Cyberfraud & identity theft

The hidden costs of business process outsourcing

Offshore business process outsourcing involves additional risks, according to *Anne Rouse* and *David Watson*. Here they outline some of these with strategies for their management.

Around 130,000 Australians woke up one morning in June 2005 to find that there had been a security breach at CardSystems Solutions. A total of 40 million MasterCard, Visa and American Express cardholders' account details had been stolen worldwide, and highly personal data compromised. The theft is only one of several recent incidents in which customers have discovered that what they thought were personal details, protected by privacy legislation, had fallen into the hands of criminals engaged in 'cyberfraud' or 'identity theft'.

ABC's *Four Corners* television program *Your Money and Your Life*, broadcast 15 August 2005, illustrates the opportunities for identity theft when highly sensitive personal information is passed to call centres or processing centres. A point not emphasised was that these thefts occurred as part of *outsourced* arrangements. Theoretically, the penalties in the contract, the threat of cancellation, or reputation effects of a major security breach are sufficient to ensure vendors protect information, but not always. The threat of identity theft from outsourced call centres is a hidden aspect of business process outsourcing (BPO) – the outsourcing of relatively complex business processes or functions supported by information technology (IT)and telecommunications networks. This form of outsourcing inevitably involves transfer of key data to the vendor's site.

Have you seen this information?

FINANCIAL BENEFITS MIXED

An important perspective on outsourcing comes from transaction cost economics, an economic theory that considers the strategic 'make or buy' decision in terms of the interplay of production and transaction costs. Outsourcing vendors promote the economic argument that competition keeps production costs lower; however this ignores the higher costs of dealing with the marketplace. 'Transaction costs', the costs of finding, contracting and controlling the vendor, are sometimes so high it's cheaper to keep services in-house. Another cost that has to be balanced against production cost savings is the cost associated with risks – particularly reputation and litigation risks. These may be relatively unlikely, but recovery in the event of a failure can be very costly.

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Economic theory holds that the financial benefits of outsourcing are mixed and generally limited for non-standardised services. What is perhaps surprising is that even though service outsourcing has been common for more than 15 years, there is little evidence that local (onshore) outsourcing saves much money. Those studies confirming substantial savings of 25 per cent or more from outsourcing, investigated relatively simple, standardised services like cleaning or garbage collection, where cost savings are often associated with the use of new technologies and cheaper labour. Even then, studies generally only considered production cost savings, not associated transaction costs.

There has been limited systematic research into savings associated with more complex forms of outsourcing, particularly BPO. However, evidence indicates onshore outsourcing offers minimal savings and sometimes actually increases costs. It is partly for this reason companies are now embarking on riskier offshore BPO ventures in India, China and other developing nations.

When contemplating offshore BPO, decision makers often consider only the salary 'arbitrage' between developing nations and western countries, and not the higher costs of infrastructure and telecommunications. Interviews with practitioners suggest that offshore BPO frequently saves 20 per cent to 30 per cent, rather than the 40 per cent to 50 per cent suggested by vendors. Furthermore, these savings usually do not take into account the transaction costs of finding and working with overseas suppliers. These costs can be high, particularly if problems arise and clients are hit with unexpected demands, such as sending key executives overseas for substantial periods to 'put out fires'.

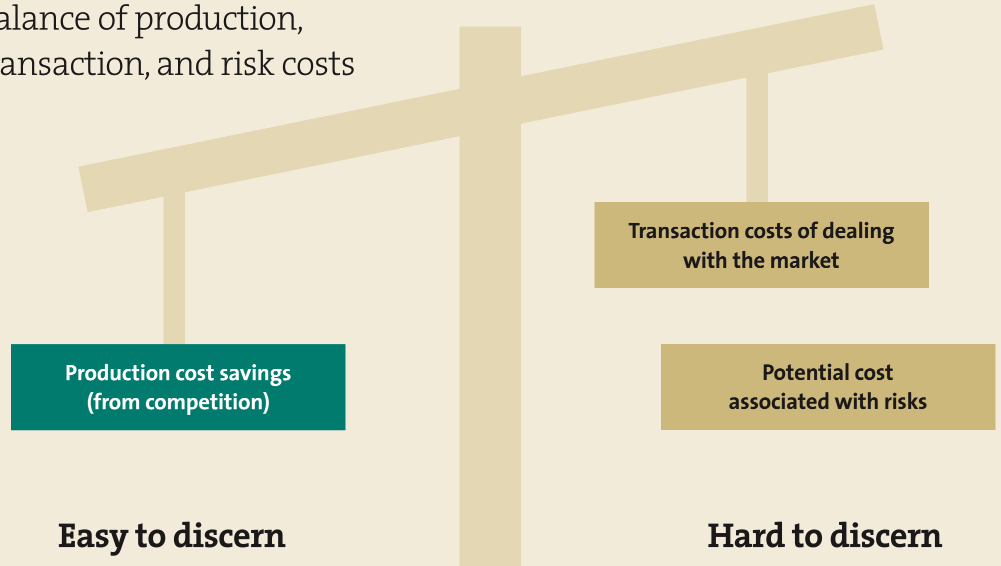
It is not clear whether offshore vendors will be able to count on large salary arbitrage savings over the life of their BPO arrangements. Just as in western countries, strong demand for skilled labour eventually pushes up salaries in countries like India and China, and some vendors are already moving call centres to countries like Vietnam or the Philippines as a result.

Offshore vendors' profit margins are being squeezed by a growing demand for highly skilled labour. This is not good news for clients because these vendors can go out of business or become takeover targets, with major ramifications for the purchaser's customers, and sensitive corporate data that may be on-sold. Even when vendors stay in business, clients can find prices for renewed contracts are substantially higher, because by then the purchaser is confronted with significant switching costs.

If outsourcing arrangements 'go wrong' clients can bring back the services in-house or move to another vendor, but this is an expensive process. Research found many organisations continue with quite unsatisfactory outsourcing arrangements because of the financial costs, distraction to managerial attention, or organisational disruption

Relative balance of savings and costs

Costs saved from outsourcing depend on the relative balance of production, transaction, and risk costs



associated with changing their supplier. Plus, when offshore labour is used, contracts may not be practically enforceable in foreign jurisdictions. Many outsourcing clients do not think seriously about these issues because they are so embedded in their own national culture.

MANAGING RISKS

Some suggest a comprehensive detailed contract is 'old fashioned' and may discourage a good relationship between vendor and client. However evidence suggests it clarifies expectations and compliments the vendor-client relationship.

A comprehensive contract reduces, but does not eliminate, the likelihood of unexpected hidden costs. Much outsourcing cost escalation is due to changes in the business environment and unforseen demands. Purchases should consider and plan for breaches in the contract; costs of litigation; the difficulty of obtaining enforcement in other jurisdictions; and inclusion in the business case of the costs associated with the realistic possibility that the arrangement sours.

Even if the contract is legally enforceable, the collapse of the relationship between vendor and client that accompanies legal action may destroy the arrangement.

THE RISKS INVOLVED

Paying attention to and planning for the risks of outsourcing tends to make purchasers far more alert and, in fact, better outsourcing customers. Here are the major risks of business process outsourcing and some additional risks that are particular to offshore outsourcing.

General BPO risks (on and offshore outsourcing)

- Unexpected cost increases
- 'Moral hazard' risks where the vendor overstates its skills and performance capacity
- Vendor opportunism
- Loss of critical intellectual property (IP) and know-how
- Changes in taxation law
- Data security or privacy breaches
- Unexpected costs and time to manage the outsourcing arrangement
- Reduced capacity to make strategic decisions associated with the outsourced services
- Obtaining 'average industry practice', when innovation or new technologies are needed for business benefits
- Technology risks associated with the infrastructure linking vendor and client and the vulnerability of systems to damage or loss
- Business continuity risks

Additional risks associated with offshore BPO

- Escalation in labour rates
- Foreign exchange risks
- Additional travel costs, and time
- Political risks including terrorism, war
- Subsidies that affect the attractiveness of the vendor
- Increased privacy/data security risks, particularly risks associated with high levels of corruption
- Consequences of cultural and language barriers
- Difficulties/costs associated with remedying problems from a distance
- Difficulties/costs for managing loss of intellectual property (IP), or transfer of IP

Purchasers need to adopt a systematic risk management process that involves analysing the risk likelihood; establishing the impact of risks; and recognising that by outsourcing business services, companies cannot devolve their own responsibilities.

Although most outsourcing arrangements are a success, many have failed by being over-optimistic and without adequate financial provisions. Very few outsourcing arrangements avoid unexpected changes and very few encounter no risks at all. The contingencies that allow organisations flexibility and protection from risks need to be budgeted for. If that means the business argument for outsourcing becomes much weaker, this is an important warning that should be heeded. BPO presents challenging problems – with new legislative demands and a customer base alerted by recent data failures, the management of BPO arrangements is becoming a mission-critical activity. So paying attention to the downsides, having realistic, evidence-based expectations and planning for risks makes good business sense.

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