

BPO Overview

Part One of this book provides readers with an overview of business process outsourcing (BPO). BPO has been both hailed and vilified during the 2004 presidential campaign, and it is likely to be a topic of controversy for some time. This book takes a neutral political stance on BPO but assumes that it will survive in some form regardless of which party dominates U.S. politics in the coming years.

Chapter 1 consists of an analysis of the primary drivers of BPO and the various types of BPO that are being practiced today. The chapter includes some of the latest projections of the size of the outsourcing industry and the number of jobs that are likely to be affected. It also points out that BPO is a socio-technical phenomenon that impacts both technical and social systems of the organization.

Chapter 2 provides examples of successful and unsuccessful outsourcing projects implemented by a wide variety of firms. The brief case studies examine decision-making processes, BPO implementation challenges and tactics, and outcomes. The case studies are derived from the popular business literature or from actual experiences and provide a broad look at how companies are using innovative approaches to BPO to reduce costs and to improve their strategic advantages.

What Is So Revolutionary about BPO?

We ought not be over anxious to encourage innovation, in case of doubtful improvement, for an old system must ever have two advantages over a new one; it is established and it is understood.

—C.C. Colton, British author

The Internet bubble bursts, and the world keeps on turning. Terrorists attack the World Trade Center, and the world keeps on turning. The global economy reels in the throes of a major recession, and the world keeps on turning. Despite their unpredictable—and sometimes despicable—natures, humans are nothing if not innovators and perpetual optimists. In the face of doubt, ambiguity, and even terror they continue to strive to build a better world. We are fortunate to be so resilient.

And so, as our hopes for an easy peace and “new economy” prosperity in the twenty-first century were dashed within months of its arrival, humans have continued to strive to create a better world. Part of that striving is based on the technological breakthroughs that seemed to arrive breathtakingly fast during the 1990s. Standing on the shoulders of those innovators, a new generation of visionaries has created compelling new business opportunities. Among the vast array of novelties introduced in the past few years, none is more important than the creation of the global communications and information infrastructure that has now burrowed into nearly every city, village, hamlet, and encampment around the world. Fiber-optic cable spans oceans and continents. Low-earth-orbit satellites provide streaming images, data, and voice to the most remote locations. Tragedy and joy each mark the onset of this communications revolution. A doomed climber places a phone call from the top of Mount Everest to say goodbye to loved ones as he succumbs

to the elements in that unpredictable environment.¹ A Russian astronaut staffing the orbiting international space station is joined in marriage to a terrestrial-based bride.² No place on earth, or in near-earth, is now beyond the reach of the information and data nervous system that was constructed over the past few decades. This *is* revolutionary, and this nearly universal telecommunications infrastructure is a major part of what gives life to the business innovation called *business process outsourcing*.

Business process outsourcing (BPO) is defined simply as the movement of business processes from inside the organization to external service providers. With the global telecommunications infrastructure now well-established and consistently reliable, BPO initiatives often include shifting work to international providers. Five BPO international hot spots have emerged around the globe, although firms from many other countries are specializing in various business processes and exporting services:

1. *India*. Engineering and Technical
2. *China*. Manufacturing and Technical
3. *Mexico*. Manufacturing
4. *United States*. Analysis and Creative
5. *Philippines*. Administrative

Each of these countries has complex economies that span the range of business activity, but from a BPO perspective they have comparative advantages in the specific functions cited.

Because of the job shift that accompanies the quest to employ the highest-value talent, BPO has been both hailed and vilified from different quarters. Business executives and owners hail BPO as a means of eliminating business processes that are not part of the core competence of their organizations. Back-office functions such as payroll and benefits administration, customer service, call center, and technical support are just a few of the processes that organizations of all sizes have been able to outsource to others who specialize in those areas. Removing back-office functions from their internal operations enables organizations to reduce payroll and other overhead costs. In an era when executives have been admonished from a wide range of business commentators and analysts to focus on core competence, BPO offers them an opportunity to finally achieve that goal in a dramatic new way.

Like appliance manufacturers that moved production from the Midwest to Mexican *maquiladoras* or apparel firms that moved production to the Far East, businesses of all types and sizes are now shifting back-office jobs to international locations such as China, India, and the Philippines where the labor is inexpensive and highly skilled. In the past several years, companies have turned to these regions for increasingly sophisticated tasks: financial analysis,

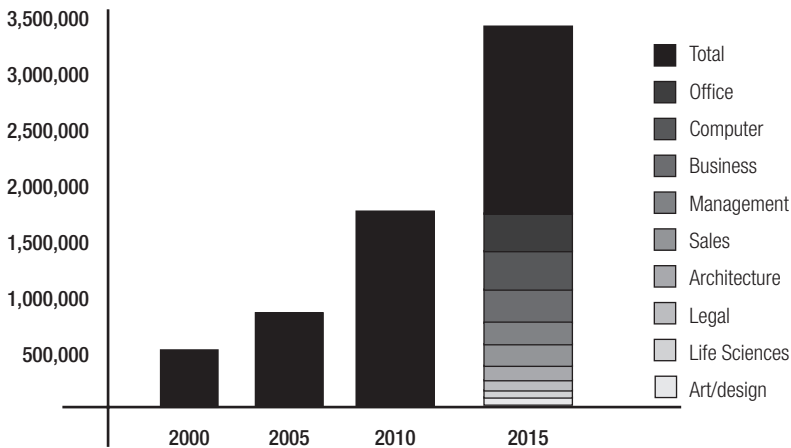
software design, tax preparation, and even the creation of content-rich products such as newsletters, PowerPoint presentations, and sales kits.³

With the increasing education levels around the world, BPO is no longer confined to routine manufacturing jobs or boiler-room telemarketing centers. Today's outsourcing involves complex work that requires extensive preparation and training. For example, Indian radiologists now analyze computed tomography (CT) scans and chest X-rays for American patients out of an office park in Bangalore. In the United States, radiologists are among the highest-paid medical specialists, often earning more than \$300,000 per year to evaluate magnetic resonance imaging (MRI), CT scans, and X-rays. In Bangalore, radiologists work for less than half that. Not far from the radiology lab in Bangalore, Ernst & Young has 200 accountants processing U.S. tax returns. Starting pay for an American accountant ranges from \$40,000 to \$50,000, whereas in Bangalore accountants are paid less than half that amount.⁴

In the next 15 years, Forrester Research predicts that 3.3 million service jobs will move to countries such as India, Russia, China, and the Philippines. That is the equivalent of 7.5 percent of all jobs in the United States right now.⁵ Exhibit 1.1 shows that the number of back-office jobs being outsourced will escalate rapidly in the coming years. The 2015 bar includes a breakdown of the projected numbers of jobs going overseas in common work categories.

The Gartner Group, a Stamford, Connecticut-based research firm, estimates that 85 percent of U.S. companies will outsource their human resources (HR) functions in the near future and that revenue from these transactions will exceed \$45 billion in 2003.⁶ Gartner also estimates that one in ten jobs

EXHIBIT 1.1 Jobs Expected to Shift Overseas



at specialty information technology (IT) firms in the United States will move abroad by 2005, along with one in twenty IT jobs at general businesses—a loss of about 560,000 positions. Gartner also predicts that BPO will reach \$178 billion in revenues worldwide by 2005, representing a compound annual growth rate of 9.2 percent for the five-year forecast period.⁷ Market research firm IDC predicts that finance and accounting outsourcing will grow to nearly \$65 billion by 2006, up from \$36 billion in 2001. Two-thirds of U.S. banks already outsource one or more functions.⁸

BPO has caught on as well with the venture capital community. In 2002, venture capital firms in North America poured nearly \$3 billion into BPO firms and another almost \$1 billion by June 2003. Some BPO providers currently enjoy operating profit margins as high as 40 to 50 percent. Even though margins are expected to level out to between 20 and 25 percent as the market matures, these returns are greater than are currently being experienced in nearly any other industry.⁹

Despite this increasing global adoption and capital inflow, BPO is not without its critics and naysayers. There is no doubt that the history of outsourcing in manufacturing has been black-marked by the many American workers who lost their jobs and cannot find new ones in the traditional manufacturing sector. Today, everything from electronics to home furnishings is being manufactured by low-cost labor in places such as Shanghai and Monterrey. American workers were told that free-trade agreements such as the North American Free Trade Agreement (NAFTA) would create a “giant sucking sound” as jobs moved to low-wage labor environments. That prediction has rung true for many U.S. workers. Factories across the country, including steel mills, paper mills, and other staple industries of America’s industrial past, have gone silent—apparently for good. Families and towns have been broken apart, as workers have had to pack up and seek alternative work far from home. The Ethics and Governance insert addresses the issue of how outsourcing relates to the U.S. unemployment rate.

No doubt, such wrenching change at the level of individual human lives is painful and unsettling. At the same time, the resilience of the American worker to find new ways to create value in a global economy shows few limits. As the nineteenth century’s Agrarian Age came to an end and workers moved from farms to factories, they adapted and built some of the greatest cities in the world. At the end of the twentieth century, the Industrial Age gave way to the Information Age, and workers were moving out of factory jobs into information-rich occupations and built some of the greatest technologies in the world.

Today we are faced with adapting yet again to a world that is only partly of our creation. There is no question that we funded and built the enabling technologies that make the BPO revolution possible, but we did not necessarily do so intentionally. As C.C. Colton asserts in the quotation at the begin-

ETHICS AND GOVERNANCE

BPO Increases U.S. Unemployment Rate?

The Labor Department, in its numerous surveys of employers and employees, has never tried to calculate the number of jobs that are shifted overseas as a result of BPO. But the offshoring of work has become so noticeable that experts in the private sector are trying to quantify it. Initial estimates are that at least 15 percent of the 2.81 million jobs lost in America since the recession began have reappeared overseas. Productivity improvements at home account for the great bulk of the job loss. But the estimates suggest that work sent offshore has raised the U.S. unemployment rate by four-tenths of a percentage point or more.

Among economists and researchers, one high-end job-loss estimate comes from Mark Zandi, chief economist at Economy.com, who calculates that 995,000 jobs have been lost overseas since the recession began in March 2001. That is 35 percent of the total decline in employment since then. Most of the loss is in manufacturing, but about 15 percent is among college-trained professionals.

Source: Adapted from Louis Uchitelle, "A Missing Statistic: U.S. Jobs that Went Overseas," *New York Times* (October 5, 2003).

ning of this chapter, be careful to encourage innovation because we do not really know where it will lead. Colton and many others would be distressed at the prospect of BPO. We, however, are hopeful that BPO will help create a more tightly integrated business world that will lead to a more tightly integrated cultural and economic world. BPO has the potential to create new prosperity for workers everywhere through participation in a BPO-based business super-culture that spans the globe. This book is designed to help you determine how BPO can work for your organization and to help you transition to BPO in a manner that considers the human implications of its adoption.

BPO: A SOCIO-TECHNICAL INNOVATION

A lot of executives and managers shy away from BPO because they wrongly believe it to be a technical innovation—one better left for the chief information officer (CIO) or other technology administrators. In part, this belief results from the IT origins of BPO. Many of the early adopters of outsourcing

were those who needed software development expertise or who sought technical expertise to staff help desks and call centers. During the 1990s, the labor pool for such talent in the United States was very tight, prompting many leading companies to search abroad for the personnel they needed. These organizations turned to international labor markets, where they were able to identify and hire highly skilled technical workers who were far cheaper than their U.S.-based counterparts. Today, the talent shortage in the United States has abated, but the cost savings to be gained by using outsourced talent remains.

BPO has evolved far from these IT-specific roots and now encompasses nearly every business process. To be sure, the implementation of a BPO initiative will always involve a technology component, but for that matter so does implementation of an accounting system at the local beer distributor. The point is, nearly every modern business innovation comprises both a technical and a social component. Workplace teams use collaboration tools such as groupware or instant messaging to converse and work on projects; HR administrators train employees through e-learning systems; and executives monitor the entire organization using online balanced scorecards. Decision making, strategy setting, service delivery, and nearly every other business activity is now socio-technical in nature, involving humans interfacing with technical systems. BPO is like that.

Fundamentally, then, BPO is a socio-technical business innovation that provides a rich new source of competitive advantage. By socio-technical we mean that BPO requires skillful management of people and technology (hardware and software). The manager who initiates a BPO strategy must find effective ways to introduce people to technology and vice versa. If left solely in the hands of technical specialists, a BPO initiative is likely to fail for lack of paying attention to the soft issues of human relationships, change management, and organizational culture. If left solely in the hands of nontechnical managers, a BPO initiative is likely to fail for unrealistic expectations about the potential and limitations of the enabling technologies.

BPO is one of those interdisciplinary workplace innovations that require a diverse set of skills in order to be successful. The initiation and implementation of a BPO project in an organization requires focused attention on several human factors, both within the organization initiating the project and within the outsourcing vendor. These human/social factors cannot be ignored and must be handled correctly in order for the project to succeed. Human factors include the following:

- Developing various teams to manage the BPO initiative throughout its life cycle
- Reassuring staff of their role in the company
- Training people on the new way of doing business

- Dealing with job loss and/or reassignment
- Keeping morale high throughout the change process
- Encouraging people to participate in decision making
- Understanding cultural differences between the organization and BPO partner

The initiation and implementation of a BPO project also require attention to technology issues. Among these are the following:

- Compatibility of systems between the BPO buyer and vendor
- Data and system security
- Backup and recovery procedures in the case of system failure
- Data interface challenges and strategies
- Software and database compatibility challenges
- Data and knowledge management

These various issues are discussed in detail throughout the book. Next, let us examine the major driving factors of the BPO revolution.

DRIVING FACTORS

Scholars who study how complex systems change over time are familiar with two types of change: evolutionary and emergent. Evolutionary changes are those that a system is likely to produce based on its current design and goals. For example, living systems develop sensory equipment to help them react to what is going on in their environment. Because the goal of such systems is to live and procreate, it would be reasonable for us to predict that they would evolve sensory apparatus over time. It is not surprising that creatures that live in a lighted world develop eyes and that creatures that live in darkened worlds do not.

Occasionally, however, complex systems develop structures that are not predictable from their goals and current state. These phenomena are referred to as *emergent*. They are system features or capabilities that would not have been predicted in advance based on the understood design and goals of the system. They are usually the result of a series of parallel evolutionary changes that, when taken together, produce surprising or unexpected results. Consciousness in humans is often highlighted as an emergent phenomenon of increasingly complex and integrated brain systems, rather than as something that is a natural result of our evolutionary past.¹⁰

We contend that BPO is revolutionary because it is such an emergent phenomenon. It is emergent because, as far as we can tell, no one set out to design the potential for organizations to use BPO. BPO is emerging from a set

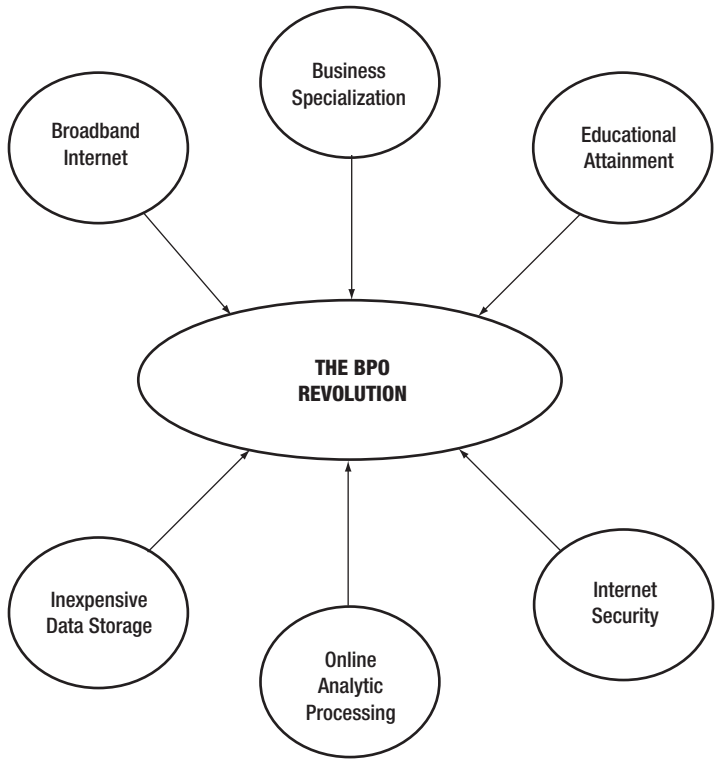
of driving factors that have unintentionally converged in this particular time to enable the shifting of work to its lowest-cost/highest-quality provider regardless of the provider’s physical location. BPO is a business innovation that leverages these driving factors and applies them to practical business problems. The main drivers at the heart of the BPO revolution are illustrated in Exhibit 1.2.

Each of these drivers is discussed in detail in the following sections.

Educational Attainment

The United States still dominates the world in the quality of its higher education, but the rest of the world is catching up quickly. As more and more Ph.D.-qualified faculty return to their home countries with their degrees from Harvard, MIT, Stanford, and other prestigious schools, they are helping to transform higher education worldwide. At the K–12 level, it has long been noted that the United States lags behind other countries, especially in technical areas such as math and science as measured by standardized test scores. The gap between the United States and many foreign nations has increased

EXHIBIT 1.2 BPO Drivers

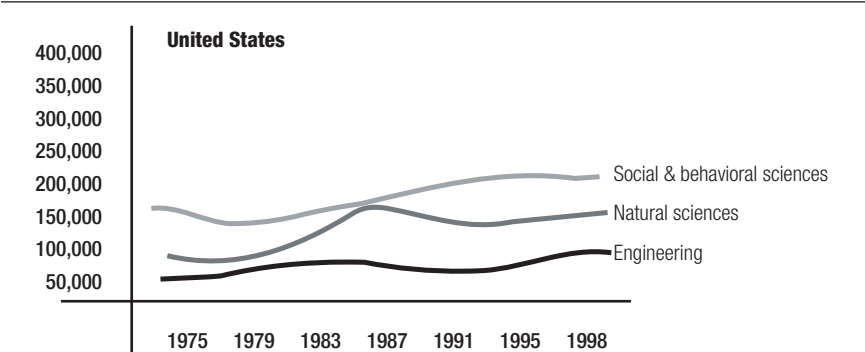


over time in technical education, which has now also translated into fewer U.S. students seeking college degrees in technical fields. Exhibit 1.3 compares the relative numbers of U.S. and Asian students pursuing science and engineering disciplines at the collegiate level. As illustrated in the exhibit, Asian students are increasing their engineering expertise in a world that increasingly appreciates and utilizes their new abilities.

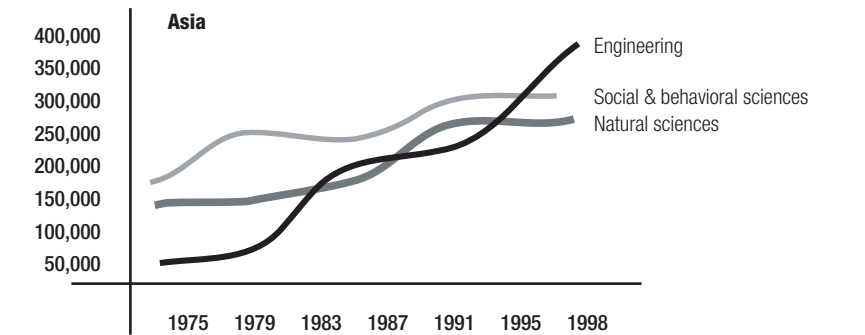
Of the nearly 590,000 foreign students enrolled in U.S. higher education in 2002, more than 20 percent came from India or China. Ironically, the United States is not only relocating its coveted technical jobs to these foreign locations, but it is also preparing many of the workers who fill those jobs. The following list provides some sobering statistics on technical education

EXHIBIT 1.3 Comparison of Asian and U.S. Technical Education

Bachelor's S&E Degrees in the United States and Selected Asian Countries and Economies by Field (1975–1988)



Natural sciences include physics, chemistry, astronomy, biology, earth, atmospheric, ocean, agricultural, as well as mathematics and computer science.



Asian countries and economies include: China, India, Japan, South Korea, and Taiwan. Data for China is included after 1983.

Source: Science and Engineering Indicators—2002.

worldwide that indicates why so many U.S. firms are looking abroad for the talent they need to compete in today's marketplace:

- In 2001, 46 percent of Chinese students graduated with engineering degrees. In the United States, that number was 5 percent.
- Europe graduates three times as many engineering students as the United States and Asia five times as many.
- In 2003, less than 2 percent of U.S. high school graduates went on to pursue an engineering degree.
- In 2001, almost 60 percent of those receiving Ph.D.s in electrical engineering in the United States were foreign-born.
- Among the more than 1.1 million seniors in the class of 2002 who took the ACT college entrance exam, fewer than 6 percent planned to study engineering, down from 9 percent in 1992.
- Less than 15 percent of U.S. students have the math and science prerequisites to participate in the new global high-tech economy.
- In the United States, more students are getting degrees in parks and recreation management than in electrical engineering.¹¹

It now makes sense for U.S. firms to rely on foreign providers of highly skilled labor. The logic is simple: The quality of talent is high and the cost is low. Educational attainment around the world will drive BPO innovators to seek new ways to tap that talent for business purposes. There is no way to put that genie back into the bottle. It would be foolhardy to the point of malfeasance for managers not to seek and use the best available talent that fits the organization's budget—wherever that talent may reside.

Broadband Internet

In fall 2003, the *Wall Street Journal* published its annual report on telecommunications. In the front page article, the journal writer stated, "After years of hype and false starts we can finally declare it: The Age of Broadband is here."¹² The article reports that by the end of 2003, 21 percent of all U.S. households will have broadband Internet and about 50 percent by 2008. It is also expected that more than 7 million businesses will have broadband connectivity in the United States by the end of 2003.

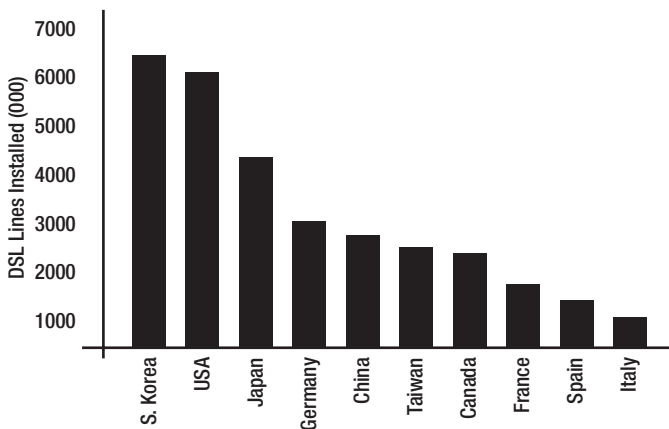
Broadband refers to the growing pipeline capacity of the Internet, allowing larger chunks of information to flow with fewer congestion issues. *Broadband* is the term used to refer to Internet connectivity speeds that are in the range of 2 megabits/second (2 million bits/second). Leading semiconductor maker Intel has predicted that by 2010 there will be 1.5 billion computers with broadband connections.¹³ High-speed Internet access is becoming commonplace in regions where dial-up was once the only option. With broadband,

workers in different countries can share data, while consumers can surf the Web for the latest bargains.¹⁴

Growth in broadband connectivity is largest in regions where deployment is still scattered—Latin America (up 63 percent to 619,000), South and Southeast Asia (up 124 percent to 1.12 million), and the Middle East and Africa (up 123 percent to 107,000). The Asia-Pacific region is the runaway regional leader, with nearly 11 million digital subscriber line (DSL) users, followed by North America with 6.5 million and Western Europe with 6.3 million. Eastern Europe has the lowest level of broadband connectivity, with barely 70,000 DSL users. In relatively mature markets, the percentage of DSL subscribers who use the service at home is much larger than in new markets and smaller economies, where businesses account for a larger percentage. In North America 22.6 percent of users are businesses, and the figure for Western Europe is 16.5 percent.¹⁵ Hong Kong tops the world in broadband connectivity with more than 66 percent of Internet users opting for the high-speed connection.¹⁶ Exhibit 1.4 highlights broadband/DSL leaders around the world.

Broadband penetration around the world is driven by the creative and business behaviors of users. Research from the Pew Internet & American Life Project, the results of which are illustrated in Exhibit 1.5, found a correlation between specific online behaviors and demand for high-speed access. Pew found that broadband users are extraordinarily active information gatherers, multimedia users, and content creators. Internet users with six or more years online who engage in similar activities are most likely to switch to high-speed access. In fact, Pew found that of those dial-up users who are

EXHIBIT 1.4 World Leaders in DSL Broadband



Source: Point Topic

EXHIBIT 1.5 Online Behaviors and Demand for High-Speed Internet

	Broadband Users	Experienced Dial-up Users	Dial-up Users
News	41%	35%	23%
Research for Work	30%	30%	15%
Participation in Group	12%	11%	4%
Content Creation	11%	9%	3%
Stream Multimedia	21%	13%	7%
Download Music	13%	3%	3%

Source: Pew Internet and American Life Project.

contemplating broadband, 43 percent logged six or more years online, compared to 30 percent of those online for three years or less. Greater disparities in these behaviors are seen between less experienced dial-up users and those with broadband connections.¹⁷

Although Western Europe currently lags behind North America, by 2005 the European market will match North America for size. Undeveloped telecommunications infrastructure and economic volatility continues to hamper broadband growth in Latin America.¹⁸

Abundant Data Storage

Data storage has always been a critical resource for business. In the days of paper-based record keeping, data storage was primarily accomplished via file cabinets, closets, and dingy overstuffed basements. The computerization of the workplace gradually replaced paper-based filing systems at first with punch cards and later with magnetic tapes and then disk-based storage. As the integration of the Internet and its related technologies into business processes and functions has progressed, data storage has gone from being a problem to one of oversupply. Firms that had envisioned growing rich by supplying online data storage on an as-needed basis have discovered that storage has become a commodity—it is nearly as limitless as the Internet. Advances in data storage, including sophisticated data retrieval, have driven down storage costs dramatically. Rare is the individual today who walks about with a floppy disk in his or her shirt pocket. Rather, most have learned to transfer files into a virtually limitless cyberspace storage room, where they can be retrieved whenever and wherever needed.

The elimination of the barriers to data storage has enabled new ways of thinking about what is possible in the structure and procedures of the workplace. In times when storage was scarce, difficult decisions had to be made about what data to collect, keep, and eliminate. Even more limiting, in times

when storage was scarce, decisions had to be made about who had access to critical information and when.

In an era of storage overcapacity, an embarrassment of riches awaits savvy executives if they can move beyond the scarcity mindset. Data protection and access controls must continue to play a role in a storage-rich environment, but they play a different role. In the storage-poor past, data access was controlled in part because storage limitations affected the number of copies of data that could be made. That barrier has been lifted by digitized document storage that allows literally infinite distribution of key documents, forms, and plans. In the past, gatekeepers, whose approval was needed to acquire and use company information, managed data access. That barrier has been lifted by precision software-based systems that enable rapid access to very specific data sets based on prearranged approval levels. These systems are constantly being upgraded to be more user friendly and can adapt quickly to unique work processes and systems.

One danger of shifting work to a third party is the potential loss of organizational learning. When a process is executed internally, the organization's employees handle the related transactions and, over time, are able to discern and adapt to specific patterns or trends. Some of these patterns concern customer or competitor behaviors. When these transactions are no longer executed internally, there is potential for this vital learning to be lost. With nearly infinite data storage, however, each transaction that occurs remotely can be stored for independent analysis. As we discuss below, sophisticated analytical software can then be used to mine the transactional data to reveal customer or competitor patterns—preserving and even enhancing organizational learning.

Analytic Software

Software is a major source of business competitiveness, as well as a major source of headaches for anyone who has ever booted a computer. Originally invented as a tool for us to work *with*, software has increasingly been designed to perform work *for* us. Expert systems, decision support systems, and artificial intelligence all are software tools that perform analytic tasks. Business analysis tasks were formerly the domain of human logicians, administrators, and executive decision makers. The advent of analytic software capable of re-creating and possibly improving on human decision making has revolutionized the power of the desktop computer. Where the ideal of the Industrial Age was to eliminate the need for human thinking through mechanical design, the ideal of the Information Age seems to be to improve on human thinking through software design.

Online analytic processing (OLAP) has created a wide range of new possibilities in workplace structure, including effects on hiring practices,

organizational design, and productivity. Although OLAP has enabled some human resources to be eliminated, it has also placed a premium on individuals who can use the sophisticated output and create new value with it.

Software that provides human-like data output has opened the door to the possibility for data and information to seek lower-cost labor in the same way that manufacturing has done. Computational systems that have replaced human analysts range from trend analysis in sales and marketing to workflow optimization on the shop floor.

Before the advent of sophisticated OLAP software, it was necessary for highly educated people to analyze a firm's data and information to make it useful. In general, the more highly educated the labor, the more costly it is. As software takes the place of humans in an ever-widening array of business analysis functions, the roles left to people are increasingly confined to implementation tasks. The training required to implement the results of processed data is usually less extensive than that required to analyze it in the first place. Reliable data analysis software can eliminate high-cost analyst labor and replace it with relatively lower-cost implementation labor. For many business processes, the outcomes of processed data are predictable within a range. Business rules can be developed to specify the actions required within a range of possible outputs. In the case of an outlier, it is simple enough for the data implementation specialist simply to escalate the output to a few management-level analysts for additional processing.

Analysts traditionally have been the white-collar middle managers who have served as the glue, gatekeepers, and information stewards in organizations of all sizes. The transition of analyst jobs from inside the organization to outsourcing partners will displace many of these middle-level roles in organizations. In fact, as the development of analytic software continues, it is likely that the swath of job shift in middle management will grow wider and reach ever-higher levels of the organization chart.

Internet Security

Internet security refers to the ability to send information and data (including voice) over the Internet without fear of leakage, espionage, or outright loss. It is critical for companies to be certain that their data integrity will be maintained despite its movement around the globe in the servers, routers, and computers that make up the World Wide Web.

In the past, many executives were reluctant to conduct any back-office business transactions over the Internet or beyond their own four walls because they felt the security risks outweighed the value proposition. However, in today's world of ever-changing technology advancements, most executives are more computer savvy and better understand the security protocols now available. With these new technical breakthroughs, companies can now work

within virtual walls with the same level of security they enjoyed within physical walls.

One of the most significant enablers of this new virtual workspace is the use of Kerberos technology, developed at the Massachusetts Institute of Technology (MIT) as a cryptographic environment. This technology allows computer systems to use digital certificates for authentication within their transactions. Kerberos is just one piece of a much larger security framework that is now in place. Security systems today include proxy servers, passwords, authentication, firewalls, encryption layering, certificates, virtual private networks, open systems interconnection, and extranets. With these security advances, two companies can partner and safely share resources in the virtual world.

In addition to the security innovations at the technical level, there have been significant changes at the policy and regulatory levels. Most organizations have enacted internal policies to protect sensitive data and information, including institution of security access to physical facilities and requirements for employees to wear identification badges. At the regulatory level, national governments have instituted laws regarding data security. For example, the Indian IT Act of 2000 addresses privacy-related issues and attempts to define *hacking* and *computer evidence*. It also strongly prescribes the implementation of digital signatures and Public Key Infrastructure (PKI) for facilitating secure transactions. The Data Protection laws enacted by the United Kingdom and the European Union (EU) are considered to be benchmarks in international privacy laws.

In addition to federal legislation, several international certifications and standards mitigate security risks. Most BPO providers adhere to one or more of these standards and have received the appropriate certifications. Several global and national compliance benchmarks include the following:

- **BS 7799.** First published in February 1995, BS 7799 is a comprehensive set of controls comprising best practices in information security. BS 7799 is intended to serve as a single reference point for identifying a range of controls needed for most situations where information systems are used in industry and commerce, and to be used by large, medium, and small organizations. It was significantly revised and improved in May 1999 and a year or so later published by the International Organization for Standardization (ISO).
- **ISO 17799.** ISO 17799 is an internationally recognized information security management standard. The ISO first published it in December 2000.
- **HIPAA.** The Health Insurance Portability and Accountability Act (HIPAA) of 1996 establishes standards for the secure electronic exchange of health data. Health care providers and insurers who elect to transmit data electronically must comply with HIPAA security standards.

Even with these security standards, organizations should be aware of security best practices and ensure that the BPO vendor they choose has the capability and processes in place to meet and exceed security needs.

The new laws governing data protection, organizational policies, and new technologies have converged to create a highly secure—although still imperfect—communications infrastructure. Although hack-proof systems have yet to be constructed, the ever-more-complex barriers erected to prevent cyber-espionage and cyber-crime make them increasingly less attractive projects for weekend hackers and an expensive undertaking for anyone else.

Business Specialization

Since the days of Adam Smith, capitalist economists have touted the benefits of specialization as a key to productive exchange among economic agents. The famous example of the pin factory used by Smith has stood the test of time. His eloquent analysis of division of labor in the production of pins and the vastly greater output that would occur if people each specialized in a part of the process can be applied to nearly any product or service.¹⁹ As it turns out, in a world where business-to-business (B2B) services have become as common a part of the economy as business-to-consumer (B2C) products and services, the basic economic agent can as readily be construed to be a business firm as it could be a person.

Business specialization has been urged for several decades. Former General Electric CEO Jack Welch, for example, famously stated that GE must be number one or two in the world in a given business or it should get out of that business. In their popular book *Competing for the Future*, Prahalad and Hamel called on businesses to focus on their “core competency.” They urged companies to develop a “portfolio” of core competencies around the customers they serve.²⁰

The idea of focusing on core competence, if pursued logically, leads to the idea that a business organization should operate as few non-revenue-producing units as possible. In the early days of a business, when the firm is small and everyone pitches in to do whatever is necessary for the business to succeed, it is easy to call everything core. However, as a business grows, and as administration and overhead grows with it, there are many things a business does that are expensive but not directly involved in revenue generation. Accounting, legal counsel, payroll administration, human resources, and other processes are all necessary for the business to operate but not tied directly to the top line of the income statement. If a business truly focused only on its core competence, it would not operate those units that are not tied directly to meeting customer needs and generating revenue.

This mind shift could easily be overlooked as a driving factor of the BPO revolution, but it is crucial. Transformational organizational changes—

paradigm shifts, if you will—often cannot occur until a sufficient number of managers and executives have changed their thinking about the form and function of their organization. Such mind shifts can occur through education and experience, but they are far more likely to be a result of competitive pressures.

As B2B operations have flourished, the potential for firms to shed more and more of their noncore activities has accelerated. For example, it is estimated that 2 to 3 million Americans are currently co-employed in a professional employment organization (PEO) arrangement. PEOs are operating in every state, and the industry continues to grow at an average of 20 percent each year. Today, it is estimated that approximately 800 PEO companies are responsible for generating more than \$43 billion in gross revenues.²¹ Many firms today have simply eliminated their personnel function by outsourcing their employees to a PEO.

The potential for B2B firms to exist and to provide the specific services they do is based entirely on their ability to add value to their clients' businesses. If these firms were not able to provide high-quality, lower-cost services, they would not exist. At the same time, they would not be in business without the relatively new concept of core competence driving management thinking and behavior. Just as quality and customer service seem to be patently correct ways to organize a business today, they have not always been important factors to business managers. Ford was an early adopter of quality management in the United States, but only because Japanese automakers had begun to erode Ford's domestic market share. Until then, American automakers and manufacturers in general did not pay attention to quality as a major factor in their production processes. Likewise, the idea of focusing on core competencies—really focusing—did not seem important and strategic until some organizations demonstrated that they actually were able to perform better by outsourcing their internal processes. Early BPO adopters among Fortune 100 companies include British Petroleum, IBM, American Express, AT&T, and General Electric. These pioneers were able to risk outsourcing noncore processes. In many cases they succeeded, and sometimes they failed. But the trail had been blazed by these pioneers, and the lessons they learned along the way now ensure a higher probability of success for those firms that follow the leaders.

Management behavior on a large scale resembles crowd behavior in a stadium full of people at a major sporting event. An innovator in the crowd decides to start the wave. Rising up out of his seat with arms outstretched, he implores those around him to join in. Some are reluctant, but others decide to join in. The wave spreads from section to section, each re-enacting the first instance with some early adopters and some reluctant doubters. The wave picks up steam after a few passes around the stadium until most people have decided to give up fighting its inevitability. As the BPO wave goes around

several times, more companies will recognize its inevitability and join in. It will become less remarkable as it becomes the norm. And then the day will come when we wonder how we got along without it.

BPO TYPES

Business process outsourcing has usually been discussed in terms of the international relocation of jobs and workplace functions. In reality, there are three types of BPO: offshore, onshore, and nearshore. Exhibit 1.6 illustrates how these types are differentiated.

Organizations are prone to use any or all of these types, depending on their needs and the BPO initiative being implemented. In some cases, firms use a combination of types to achieve their objectives. The following sections look at each BPO type in more detail.

Offshore

Offshore BPO is the most challenging type of this relatively new approach to conducting business but potentially the most rewarding. It began with movement of factory jobs to overseas locations and has been made both famous and infamous with stories of suddenly prosperous geographic regions mixed with stories of exploitative labor practices. The so-called sweatshops identified in Vietnam, India, China, and elsewhere have stirred criticism for American companies, including Nike, Wal-Mart, and Walt Disney Company. Despite the criticism leveled at some companies that outsource processes and functions to international labor markets, the advantages of doing so continue to

EXHIBIT 1.6 BPO Types

Type	Location	Functions
Offshore	India	Manufacturing
	China	Programming
	The Philippines	Financial Analysis
	Russia	Call Center
Nearshore	Mexico	Manufacturing
	Canada	Call Center
	Central America	
	Latin America	
Onshore	U.S.A.	HR Administration Call Center

outweigh the disadvantages. By taking advantage of lower wages overseas, U.S. managers can cut their overall costs by 25 to 40 percent while building a more secure, more focused workforce in the United States.²²

The complexity of business functions being moved offshore continues to increase. As such, organizations using the offshore approach have developed a variety of different models to ensure continuity. Some have utilized a model known as *offshore insourcing*. Under this model, the organization establishes a wholly owned subsidiary in the international market and hires local labor. An extension of this model is the so-called build-operate-transfer (BOT) model. Organizations build offshore companies (usually with a local joint-venture partner) specializing in a business process, operate them jointly for a year or so, and then transfer the firm to internal control (insource).

It is important to note that there is no one-size-fits-all approach to offshore BPO. With the growing list of companies outsourcing at least some business functions to offshore vendors, the range of possible approaches will grow as well. This makes it increasingly likely that the next adopter of offshore BPO will find a model suitable to its needs. The Case Study describes how GE Capital and Microsoft have utilized outsourcing for value-added services at low costs.

CASE STUDY

Two Giants Take the Offshore BPO Lead

GE Capital's International Services unit, which provides everything from risk calculation to IT services and actuarial analysis for GE worldwide, has grown from 634 employees to 17,000 during the past five years. More than half of those workers are in India, and they are not being used for mindless data entry—in India every employee has a college degree, and more than 1,200 have Master's degrees in Business Administration (MBAs).

Microsoft has about 200 employees developing software in Bangalore, where it opened its first non-U.S.-based product development center five years ago. In July 2003, the company announced it will be shifting more currently U.S.-based jobs to India as it seeks to lower technical support and development costs. Microsoft will increase its staff in India in the coming years, as the country continues to turn out tens of thousands of English-speaking engineers each year.

Sources: Adapted from Reed Stevenson and Anshuman Daga, "Microsoft Shifting Development, Support to India," *Reuters News Service* (July 2, 2003); and Nelson D. Schwartz, "Down and Out in White Collar America," *Fortune* (June 23, 2003), p. 82.

Onshore

It would be a mistake to conceive of BPO only as an international business phenomenon. Many U.S. businesses are outsourcing back-office functions to firms based in America. One of the more prominent examples of this is payroll outsourcing, which is managed by several large U.S. companies. Automatic Data Processing (ADP) provides a range of payroll administration services, time sheets, and tax filing and reporting services. The firm has more than 40,000 employees and, as an indication perhaps of the future potential of the firm, has seen Warren Buffett steadily increasing his company's position in its stock.²³

There are many reasons that a firm will use BPO. The cost savings that result from moving back-office processes to low-wage environments is the most oft-cited one. However, firms can also use BPO to transfer service functions to best-in-class performers to gain competitive advantage. A firm that outsources customer service functions to a firm that specializes in and provides world-class support in that area will perform at a higher level in that function than its competitors. Moving to a best-in-class provider may actually increase costs in the short run in the interest of developing competitive advantage. Under this rationale, BPO is a strategic investment that is designed to upgrade service levels at a cost, with the intent of increasing revenues through enhanced competitiveness. What matters most is the acquisition of partners that provide market-shifting capabilities for the firm doing the outsourcing.

Many U.S.-based outsourcing firms use the world-class provider strategy to acquire business. Staked to a head start over their low-cost international rivals, U.S.-based outsourcing firms must continuously innovate and seek new ways to provide value to remain in front. They are worth considering for services, even if their costs are higher, if strategic advantage is the goal of an organization's BPO initiative.

Nearshore

Nearshore outsourcing is a relatively new term that is used to refer to the practice of outsourcing on the North American continent. International issues will arise when American firms outsource to Mexico, Canada, or Central America, but they are likely to be less complex than those that attend outsourcing arrangements in, say, India or China. Nearshore outsourcing allows companies to test the BPO waters without the level of risk associated with going offshore. Firms that go with a nearshore strategy are often seeking cost savings, but they are also occasionally able to find best-in-class providers of the services they need.

For example, Mortgage Electronic Registration Systems, an organization created by the mortgage banking industry to develop systems for mortgage tracking, is moving its customer relationship management (CRM) function

from Michigan to Nova Scotia. The move is expected to save the group 15 percent annually on CRM costs.²⁴ The firm could have saved even more by outsourcing with firms in India, but it wanted to keep its CRM operations closer to home.

TO BPO OR NOT TO BPO? A STRATEGIC QUESTION

BPO has managers around the world asking what it can do *for* them and what it might do *to* them. They are excited about the potential for BPO to help them manage costs and improve their balance sheets. Under constant pressure from analysts to control headcount, outsourcing back-office activities to contract laborers in remote corners of the world can provide welcome and quick relief. Whether the labor source is in India, Pakistan, China, or some other international port, the prevalence of high-speed Internet provides opportunities for real-time back-office support regardless of location.

At the same time as these new possibilities are opening up as a result of the BPO revolution, new questions are being asked and new challenges in organizational design and leadership are arising. Many organizational leaders remain skeptical about BPO because of the lingering aftereffects of the tech bubble burst. Their memories are still fresh with images of the “change the world” mentality of the tech bubble and its dismayingly rapid crash. The very thought of investing in new business models right now—especially those with a technology or Internet component—is very difficult for many managers and executives.

Many leaders are also concerned about the risks of BPO. They are unsure about the information security issues associated with outsourcing back-office processes. For example, in order for a BPO vendor to assist a client in managing employee benefits, the vendor must have access to some of the most sensitive and mission-critical information the organization possesses. The thought of shipping this data overseas to be managed and used by individuals who are not bound by the organization’s formal and informal controls is enough to keep a manager awake at night.

BPO is based on the fundamental proposition that organizations should focus on what they do best and outsource everything else. If your company markets and sells sporting goods, it should spend substantially *all* of its time doing that and as little time as possible managing its accounting, customer service, and employee benefits plans. In theory, the concept makes a great deal of sense. In practice, it still seems to invite a new set of challenges that may cost more than the problems that are supposed to be solved.

It is critical to point out that BPO is not a technology or a technology system; it is a business strategy. In that regard, to BPO or not to BPO is a

EXECUTIVE VIEWPOINT SME's Board the BPO Express

Lalit Ahuja, CEO, Suntech Data Systems, Bangalore, India

From my perspective as a provider of BPO services to companies all over the world, the decision to use BPO is actually a decision to focus on core competence. There are only so many things that any company can do well. Whether their core focus is on price, cost, quality, or innovation, a firm can leverage BPO to dedicate resources more intensely on what it does best. Of course, initially firms chose BPO for cost savings. Today, they recognize that an outsourcing partner whose sole business is to service a specific business process can develop unique and highly competitive domain knowledge. Harnessing this knowledge has become an important source of competitive advantage for the BPO buyer.

Today, we are seeing a shift from primarily large companies using BPO to SME use of BPO as well. While the large firms develop exclusive relationships with providers, many SMEs use a shared-services model. This approach enables SMEs to realize many of the same BPO benefits as the larger organizations. BPO providers are meeting the marketing challenge by increasing their risk-management capabilities, and by placing agents in the buyers' markets using a dual-shore strategy. These agents not only educate and acquire SME customers, but they help them reengineer their business processes and manage the BPO transition.

question nearly anyone who manages a business process must now confront. As a strategic choice, the BPO option is a live one for anyone with a budget, limited resources, and decision rights over a business unit. In the Executive Viewpoint insert, Mr. Lalit Ahuja, CEO of outsourcing vendor Suntech Data Systems in Bangalore, India, notes the growing ranks of small- to medium-sized enterprises (SMEs) using BPO. For some managers, the decision may even involve the continued existence of their own departments and their jobs. No one is likely to decide to eliminate his or her own job, so managers must learn to understand how BPO may fit into their overall responsibilities and develop the skills to manage the BPO transition and maintain it once it is up and running.

Taking advantage of business process outsourcing will be a challenge for managers in all types of organizations and at all levels within those organizations. As we move into an age of greater accountability among organizational leaders, boards of directors, and others with fiduciary responsibility, it is imperative for those leaders to ask the question of whether the firm could

perform better by adopting new business models like BPO. Furthermore, as firms within an industry adopt BPO, others will be forced to consider it as the traditional cost structure of their industry comes under pressure.

The competitive and regulatory pressures that will compel managers to take a serious look at their BPO options are only beginning to be felt in some industries, but the revolution is upon us, and its will is relentless. Competitive forces that drive each industry to seek the most effective cost-control measures are as irresistible as a river of water seeking its level. No earthen structure has yet been proven to be able to hold off a persistent river, and no management or organizational structure will be able to hold off the BPO revolution. This means that adoption of BPO in whatever industry you are in is virtually inevitable. Managers must prepare for the changes that are coming by understanding the factors that go into making a sound BPO decision.

In addition to the basic choice of whether to use BPO, a host of technological, business process, and HR issues follow in the wake of an affirmative decision. The technological issues will range over the type of electronic infrastructure that will be required to communicate effectively with BPO partners to the integration of new technologies with legacy systems throughout the organization. These difficult issues require the skillful assembly and management of a team of diversely talented individuals. Because BPO is fundamentally a strategic issue, managers cannot simply call upon their firm's CIO or systems administrators to decide how to achieve an outsourcing relationship. The web of relationships that make up successful BPO initiatives will be based on a range of managerial actions and skills that is unlikely to be present in any single manager or executive.

SUMMARY

- Business process outsourcing (BPO) is simply the movement of business processes to the highest-skill/lowest-cost provider.
- There are talent hot spots around the world, including India, China, Mexico, the Philippines, and the United States.
- Gartner Group estimates that 85 percent of U.S. companies will outsource their HR functions and that BPO will reach \$178 billion in revenue by 2005.
- BPO is a socio-technical revolution in that it is both a social shifting of jobs and a technology-based method of doing so.
- BPO is an emergent phenomenon to the extent that it is a result of several driving factors, none of which was intended to create the potential for BPO.
- There are six primary driving factors of the BPO revolution: educational attainment, broadband, data storage, analytic software, Internet security, and business specialization.

- There are three types of BPO: offshore, onshore, and nearshore.
- To BPO or not to BPO is a strategic decision for organizations.
- A BPO initiative requires both technical and nontechnical managers in order to implement it properly.