Profiting from Business Process Outsourcing

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Companies have successfully used outsourcing for decades to generate savings and allow greater focus on core (essential) business. Outsourcing traditionally noncore (nonessential) yet critical functions to larger service providers is one of the fastest-growing changes in the business market today. We refer to this process as business process outsourcing (BPO). Two significant market forces are driving this practice: a growing low-cost white-collar labor pool and automation and codification of best practices.

Labor cost arbitrage (profiting from skilled-labor wage discrepancies) and process modules (automation of best practices) can make business process outsourcing profitable.

The potential for lower labor cost and greater efficiency are two important factors as companies consider BPO. One of those two factors alone isn't enough to create sustainable value because skilled labor and technology are the most important cornerstones of any business process and both must be optimized to create lasting value and maintain a competitive edge.

Industry analyst Gartner estimated the overall BPO market to be around $110 billion in 2002 and predicted it would grow to more than $173 billion by 2007 (R. Scholl and colleagues, "BPO Market to Grow to $173 Billion in 2007," http://www.gartner.com, July 2003).

Although outsourcing IT and other specific services has taken place for about 50 years, outsourcing entire functions started in the late 1980s and early 1990s. But it has been less attractive to many organizations because of the time it took to realize any meaningful cost savings, if at all. The "Business Processes Defined" sidebar clarifies the meanings of various business processes.

Factors such as lower labor costs and improved process efficiencies through automation of best practices are forcing companies to take a fresh look at BPO.

BUSINESS VALUE OF BPO: THE FIRST GENERATION

Companies have always considered outsourcing for various reasons. Focusing on core competencies (essential needs), reducing operating costs, and freeing resources for other purposes are the primary ones, and gaining access to world-class capabilities is a secondary reason.

BPO did not take off as a growth market for a long time because the cost reductions were only 5 percent to 10 percent, too low to make it worthwhile for organizations to deploy the required resources, as Figure 1 illustrates.

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Business Processes Defined

Industry consultants divide a corporation's business processes into four categories:

- **Core and critical.** **These processes are central to a corporation and are processes through which the company derives competitive benefits. Outsourcing is not an option for these processes, although over time, some might become noncritical. Examples of these processes are strategic planning, research and development, and hospital patient care.**
- **Core and noncritical.** **These processes, once critical, are generally core to an organization and as the industry has evolved, these processes have been commoditized to the point where they can be outsourced. An example would be pharmaceutical clinical trials.**
- **Noncore and critical.** **These are processes that are not central but are essential to keep the core and critical processes running. Examples would be IT services, manufacturing, and finance. This is the fastest-growing outsourcing segment, as companies are moving toward outsourcing these services to third-party providers.**
- **Noncore and noncritical.** **These are processes that companies have traditionally outsourced to third parties. Examples would be janitorial, travel, and food services.**

This framework is helpful, but you should keep the following in mind when considering it. First, there is no standard for classifying the processes into the above-mentioned categories, and companies have to do their own analysis. Also, a single process might have subcomponents that fall into the various categories. Third, the list is also not static. Over time, a process that is critical might become noncritical.

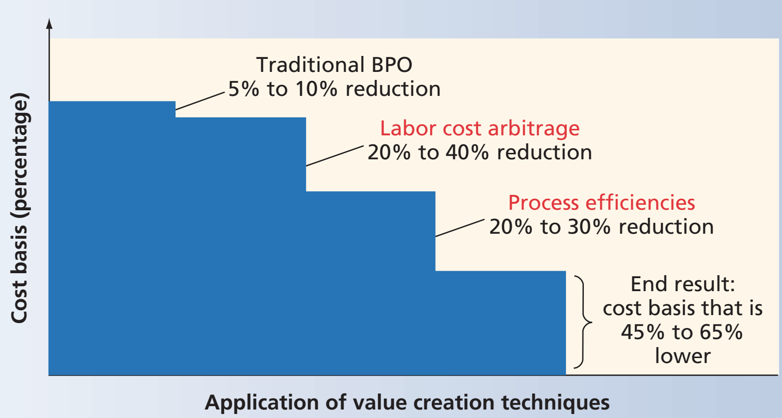
The large service providers were sometimes unable to provide substantial cost savings because they relied on scale (wherein cost per transaction declines with the number of transactions performed) and process specialists to achieve cost savings (if any). They could not achieve scale because of the custom and complex nature of the processes and functions they inherited. They had to rely on best practices and other process redesign techniques to achieve the cost savings (achieving 5 percent to 15 percent cost savings required target savings of 15 percent to 25 percent to make a profit of at least 10 percent). They also had to customize standard ERP (enterprise resource planning) applications to automate the processes through technology, thereby losing money on the contracts during the initial years.

NEW BPO ADVANTAGES: WHAT HAS CHANGED?

Two new opportunities are emerging that are making corporations take a fresh look at BPO because they lead to cost savings of 20 percent to 60 percent, reducing the long-term cost base of a specific function by 35 percent to 50 percent:

- labor cost arbitrage (profiting from labor wage discrepancies) by locating service centers in low-wage countries, thus taking up to 70% of the workforce offshore; and
- process efficiencies realized through the automation of best practices and process reengineering, provided by process modules, which are technology applications that can be duplicated with minimal customization for a specific function.

Figure 1. BPO value creation techniques.



Savings from traditional BPO range between 5 percent and 20 percent. The new BPO (techniques in red) generates significant cost savings. Savings from these techniques don't add up because of overlap.

For Further Reading

- ➤ J.K. Halvey and B.M. Melby, *Business Process Outsourcing Process, Strategies and Contracts*, John Wiley & Sons, 2000.
- ➤ R. Scholl and colleagues, "BPO Market to Grow to $173 Billion in 2007," Gartner, July 2003; http://www.gartner.com.
- ➤ *Nasscom-McKinsey Report, A Vision for Indian IT and IT-enabled Services*, National Association of Software and Services Companies, June 2002; http://www.nasscom.org/artdisplay.asp?cat_id=326.
- ➤ "The Cusp of a Revolution: How Offshoring will Transform the Financial Services Industry," Deloitte Research financial services industry viewpoint, Deloitte Consulting; http://www.deloitte.com/dtt/cda/doc/content/The%20Cusp%20of%20a%20Revolution(1).pdf.
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- ➤ E. Simonson, Everest Group, "What Is Driving the Growth of BPO? The Emergence of Transaction Engines," *BPO Outsourcing J.*, Dec. 2002; http://www.bpo-outsourcing-journal.com/issues/dec2002/everest.html.
- ➤ S. Morstead and G. Blount, "Offshore Ready: Strategies to Plan & Profit from Offshore IT-enabled Services," ISANI Group, Jan. 2003.
- ➤ M. Michaels, "Why Offshoring is Good for America," *Business Today*; Oct. 26, 2003.
- ➤ "Business Process Outsourcing," *CFO.com*; http://www.cfo.com/guides/1,6106,161,00.html?f+hpbg.
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The two opportunities, by themselves, provide reasonable cost savings. But companies can attain sustainable savings and business value by integrating the two opportunities.

Opportunity No. 1: Cost arbitrage through offshoring

Ever since companies began moving their manufacturing units to low-labor-cost countries such as Mexico, China, Taiwan, and Malaysia in the 1970s, many companies have looked for labor arbitrage in other sectors as well. Globalization, driven by agreements such as the North American Free Trade Agreement (NAFTA) and the liberalization of economies like those of China, India, and Brazil, increased organizations' propensity to outsource to low-labor-cost countries. The use of services from such countries was low at first due to these sectors' unique requirements, such as close proximity, intangible services, high customization levels, and English requirements (spoken and written). All this changed in the 1990s when the cost of telecommunications dropped rapidly due to deregulation, dramatic improvements in optical-fiber technology, and widespread use of the Internet.

With the increased use of the Internet, the forced standardization of underlying telecommunication protocols such as TCP/IP (transmission control protocol/Internet protocol), and the development of Web-enabled applications, companies found a way to finely subsegment their existing business processes and execute and manage them at low-cost destinations around the globe. The economic downturn of the early part of this decade has forced companies to look at further ways to reduce their service costs.

Various destinations around the globe are candidates for sourcing of services, commonly referred to as offshoring. The destinations range from countries that are near-shore to the US (such as the Caribbean, Mexico, and Canada) to offshore destinations such as India, the Philippines, Malaysia, and China.

India is currently the top destination for business process outsourcing services because of low-cost labor (less than $2,500 annual salary for professionals), many qualified workers (more than two million graduates per year), and high-quality work. India has also established a track record in the software services sector, where it controls about 80 percent of the offshore outsourcing market.

Although India is currently the top outsourcing choice, countries such as China and the Philippines are emerging quickly in the BPO sector. We'll treat India as the proxy for offshore BPO outsourcing and examine this model's sustainability.

Offshoring: When does it make sense?

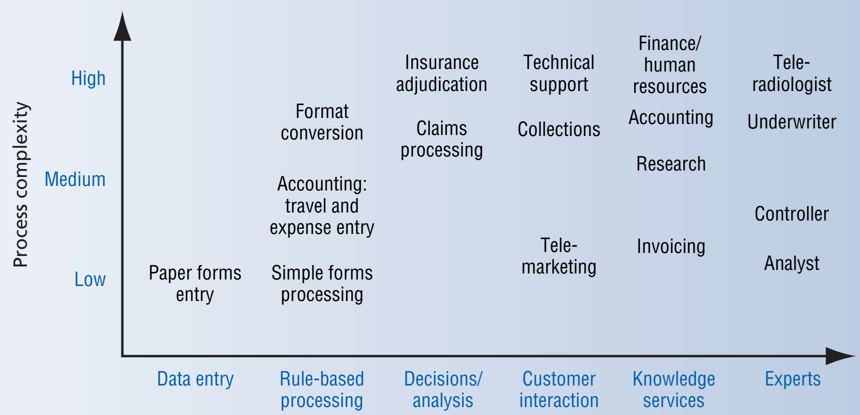
Not all business processes are candidates for offshore execution. Businesses must carefully analyze the processes and subprocesses before selecting the suitable ones for offshoring. In general, candidate processes have the following characteristics:

- *They are labor intensive.* If a process has a high degree of labor content, the benefits of offshore migration will be maximized. Examples include call center and insurance claims adjudication (settlement) processes that have a high labor component and, hence, high labor cost.
- *The processes are scale- and efficiency-driven.* These are processes that have repeatable tasks with well-defined rules. Offshoring such processes can result in scale efficiencies from training and implementation. Examples

include invoice entry and manual data entry that have high volume and well-defined rules.

- *They allow remote execution.* Businesses can execute these processes remotely, with minimal interaction, minimal management, and minimal access, and integration to local resources.

Figure 2. Remote process identification.



Are offshore outsourcing benefits sustainable?

A country such as India can remain a sustainable destination for sourcing specific business processes only if various factors are present.

Supply. The BPO industry needs college-educated, computer-literate employees with analytical and professional skills in accounting, finance, engineering, design, and technology. English communication skills are necessary for customer service or phone-related processes. This workforce must be plentiful, so that wages don't creep up when demand increases.

India currently has about 200,000 to 250,000 college-educated, computer-literate workers, according to Nasscom, the India-based IT and BPO association (http://www.nascom.org). The demand for such qualified Indian workers is expected to quadruple in the next five years (Nasscom). Can the country accommodate this demand? India produces about two million college graduates every year, with an annual 10-percent growth rate. India also has more than 84,000 secondary schools, 5,000 colleges, and 200 universities (Ministry of Education, Government of India, http://www.education.nic.in). With such an abundant supply, an adequate workforce will be available in the future.

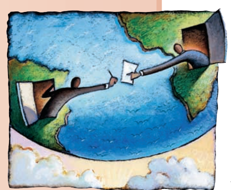
Cost structure. To determine whether cost arbitrage is sustainable, we analyze the cost structure of a typical India-based remote processing facility. The components include the following:

- *Cost of processing agents*. These are the wages, including benefits, for the basic processing agents, who perform the rules-based tasks such as providing answers to customer queries, paying healthcare insurance claims, and entering and paying invoices. In India, additional costs for quality agents might also include benefits such as transportation and food service costs.
- *Management and support.* The cost of management and support tends to be about 50 percent of the cost of the processing agents, as compared to about 25 percent in the US. The wages of managers in India are anywhere between three and 10 times the wage of a basic processing agent; the number in the US is typically between two and three times as great.
- *Infrastructure and overhead.* The cost of infrastructure includes the depreciation of leasehold improvements, computers, and other capital equipment. In India, infrastructure and overhead cost tends to be about 50 percent to 60 percent of the wage costs, quite high compared to the US.
- *Real estate and facilities management.* The cost of rentals and facilities management is about 40 percent to 50 percent of the base cost of the processing agent. By deploying two or three work shifts, the fixed costs of assets and facilities can be efficiently utilized.
- *Telecom and technology.* Telecommunications is an additional cost that businesses incur because of the operation's remote nature. In offshore sites, telecommunications expenditures form a major part of the cost structure, with redundancy and security requirements further increasing outlays. For voice-intensive processes, the cost per agent can be as much as 50 percent to 100 percent of workers' wages.

Value-added services. In addition to the basic processing tasks, sustainability of BPO services comes from the ability to get a single workforce to perform high-value added work. Figure 2 illustrates the labor value-added ladder. The Indian workforce has proven over the last five to seven years that such a migration up the value-added ladder is possible. Early in the process, workers in India performed only data entry and mundane tasks. Over the last three to four years, however, they have performed customer service, knowledge services, decision analysis, and high-end design work in areas such as industry and equity research, chip design, underwriting, and risk modeling.

Cost arbitrage by itself is not sustainable, and does not have compelling business value unless better quality and

BPO Challenges



The following list shows challenges that the Indian BPO (business process outsourcing) industry faces in providing sustainable benefits. This list opens a window into the challenges that all offshore destinations will face as they compete for business.

- ***Productivity.*** **Worker productivity must improve to meet or beat customer standards, through process improvement techniques.**
- ***Effectiveness.*** **It is not enough to be productive or low cost if the worker is not effective in solving the goals of the transaction. For example, ineffective customer care means the customer must call two or three times to solve a problem.**
- ***Availability of management talent.*** **India lacks high-quality middle-management talent, which is necessary to manage the large labor pool. The proportion of management talent must keep up with the proportion of a labor pool that is increasingly available.**
- ***Motivation and growth opportunities for agents that join an organization.*** **The biggest question is the matching of an individual's skills to the available work. It is entirely possible that low-end processing work might not require a college degree.**
- ***Attrition rate.*** **As demand goes up and the level of opportunities for an agent diminishes in an organization, the attrition level goes up. Attrition is one of the main reasons why many call centers in the US moved their operations to India and the Philippines. Attrition can have a large impact on the cost structure with the departure of agents who are well trained and who have finally reached their target productivity.**
- ***Robust and low-cost telecom infrastructure.*** **This is essential for the execution of remote business processes. A physical infrastructure that includes a transportation network, roads, office buildings, and power and water availability is a must. If the infrastructure does not improve, operations start to bear the cost of additional investment required to get it to world standards. India is improving in this area, but this improvement is far from adequate.**
- ***Political stability.*** **Geopolitical considerations such as the Indian-Pakistan conflict create an uncertainty that does not go away even if other basic infrastructure and supply issues are resolved.**

Although these above factors might make a country like India less desirable in the long term, alternatives are available for corporations seeking to diversify their risk. These include China, the Philippines, Jamaica, Malaysia, Hungary, Poland, Russia, and South Africa.

better service levels accompany it. This is where Indian organizations and service centers have excelled and have built market presence.

About 60 percent of the software development centers that have attained SEI (Software Engineering Institute) Level 5 certification are located in India. About 215 of the top 300 companies in the software and BPO sectors in India have attained ISO (International Standards Organization) certifications. Most of the BPO service centers in India are following Six-Sigma, ISO, or COPC (Customer Operations Performance Center) standards.

Examining some of the factors facing the Indian BPO industry in providing sustainable benefits opens a window into the challenges that all offshore destinations will face as they compete for business. The "BPO Challenges" sidebar shows factors that can derail growth.

The offshoring trend is here to stay and provides many positive benefits. But offshoring alone is not enough to sustain business value for a specific process or function. This is where the next opportunity, attaining process efficiencies through automation of best practices, comes into play.

Opportunity 2: Process modules and automation of best practices

A corporation's back-office operations are highly customized to serve its employees and customers. As corporations have evolved, back-office operations such as human resources, finance, accounting, and customer service have also become greatly complex with highly customized infrastructures, applications, and processes. If an organization decided to outsource such functions to a third-party service provider, that provider would have to make decisions on how to improve the efficiencies of such custom processes without affecting service levels. In many cases, achieving any meaningful efficiency took a long time.

The adoption of third-party ERP applications such as PeopleSoft and SAP in the 1990s changed all that by helping to create an almost-standard technology infrastructure. This phenomenon really started the standardization of common back-office functions among large corporations. The BPO service providers also benefited from the ERP applications. Because the underlying business application is fairly standard, whether it is an ERP, claims processing, or customer service application, the service providers can create standard modules and tools to make the business function more efficient. This has led to the creation of process modules around a back-office function or the vertical industry process that a company can duplicate across multiple organizations, as Table 1 illustrates. Outsourcing companies use multiple terms for this, including *transaction engines*, a term that the industry consulting company Everest Group coined (E. Simonson, Everest Group, "What Is Driving the Growth of BPO? The Emergence of Transaction Engines," *BPO Outsourcing J.*, Dec. 2002, http://www.bpo-outsourcing-journal.com/issues/dec2002/everest.html).

Table 1. Best-practice process modules.

Process modules	Examples of functions
Best people resource	Divide and distribute work to the right type of people through workflow (such as analytical, simple rule-based work, complex rules, simple phone calls)
Best people expertise	Industry- or function-specific resources
Best practices automation	Quality process, training, metrics and measurements, reporting, knowledge management
Business process automation	Workflow, image acquisition, self-service
Base applications	ERP, claims processing, logistics, customer care applications (PeopleSoft, SAP, Oracle)

Process modules feature the following characteristics:

- They are typically a collection of standard technology applications, codified best-practice modules, domain-specific proven business processes, and people resources that you can duplicate with minimal customization for a specific function such as human resources, claims processing, procurement, contract management, finance, and accounting.
- They include full or partial automation of the cumbersome transaction processing that is characteristic of almost every administrative or back-office function. Examples include receiving and processing mail and entering paper-based forms, invoices, or claims into application systems.
- Automation of best operating processes for areas such as training, quality management, reporting, metrics and measurements, and knowledge management. This includes the creation of productivity, management, and profitability reports.
- They include workflow automation and definitions. The process modules clearly define the process inputs, outputs, and rules, and they are segregated so that businesses can perform and manage any part of the process anywhere, anytime. This involves dividing the process into subprocesses and assigning them to people based on skill and geography.
- Work includes segregation of repeatable tasks into rules-based and analytical subtasks.
- Synergy creation involves grouping processes into modules. An example is the reduction of administrative work by combining payroll and employee benefits.
- They integrate with base ERP or other business applications.
- They might include self-service applications—for example, the Web-enabled myHR, a one-stop application that lets employees handle all their human-resources processes such as payroll, benefits, and expense reporting, through a Web portal. The employees make their own choices and contact a human resources call center only when necessary.

Outsourcing service providers are building such process modules, or transaction engines, in functions such as human resources, finance and accounting, procurement, and claims processing. Transaction engines have been around for a while and have proven very successful. Claims processing is another area where these process modules have been quite successful. Finance and accounting transaction engines are still in development with accounts-payable transaction engines being the most prevalent.

Process modules include the following benefits to corporations that are considering outsourcing:

- *Cost savings*. Savings are 20 percent to 40 percent.
- *Rapid deployment*. This includes rapid deployment of processes and process changes across organizations (in a matter of months rather than years).
- *Best practices*. These include service provider's expert knowledge and industry best practices.
- *Cross-synergies*. There are several cross-functional benefits.
- *Automation*. Service providers spread technology costs over multiple customers and achieve scale.

Health care claims processing: Process modules in practice

The health care claims processing function in a typical mid-size insurance or payer organization lacks automation because the health care industry does not have sufficient scale or return on investment to invest heavily in this back-office function. For example, the claims department might receive about 70 percent of all claims in paper format, sort the paper claims, and enter them into a claims adjudication (settlement) system. The adjudication system then automatically adjudicates about 30 percent of these claims, leaving the rest for claims examiners to adjust manually.

The health care outsourcing service providers in a typical mid-size insurance or payer organization have developed process modules through improvements in technology, people, and processes. Functionalities include

- segmenting processes so that the industry can perform complete or subparts of the process in the most cost optimal location that has the right type of people (for example, dividing claims into simple and complex claims and routing the simple ones to offshore service centers);
- improving the receipt of electronic claims through best practices;
- developing standard workflow and imaging solutions to receive, convert, and distribute paper claims to service locations around the world;
- standardizing and developing best practices around claims adjudication systems that are rule based and that help to continually improve the auto-adjudication of claims to 60 percent to 80 percent; and
- codifying reporting, service metrics, training, and knowledge management best practices through development of standard application modules.

Process modules are not the only way to improve the efficiency of operations. Process reengineering might be effective for certain types of business processes. For example, in the accounts-payable function, it might be more effective to reengineer the basic processes and achieve substantial cost savings by reducing the amount of labor required, establishing effective communication between procurement and accounts-payable systems, utilizing EDI (electronic data interchange) to validate and automate payments (thereby reducing the number of paper invoices), and reducing the number of approvals required, rather than through just labor-wage arbitrage.

BRINGING IT ALL TOGETHER: HOW AND WHEN TO CHOOSE BPO

Both opportunities together—cost arbitrage and the process modules concept—can make BPO profitable for corporations. A simple health care claims process example illustrates why companies must consider both opportunities. Assume that a health insurance company outsources the data entry of a paper claim to an offshore provider and that the offshore provider charges on a per-claim basis. The offshore provider will provide data entry of the paper claim for 30 percent to 50 percent savings. This provider will guarantee better quality and turnaround time. In essence, the offshore provider will take an inefficient, unnecessary process and derive 30 percent to 50 percent savings through labor arbitrage and better service. It's not in the offshore provider's best interest to automate the process; the provider's main value proposition is lower cost through labor arbitrage, so the provider's fee is based on the number of paper claims it enters.

But the insurance company should think of more than labor cost arbitrage. Two methods can eliminate or reduce the cost to almost nothing. The company can completely eliminate the cost of entering the paper claims if it receives the claims directly from the health care provider in electronic format or if the paper claims are converted into electronic format through new OCR (online character recognition) technologies and best practices. Obviously, a service provider that uses both methods is a better candidate for such outsourcing services. Alternatively, if the organization has sufficient scale and expertise, it should consider these two trends when choosing whether to outsource or manage the processes in house.

One benefit of considering these trends simultaneously is the opportunity to use the benefits of one trend to fund the other, thereby making the business value sustainable over a long period of time. In fact, due to the initial investment required to deploy process modules, the insurance company could redirect some of the offshoring savings to fund the process modules' deployment, which will start to bear fruit once the initial cost arbitrage benefits from offshoring are exhausted. So, for example, if an organization can generate 20 percent savings from offshoring in the first year and 35 percent in the second year, it should redirect 10 percent of these savings in the first year, and 20 percent in the second year, to deploy process modules, so that by the third year, it can generate up to 40 percent savings. This also helps mitigate the risk that wages in offshore locations might rise in the future.

Although the BPO market has been around for more than 40 years, it is only now reaching many companies' radar screens because of the better service levels and cost-savings promise. The two opportunities behind the recent growth of this sector—process modules and offshoring—show enormous promise, and companies must use them in conjunction to show sustainable savings and, hence, long-term profitability. Future work in this area would involve understanding the definitions, costs, benefits, and risks associated with various service delivery models that service providers deploy, such as a global services delivery model that uses on-site, on-shore and offshore locations and a pure offshore services delivery model. ■

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