research report

Outsourcing IT in the Financial Services: Nearshore or Offshore?

The NOA's Perspective

The results of this survey reflect the market trend that increasingly finance companies are outsourcing complex IT functions and many are looking at nearshore and offshore options to do that.

The outsourcing of complex IT functions in the finance sector is increasingly done for transformational purposes. The finance company does not want the supplier to conduct the process as it was conducted in-house. They want to harness the domain expertise of the suppliers to build systems and applications that supercede anything that they could build themselves in-house.

Whether finance companies opt to work with nearshore locations or offshore locations very much depends on their position and what characteristics they believe best suit their company. As the research shows, the finance companies that are looking for scalabilty may be better suited to offshore destinations where the working population is significantly larger than the domestic market. If finance companies count tighter management and agility as more important characteristics then a country that is geographically closer could be more beneficial.

Whether finance companies choose to work with nearshore or offshore countries in the outsourcing of complex financial IT, the NOA has always advocated that best practice underpins outsourcing success of any kind. Finance companies have to ensure they follow best practice methodology in all aspects of outsourcing, from the first review through to supplier selection and performance levels.

The NOA hopes that this research has provided you with some useful insight and thought provoking ideas into the issues around offshoring and nearshoring financial IT. If you would like to find out more about the NOA, please find our contact details on our web-site **www.noa.co.uk**.

Martyn Hart
Chairman
National Outsourcing Association

Luxoft/NOA
Research Report

Over the last ten years, IT offshoring and nearshoring has continued apace in the UK, with companies outsourcing different technology tasks: from application development and CRM solutions, to network management and ERP. In the formative years, India emerged as the dominant offshoring location for the UK, due to its language capabilities, graduate workforce and the wage differential between India and the UK. On the other hand, we are now witnessing how nearshoring has significantly grown in prominence with countries such as Russia, the Czech Republic, Poland and Hungary offering IT outsourcing services to the UK market.

There are undoubtedly advantages and disadvantages of offshore and nearshore models. The choice is generally based on such variables as type of outsourced work; project's complexity and size; and the working culture of the client organisation.

As a rule, commoditised functions with more generic and easily acquired and replaced skill sets could be more suited to offshoring, due to the large workforces and the resulting scalability. In contrast, more complex and business critical functions are more susceptible to security risks and will have significantly different cost and risk profiles to commoditised work. The projects of this kind will warrant tighter management control. In this scenario, a nearshore strategy could posibly prove more suitable, as it will enable access to the necessary skill sets, plus provide the mitigation of the risk and management issues due to geographic, cultural and regulatory proximity, as well as being cost effective.

Nearshoring and Offshoring – Complex IT Projects n the Financial Sector

In the UK, the financial industry is still head and shoulders above other markets as the primary outsourcing sector with the industry players being amongst the first to embrace offshoring and nearshoring strategies for IT outsourcing. As such, Luxoft, in conjunction with the National Outsourcing Association conducted a research survey of nearshoring and offshoring in the financial industry to identify trends and look at comparisons. The questionnaire was conducted as a focused online survey of 76 outsourcing decision makers in UK financial sector, with the objective to identify trends in financial ITO.

The survey found that in addition to outsourcing lower level IT functions, more and more of the financial services providers are engaged in outsourcing more complex IT projects considering offshoring and nearshoring as potential delivery models. Finance companies are starting to realise that by involving an external ITO vendor with domain and technology expertise they can increase value and ROI for IT within their organisations.

This was demonstrated by the following results:
• 100% of survey respondents said that they would much rather be challenged in business critical financial ITO projects than suppliers take the role of "yes men";
• Over half of those surveyed considered domain/technology expertise was considered crucial.

As the survey indicates, Sub Continental Asia, as an offshore destination, is still perceived as the easiest region to do business with, securing a score of 44.9%, – although nearshore destinations come a close second, garnering 40.8% of the votes. What really counts by IT decision makers as critical factors in supplier selection is the access to talent pool, the quality of staff and cultural compatibility.

As financial companies grapple with the nearshore and offshore question, they are urged to analyse their business and technology objectives fully. I strongly believe there is never a standard solution – each decision needs to take into account factors such as: the merits of different geographies, the assessment of whether variables such as cultural alignment and adjacent time zone are crucial or not; and the ability of the supplier to rise to the challenge of complex processes.

Dmitry Loschinin
President and CEO
Luxoft

Outsourcing Complex IT in the Financial Services: Nearshore or Offshore?

Introduction

In October 2006, the National Outsourcing Association (NOA) and Luxoft, Russia's leading provider of end-to-end information technology services and solutions, embarked upon a research project to investigate the trends and geographies for complex IT outsourcing in the finance industry.

The aim of the survey was to identify the various requirements that UK financial companies have in terms of outsourcing complex IT projects. What are the headaches that keep IT and outsourcing executives in financial companies awake when using nearshore or offshore partners to conduct critical processes? What destinations do they prefer to do business with and why? What are the all important factors when nearshoring or offshoring complex IT projects?

Respondents

Seventy six responses were received from outsourcing decision makers within financial organisations throughout the UK, with the bulk of outsourcing activities in applications development.
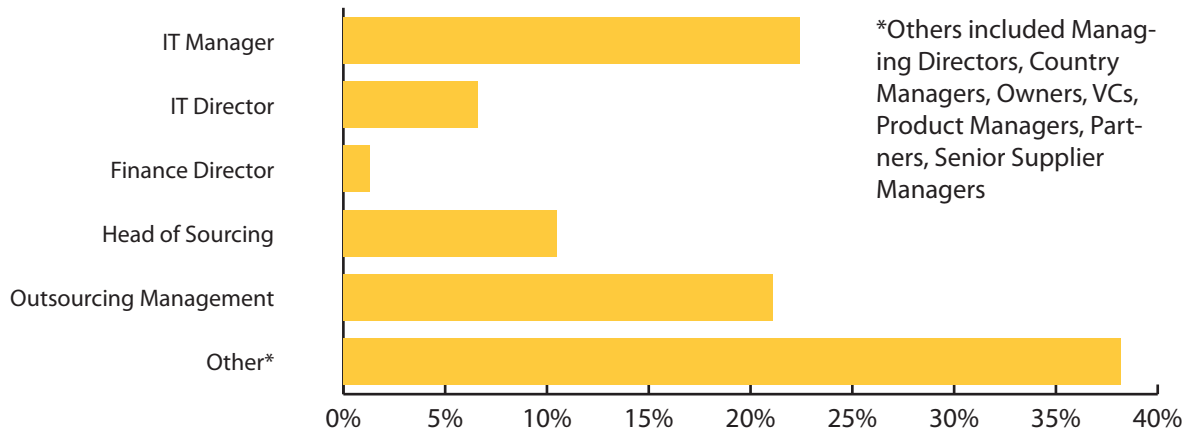
Methodology

The survey took the form of a short web-based questionnaire, consisting of 13 questions of multiple choice or rating scales format. The survey questionnaire was developed by Luxoft in conjunction with the NOA and was aimed at financial end user companies in the UK.

The questionnaire surveyed financial end user members of the National Outsourcing Association and financial organisations, readers of Financial Sector Technology magazine. The survey was available for a limited timeframe –- for just two weeks from 27 September to 12 October 2006. Participation was by email and telephone invitation. Additionally, the research was advertised on the NOA website, so anyone interested in participating could join.
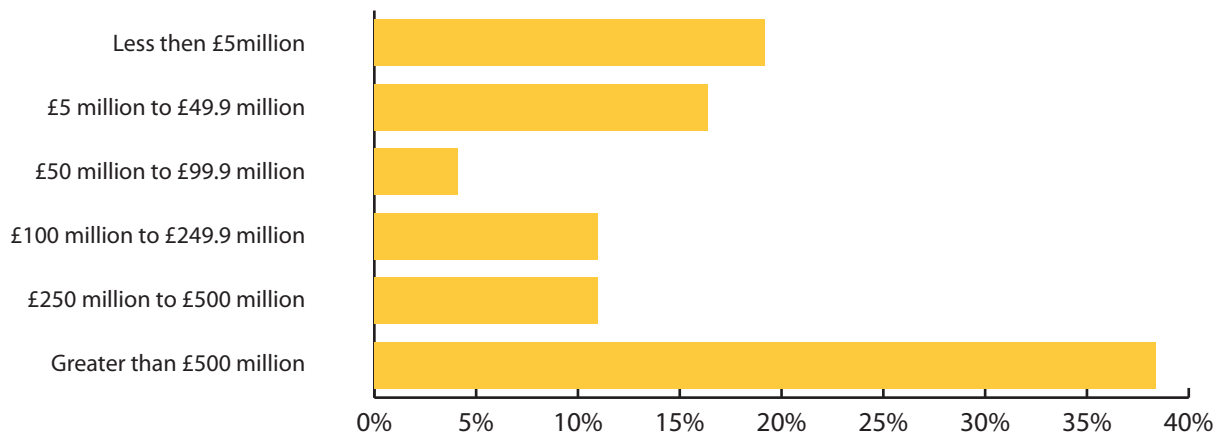
Demographic Breakdown of Respondents

A demographic breakdown of the survey respondents is the following:
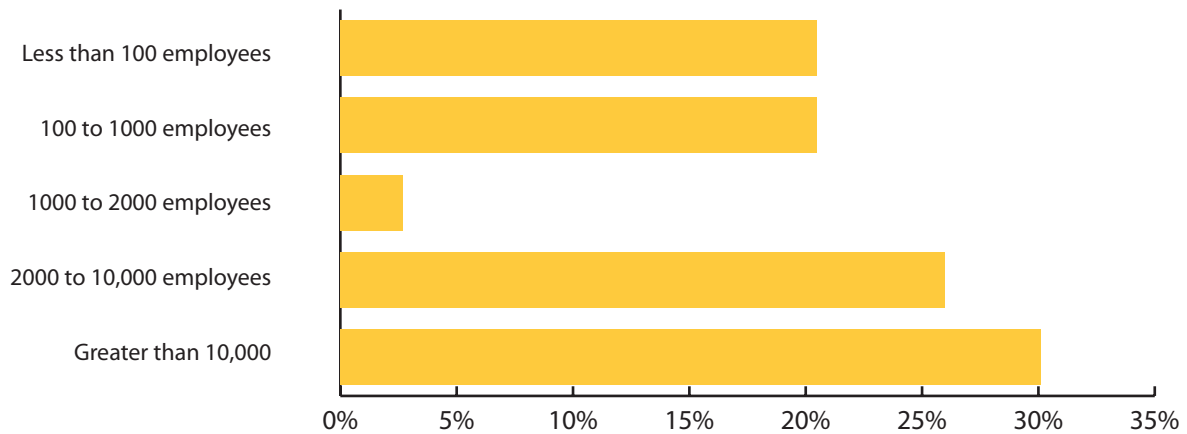
Occupation Type

*Others included Managing Directors, Country Managers, Owners, VCs, Product Managers, Partners, Senior Supplier Managers

Turnover of the Company

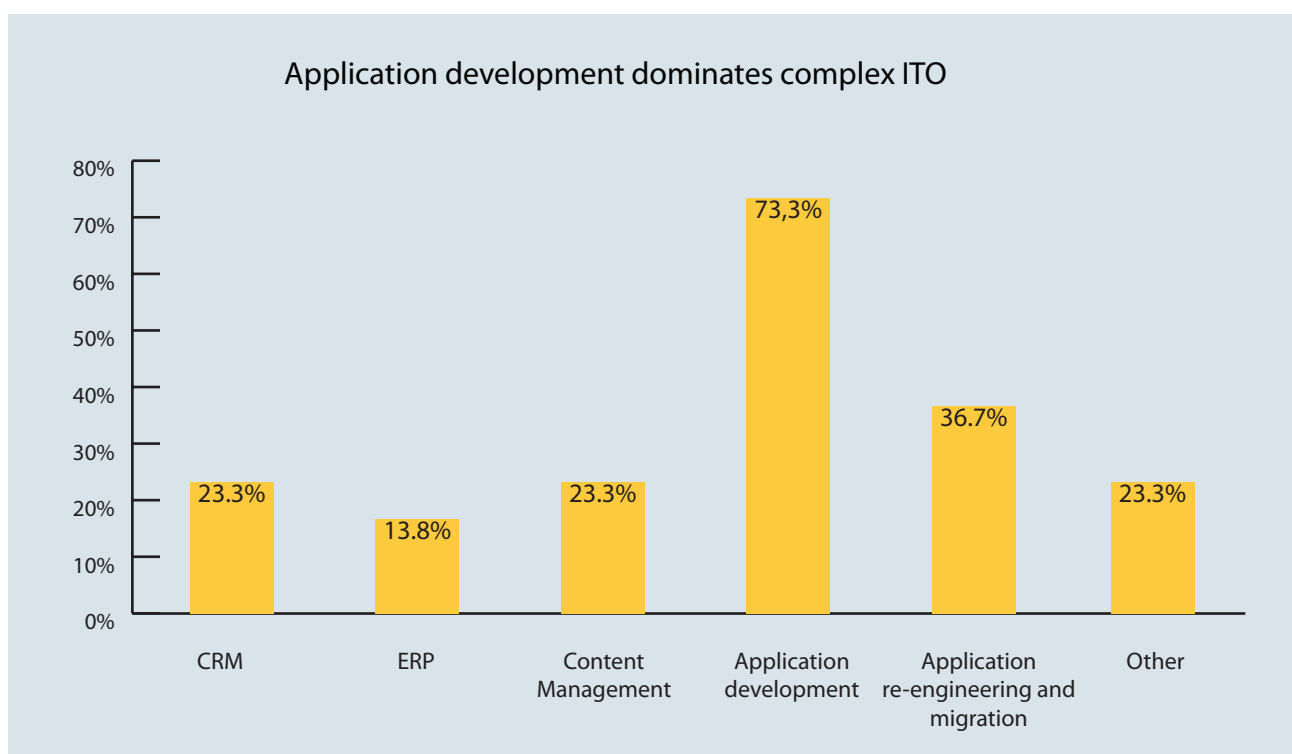## Number of Employees with the Organisation

Outsourcing Complex IT in the Financial Services: Nearshore or Offshore?

Outsourcing Complex IT in Financial Services
Application Development dominates

Over half of respondents currently outsource complex IT projects, with 56% of financial companies saying that they currently engage in complex ITO.

Of these, 73.3% of respondents state that their organisations outsource application development. This supports the fact that many financial companies, attracted by cost reduction, access to additional skills, improved quality and decreased time to market, outsource their application development.

Application development dominates complex ITO

Category	Percentage
CRM	23.3%
ERP	13.8%
Content Management	23.3%
Application development	73,3%
Application re-engineering and migration	36.7%
Other	23.3%

The second most popular complex IT process to outsource was application re-engineering and migration – 36.7% of companies state that they currently do it.

CRM and Enterprise Content Management (ECM) share the third and fourth places with 23.3% of respondents saying they currently outsource these functions. This could be due to the reason that CRM is still considered to be the knife edge of critical business applications – ultimately the customer is at stake. According to Meta Group, over 95% of Global 2000 organisations deploy some type of XML-based content management infrastructure across the Internet, intranets and extranets. This could signify that although many companies are outsourcing elements of ECM, they are still reticent about outsourcing more business critical components.

The outsourcing of ERP (enterprise resource planning) was in last place with 13.8% of respondents currently out-sourcing the function.

Other ITO projects that were mentioned that respondents engaged in included network outsourcing, IT support and software maintenance.
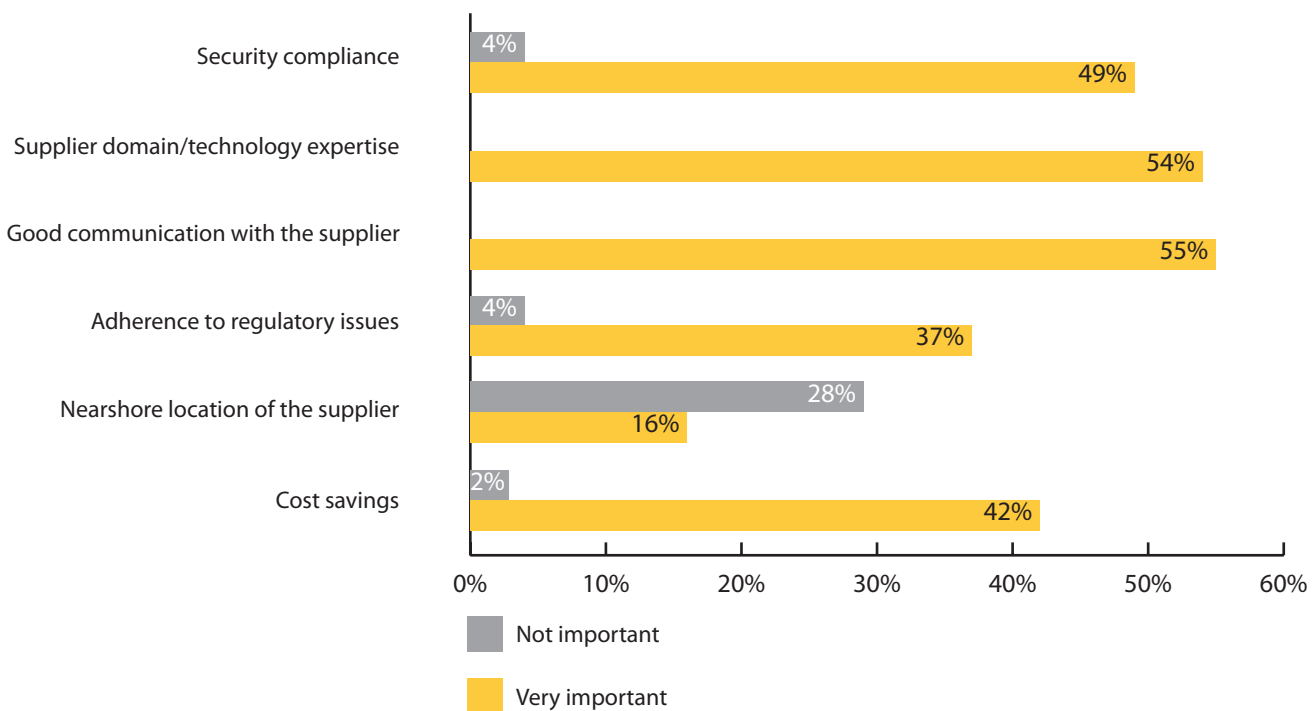
Supplier Selection Factors in Financial Companies' Decisions to Outsource Complex IT

Good Communication Trounces Cost in Supplier Selection for Complex IT Outsourcing

Top Four Factors in Supplier Selection:
- 55% of respondents considered airtight and fluid communication with the supplier crucial in their supplier selection for complex ITO projects.
- Domain/technology expertise was considered critical by 54% of respondents classifying it as "very important".
- Security compliance came in third place, with 49% of respondents counting it as a "very important" factor in their supplier selection.
- Cost savings came back in 4th place with 42% of respondents deeming it as "very important".

Supplier Selection Factors

Surprisingly, adherence to regulatory issues was not amongst the four most essential supplier selection factors. 37% of respondents regarded it as "very important". It is likely that adherence to regulatory issues will increase in importance in the coming years as banks and other financial organisations come under increasing scrutiny with regards to compliance.
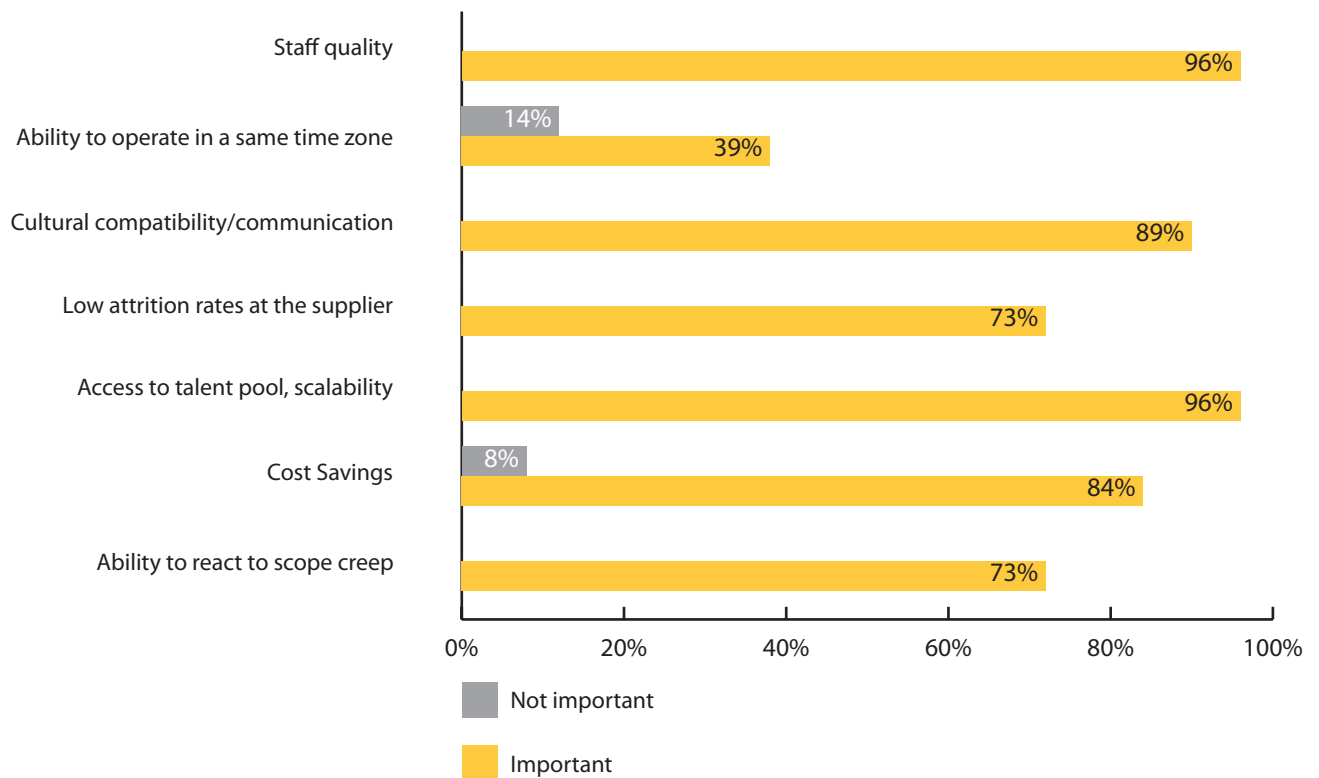
We would like to point out that respondents had four criteria to choose from when judging the importance of supplier selection factors. This is the reason behind the fact that for some supplier selection factors, no respondents selected "not important."

Access to talent pool/ scalability and quality of staff are the most attractive features of suppliers

96% of survey respondents considered quality of staff, the access to talent pool and the supplier's ability to scale up and down the outsourcing operation as "important" or "very important" when assessing suppliers for their ability to deliver complex IT outsourcing.

This demonstrates that finance companies are much more interested in the opportunities that offshoring and nearshoring can bring from a skills perspective, thereby being able to significantly improve the quality of complex ITO projects.

Important qualities of selected suppliers

Cultural compatibility came third, with a combined score of 89% for respondents considering it as either "important" or "very important". Cultural compatibility is considered essential for ease of relations between financial companies and their suppliers, particularly when outsourcing complex IT, as teams have to work in very close conjunction with each other.

Cost savings accrued a combined percentage of 84% for respondents rating it as either an "important" or "very important" factor. This indicates that although cost is still important when conducting due diligence on suppliers, cost savings are not as important as the quality of service that financial companies get from their outsourcing provider. Although the fact that suppliers' inability to react to changing requirements is often cited as the primary bug bear in outsourcing, a supplier's ability to react to scope creep achieved a combined score of 73% when rated as "important" or "very important". Low supplier attrition rates also scored a combined total of 73% when rated as "important" or "very important".

For some qualities of selected suppliers no respondents selected "not important" as indicated by the graph.
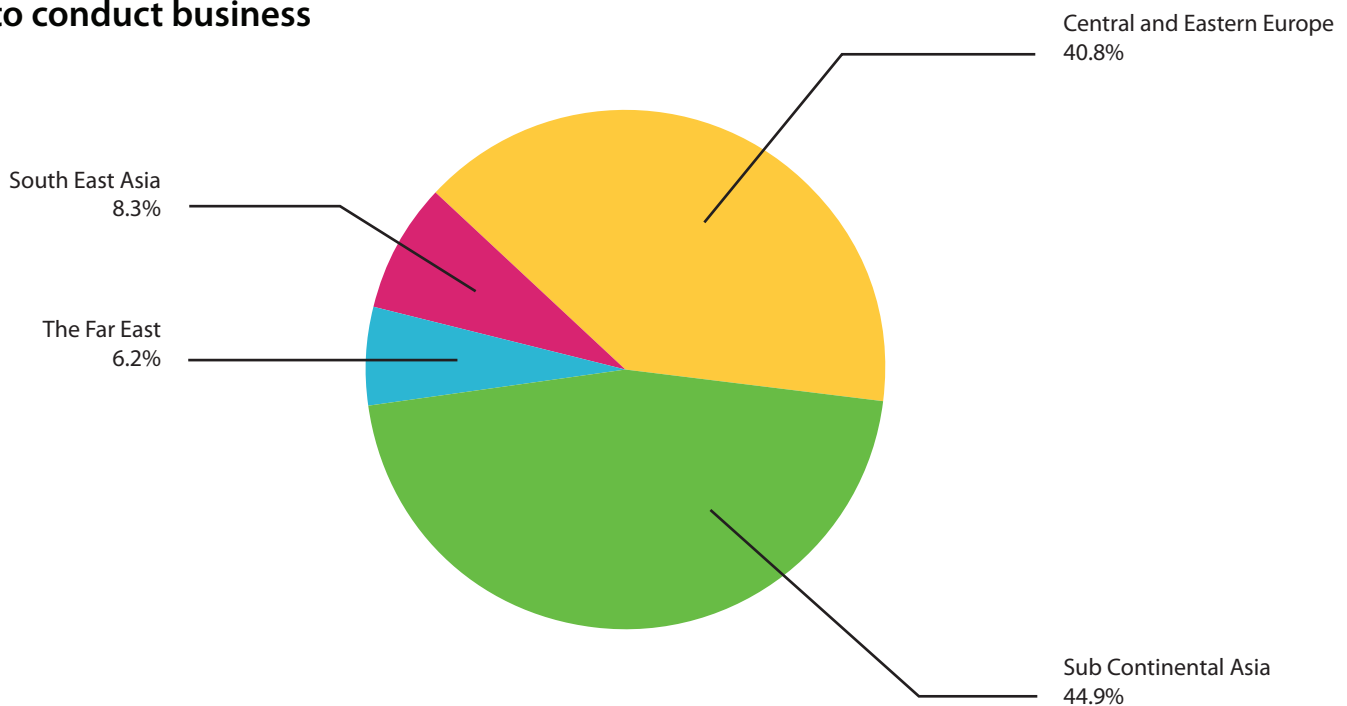
Nearshore and Offshore IT Outsourcing Destinations: Perceptions and Evaluation Criteria

Sub continental Asia still perceived as the easiest region to do business with – although nearshore destinations come a close second…

With regards to nearshoring and offshoring IT projects, Sub Continental Asia (e.g. India and Sri Lanka) is still seen as the region that it is easiest to do business with, securing a score of 44.9%. However, nearshore in the form of Central and Eastern Europe destinations, such as Poland, Russia, the Czech Republic and the Ukraine, came a very close second, garnering 40.8% of the votes.

As India is a much more mature market in terms of global outsourcing, it would stand to reason that India has higher awareness as a nation to engage in IT Outsourcing. On the other hand, as nearshoring grows in prominence, particularly for outsourcing complex IT projects, perceptions are likely to shift.

Geographic locations in terms of easiness to conduct business

Central and Eastern Europe
40.8%

South East Asia
8.3%

The Far East
6.2%

Sub Continental Asia
44.9%

The Far East was the region considered the region least easy to engage in business with, with only 6.2% of respondents selecting this region as the most preferable. South East Asia, including regions such as Malaysia and the Philippines secured votes from 8.3% of respondents.

The reasons for the region selection vary. A summary of the reasons is as follows:
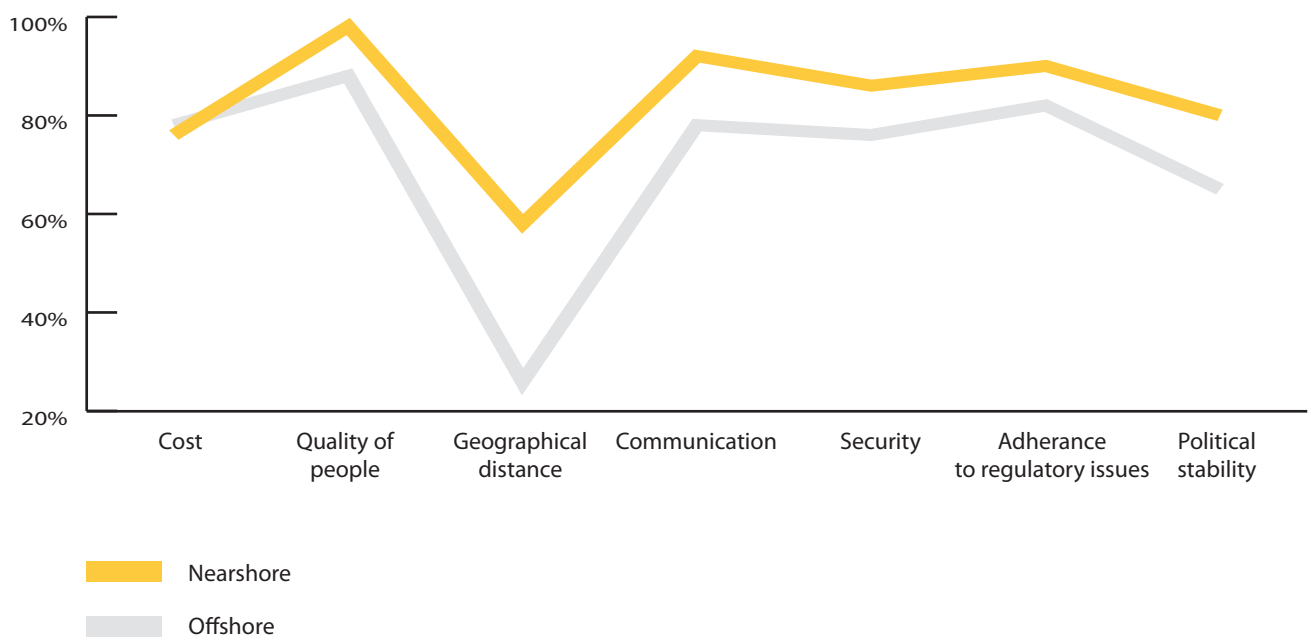
• Sub Continental Asia: Cost savings/ low cost labour; access to talent pool; cultural compatibility.
• Central and Eastern Europe: Talent pool; geographical proximity; and cost savings/low cost labour.
• South East Asia: Cost savings/ low cost labour pool and access to talent pool.
• Far East Asia: Cost savings/ low cost labour pool and access to talent pool.

Nearshore Vs Offshore – the comparison of important characteristics

When it comes to outsourcing to a different geographical location, many financial companies face the issue of whether they should use an offshore or a nearshore location and find it difficult to assess between the two. When faced with assessing how offshore and nearshore destinations compare on various factors, offshore destinations were still considered for their cost effectiveness, marginally more so than nearshore destinations. The majority of respondents thought that cost was a "very important" factor when offshoring with 43% (35% considered cost in offshoring an important factor). The significance of cost was considered less important in nearshore arrangements, with the majority (42%) rating cost as "important" and 34% rating it as "very important". This would fit with the idea that financial companies are potentially more interested in offshore destinations for commoditised services, as cost savings on less business critical applications and processes are easier to garner.

The quality of people was considered more crucial in nearshore operations than it is in offshoring. The majority (54%) believed that quality of people should be front of mind when nearshoring, rating it as "very important" and 44% rating it as "important". Quality of people was considered slightly less relevant in offshoring, with the majority of respondents considering it as "important" in offshoring (52%) and 36% considering quality of people as "very important". This could also be aligned to the fact that nearshore destinations are primarily used for complex IT projects.

Comparisons of nearshore and offshore locations

Legend:
- Nearshore
- Offshore

Communication is important for both nearshore and offshore IT outsourcing. However, the communications factor is more important for nearshore engagements, with 46% rating it as "very important". For an offshore delivery model, communication was given a majority 3 rating of importance on the 1 – 4 scale. 48% considered it "important" as opposed to "very important".

This supports the fact that if financial companies are more likely to use nearshore environments for complex IT projects, airtight and trouble free communications will be more vital.

When taking the issue of security into account and how the importance of security fares in nearshore and offshore environments, respondents considered it as very important in both nearshoring and offshoring. 86% rated security as either "important" or "very important" in nearshoring and 76% in offshoring.

Regulation is another increasingly important issue for the UK financial industry. From compliance policies set by the FSA, to the newly emerging MiFID (Marketing in Financial Instruments Directive), financial companies are increasingly having to bow to regulatory pressure. So how did respondents compare regulatory adherence between nearshore and offshore? 90% of respondents rated it as "important" or "very important" in nearshore, whereas 82% in offshore – the majority regarded gave it a rating of 3.

Nearshore vs Offshore – other facts

When considering whether financial companies would rather conduct business with a nearshore IT vendor with focused technology/ domain expertise (a so-called "pureplay" company) or a nearshore operation of a global vendor, 79.2% selected a "pureplay" IT vendor with domain/technology expertise. This statistic is interesting in light of the proliferation of "multisourcing" with traditionally offshore vendors setting up nearshore operations in addition to offshore development centres.

Respondents were also surveyed on whether they would rather be challenged on a complex project and be made to think about the potential risks and issues or select a supplier who would simply take the project on and do as they were told - 100% of respondents selected to be challenged on the project. This issue often crops up when using suppliers who are based offshore – financial companies state that all too often, they fail to be adequately challenged in ITO projects. This can be a seriously flawed approach when dealing with complex ITO projects that by their nature should be transformational.

Conclusion

As financial companies assess complex IT outsourcing and decide on whether they choose a nearshore or offshore destination, they need to develop a long term perspective that enables them to evaluate benefits beyond cost saving. There is little doubt that both nearshore and offshore environments have their advantages and disadvantages – outsourcing to any of those two geographies can be benefitial. It is important that financial organisations thoroughly assess all options and analyse how different factors will not only bring benefits in the short term, but how those same factors could change over time.

Take the macroeconomic trends around offshoring and nearshoring. India, as the most mature of offshoring destinations, has experienced a huge upsurge in business over the last ten years due to its English language capabilities and low cost of labour, relative to countries in the west. Compared to the declining populations in Europe in particular, India's supply of human capital is vast. What financial organisations need to bear in mind, however, is that the true size of the employable workforce in ITO is a mere fraction of the total workforce, as India's educational infrastructure is unable to support the whole population. This means that demands upon this finite ITO skills pool are high due to the level of competition in the market – this had led to sharply increasing wage inflation and has also boosted attrition rates. India's attrition rates are amongst the highest in the global outsourcing industry, between 15 and 20% (source: The Economic Times India). If this pattern continues, the cost savings that offshoring can bring will be seriously impaired.

The companies should look beyond cost savings when outsourcing IT and take other factors into account, such as management time, wage inflation, attrition rates etc. When all the factors are considered, savings in offshore would stand around the 30%, as opposed to the 70 – 80% that is often believed. When these costs are considered, the savings profile for nearshore outsourcing can significantly change. Where nearshoring is concerned, benefits such as geographical proximity which can ease the strain of management (particularly in business critical projects), cultural similarities and lower attrition rates can add to the savings proposition.

It is essential that financial organisations thoroughly assess the IT process they wish to outsource before they decide which country to send the process to. Different projects will suit the characteristics of different countries, whether they be nearshore or offshore. Sound requirements definition and planning and thorough analysis of the supplier and geographical location will be essential in the success of both offshoring and nearshoring.

National Outsourcing Association (NOA)

The NOA is an independent body whose objective is to ensure effective business management through the promotion of best practice, service and innovation in the application and development of outsourcing. The NOA's role is to lobby UK government, OFCOM and the European Union on matters affecting the collective interests of its members and to deliver information on market developments and lessons learned from business outsourcing.

Members fall into three main categories:
• Users - UK and overseas companies, which have outsourced (or are about to outsource) significant business infrastructure, such as: IT; telecoms; and processes
• Suppliers – companies which fulfil outsourcing contracts
• Support services - legal, recruitment and consultancy service companies which support the industry

The NOA communicates the significant benefits and strategic lessons of outsourcing to a wider audience, through conferences, seminars and publications.

For more information on the NOA please go to: **www.noa.co.uk**

Luxoft

Luxoft, founded in 2000, is a global software developer and IT services exporter with operations in the US, UK, Ukraine and Russia. Luxoft has the world's largest delivery capabilities in Russia and CIS.

Luxoft provides a full range of custom software development services and enjoys long-term relationships with clients including some of the best-known global business leaders, such as Boeing, Deutsche Bank, IBM and Dell. Luxoft also works closely with many mid-size growth companies and independent software vendors (ISVs).

Luxoft's software development processes meet the highest quality standards, and the company was the first in Europe to achieve Level 5 CMMI quality certification. Luxoft runs research and offshore development centers in Moscow, St. Petersburg, Dubna, Omsk plus centers in Kiev and Odessa, Ukraine.

Nearshore capacity enables Luxoft European clients to gain the most from cultural proximity, communication processes and price. Combined with top technology talent, it results in higher productivity and ultimately superior ROI for high-end IT projects.

Luxoft has won the National Outsourcing Association's "Financial Outsourcing Project of the Year 2006" for its work with Deutsche Bank. The company has recently been recognised by BusinessWeek as the top emerging outsourcing provider in Russia and Eastern Europe, was ranked as the top IT services company on the Rising Star list in the IAOP's Global Outsourcing 100 and was featured in Global Services Magazine's Global Services 100 which recognises the world's most innovative business and technology service providers.

For more information visit **www.luxoft.com**

LUXOFT

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The Nearshore Advantage

"For large firms, like Deutsche Bank, the key is, to use a British expression, 'horses for courses.' It's important to think about what the business is trying to achieve…The Russians are definitely a powerful part of our strategy".
Daniel Marovitz, Deutsche Bank

o Adjacent time zone to the UK

o Cultural, regulatory and geographic proximity to the UK

o Russia's best technical talent

o 7% employee attrition rate

o State-of-the art infrastructure

o Data & physical security backed by SLA's

o Individual approach and flexibility

Benefits beyond price

With its close cultural alignment and geographic proximity, Luxoft, with its six development centres and 1600 skilled IT professionals, offers the best in managed delivery and value added services for high-end IT projects.

To find out more about what Luxoft can offer your business contact our top executive:

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