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Strategic Implications of Offshoring by Financial Services Firms

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Abstract: The financial service industry is facing intense pressures to reduce costs while growing new customers and introducing new products to attract those customers. Recently, more firms are using offshoring strategies (i.e. outsourcing of operations to foreign countries) to cut costs. However there is some empirical evidence that financial service firms are increasingly offshoring operations to improve their cost structure as well as develop added capacity and improve their capabilities. In this paper, I explore the development of offshoring as a strategy and elaborate how the buyers of offshoring services (the financial service firms, or FSFs) may use offshoring as a strategy for competitive success. In addition, the development of offshoring capabilities by the offshore service providers (or OSPs) and their competitive activities and relationships with competing local financial service providers may influence how both the FSFs and OSPs compete in new markets.

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Overview

The financial services industry has been increasingly facing pressures to reduce costs and increase efficiency. Reducing costs and expanding their services into new markets are key factors in the success of financial services firms and managing the offshoring of their own operations or dealing with the threat posed by competitors that are engaged in offshoring or from new competitors which have been created and enabled through offshoring by other financial services firms.

In this paper, I seek to explain how the motivations for offshoring of operations (outsourcing operations to foreign locations) will affect competition and expansion of financial services markets in an increasingly accessible and competitive global marketplace. While most studies and press reports emphasize offshoring as a cost reduction strategy its long term effect may be an important gateway to a variety of global expansion strategies. According to Maskell, et. al. (2007) there is evidence that firms are expanding both the amount of operations they offshore and the range (or type) of operation that they consider appropriate to offshore. Expanding the range of operations implies that firms see additional opportunity to benefit from resources and capabilities located in the offshore country and controlled by offshore service providers (OSPs). In particular, they point to innovation seeking firms using offshore services to achieve “shortened delivery time, reduced development time for new products, improved access to new knowledge, increased revenue as well as employment growth in their home country” as well as decreased operating costs (Maskell, et al 2007, pg. 252).

In order to enhance the evolving view of offshoring as a potential springboard for strategic competitive initiatives, I treat the use of offshoring as a strategic opportunity that, depending on the purpose of its user and the capabilities of the service provider, can lead to a variety of strategic approaches to competing in the global financial services marketplace. Building on previous work by Cyert and March (1963), Nelson and Winter (1982) and March (1991) and consistent with the views that offshoring is part of a learning process (as noted by Maskell, et. al. 2007 in their empirical study). My contribution to this literature is to move forward our thinking about offshoring in terms of its role as part of competitive processes that require specific capabilities and that can lead to competitive advantages for the buyers (FSFs) as well as the sellers (OSPs) and to clarify the roles of potential competitors in the offshore market consisting of local financial service firms or evolved offshore service providers.

To develop the theoretical and practical considerations underpinning these strategic processes, I briefly explain key offshoring concepts and terminology, the traditional and evolving motives for offshoring of operations, and several concise examples of offshoring behaviors by financial services firms and manufacturers. Next, I provide a theoretical framework to explain the development of offshoring practices and explore the strategic implications of offshoring on the competitive landscape of the financial services industry. I draw key implications from established theories of organizational learning, diffusion of innovation, institutional theory, transaction cost economics and competitive business strategy. Finally, I develop propositions that predict situations that financial services firms will have to face in an environment of increasing competitive pressures and new market opportunities and speculate on the strategic effects of those decisions and what managers in the financial services firms, their potential competitors and the offshore service providers will face as offshoring continues to develop.

Offshoring defined

In their quest for success firms seek to capture new markets and additional market share, in addition firms manage their costs in order to improve profits. The patterns of actions firms use to achieve these ends are called strategies (Porter, 1980). Unique resources, skills and abilities can form the basis for competitive advantage and higher profits than other firms (Wernerfelt, 1984; Barney, 1991). These skills and abilities may evolve as part of a national system (Kogut, 1993) and will influence the competitive abilities of firms operating in particular countries and enjoying factor endowments and access to skilled labor (Porter, 1990, Kogut 1993; Mowery and Nelson, 1999). Expansion by firms to international markets is a fundamental strategic initiative that leads to significant change in the organization itself and in the market it enters. (Aldrich, 1979; Dunning, 1993). Recently, the internationalization of services has been categorized as a stage-based process (Contractor, et. al., 2003) in a way similar to the early internationalization of manufacturing.

As industries become more competitive, search for cost-saving measures and productivity improvements intensifies. Competitive pressures including the introduction of competition at a global level in many industries have led to increased outsourcing by companies on the outsourcing of value-chain activities to independent suppliers and captive subsidiaries. In the search to minimize costs, firms have been moving their outsourced operations to foreign countries that have lower wage levels and can perform operations at a much lower relative cost per unit. Recently, this trend has hit service industries such as information technology (Wong, 2007), banking (Mears, 2007), insurance, medical research and testing (Crabtree, 2006; Bowling and Huth, 2007)

Outsourcing of company operations to foreign countries is called “offshoring”. The foreign country often has a significantly lower cost of operations (usually due to low wages) than that in the firm’s home country. Some of the cost differences can also be

attributed to the difference in purchasing power between the currencies of the home country firm and the outsourcing country, adding to the lower wage effect by using a stronger currency to pay for services in the weaker currency.

Financial services firms (abbreviated 'FSFs' in this paper) have been under great pressure to cut their costs and spread their overhead over more customers, offer a greater variety of services and make those services cheaper, more flexible and available in all parts of the globe. As a result, banks and insurance companies have formed financial conglomerates offering loans, credit cards, life, health and other forms of insurance, short-term loans, mortgages, business loans, investment brokerage, retirement planning, and the list goes on and on.

The increasingly competitive (read "low") margins on these businesses have pushed many of the FSFs to move their operations out of the home country and into lower cost, lower wage economies, with India an especially attractive market due to workers ability to speak English and the strength of its information technology workforce. (Economist, 2007; Lall, 2006). Examples of activities in the financial services sector that are commonly offshored include: Data processing of transactions in banks, insurance companies and card operations (credit and debit card processing). In addition, some companies have added customer service (account inquiries, bank by phone). The common element of these operations is that they all tend to be portable so that they can be done in a remote location and returned to the home office with little risk of loss or error.

Another reason FSFs offshore processing and analysis tasks is that they can be somewhat labor intensive and the firms are already relatively efficient using technology to process large volumes efficiently. Given that efficiency gains may already be exploited fully, finding lower wage locations offshore is one way to cut costs. (Economist, 2007; Lall, 2006). For example, a key element in Citigroup's \$10 billion dollar cost cutting

program is consolidating its information processing activities into half as many locations and move “thousands of jobs to lower cost locations in the US and abroad” (McDougall, 2007). Citigroup faced operating costs rising twice as fast as operating revenues. (McDougall, 2007). However, according to a Deloitte study, few banks have yet to take advantage of offshoring opportunities but within 3 years 30 percent of IT spending will move to low-cost locations (McDougall, 2007).

Japanese automakers built factories in the US for several different reasons and typically had to work to improve US productivity compared to their Japanese locations. In some cases, the US market was more open to the Japanese manufacturers than their home market (Pascale, 1984) In other cases, the Japanese firms came to the US to avoid potential import quotas and trade sanctions that might have been imposed to stem US domestic job loss due to imported cars. In addition, the Japanese automakers introduced significant change into the supplier networks in the US, bringing many of their domestic suppliers with them and also pressuring US suppliers to adopt their manufacturing systems. (Martin, et. al., 1998).

However, German entry into the US market came in part to improve cost efficiency by moving operations to foreign lands. For example, in the late 1990's German automakers BMW and Mercedes-Benz began to establish their assembly plants in the US primarily to take advantage of lower US labor costs compared to their own European factories due to favorable US wage rates and the weakness of the dollar compared to the Euro.

Similar incentives and pressures have taken hold in the financial service industry as rules and regulations have relaxed and competition among leading financial institutions has increased forcing greater emphasis on efficiency, economies of scale and scope and market seeking efforts by firms pioneering in foreign markets once closed to their entry or unattractive while domestic markets were more lucrative.

Just as the initial motives for manufacturing overseas have changed over time, the motives for offshoring are also changing. Some FSFs need to add capacity and see offshore locations as a way to do that with the ability to scale-up quickly. Offshore locations can also enable the FSF to provide 24 hours of service by locating operations strategically in different time zones around the globe. This can greatly enhance customer service and also shorten development time for software projects or analysis decision. In India for example, software development, insurance risk assessment, financial analysis and global supply chain management are being added to the more routine transaction processing and customer help line services. (Chakrabarty, 2006). As the OSPs become more sophisticated in their service offerings and the FSFs gain confidence in the market, the level of services offered in the offshore location appears to expand into more complex operations (Ascribe Newswire, 2006).

Organizational learning and new routines

In the classic organizational learning model, firm behavior is motivated by a need to solve some sort of organizational dilemma. The need motivates a search for potential solutions. This is the exploration stage where firms identify possible solutions. (Cyert and March, 1963). These potential solutions are the evaluated by the firm's managers and one or more are selected for adoption. Once the new routine is accepted by management it is incorporated into the organization's scripts and routines (Nelson and Winter, 1982) and the new routine is retained and developed further in the exploitation phase (March, 1991). This cycle of variation, selection and retention is repeated as the organization's managers face differing circumstances over time. Through this process of change organizations evolve with new capabilities or may eliminate routines that are ineffective and/or inefficient. (Nelson and Winter, 1982). Key factors in the adoption or spin-off of routines are whether the routines support the organization's goals, are efficient relative to alternative routines and competitors' capabilities and the outside

perception of the value of those routines to the regulators and suppliers of resources and other stakeholders in the organization. (Rogers, 1995). Successful and proven innovations can spread rapidly across populations organizations through agents, such as consultants and board-level ties (Davis, 1991). Similar mechanisms can be expected to encourage the spread of offshoring if firms have favorable experiences with it and then broadcast that information to other organizations in their networks.

I have chosen to focus much of this work on offshoring as it relates to the financial services industry. Financial services include the following businesses banking, credit card issuers and services, specialized lenders, brokerages, and insurance companies. This is not an exhaustive list but contains many of the businesses that appear to be most likely to be able to use offshoring as a source of lower costs and potential innovation. Financial service firms face growing competitive pressures to cut costs, improve service and expand their services which are all primary motivations for outsourcing some operations to lower-cost locations in other countries. In fact, Maskell et. al. (2007) in their survey of Danish firms in 2004 found that 8% of business service & finance firms offshore some of their operations. That number appears to be out of date as the trend toward offshoring financial services to India continues to grow over 30% per year. (Financial Wire, 2006). In fact, the pace of change driven by expansion of offshoring is so rapid that the “crumbling” infrastructure of Indian roads, sewers and electricity cannot hope to keep pace with it. (Krebsbach, 2007).

As long as cost and other advantages exist, FSFs searching for solutions to their cost and capacity problems will continue to consider offshoring as an attractive option. To effectively move offshore operations to lower cost countries, FSFs will have to learn how to carve out internal operations that can be efficiently offshored avoiding process losses and inefficiencies in related processes. There is evidence that the learning process is difficult and that many offshoring efforts end in losses to the financial services

firms. Maskell, et. al. note that even though offshoring is a relatively new innovation, over time firms are learning to build cooperation with their offshoring partners (Maskell, et. al., 2007). In addition, the introduction of offshoring as a capability (Barney, 1991) will lead to changes in the work performed at both the home office of the FSF as well as that of the OSP. These changes will be the result of the need to maintain a relationship between the buyer and the supplier but will require specialized knowledge leading both organizations to hire particularly skilled individuals (Robinson and Miner, 1996) to understand how to outsource to a foreign location and to enable the OSP to integrate its work product with the FSF.

In part of this paper, I take this learning perspective and apply strategic and other lenses to the offshoring relationship to predict how the strategies and relationships formed by pressures leading to offshoring strategy may lead to other intended, and unintended, outcomes and strategic initiatives. These situations and initiatives will demand certain capabilities and conditions that will affect the offshoring partners and competitors. Like many strategies, creating the capabilities needed to carry out the strategy often means limiting other initiatives, prioritizing other activities and can lead to the abandonment of capabilities that were once central to the success of the FSF and a loss of knowledge of these practices and related operations now outsourced offshore.

The learning process for offshoring involves some of the same elements described by researchers in the early internationalization studies which characterized manufacturing firms' transition from domestic only to fully-engaged in international business as a progressive sequence of increasingly sophisticated and deliberate actions to serve customers outside the home country. (Bilkey and Tesar, 1977; Dunning, 1993; Contractor, et. al., 1998). Over time and through experience, businesses build and elaborate capabilities needed to serve international markets in a competitive way and

under limits imposed by competition, regulation and the managers' aspiration level for the growth of the business. (Dunning, 1993).

Both the FSFs and the OSPs can be expected to adapt their language and practices to the new technical systems developed to handle the business between them as we have seen in the adaptation of healthcare organizations and personnel to the introduction of technological innovations (Barley, 1986). The resources and capabilities developed as part of this learning and adaptation process may form the basis for competitive advantage for both the FSF and its OSP. (Barney, 1991). There is empirical evidence that learning through experience in offshoring is changing the make-up of the firms willing to engage in offshoring. For example, Sinnock reports that while demand for services is causing offshore costs to rise, improved service provider skills and good outcomes are leading to diminished fear that offshoring is a risky business practice in the mortgage industry. (Sinnock, 2006).

The learning process predicted in an offshoring relationship (Maskell, 2007) is similar to learning experiences in joint ventures where over time, venture partners learn to work together and firms learn how to find compatible partners and evolve internal mechanisms for managing their ventures. (Lyles, 1988; Lavie and Rosenkpf (2006). Firms attempting to enter new markets that form joint ventures often fail to achieve their ultimate ends (Lyles 1988, Lane, et. al., 2001). Key issues that cause problems in joint ventures have been identified as conflicting goals, poor communications between partners, different time lines, perceived loss of competitive advantage. An important element in the success of joint ventures has been the negotiation of a clear joint venture agreement that spells out the expectations of the partners for the new venture. (Lyles, 1988). The relationship between an FSF and an OSP is similar to that of joint venture partners if the FSF takes an active role rather than a more hands-off third-party view. This relationship will lead to learning on the part of both organizations and both

exploration motives, in this case learning the new offshore market and exploitation motives, entering the market with added competitive capabilities. (Lavie and Rosenkopf, 2006).

Control of information is a key element in the reluctance to allow offshoring of revenue cycle management operations (medical coding and billing) by US healthcare insurers. However, with adequate safeguards in place, the cost savings available through offshoring appear too good to resist. (Business Wire, 2007) This does not appear to be the case with worker's compensation claims processing which managers appear to be reluctant to move offshore. (Bowling and Huth, 2007). In offshoring, an explicit agreement as to the services to be performed and the security arrangements to protect confidential data and payment terms should be spelled out to minimize potential conflicts between partners. This leads to the following propositions:

Proposition 1: Financial service firms will need to exercise greater care in selecting offshore service providers as more information intense and more proprietary processes are moved offshore. The FSF must ensure that there is a clear agreement with the OSP regarding proprietary knowledge and data and understand clearly how the OSP will maintain that security.

Proposition 2: FSFs will take more risk and offshore more knowledge sensitive activities in proportion to the degree the offshore service provider is similar in culture to the FSF, has a legal system that protects proprietary information, and is deemed trustworthy by the FSFs or its partner or peer organizations.

Implications: There is still a potential for process loss making legal and operational safeguards important to have in place from the beginning of the process. This implies that in offshoring of operations, financial services firms will be risking both

losses of proprietary processes (know-how) as well as loss of confidential data from their clients. Safeguards can protect some of the information however, perhaps most importantly, there is a need to elaborate effective service agreements with adequate protection with offshoring suppliers in countries and perhaps most importantly to select vendors that can be trusted or use a captive supplier strategy to limit risks of loss where protection of information is especially important to maintain the competitiveness of the financial firm. In cases where loss appears likely, the FSF may establish a wholly-owned subsidiary to minimize its risk of loss enabling it to exercise control over operations at the offshore location without having to deal with local court systems for example. On the other hand, there may be relatively little concern raised by third party service providers who have strong references from firms known to the FSF and a track record of quality service.

Offshoring as an entry strategy.

Like many segments of the financial services industry, banking has well-established procedures and is highly regulated and protected in many countries from foreign competition. However, the trend toward increased access to markets for services has led to the global expansion of banks, insurers and credit/debit card companies. Large banks operating in less regulated markets have had to develop marketing and new product development capabilities. Often they have also learned to merge with other competing banks and understand the process for entering new geographic markets although usually within their own country. Opportunities to take their skills to foreign markets are increasingly available as countries open their domestic financial markets to attract foreign investment and know-how. This process has already begun in chemical and biopharmacy industries (Biotech Week, 2006) and is contributing to employment displacement from the US but also providing lower costs for the industry

however this advantage remains based mainly in the wage arbitrage between the US and India or China.

Opening of financial markets has been carefully controlled however there is some evidence of markets opening to competition. For example, India has traditionally kept foreign banks and domestic banks highly restricted, however as more foreign banks have entered the market and domestic banks have modernized, Indian banks are now looking to expand outside India. In a recent example, a major Indian bank offered higher interest rates than the prevailing banks and targeted the expatriate community in the United Kingdom. The campaign was so successful that customer response overwhelmed the bank's computers (Economist, 2006).

Deregulation does not occur at a uniform pace in all countries. The effect of deregulation as a relatively slow process allows local firms to adapt to the new conditions and improve their capabilities in time to defend their market from foreign entrants. Rapid deregulation opens the door to foreign acquisition of domestic banks and insurers. Under these conditions the best domestic firms (most entrenched politically, largest market, most assets) can stand alone or partner with the best of the foreign banks who may be trying to enter the market.

Many banks and insurance companies operate their offshore operations as subsidiaries (Financial Wire, 2006) providing services such as systems integration, financial analysis and customer support. However some are spinning those operations off into independent service providers (McDougall, 2007) and others use third-party vendors or joint ventures (Financial Wire, 2006). Captive offshore operations keep the transactions internal to the organization even though the operations are performed far from the home country. Advantages of using a subsidiary are in preserving the security of data and also the quality of service provided because all operations continue to be under the company's direct control. A disadvantage is that the company must build an

operation in a country it may not know well and that is risky (the company may not know enough to optimize its opportunity). It takes time to create the new subsidiary, hire employees, obtain the technology, train processors or consultants on the FSFs specific policies (training often requires making intrinsic knowledge explicit). This can be potentially expensive because there may initially be low transaction volume early in the venture raising costs relative to its new overhead and defeating the advantage of the wage differential.

An important implication of the trend toward less regulated financial services markets and the need to reduce costs is the possibility of using the domestic companies in the offshore market as suppliers of offshore services. Offering offshoring services to potential partners from abroad creates advantages for the domestic bank. The offshoring relationship provides the foreign bank with needed services run by those most familiar with the local labor market and able to get government cooperation where needed. In a partnership like this, as the foreign firm begins to explore entry into the new market, a significantly more complex operation than simply offshoring some back-office function, a preemptive strategy would be to partner with a major domestic partner using the domestic partner's branch network as the nucleus for the foreign bank's entry as a partner providing needed new services, technology, and capital.

Should this partnership not materialize, the domestic partner is still in a strong competitive position to pre-empt the foreign bank because of the inside knowledge acquired through the offshoring partnership. Offshoring leading to joint ventures alliances or partnerships provides immediate cost savings to the foreign bank, economies of scale to the domestic bank providing the offshoring services, opportunity to learn the new market indirectly through its domestic partner and ultimately a way to shape which domestic bank will compete with the foreign entrant and which will be captured in an alliance. This leads to:

Proposition 3: Foreign entrants will use potential offshoring arrangements to screen and select future partners for their eventual entry into the new market.

Proposition 4: By providing offshoring services for foreign firms, offshore service providers can influence the foreign firm's potential entry into their domestic market.

Implications: The domestic firm can become a full-fledged partner with the foreign firm, continue to be a supplier of services or use its knowledge gained from offshoring to build a stronger position to compete with the new entrant. The FSF benefits by its partnerships which provide cost advantage and then serve as a platform for a soft landing when it enters the new market.

Proposition 5: Financial service firms will prioritize offshoring as a strategy if the firm has a strong interest in entering the offshore market and offering it retail/business services there. Attractive markets will be those that are large in terms of potential new business, relatively similar in culture to ease the entry of the business into the foreign market. If the FSF has a strong desire to enter the consumer market, it is more likely to want to capture the knowledge benefits available by working in the offshoring market through a captive operation.

If the FSF is less certain about entering the new market, it will use the opportunity to benefit from offshoring services provided by a local service provider in the new market. The more that the FSF is focused on improving its cost structure versus expanding its markets, the more likely it will use a third-party OSP because it will not value capturing the knowledge available in the new market. If the FSF does not see the new market as a good opportunity (too small to be profitable, too unfamiliar a culture limiting ability to exploit new knowledge about the market, too regulated restricting

growth opportunities of foreign firms, too unique so that learning will not generalize to other markets) it will not invest in establishing a captive operation there. Instead, the FSF will simply offshore the services it needs to improve its cost position through third-party vendors. If the main motivation for offshoring is to increase capacity to enable the global expansion of the core financial services business, the FSF will also favor a third-party vendor to minimize its financial and managerial investment while the OSP focuses on providing a high volume of services.

The more familiar the foreign firm is with the domestic market, and the more transparent the offshore location, the less the foreign firm needs local expertise. (Nachum and Zaheer, 2005) This means that near-shoring or moving operations from the UK to Scotland or Ireland may be easy for the UK-based buyer of offshore services because they understand those locations and have similar legal systems, educational systems, culture and languages. The ability to go it alone without facing a very high cultural and administrative learning curve in the offshore location gives the buyer (the FSF) more alternatives and a better ability to price what the OSP is offering thereby minimizing these informational costs. (Nachum and Zaheer, 2005)

That same argument might not apply if that same buyer wanted to move some of its operations to less culturally similar countries such as China. The unfamiliar culture and business practices as well as political risk increases transaction costs for the buyer by requiring more significant efforts to form relationships in the offshore location, learn to operate there, create the ability to access talented employees and work with those employees to make them very effective. Technology issues may be a neutral in that the technology available to work with financial services transactions is relatively available and the routines can be translated effectively across information systems.

Learning effects and the offshoring of financial services.

Not all offshoring efforts are successful in reducing costs and many involve significant risks of loss of control and information security. (Bollen, 2006; Compass, 2007). In spite of the costs and risks, the lure of potentially lower costs and competitive pressures in the financial services industry continue to attract companies to an offshoring strategy. Transaction cost economic theory helps illustrate the competing motivations for adoption of offshoring and for competing models that maintain domestic control of organizational processes. (Williamson, 1985) The main effect of offshoring is to immediately lower the company's production costs but comes at a cost of an initial investment in making the transition to locating part of their business processes in another country and an ongoing cost for coordinating the offshore operation with existing domestic operations.

Like most strategies, offshoring offers both opportunities for improving the organization's future earnings but requires investment and may produce unanticipated costs. On the surface the cost differentials, especially those in labor intensive operations such as call centers and transaction processing or software development and maintenance are significant and look like they will generate significant savings if offshored. However, there is some evidence that these benefits may be less than the potential benefits from investing in improved operations. (Compass, 2007). In addition, FSFs that engage in offshoring potentially face bad publicity over job losses in the home country (Bollen, 2006; Lall, 2006), the cost of re-design internal processes to accommodate the offshore service provider (data transfer for example), potential loss of security of customer and company data, and differences in regulatory and cultural practices (Bollen, 2006).

Consultants point out that cost savings from lower wages may mask inefficiencies in the underlying business processes. (Compass, 2007). Investing in domestic process improvement avoids the potential costs of negative publicity in the

home country and the uncertainty that cultural differences in the offshore location which make managing the processing operations there risky for the FSF. Regardless of whether the FSF uses a domestic or offshore strategy, outsourcing of its operations will require some process re-design costs be incurred.

More commoditization of services or tasks has contributed to the development of intermediary service providers in low-wage economies. The availability of experienced OSPs who are familiar with the cultural differences between the two countries helps facilitate the transfer of tasks from the home country to the foreign location. Ease of transition should lead to more adoption of offshoring strategy by FSFs and strengthens the growth of intermediaries (the OSPs) and discourages captive subsidiaries which require greater financial investment and management attention by the FSF class than a third-party supplier relationship with the OSP.

Proposition 6: OSPs will become an important intermediary in the selection of entry strategy by the FSF if the offshore market is open to entry by foreign financial firms.

Implications: If the OSP is particularly effective, the FSF will likely consult with its “insider” as to how it could enter the OSP’s consumer market. This puts the OSP in the position to influence the decision to enter with a subsidiary, partner with a local FSF or acquire an existing local FSF. The OSP then may become the central advisor in the decision and will enjoy the ability to influence its client’s strategic choice making it an important factor for the local FSFs who may be potential partners or future competitors. The OSPs relationships are likely to be the initial network for the FSFs as it explores the entry conditions in the foreign location.

The OSP also faces key strategic decisions about its future as it grows and develops its capabilities. For example, if a British bank were to seek to lower its transaction processing costs it could seek out an Indian firm specialized in that process.

The Indian firm would likely be small, very focused on serving a niche and a local player in India looking to grow. The Indian firm's absorptive capacity (its ability to learn from the environment) (Cohen and Levinthal, 1990) would be focused on how to perform the specialized operations and how to import and export the needed information and work effectively with the bank. The Indian OSP faces several strategic alternatives for its evolution as an entrepreneurial firm: It can continue to specialize in transaction related services and identify other firms needing these services and serve that segment of the market. As long as the outsourcing trend continues the firm will have strong growth prospects. However, as time passes, cost gains tend to be eroded by higher wages and efficiency gains available to the firm's clients in other locations. This puts the OSP in a position where it may want to evolve into a broader service provider of services targeted to a wider array of industries, provide services in other foreign countries, or evolve into an FSF through vertical integration (acquisitions or new business formations up and down the value chain). Converting to an FSF will require either partnering with the existing FSF in a joint venture or by being acquired and operated as a subsidiary.

Proposition 7: OSPs facing strong domestic competition in a maturing market for offshore services, will be more likely to form a partnership with their FSF client to facilitate the FSFs entry into the local market.

Implications: This implies that the entrepreneurial drive that led to the formation of the OSP will be difficult to maintain in a competitive market. Those early OSPs will have carved out more market share and achieved scale economies and reputations allowing them to broaden their prospects and remain specialized. Later entrants in the OSP market will face difficulty taking market share once growth of offshoring slows and costs in the offshore location begin to rise in response to demand. There is evidence of this affecting offshoring in China and India and causing their OSPs to expand to lower cost markets or move to more value-added services to survive (need cite here). This

leaves the small or medium-sized OSP with a difficult choice...join in the frenzy for new customers and the inevitable slide to lower margins or, if possible, continue as a partner with their client as it attempts to expand its global business entry strategy.

Key issues associated with potential loss of control of internal processes.

Transaction cost economics explains in part the development of the offshoring specialist firms. As noted earlier, cost concerns drive the FSF to seek new ways of operating. However the FSF faces options of keeping operations internal and improving efficiency, but at some point the firm may feel it cannot improve its operations sufficiently enough to exceed savings that could be gained by taking advantage of differential cost levels in foreign countries. The FSF gives up some control of the information needed to allow the foreign OSP to operate as part of the firm's supply chain. This loss of control imposes some added costs on the FSF and because the transaction takes place at arm's length then the firm is subject to exploitation by the offshoring supplier in a foreign marketplace that is relatively unfamiliar to the FSF in most cases. What masks this loss of control and potentially higher transaction costs are the greater efficiencies (lower costs) available in the new foreign location.

Initially, there is efficiency in specializing this way in that the offshore service provider is able to develop deep expertise in a particular service segment. So, for example the OSP could charge \$100 but the rate in the market may be much less and the FSF may willingly overpay because it does not know the foreign market. In a small market with few OSPs there is very little pricing information available to the FSF and they may see \$100 as a bargain compared to the \$200 in the home market.

The service firm does not have to understand consumer markets and can focus on being a specialized service provider. Specialization simplifies pricing and allows the offshore provider cost containment by tapping in to local wage rates. The offshore service provider brings expert knowledge and access to the local labor market as part of

its value added services. Even inexperienced service providers can be successful after a short learning period where they learn the operations being offshored as the client's needs become easier to obtain because what is needed is clear. Learning processes in the offshore service provider focus less on discovering new ways to address problems and more on exploitation of well understood processes (doing transactions efficiently) and developing their market relationships to achieve economies of scale by finding similar offshore customers.

Learning and the development of offshore service provider capabilities

Early in their life-cycle focused OSPs may be captive service providers supplying their transaction services to only a single organization. However, if they are to grow, learning will be needed. Volume growth requires efficiency because the motivation for offshoring is primarily to gain access to lower labor and infrastructure costs. To grow, OSPs must provide their services at very low rates and be vigilant against competitors who may be able to provide even lower costs. Learning by the OSPs will focus on faster service and higher volumes of output, essentially doing more of the same thing that was being done but in a more efficient way or at least in a more cost efficient way. Much of the service provider's learning efforts will focus on improving technology to handle greater volumes of transactions with improved accuracy. In addition, providers will focus on their abilities to access qualified employees and develop effective training processes so that their employees are able to perform. This provider strategy will require development of effective marketing skills so that the provider firms can reach and convince clients that they can provide better offshoring results than the company could get through developing its own subsidiary.

Financial services firms according to the transaction costs model, will internalize transactions to escape exploitation by overly aggressive offshore suppliers and/or protect their internal knowledge and confidential information. Information scarcity can

lead to market imperfections that drive up costs due to the inability to bargain with adequate information. Under these conditions:

Proposition 8: Offshore service providers will act to restrict the financial services firms' ability to access competition in the offshore market. This sets up a classic transaction cost situation where for example, an OSP uses its specialized knowledge of the foreign market to limit alternative supply strategies available to the FSF. For example, the OSP can limit FSFs freedom of strategic choice by lobbying the domestic government to require that FSFs have local partners, by the OSP buying out competing service providers or by the OSP gaining a strong position in the domestic labor market making it difficult for the foreign firm to access local talent.

Potential process learning losses and related strategic effects.

The absorptive capacity of the firm, its ability to learn from the environment, and the degree to which the FSF stops performing the service in-house, will moderate the amount of process loss experienced by the financial services company when it offshores part of its operations. Process loss will be highest if the financial services company abandons the operation completely and on a company-wide basis. Employees with vested interests in the area offshored may need to leave the company, transfer to the offshoring company or form part of the interface group to work between the firm and the offshorer. If the firm retains domestic operation of some services but offshores a great part of these same services (for example, retaining specific credit portfolios and servicing for high end mortgages or specific clients or geographic areas while offshoring so that the firm retains skilled employees, specialized equipment and practice knowledge while offshoring part of its operation. This could then allow the firm to recapture its offshored practices rapidly as there would continue to be incentive to maintain the internal skill-base for the retained operations.

Some consultants have shown that temporary gains can be received from offshoring due to the initial differences in labor costs between the two economies, however, those gains last only up to about 5 years. Those gains come at a cost of loss of control over what were internal processes or possibly outsourced to local service providers. (Compass, 2007) Further erosion of control through offshoring to foreign suppliers increases information costs to assess the relative bargaining position of suppliers and buyers of offshoring services. However, there is very little discussion in practitioner and academic journals of the potential costs of the loss of learning that goes on in an organization when it offshores its operations. Learning from operations has the potential to be used throughout the organization and failure to learn can lead to stagnation, loss of potential efficiencies, and dependence on the offshore supplier for process improvements which they may have little incentive to pass back to their buyer.

How do these losses occur? In a sophisticated offshoring operation, there is a transfer of the responsibility for process improvement to the offshore firm since the buyer is mainly concerned now with the price of the services rendered. The buyer will place downward pressure on the offshore price encouraging innovation by the service provider. However the process improvements made by the service provider will not be readily available to the buyer because they occur in the offshore location. While major process changes (such as adopting offshoring itself) may lead to large improvements in cost-efficiency, subsequent incremental process improvements will be captured by the offshore service provider lowering its costs and improving its efficiency.

From technological and process improvement research we know that most of the substantial gains in productivity and effectiveness (quality) come from incremental improvement (small wins) (Wieck, 1984). The offshore provider has incentive to keep those improvements internal so as to increase its profitability. Also, because the improvements occur in a context that may be difficult for the buyer to interpret they will

be difficult to capture. In addition, once the process has shifted to the offshore location there will be a loss of learning and capacity in the buyer as its capabilities in these areas atrophy through non-use.

Another important aspect of learning is that not all innovations transfer readily across different branches of an organization. Learning is sticky to where it was originally done, often is not appreciated by other parts of the organization (Not Invented Here syndrome stems in part from this phenomenon) and may need a specific catalyst or champion to spread from one location to another. (Argote, et. al. 1995; Darr, et. al., 1995). In addition, if the financial services firm offshores a portion of its operations, other operations that are directly or indirectly related to the offshored tasks may suffer from lack of innovation. The logic is that learning in organizations can be a systemic process and organizational changes do not occur in isolation in many large organizations.

The potential for loss of skills through atrophy, lost opportunities for learning and systemic improvement in areas related to the offshored process lead to:

Proposition 9: Financial services firms that retain in-house control over some of their processing, systems development, financial evaluation, customer contact and other services will be more up-to-date and efficient in the longer term (5 year horizon for example) than those that opt to take a “hands-off” approach and offshore to independent service providers.

Proposition 10: Captive offshore operations will be more effective than domestically outsourced operations. The internal bond of a captive operation will help mitigate the effects of a less familiar context and culture of the offshore location. Captive operations will continue to share their innovations with the parent bank or insurance company while independent suppliers will keep their innovation proprietary.

How financial services firms will react to shifting offshore conditions.

Research on joint ventures has found that learning takes place in joint ventures but also that firms learn how to be effective joint venture partners improving chances for success and further venturing in the future. (Lyles, 1985) Offshoring through intermediaries is to some extent inviting a stranger into the buyer's business model. With experience, financial services organizations have been outsourcing and offshoring more complex operations. Successful offshoring of one process has been shown anecdotally and empirically (Maskell, et. al., 2007) to lead to increased offshoring of as the uncertainty around the offshoring firm's ability to deliver results declines thereby reducing the buyer's transaction costs. Also, offshoring into more developed offshore economies where competing intermediaries exist will lower transaction costs through price-based competition.

Proposition 11: The longer the history of offshoring operations and the more open an economy to foreign participation in its financial services markets the more likely offshoring services will be provided by independent entities in a competitive marketplace in the offshore location. As providers become more competitive with each other they will actively solicit offshore business and have experience with the financial service industry giving them added credibility as potential suppliers or partners.

Another strategy for the OSP is that of providing more services than simply transaction processing. To extend the previous example, providing added value through additional services would require learning more about how the British bank operates and then tailoring specific services to meet the Bank's needs. For example, analysis of loan applicants credit worthiness and calculating the likelihood of default for business-based lines of credit. These new services involve creating processes that are more customized and complex than simply updating customer accounts based on current activity. The

service firm will have to learn additional context and develop acceptable routines for the Bank while preserving cost and other advantages.

Financial services firms' selection decisions for offshoring services can be part of several comprehensive strategies. Firms following a "low-cost, high volume" strategy reap offshoring's efficiency benefits of lower labor costs. In addition, offshoring can move operations to different time zones providing a 24 hour workforce capable of giving faster turnaround to transactions by locating processing and call centers in time zones that straddle the globe's major markets. These changes can also support an expansion of the organization's customer base by allowing it to scale up its support activities and transaction processing without exhausting its local labor pool or overburdening its management (or outsourcing suppliers) with large numbers of employees.

Offshoring can be an integral component to initial new market entry strategies for international expansion and the choices that financial firms make will help shape their global competitive position. In manufacturing for example, Honda Motors expanded its production of automobiles to the United States to avoid US protectionism but also to avoid head-to-head competition in Japan with the much stronger rival Toyota. Toyota dominated the car market in Japan but was restricted by import quotas in effect in the US. Honda built manufacturing capacity in the US and exported cars back to Japan. Similarly, financial services providers may be able to expand their offshoring relationships into full entry into the offshore market or as a spring-board into neighboring markets. Partnering with local financial service firms may be the political requirement for granting the offshore firm entry into traditionally protected markets.

The offshoring partner offers important advantages for the new entry strategy that reduce the costs and risks of entering an unfamiliar market. The offshoring partner will have local knowledge of the business customs. The depth of that knowledge will vary directly with the degree to which the offshore partner participates as a financial

service provider in the local market. If the offshore partner is also a financial services firm already participating in the local market, an aggressive expansion strategy using the resources of the foreign partner may be viable. The costs of adjusting to a new partnership would be minimal as the companies already are familiar with each others' routines through the offshoring work done earlier. In addition, the local partner would have strong knowledge of the financial services consumer market enabling the partners to quickly enter the market and possibly offer new services based on the foreign partner's product experience and/or expand into more locations in the offshoring host country.

Proposition 12: Financial services firms that have successful offshoring experiences will be more likely to form joint ventures with domestic financial services firms in the offshore location than firms with bad offshoring experiences.

Local firms will not be targeted equally as partners. Expanding financial services to the local market will favor partners with second tier firms (not the strongest or locally dominant firms). Second tier firms with strong reputations have the capabilities needed by the foreign firm. They will also be looking to expand and facing difficulty trying to compete against the market leader.

Avoiding the leading local firms as potential partners helps protect the financial services firm from having to pay a substantial premium to form an alliance with the market leader. In addition, the second tier banks or insurance companies are unlikely to mount an aggressive expansion strategy of their own. Partnering with the second tier minimizes the risk of "creating competitors" that could turn around and expand into the foreign firm's market or to third country markets where they would also compete. This risk is a significant one given the sophistication of many financial service providers in developing countries. For example, according to industry experts, Indian banks are not

known and trusted in the west but given time they could be successful in building the trust needed to attract depositors just as foreign carmakers have done in the US. By having lower costs an Indian bank successfully solicited accounts in the UK because it could offer lower interest rates. (Economist, 2007). The offshoring provider may be the likely bridge to form the partnership with the local firm. The offshore service provider will likely be able to judge the strength of local financial service providers and facilitate a negotiation between their customer and the local bank or mortgage company.

Focusing on the second tier firms for partners limits the political risk of threatening the independence of a dominant (or first tier) local firm may anger protectionists in the local government inviting retaliation or prohibition. In addition, if the offshoring relationship is promoted as a result of the excellence of the local firm then the expansion of their partnership into the host country market will also be viewed as a positive for the local firm easing the partnerships entry into the broader host market.

Proposition 13: If the local market is of sufficient size and has a well-developed competitive financial services sector (India for example) foreign financial services firms will deepen their involvement in the local market by partnering with second-tier local financial firms at the retail or wholesale level, avoiding partnerships with the most dominant local firms.

Firms that are not interested in pursuing international expansion will seek relationships with specialized offshore service providers in the local market. These service providers will be most able to provide the greatest efficiency because they are specialized in providing services and are not distracted by running a retail operation as the local FSFs would be. Developing a local market presence would not be an attraction to a foreign financial service provider that has no interest in international expansion of its markets. These firms would also prefer a third-party specialized OSP. The lack of

expansionary ambitions by the foreign FSF also frees the local OSP to provide services for local financial services providers, helping the OSP to build scale economies.

Conclusion

Offshoring of operations creates risk by moving processes from one place that is usually well understood, such as the headquarters or at least somewhere in the home country, to a foreign location that offers reduced costs but is often a mysterious place to the FSF with unfamiliar customs and laws. Due to the relative recency of the offshoring phenomenon, the service providers are often an unknown operated by people with low levels of experience but significant ability to organize productive activities in the offshore location. As FSFs vary their routines in search of improved cost performance, any uncertainty becomes a cost raising the “bar” for the cost efficiency necessary to make the offshoring project viable or the innovation will not be retained.

In part because of its newness, offshoring requires the development of absorptive capacity on both the part of the offshore service provider but also for the FSF in creating the ability to effectively transfer part of its operation to an outside firm or a foreign captive operation. The OSP may have very little ability to absorb the knowledge it needs however its specialization helps keep its focus limited and thereby more manageable.

The manner of using offshoring in the financial services industry will depend on the ambition-level of the FSF, its goals in terms of international expansion and/or efficiency, the cultural distance between the home country and the offshore and the attractiveness of the offshore market to foreign entry. While there are difficulties in adopting any new process, over time the ease of adoption will improve as more and more actors within the system have the capacity to know how to do offshoring and its success stories prove it effective (relative advantage over previous methods) (Rogers,

1995) and even create bandwagon effects (Abrahamson and Rosenkopf, 1993) where it is both fashionable and effective to offshore. With increasing competitive pressure in financial services motivating more adoption of offshoring, over time offshoring will reach a taken for granted status as a necessary capability to maintain basic financial service operations just as it seems to have become for global manufacturing firms. However, as the propositions developed above illustrate, offshoring strategies will be focused in several directions and serve a variety of strategic purposes designed to fulfill organizations needs and will survive as organizational routines until organizations experience problems that trigger search and learning routines in order to adapt to future circumstances.

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