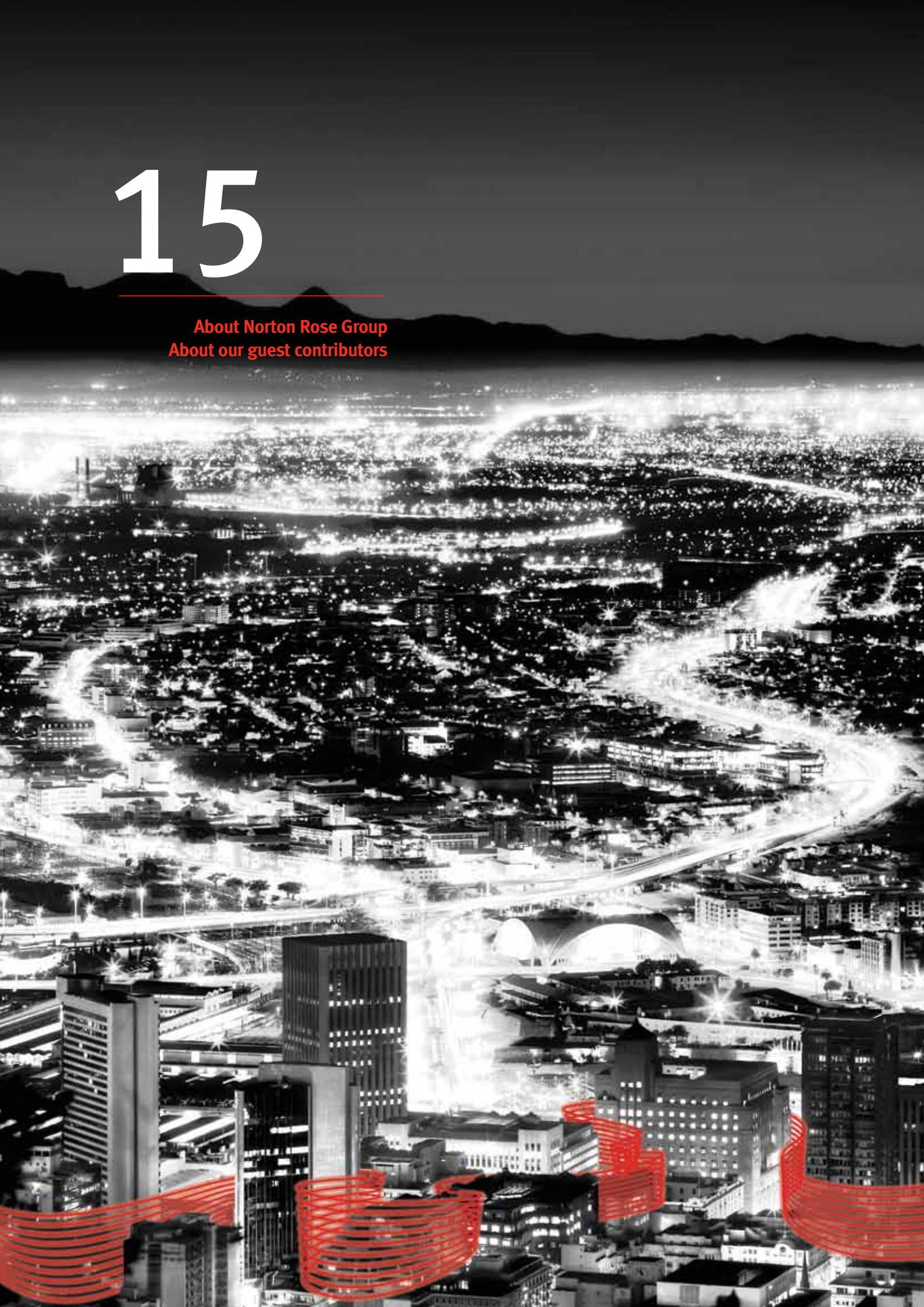

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EquaTerra was founded upon the principle of helping clients achieve sustainable value in their IT and business processes through internal transformation, shared services and outsourcing. On 18 February 2011 the business of sourcing advisory firm EquaTerra Inc and its subsidiaries was acquired by KPMG LLP (US), KPMG Holdings Limited (UK) and KPMG International.

For country, industry and service-specific contacts, please visit: www.kpmg.com/Global/en/Pages/contactus.aspx

For information and research on outsourcing, shared services and internal improvement, visit: www.equaterra.com/library

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Our outsourcing advisors are well known throughout the marketplace for their insight, independence and innovative approach to creating the right solutions for our clients.

16

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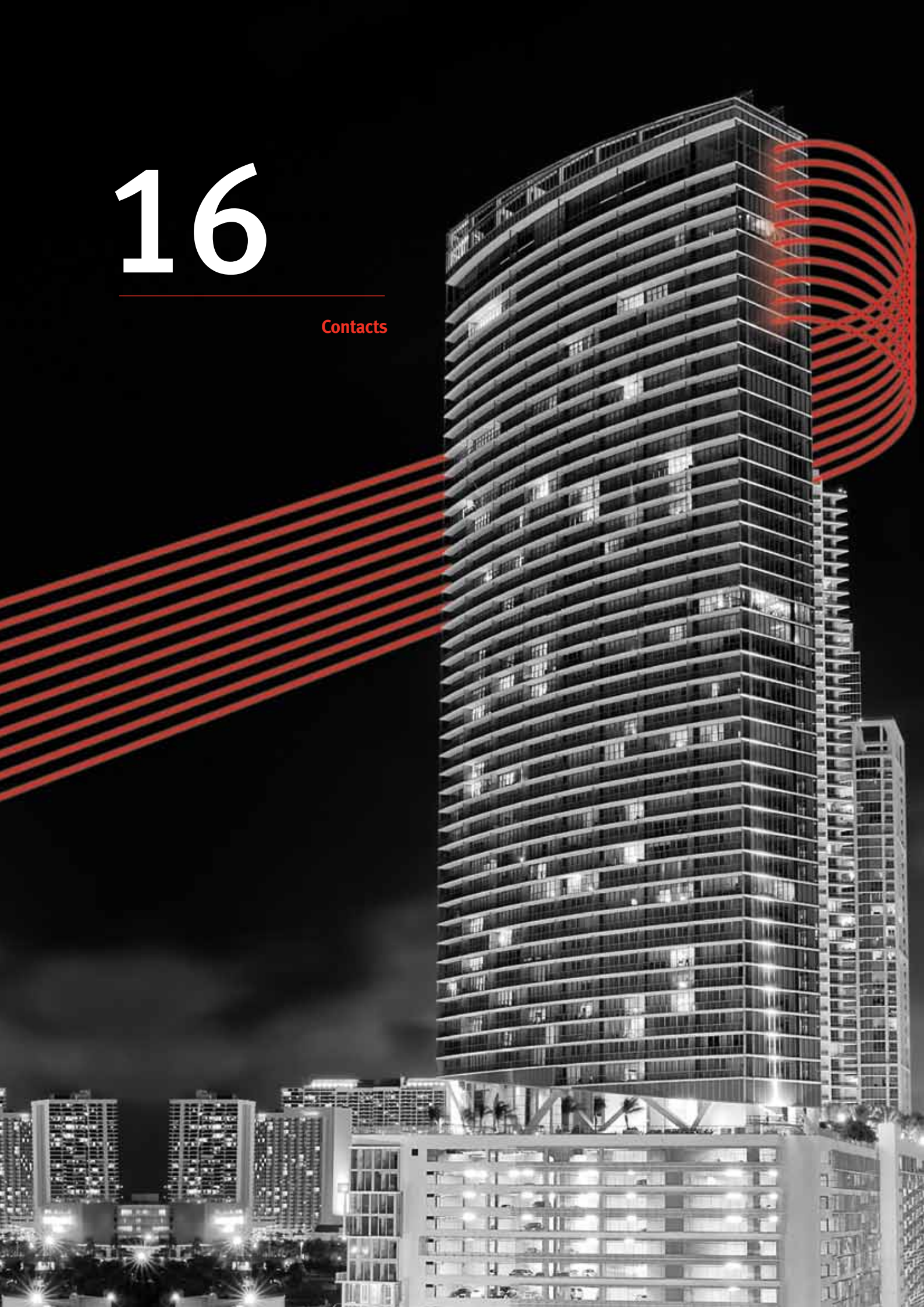

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