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SECTOR REVIEW

06 October 2004
Asia Pacific/Australia
Regional Banks
Financials
MARKET WEIGHT

Bank Offshoring Part II

The banks respond...

- **CSFB's bank offshoring survey assesses a sensitive yet important issue for each of the larger banks.**
- **Australian banks now appear to be selectively and quietly responding to the global bank offshoring phenomenon.**
- **We assess that SGB is the most highly evolved in its *thinking* in relation to offshoring, but that CBA has perhaps more positively reassessed this issue in recent times. Interestingly, NAB, under its new leadership team, may also be more inclined to assess its offshoring potential. Conversely, ANZ's current leadership position could be at risk of being eroded over time.**

CSFB's bank offshoring survey: Following the publication of our original report *Bank Offshoring: who will lead the next secular profit driver?* 21 June 2004, CSFB undertook a survey to assess for each of the larger banks the maturity and evolution in their approach to offshoring as well as their apparent commitment to pursuing offshoring strategies overall.

Offshoring is a sensitive issue, being quietly pursued by a select few: Responses to our detailed survey suggested to us the highly sensitive nature of offshoring within the industry, and the acute awareness of each bank (particularly the major banks) of the perceived political and brand risks seen associated with pursuing offshoring initiatives (note the response to Qantas' recent offshoring of its steward service function). We see at least reasonable prospects for initial / increased offshoring initiatives being undertaken at some stage by *St George Bank* (which appears to us to be clearly enthusiastic and focused regarding offshoring as a relevant theme) and *ANZ Banking Group* (incremental scaling up of current IT initiatives). We see some potential for offshoring to be pursued by *Commonwealth Bank* (note the recent appointment of a former offshoring and outsourcing management consultant to establish its Indian branch). However, we see little or no prospect for offshoring initiatives being pursued by *Westpac Banking Corporation* (perceived political and brand risks) and *National Australia Bank* (however, NAB 's ultimate offshoring initiative could be subject to recent management changes). Our report reviews the NAB / WBC / CBA "Vipro" back office utility consortium as a potential alternative to offshoring.

Ongoing global groundswell towards the bank offshoring phenomenon: A recent Deloitte & Touche survey stated that the top 100 global financial services companies reported that the majority of firms expect on average 20% of the industry's cost base to move offshore by 2010.

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Revisiting bank offshoring

In our original report *Bank Offshoring: Who will lead the next secular profit driver?* dated 21 June 2004, we made the following arguments:

- Offshoring has the potential to be an important strategic lever / driver of shareholder value creation over the next few years, with offshoring no longer restricted to traditional transaction processing operations (now encompassing group-wide activities). Offshoring could potentially be particularly relevant as a technique for banks to either directly or indirectly achieve further M&A-like productivity gains in retail banking (previously considered unachievable) in the face of current Federal Government and Australian Competition and Consumer Commission (ACCC) constraints on consolidation amongst the five larger banks.
- We consider the emergence of a credible, third-party vendor market and specialist service providers (across several major domains) has significantly reduced this scale and size barrier for smaller organisations / organisations with no emerging markets exposures to pursue offshoring strategies (e.g. Greenpoint Financial in the USA).
- We estimate potentially 30% to 40% of a typical banking and financial services company's total cost base is amenable to offshoring (given the current state of the global offshoring industry) with a 30%-50% reduction costs possible within this portion of the cost base:

Figure 1: **Potential value creation from outsourced process groups**

Cost savings category	Amount
Net factor cost savings (i.e. net of transition and telecom costs)	15% - 25%
Ongoing process consolidation and platform rationalisation	5% - 10%
Six Sigma metrics driven productivity improvements	10% - 15%
Operational risk capital efficiency	Not quantifiable, but an emerging factor
Total estimated value creation per outsourced process group	30% - 50%

Note: Assumes a 21 to 33-month implementation period
Source: CSFB estimates

- In terms of structuring an appropriate offshoring model for Australian banks and financial services companies, we believe that a combination of a 'captive' with a multi-vendor / multi-location strategy arguably provides maximum long-term flexibility for evolving the offshoring strategy. Re-negotiating and re-structuring current outsourcing structures and constantly locating newer vendors and/or newer locations should be seen as important a success factor in any offshoring strategy as being able to execute and monitor the original transaction.
- Implementation of a successful offshoring strategy requires a mindset and cultural change, shifting from a routine 'grind-out-the-costs' operations management mindset to a group-wide strategic-sourcing mindset, perhaps necessitating the creation of a separate, cross-functional Global Strategic Sourcing division, reporting directly to the CEO. Ideally a large-scale offshoring strategy should also be a Principal Board and CEO-supervised effort.
- An estimated impact of potentially successfully executed offshoring strategies for each of the five major banks is as follows:

Figure 2: **Potential financial and valuation impact of offshoring**

(A$m)	ANZ	CBA	NAB	WBC	SGB
Cash Operating Costs FY06F	4,197	5,770	6,353	4,191	1,358
Offshorable Operating Cost Base (35% of total)	1,469	2,020	2,224	1,467	475
Estimated Upfront Net Factor Cost Saving @ 20%	294	404	445	293	95
Estimated Consolidation / Six Sigma Improvements @ 20%	294	404	445	293	95
Estimated Total Pre-tax Impact	588	808	889	587	190
Cash Cost-to-Income Ratio FY06F	**41.2%**	**51.2%**	**51.6%**	**46.4%**	**44.7%**
Pro-forma Cash Cost-to-Income Ratio FY06F	**35.5%**	**43.3%**	**44.4%**	**39.9%**	**38.5%**
Estimated Post-tax Impact (30% tax rate)	411	566	622	411	133
2006E Cash PE ratio	10.2x	10.8x	11.3x	11.2x	11.5x
Estimated Valuation Impact	4,192	6,113	7,029	4,603	1,530
Current Share Price	$19.25	$30.71	$27.15	$17.82	$22.37
Estimated Upside Potential Per Share	**$2.30**	**$4.84**	**$4.53**	**$2.59**	**$2.98**
…% Current Share Price	**12%**	**16%**	**17%**	**15%**	**13%**

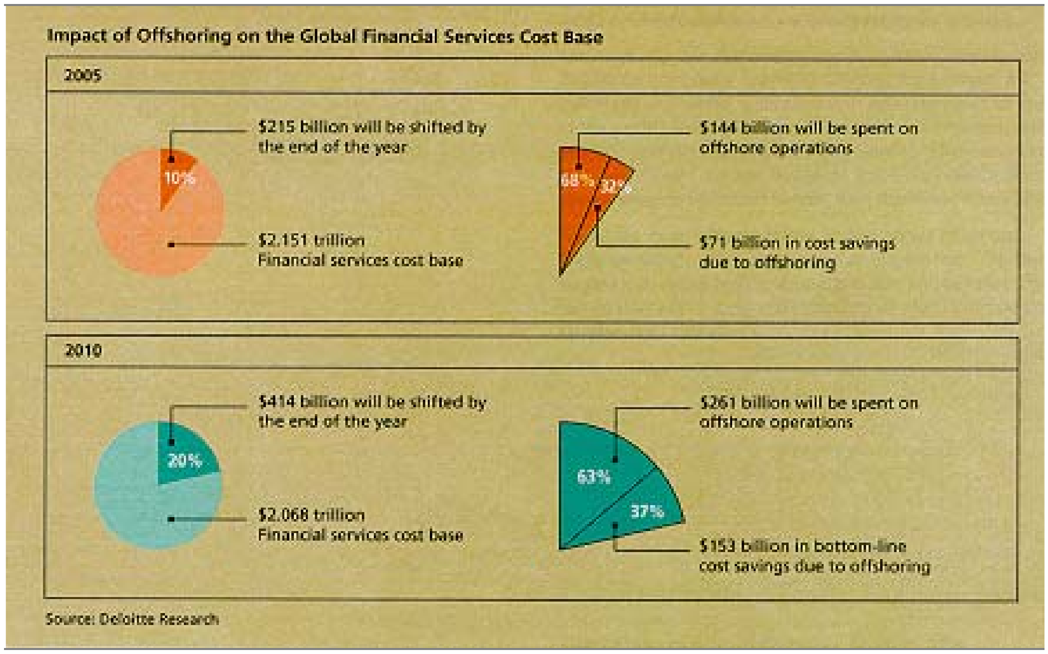
Note: Estimated upside potential per share based on estimated valuation impact (FY06E Cash PE x estimated post-tax impact) / current shares on issue. NAB relates to banking operations only. Table assumes: 1) Non-direct customer interacting domains outsourced first (i.e. group technology, group finance and accounting, group HR, mortgage and personal loans document mgmt, funds management new business and administration). 2) Transition time of nine months, as we assume primarily a "third-party service provider" strategy. 3) Upfront net factor cost price savings (including transitioning costs) of about 30%. 4) Ongoing quality improvement and "process championing" cost savings of about 25%, spread over a further 12 months.
Source: ASX, Company data, CSFB estimates

Deloitte's second annual global offshore survey

In June 2004, Deloitte Research published aspects of its Second Annual Global Offshore Survey in a report titled *The titans take hold: how offshoring has changed the competitive dynamic for global financial services institutions.* This report incorporated responses from 43 financial institutions based in seven countries and included 13 of the top 25 institutions in the world by market capitalisation. Key conclusions from the report were as follows:

- *As many as 80% of the world's largest financial institutions (i.e. those with market capitalisation exceeding US$10bn) are already working offshore.* Last year saw a 38% increase in the number of financial institutions with offshore operations, along with an estimated 500% increase in offshore jobs.
- *The majority of firms expect on average 20% of the industry's cost base to move offshore by 2010*. In time, the 100 largest financial institutions in the world will have moved nearly US$400bn of their cost base offshore, reducing costs by 37% for each process relocated and saving each firm on average a little below US$1.5bn annually. By the end of 2005, an estimated US$210bn of the cost base will be offshored with average cost savings to be over US$700m for the largest 100. Firms with offshore operations are also finding they can afford to hire workers that are more highly skilled than their domestic counterparts – and still save money – delivering an appealing combination of higher quality and lower cost.

Figure 3: **The impact of offshoring on the global financial services cost base**



Source: Deloitte Research

- *A financial institution's first attempt at offshoring generally requires four to five months of planning, followed by a three to six-month deployment*. Average payback time is one to two years – a figure that is expected to shrink even further as firms build offshore experience and capabilities.
- *The captive model has recently pulled into a virtual "tie" with the outsourcing model approach to offshoring*, with more and more companies electing to retain control and ownership through a wholly owned offshore subsidiary.

CSFB's bank offshoring survey

Following the publication of our original report, CSFB conducted a survey of the five larger capitalisation banks to assess the philosophy, commitment and level of preparedness of each individual bank in relation to the issue of bank offshoring. The survey was sent to ANZ Banking Group, Commonwealth Bank, National Australia Bank, Westpac Banking Corporation and St George Bank.

Our survey asked the following questions:

1. *Over the preceding six-month period, how frequently did your Executive Committee meet to discuss your company's offshoring strategy?*
2. *And roughly what proportion of time was devoted to this issue at monthly Executive Committee meetings?*
3. *Over that period, has there been a separate agenda item for discussion by Board members?*
4. *Does your organisation have a separately designated team dealing with offshoring strategy and initiatives?*
5. *If so, who is leading this initiative (e.g. typical designations might be GM Strategic Sourcing, etc)?*
6. *Further, if yes, has this separately charged team produced a forward looking strategy document detailing the scope and does the scope cover both transaction-driven operations processing and head office functions (e.g. Group Finance & Accounting, Group Treasury, Group HR, etc) or just some of these?*
7. *If no, how are group-wide offshoring opportunities identified, reviewed, assessed and implemented within your organisation?*
8. *Further, how is your organisation's offshoring strategy aligned with your overall group strategy?*
9. *Looking forward, over the next three-year period, what percentage of your organisation's current cost base do you believe is outsourceable?*
10. *And what proportion of this outsourceable cost base do you believe is offshoreable?*
11. *Could you please list the five top key activity domains that you deem as outsourceable in that timeframe?*
12. *And what percentage of your current cost base is covered by these activity domains?*
13. *Typically, in terms of these activity domains deemed outsourceable, what proportion of the cost savings do you expect to achieve from Upfront Factor Cost savings and what proportion from consolidation and ongoing Six Sigma and other process improvement techniques (please list the percentages for the two categories separately)?*
14. *What are the top five risk categories impacting such an outsourcing strategy?*

15. *Over the next five-year period, what do you see as the impact of analytics outsourcing (i.e. outsourcing of analytics functions such as data mining, data warehousing and customer analysis, portfolio credit risk management and VAR analysis, management accounting and budgeting and due diligence support, etc) on your organisation?*

16. *Any other comments?*

Figure 4: Findings from CSFB's Bank Offshoring Survey

ANZ Banking Group	Commonwealth Bank	National Australia Bank	Westpac Banking Corporation	St George Bank
How Advanced is the Offshoring Strategic Approach?				
ANZ seems to regard offshoring as an integral part of its operations, but to be expanded incrementally and with no step-changes in the scale of offshoring contemplated at the current time. It therefore appears that ANZ is pursuing offshoring opportunities with a gradual and measured approach	CBA appears to have considered offshoring strategies amongst the productivity initiatives considered when the "Which New Bank" restructuring program was being formulated, but apparently decided not to proceed with offshoring as part of that review. However, we understand that the EDS Australia IT outsourcing contract implicitly captures any offshoring benefits accruing to its vendor given the lower of unit cost or benchmark unit price used by CBA in setting contract prices. To the extent that offshoring equates to measurable global best practice costs (that are in fact being captured by EDS Australia), then the benefits should accrue to CBA through the outsourcing contract price setting mechanism	NAB has apparently undertaken numerous internal debates in relation to offshoring and outsourcing over the past few years, but does not currently have a separately designated team dealing with offshoring strategies and initiatives (but does have a strategic sourcing unit, which NAB believes has the requisite skills to evaluate outsourcing options). Examples of outsourcing that have been undertaken by NAB previously include facilities management, desktop and telephone management, credit card process (the processing code and development occurred in the USA) and merchant acquiring in the UK. NAB's list of top five risk categories impacting outsourcing are Country risk, Entity risk (probability of the outsourcer remaining viable), Relationship risk, Transaction risk and Non-delivery risk	Whilst we understand that WBC has a dedicated outsourcing team, WBC appears to us to be reluctant to pursue offshoring initiatives, particularly given the political sensitivities involved. Nevertheless, we understand that WBC has at times sourced skills from outside of the domestic markets where the necessary skills (and / or quantum of those skills) have not been readily available in Australia / New Zealand (e.g. CRM applications). WBC's IT outsourcing contract with IBM specifically incorporates the sharing of gains arising from technological innovation, etc.	SGB recognises the need to continually review current business models and align with industry best practice, and to that extent has outsourced a number of activities and offshored some functions. SGB's list of top five activity domains deemed outsourceable are as follows: Product application processing; Product servicing; Group administration processing; Data analytics and reporting; and Contact centres. SGB believes that c20% upfront factor cost savings and c20% consolidation savings are achievable (although this is dependent upon process / activity outsourced and the offshoring model adopted) SGB's list of top five risk categories impacting outsourcing are: Brand and reputation, Service delivery risk and business continuity, Regulation and privacy, and Service provider management
What is the Apparent Management Commitment to Offshoring?				
ANZ Banking Group	**Commonwealth Bank**	**National Australia Bank**	**Westpac Banking Corporation**	**St George Bank**
ANZ appears to us to be consistent but tentative in its commitment to offshoring, working from the platform inherited from its former Grindlays subsidiary	CBA appeared to us to be relatively uncommitted until its announcement of Ravi Kushan (ex AT Kearney outsourcing expert) as head of its newly established Indian branch. Whilst ostensibly a trade and business finance initiative, we believe there could be an offshoring dimension to this announcement in the future	NAB's commitment appears tentative, with most offshored functions to date merely offshored internally back to the NAB Group in other regions. Recent management change, however, could potentially drive an unexpected greater commitment to offshoring in the future	WBC is not opposed to the offshoring concept and keeps abreast of developments in the field. Our sense is that the political and brand risks WBC sees associated with offshoring inhibit any real commitment to offshoring near term	SGB appears to be actively reviewing the scope for implementing offshoring strategies in the context of the Group business strategy. We believe SGB's commitment to offshoring could increase near-term
CSFB's Assessment of Offshoring Maturity				
ANZ Banking Group	**Commonwealth Bank**	**National Australia Bank**	**Westpac Banking Corporation**	**St George Bank**
ANZ appears to us to be at risk of having its current leadership position with respect to offshoring eroded over time, with other banks likely increasing their offshoring commitment ahead of ANZ	CBA appears to us to be relatively less developed with respect to its offshoring strategy, although may be investigating this further given the recent Indian initiative	Whilst apparently understanding the issues surrounding internal strategic sourcing within the Group, NAB appears relatively less developed with respect to offshoring	Whilst not immature, WBC in our view is unlikely to pursue offshoring initiatives in the near-term and therefore could potentially see its relative position eroded on this basis	SGB appears to us to be the most advanced in its approach to offshoring, although it acknowledges a need to better understand analytics outsourcing

Source: Company data, CSFB estimates

Bank processing utility consortiums – an alternative to offshoring?

Over the past couple of months, NAB, WBC and CBA have announced the formation of the "Vipro" utility consortium to improve the productivity of Day 1 and Day 2 process groups (such as cheque processing) and paper voucher processing (such as credit card merchant slips, etc.). (By way of background, Day 1 processes include imaging, entering and balancing functions. Day 2 processes include reconciliations, reprocessing, call centre and enquiry handling). On 20 August 2004, the ACCC, after scrutinising the proposal for potential downstream anti-competitive impacts, gave its approval specifically for the proposed plan. The participating banks have also made media announcements about the commencement of the tendering process for these activities involving third-party service providers such as Unisys and IBM. They have also announced that other activities such as payments, trade finance and collections would be eventually moved into the utility structure, subject to ACCC approvals.

As the structure and vendors are still being finalised, we have restricted our review to the underlying economics of these structures and have not addressed other aspects of the proposed structure, such as flexibility with respect to geographic location, speed of response, staff selection and management issues, vendor selection and replacement, business continuity planning, etc.

Underlying economics

We have set out below our review of three fundamental arguments made by the banks to support the economics of utility structures, namely:

- economies of scale;
- economies of scope; and
- fixed to variable cost transformation of the cost base.

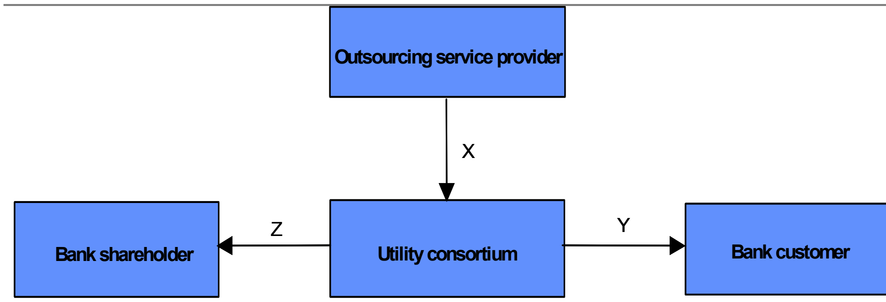
1. Economies of scale

It is correct, in our view, for the individual banks to believe that there are significant cost and capital expenditure savings from the outsourcing of these processes to third-party service providers with scale and, more importantly, domain specialised skills. Indeed, we believe these vendors are likely to offshore these processes as part of their own global delivery models in any case, thus *indirectly* offshoring these processes.

However, even assuming the savings are delivered by the outsourcer as per the outsourcing contract and the service level agreements, we believe the utility consortium structure proposed potentially faces the issue of the time period over which cost savings achieved can be retained by the individual banks before being competed away. Whilst we acknowledge that the sharing of future cost benefits should occur between the outsourcers, bank customers and bank shareholders of the individual banks regardless of the model chosen (utility or offshoring structure) our point is that there is arguably a "first mover" advantage for a bank individually pursuing an offshoring strategy, since this should provide greater longevity for that bank's shareholders to retain the productivity savings achieved (before other banks also pursue such offshoring initiatives and productivity gains are ultimately competed away to customers). Our basic premise is therefore that, once all banks pursue the same productivity initiative, then the productivity benefits are rapidly competed away to bank customers (notwithstanding oligopoly industry structures). On this basis, our preference therefore is for each bank to individually pursue their productivity initiatives independently of their peers, in order to preserve the productivity advantage gained for as long as possible.

The schematic representation of the consortium has been set out below:

Figure 5: **Potential financial and valuation impact of offshoring**



Z=X−Y

X is the NPV of net $$$ cost savings created by outsourcer (net of utility's operational expenses)

Y is the NPV of net $$$ cost savings passed on to the customer in future fees and margin reductions

Z is the residual of net $$$ cost savings obtained by the shareholder

Source: CSFB estimates

We note that there is, in effect, an immediate three-way tussle is created for the same pool of future cost savings that will be generated by the combined scale, namely amongst the outsourcer, the bank customer and the bank shareholder. By way of contrast, the offshoring structure should enable the offshoring bank to leapfrog its competitors in terms of productivity benefits, and therefore able to retain this advantage for a longer period. In particular, we believe that the reward to the shareholder of an individual bank in the consortium is a residual reward – calculated as the savings produced by the outsourcer less that passed on to the customer in reduced fees and margins. If the banks were to engage the outsourcer all at the same time through the utility process and if they were to compete fiercely on the other side for the bank customer's business, then ostensibly most (if not all) of the savings should end up in the hands of the customer. As a corollary to this, very little of the cost savings obtained through the consortium from the outsourcer are seen as likely to accrue to the shareholders of the participating banks who are assuming the risk and creating the utility process.

Conversely, we believe there are only two scenarios under which the shareholders of the individual participating banks could keep most of the cost savings produced by the outsourcer:

- *If the bank consortium were to somehow contractually avoid passing on the savings created by the outsourcer to the customer* – this would likely be very hard to execute and maintain over the five or seven-year period of such arrangements. Also, it would likely attract strong ACCC scrutiny on the grounds of collusion; or

- *If one individual bank were to leapfrog others forming the utility consortium and obtain better terms from the outsourcer (adjusted for scale) than the other two banks* – this should provide that particular bank's shareholders with a higher residual reward than the others. We would also expect this to be explicitly prohibited by the consortium contract.

2. Economies of scope

Economies of scope are often created by the reduction of the number of interchanges and interfaces involved in the overall delivery of the service relating to the relevant processes. These typically involve elimination of approval processes within the hierarchy of the bank involving business cases for capital expenditure, technology selection review, performance measurement and management, exceptions processing, etc., all of which are performed now by the outsourcer at its time and cost. Thus, the bank can typically expect significant savings in terms of direct and indirect time and cost spent on all these multiple interfaces.

However, whilst this is true when an individual bank contracts *directly with a selected outsourcer*, we are not sure that this is true for the utility consortium structure. The creation of the utility structure by itself could add significantly to the overall number of interchanges and interfaces required for various minor and major changes in the scope of the outsourcing contract.

Considering further that the utility structure is likely to have its own CEO, CFO, process champions, project managers, risk management staff, quality management personnel, etc., and is likely to engage several advisers to advise on various aspects of its operations, we are not sure about the extent to which economies of scope can be created with reference to the starting point. Further, it is not clear to us as to what processes would exist between the utility and the managers of the "client businesses" within *each* of the individual banks to ensure that the economies of scope are truly created and captured. Therefore, we remain sceptical as to whether the number and time intensity of hierarchical interchanges can be substantially reduced under this structure.

3. Fixed to variable cost transformation of the cost base

The third fundamental component is the conversion of a fixed to a variable cost for such an exercise. This is created, in effect, when the banks hand over the legacy equipment, systems and staff that are used to deliver the associated processes and receives a variable per transaction cost for the output delivered (e.g. cost per cheque processed, cost per successful mortgage application, etc.).

However, we suggest that mere conversion of a fixed cost into a variable cost does NOT produce cost savings if the utility consortium and the outsourcer has the *same view* about the rate of growth of the underlying transaction parameter (e.g. future cheque volumes or merchant credit card voucher volumes). This is because one of the critical inputs used by any outsourcing service provider as part of the provider's own margin pricing and profitability calculation models is the estimated future growth rate of the underlying transaction parameter. So, for example, if both the participating banks and the outsourcer believes that cheque volumes will decrease by 10% p.a. over the next five-year period, then converting the fixed cost to a variable cost provided by the outsourcer will likely not produce major future cost savings. However, if the bank expects volumes to drop significantly compared to historical volume levels (say decline of 10% p.a. over the last five years to 25% p.a. over the next five years) and the outsourcer has a different view (say the historical decline of 10% p.a.), then conversion of fixed cost to variable cost should have significant benefits for the shareholders of the bank, since they are able to avoid the expected accelerated drop in volumes and have passed the risk on to the outsourcer.

Based on the above review of the three fundamental drivers of the underlying economics of the utility consortium structure, we believe that it remains to be seen whether the consortium can deliver significant returns to the shareholders of the individual participating banks.

Recent offshoring announcements

In this section we briefly review selected recent offshoring announcements from financial services companies globally. Since our original report dated 21 June 2004, a number of significant global offshoring transactions have been announced.

JP Morgan

- *Date:* 23 September 2004.
- *Domains:* Back-office research.
- *Geographies:* Bangalore (India). JP Morgan already has a captive BPO services unit in Mumbai, employing around 2,000 people across three centres, undertaking research activities and transaction processing for investment banking, financial services and investment management.
- *Number of jobs:* The facility is expected to ultimately house 3,000 to 4,000 people.

General Electric Capital International Services (GE CIS)

- *Date of announcement:* 7 September 2004.
- *Domains:* Restructuring and / or sale of the captive operation (partial or full sale of major units including Finance & Accounting processing and Analytics outsourcing divisions). GE CIS is the largest captive operation and has been operational since 1997 when it started as a call centre with about 150 employees.
- *Number of jobs:* 16,000 FTEs (12,000 in five centres in India and rest in Hungary, Mexico, China and South Africa).

Aviva plc

- *Date:* 7 September 2004.
- *Domains:* Acquisition of a stake in EXL Services for US$12.5m, a specialist third-party service provider catering to the general insurance, life insurance and funds management sectors.
- *Geographies:* (na)
- *Number of jobs:* Aviva is already a large customer of EXL Services.

BNP Paribas

- *Date:* 6 September 2004.
- *Domains:* French voice-based call centre.
- *Geographies:* India (Chennai or Pondicherry, an erstwhile French colony).
- *Number of jobs:* The call centre will initially hire 40 employees and scale up gradually.

Barclays

- *Date:* 15 August 2004.
- *Domains:* Acquisition of a 50% stake in Mumbai processing centre Intelenet, for GBP19m.
- *Geographies:* (na)
- *Number of jobs:* Already houses some of the work that Barclays outsources to.

Aviva plc – UK business

- *Date:* 9 June 2004.
- *Domains:* Business services operation, which manages IT, facilities and project management for the rest of the group.
- *Geographies:* Aviva is currently examining third-party partners and planned to outsource half the business services operation and keep the rest in-house. No deal has yet been signed.
- *Number of jobs:* 700.

Aviva plc – UK and Canadian businesses

- *Date:* 2 December 2003.
- *Domains:* Car and home insurance claims processing; new business and administration back office; IT and application development; customer and adviser contact centres.
- *Geographies:* Bangalore (India) or Chennai (India).
- *Number of jobs:* 3,000 over the next 12 months.

Lloyds TSB – UK

- *Date:* 29 September 2003.
- *Domains:* Call centres and transaction processing.
- *Geographies:* Hyderabad (India) and Bangalore (India).
- *Number of jobs*: 2,000 over the next 12 months.

HSBC – UK and Asia

- *Date:* 6 November 2003.
- *Domains:* Analytics and research; finance, audit and accounting.
- *Geographies:* Shenzhen and Shanghai (China), Chennai (India), Colombo (Sri Lanka).
- *Number of jobs:* 4,000.

Abbey National – UK

- *Date:* 23 September 2003.
- *Domains:* Call centres and transaction processing.
- *Geographies:* (not disclosed).
- *Number of jobs*: Not disclosed, but media reports place it at around 1,500.

JP Morgan Chase

- *Date:* September 2003.
- *Domains:* Global equity research, analysis and valuation support.
- *Geographies:* Mumbai (India).
- *Number of jobs*: Not disclosed, but media reports place it at around 50.

Morgan Stanley – USA

- *Date:* 16 September 2003.
- *Domains:* Fund accounting, portfolio services, equity research, analysis and valuation support.
- *Geographies:* Mumbai (India).
- *Number of jobs*: About 1,500.

World Bank group – Global

- *Date:* 18 November 2003.
- *Domains:* IT and systems development, finance and accounting, risk management analytic support.
- *Geographies:* Not disclosed, but media reports appear to suggest Chennai (India).
- *Number of jobs:* Around 200.

Bank of America – USA

- *Date:* 13 October 2003.
- *Domains:* Portfolio review, valuation, auditing and back-office processing.
- *Geographies:* Chennai (India).
- *Number of jobs*: (not disclosed)

ING Group – IT, Systems Development and Data Analytics

- *Date:* 27 October 2003.
- *Domains:* IT and systems development, customer contact, new business and administration, life claims processing and management.
- *Geographies:* Not disclosed, but media reports appear to suggest Chennai (India) or Hyderabad (India).
- *Number of jobs*: (not disclosed).

Appendix 1: Bank offshoring – significant traps to avoid

Prepared by Sri Annaswamy, Founder of Swamy & Associates, Independent BPSO Advisors and Managers

Given that Australian banks are relative newcomers in executing offshoring strategies, we think there are significant traps that they need to avoid in their path to offshoring.

Strategic mistakes

1. Captive utility offshoring vs. specialist third-party vendor structures

Historically, captive utilities such as GE CIS, eServe and WNS were the most important vehicle by which offshoring was executed by global financial services institutions. This was owing to three fundamental factors – lack of in-depth process knowledge on the part of the existing service providers who were predominantly IT outsourcers, lack of adequate mechanisms to ensure compliance with data protection and privacy legislation, as well as the absence of rigorous quality management and business continuity planning methodologies.

Over the past three years, two of these factors have disappeared to a significant extent as specialist vendors have acquired significant levels of domain expertise and knowledge equivalent to the operations teams of the banks themselves in addition to implementing very strong data protection structures complying with current US, UK and Canadian data protection standards.

The third factor – quality management methodologies and business continuity planning standards – is currently the focus of attention for most major third-party service providers as is evidenced by the proliferation of various CMM Level 5, Six Sigma* and TQM certifications within these organisations.

The competition from such capable third-party specialists across all major domains has heightened to such an extent that several of the captives have now become third-party specialist vendors (EXL, WNS, etc.) or are currently undergoing major restructuring exercises (GECIS, for example). Further, organisations such as Aviva, Citibank and GE with captives are now actively incorporating third-party specialist vendors in their offshoring strategies.

We believe that it would be very hard for any Australian financial services institution to justify a captive utility structure for offshoring purposes in any offshore location (India, Philippines or even, New Zealand) on a competitive viable basis, in the future especially when GE CIS (with about 16,000 FTEs) is restructuring itself significantly.

2. Group-wide strategic view vs. IT and operations focused strategy

Several Australian financial services organisations currently have offshoring strategies reviewed and examined by the Group IT and Operations divisions, sometimes even just Banking operations, with varying involvements and oversight by the Group Strategy teams.

This can potentially lead to a "blinkered" view of both the scope and drivers of offshoring strategies in these organisations as a purely banking technology and operations focused exercise. Thus significant activity domains within major functions such as Group Finance & Accounting, Group HR, Corporate and Institutional Banking, Insurance and Wealth Management business, Product management and Marketing information systems and Group Treasury are not fully considered likely resulting in a very sub-optimal result for the shareholders of that bank.

Further, a very high proportion of offshoring announcements over the past 12-month period pertains to the offshoring of group-wide analytics functions (i.e. analytics outsourcing). Again, these opportunities could be missed if an IT and operations focused framework was used by the banks.

Business case and process mistakes

1. Upfront cost savings vs. total process cost improvement

As we pointed out earlier in this report, we consider equal emphasis must be placed on both the 'upfront' factor price savings and the ongoing process cost improvements resulting from the outsourcer employing quality management methodologies such as Six Sigma and TQM techniques.

In our view, business cases and selection of outsourcers need to involve a strong focus on such ongoing productivity improvement methods as they can easily account for an extra 20% in terms of overall cost savings. Conversely, we believe upfront cost savings estimates need to be very conservatively estimated and based on each specific activity domain. Any upfront cost saving assumption greater than 35% (net of transition and telecommunication costs) should be scrutinised very thoroughly.

2. 'Plain vanilla' cost reduction DCFs versus risk-adjusted DCFs

DCFs based on simple cost reduction assumptions do not reflect the changes in the underlying riskiness of the offshore-outsourcing models. We consider a better manner to model this would be to adopt risk-adjusted return on capital methods such as ROEE, Return on operational risk capital, etc., while evaluating such outsourcing propositions.

Indeed, a properly structured offshore-outsourcing arrangement should actually, over time, reduce the operational risk capital needed to support the relevant processes as a result of improved transparency, improved documentation, improved business continuity planning, automated workgroup management and significantly better performance metrics and reporting systems.

Structuring and Implementation mistakes

1. Single partner per domain vs. multiple partner and multi-location structures

Offshoring any activity domain to a single partner usually in a single location can be a significant drawback in any offshoring strategy, especially if there are volume guarantees or FTE guarantees over the period of the contract.

Further, from a business continuity and operational risk perspective, such single-partner strategies can expose the banks to significant risks should the partner's facilities be affected for a significant period of time.

It is worth noting that even organisations that are progressed with their offshoring strategies such as Greenpoint, Citigroup and Aviva now have several service providers within the same activity domains to satisfy competition and business continuity planning requirements. They also ensure contractually and in practice that the facilities delivering the service are often in a variety of locations, again to satisfy business continuity planning needs.

2. SLAs based on cost incentivisation vs. innovation incentivisation

We consider Service Level Agreements (SLAs) have to force service providers to innovate their service offerings over the period of the contract. Traditionally, SLAs have detailed scope, cost and service delivery metrics, but have rarely focused on metrics around innovation. This usually ensures that the outsourcer carries out the processes in the same manner as before by just employing lower cost staff.

For example, several outsourcing service providers in the cheque processing industry were *lagging behind* in-house operations centres in terms of imaging and workgroup management systems simply because the contracts with the relevant banks did not force them to switch to these technologies and indeed, would have deemed it a "major scope change" if they did.

3. Service provider BCP and OR vs. bank client BCP and OR including service provider bankruptcy, downgrade and change of ownership

The latest Basle consultative draft on outsourcing (which also covers offshoring) clearly makes banks responsible for ensuring that business continuity planning requirements (BCP) have been satisfied. It also makes it imperative for regulators such as APRA to visit the outsourcing service providers' facilities and confirm this for themselves. Further, it is expected that Australian banks will be held accountable by the regulators for managing operational risk (OR) in respect of offshoring processes, especially in relation to data protection and privacy law compliance.

The implication is very clear – banks will now have to ensure that their business continuity planning and operational risk management strategies for each offshored domain are not limited to contractual obligations with the service provider. In addition, Australian banks also need to monitor on an ongoing basis the financial health and stability of each of the offshoring service providers that are contracted to provide that particular service.

For example, in the past few months international credit rating agency, Moody's, has downgraded the debt rating of a very prominent service provider, EDS Inc., to below investor grade ("junk"). Several Australian banks that deal with this particular service provider have had to re-think and re-work their business continuity and operational risk capital management, in the event of any other downgrade.

As a result, we believe that scenarios such as service provider failure, service provider credit rating downgrade, service provider bankruptcy, service provider merger / change of ownership, etc., will need to be considered and monitored seriously, on an ongoing basis.

** NOTE: "Six Sigma" refers to a measure of quality that strives for near perfection. Conversely, a Six Sigma defect is defined as anything outside of customer specifications. Six Sigma is a data-driven methodology for eliminating defects (driving towards six standard deviations between the mean and the nearest specification limit) in any process – from manufacturing to transactional and from product to service. Statistically, to achieve Six Sigma, a process must not produce more than 3.4 defects per million opportunities. The fundamental objective of the Six Sigma methodology therefore is the implementation of a measurement-based strategy that focuses on process improvement and variation. We believe this is a central process improvement technique in financial services given the current industry focus on improving customer service (improved responsiveness to customer requests, accuracy in responses) and cost efficiency (reduced re-working).*

Appendix 2: Analytics offshoring – the dominant theme of future bank offshoring?

Prepared by Sri Annaswamy, Founder of Swamy & Associates, Independent BPSO Advisors and Managers

Background to analytics offshoring

The clearest evidence of bank offshoring progressing up the value chain in our view is the emergence of a newer domain of activities being offshored. This domain of activities is quite distinct from the historical contact centre and transaction processing domains in that it involves:

- functions and process groups previously considered "un-offshoreable", including so-called capability driven functions such as corporate credit risk management, project and structured finance proposal preparation, M&A valuations and equity research, mortgage customer data mining, capital attribution and management analytics, DFA modelling for life and general insurers, etc.;
- functions that are considered "the core of banking and insurance" in as much as they contribute directly to the pricing of risk underwritten by these institutions (be it credit or event risk); and
- functions that are characterized by relatively low FTE numbers but high per FTE cost.

The rapid offshoring of these functions is the clearest sign in our view that offshoring is no longer a "grunt work" exercise but one characterised by better leveraging the global intellectual capabilities in particular offshoring destinations.

Factors contributing to analytics offshoring

Our review suggests there are three fundamental factors driving this global industry trend:

1. Growing realisation of the competitiveness of education systems in offshore destinations

It is now widely recognized globally (especially in our view in the US and the UK) that several offshoring destinations such as India have successfully created low cost yet extremely high quality education systems, which enable the relatively smooth transition of analytics functions offshore. For example, we believe it is now globally recognised that the Indian Institutes of Technology ("IITs") and the Indian Institutes of Management ("IIMs") represent *"the most selective engineering and MBA programs in the world, respectively"* (sources: Imported from India – *60 Minutes* program feature, CBS Network and IIMs – *Economist* magazine EIU survey of global MBA programs).

2. Growing realisation of the pre-standardised nature of analytics functions and analytics processes

We believe there is a slow realization that analytics functions such as credit risk management, M&A valuations or data mining and warehousing have the significant advantage of being performed on standard platforms using standardised software and tools in accordance with globally accepted procedural norms. For example, in credit risk management, there are three fundamental tools that are used (often in combination) by banks globally to price and evaluate the riskiness of their credit portfolios – JP Morgan's CreditMetrics, KMV corporation's Portfolio Manager and CSFP's CreditRisk. In terms of M&A valuation, there appear to be three primary fundamental practices for valuing the equity of businesses – PE based, DCFs and real options based models. Further, the construction and algorithms of these models are again significantly standardized (e.g. Binomial or Black Scholes valuations for options) and the nature of these inputs is again quite standardised (although, the quantum of inputs and the structuring of the option is event driven).

Therefore, as long as the framework is agreed upon, communicated and documented clearly the underlying analytics process can in our view be transitioned relatively effectively.

3. Growing realisation of the pre-standardised nature of relevant qualifications of analytics personnel

Again, we believe there is a rapidly growing realisation that the qualifications of staff performing these analytics functions are already standardised. For example, most of the chartered accountants amongst the 800 FTEs of GE CIS Analytics (the analytics arm of GE CIS) based in offshoring destinations possess US CPA or UK CIMA qualifications. Similarly, most of the staff performing customer data analysis and mining functions have masters and doctoral qualifications in engineering or statistics from the top institutions at home or from the USA.

Showcasing emerging analytics offshoring strategies

We have set out below two relevant examples of how such analytics offshoring strategies have been adopted by two different types of financial services companies – a medium-sized company, Greenpoint Mortgages, as well as a global company, JP Morgan Chase.

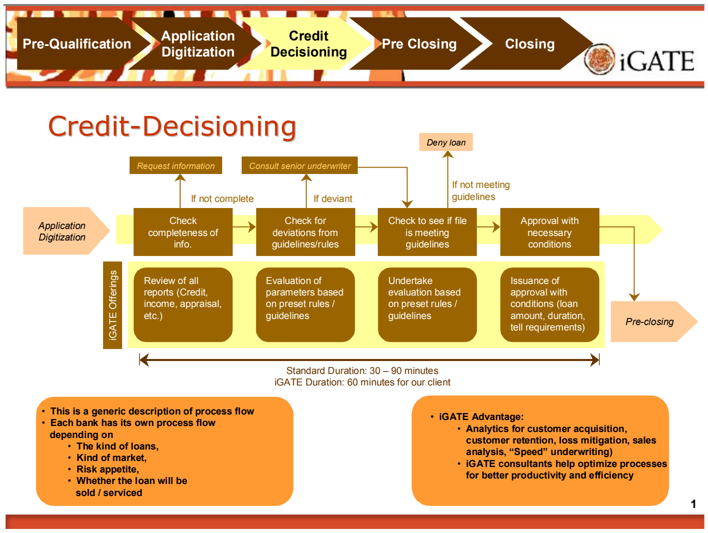
Greenpoint Mortgages and iGate Global Solutions – mortgage credit decisioning analytics

Greenpoint Financial (a medium-sized Novato, California-based mortgage originator) has two major mortgage process offshoring relationships – with Progeon and the second one with iGate Global Solutions.

The second one with iGate Global Solutions represents a significant move up the value chain for Greenpoint as it involves several functions that impact the customer selection and credit decisioning part of the value chain – traditionally considered a non-offshoreable analytics component of the process.

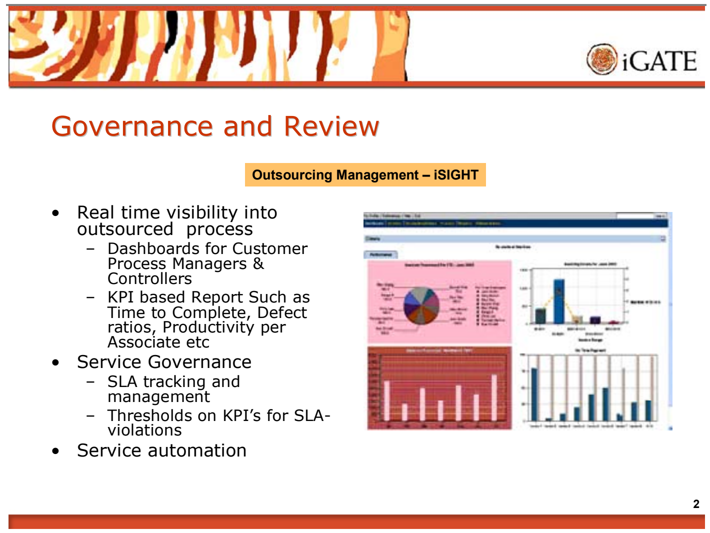
Owing to client confidentialities, we have set below only the generic scheme of such an analytics offshoring of credit decisioning and the associated workgroup management, which has been specifically created for this report.

Figure 6: Credit decisioning



Source: iGate Global solutions

Figure 7: Governance and review



Source: iGate Global solutions

JP Morgan Chase – Investment banking and equity research analytics

Over the past 18 months, JP Morgan has been significantly building up its analytics offshoring centres in two western suburban locations in Mumbai (formerly Bombay) in India and has made media announcements about opening another analytics offshoring centre based out of Bangalore.

A snapshot of its current Global Research Service Centre ("GSRC") operations in Mumbai is as follows:

- *Number of FTEs:* 2,000 (expected to increase to 4,000 over the next 12 months);
- *Analytics functions performed:* Global credit analysis for the corporate banking group, global equity research support, M&A and IPO transaction support (primarily valuations and prospectus preparation work) and global portfolio risk management support (primarily market risk mgmt. for the trading desk);
- *Typical qualifications of staff:* Engineer plus MBA, Chartered Accountants, Masters in maths and PhD in statistics.

A sample offshore credit analyst recruitment advertisement from JP Morgan to support its corporate banking group has been set out below:

Credit Analysis Unit (Mumbai) – Corporate Banking group

Corporate Banking is a part of the Global Credit Risk Management group of the Firm, which provides support to the firm's primary and secondary credit activities. The group is also an active participant in the client credit coverage and support activities for the firm. The Credit Analysis Unit in Mumbai was set-up in January 2003 to do the Credit Reviews of global clients.

The CAU analysts are jointly responsible with the Corporate Bankers for:

- Ensuring timely preparation of credit reviews for the existing clients, including financial/cash-flow analysis, risk mitigation, industry update and rating recommendations;
- Prepare credit write-ups for new clients being targeted by the firm;
- Keeping Corporate Bankers updated of client's performance or news related to the industry obtained from public materials/brokerage report (i.e. Morgan markets, Bloomberg, Reuters, other publications, etc.).

Required skills:

- Strong mathematical, analytical and writing skills with knowledge of financial modelling and accounting;
- Strong Partnership; be able to network with Corporate bankers in other countries;
- Willing to seek challenge beyond current responsibilities;
- Communicate clearly, concisely and confidently and listen well;
- Be able to work independently and have self discipline in meeting the time lines;
- Proficient in the use of MS Word, Excel and Power Point.

Required qualifications

CAs or MBAs from top 10 business schools.

Implications for Australian banks

As the response to our questionnaire demonstrated, no major Australian bank appears to have performed advanced research in relation to analytics offshoring as a group-wide strategy to create shareholder value. We expect that this might change significantly in the future, as a combination of a challenging business environment and new strategic thinking could force them to potentially look towards analytics offshoring as a meaningful profit driver.

Notes

Notes

Companies Mentioned *(Price as of 05 Oct 04)*

Australia & New Zealand Banking Group Limited (ANZ.AX, A$19.25, NEUTRAL, TP A$20.00, MARKET WEIGHT)
Commonwealth Bank of Australia (CBA.AX, A$30.71, NEUTRAL, TP A$33.00, MARKET WEIGHT)
National Australia Bank Limited (NAB.AX, A$27.15, UNDERPERFORM, TP A$25.00, MARKET WEIGHT)
Westpac Banking Corporation (WBC.AX, A$17.82, NEUTRAL, TP A$18.00, MARKET WEIGHT)
St George Bank Limited (SGB.AX, A$22.37, OUTPERFORM, TP A$25.00, MARKET WEIGHT)
ING (ING.AS, Eu21.32, OUTPERFORM [V], TP Eu21.30, MARKET WEIGHT)
Morgan Stanley (MWD, $50.60, OUTPERFORM, TP $65.00, MARKET WEIGHT)
J.P. Morgan Chase & Co. (JPM, $39.76, OUTPERFORM, TP $45.00, MARKET WEIGHT)
AVIVA Plc (AV.L, 565.00 p, NEUTRAL, TP 528.00 p, MARKET WEIGHT)
General Electric Capital Corp (GEC, $25.42, NOT RATED)
BNP - Paribas (BNPP.PA, Eu54.55, NEUTRAL, TP Eu59.00, OVERWEIGHT)
Barclays (BARC.L, 562.50 p, OUTPERFORM, TP 680.00 p, OVERWEIGHT)
Lloyds TSB (LLOY.L, 445.00 p, UNDERPERFORM, TP 535.00 p, OVERWEIGHT)
HSBC Holdings (HSBA.L, 904.50 p, NEUTRAL, TP 9.85 p, OVERWEIGHT)
Abbey National (ANL.L, 585.00 p, UNDERPERFORM, TP 440.00 p, OVERWEIGHT)
Bank of America Corp. (BAC, $44.35, RESTRICTED)
Citigroup (C, $44.52, OUTPERFORM, TP $60.00, MW)
Qantas Airways (QAN.AX, A$3.43, OUTPERFORM, TP A$4.30)
GreenPoint Financial (GPT, $46.26, NOT RATED)
International Business Machines (IBM, $87.32, OUTPERFORM, TP $100.00, MW)
Electronic Data Systems (EDS, $20.38, NEUTRAL, TP $20.00, MW)
Unisys (UIS, $10.82, NOT RATED)
Progeon (NOT LISTED)
E-Serve International (ESEI.BO, Rs936.00, NOT RATED)
KMV Corporation (NOT LISTED)
EXL Services (NOT LISTED)
WNS (NOT LISTED)
iGate Capital Corporation (IGTE, $3.85, NOT RATED)

Disclosure Appendix

Important Global Disclosures

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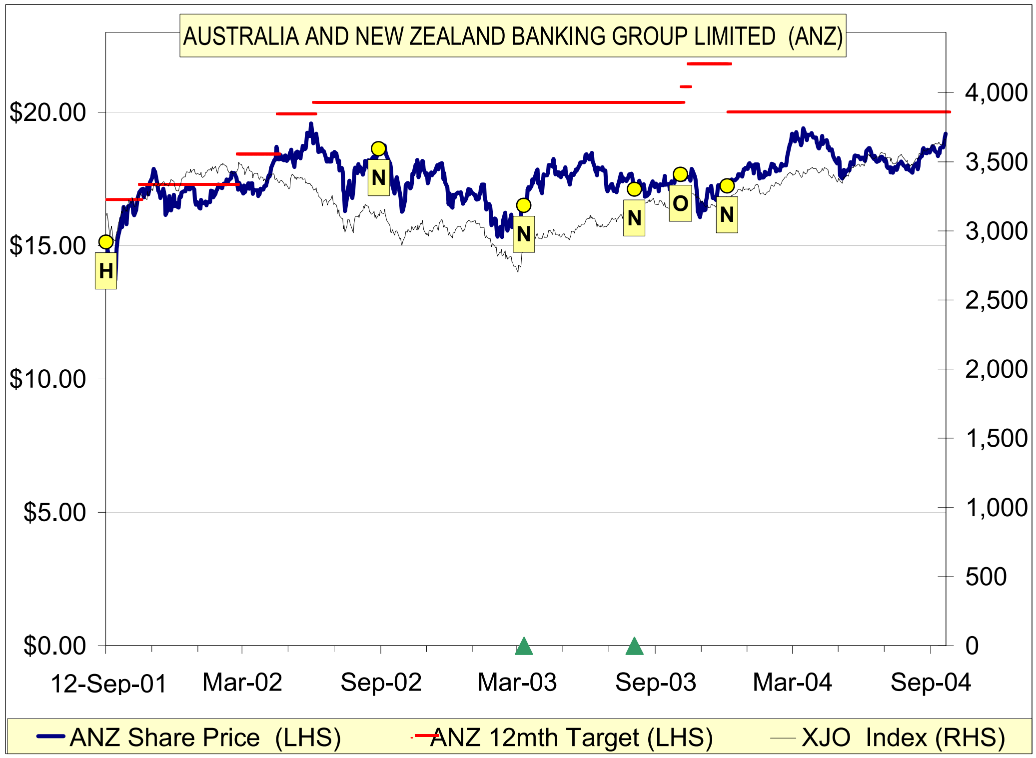
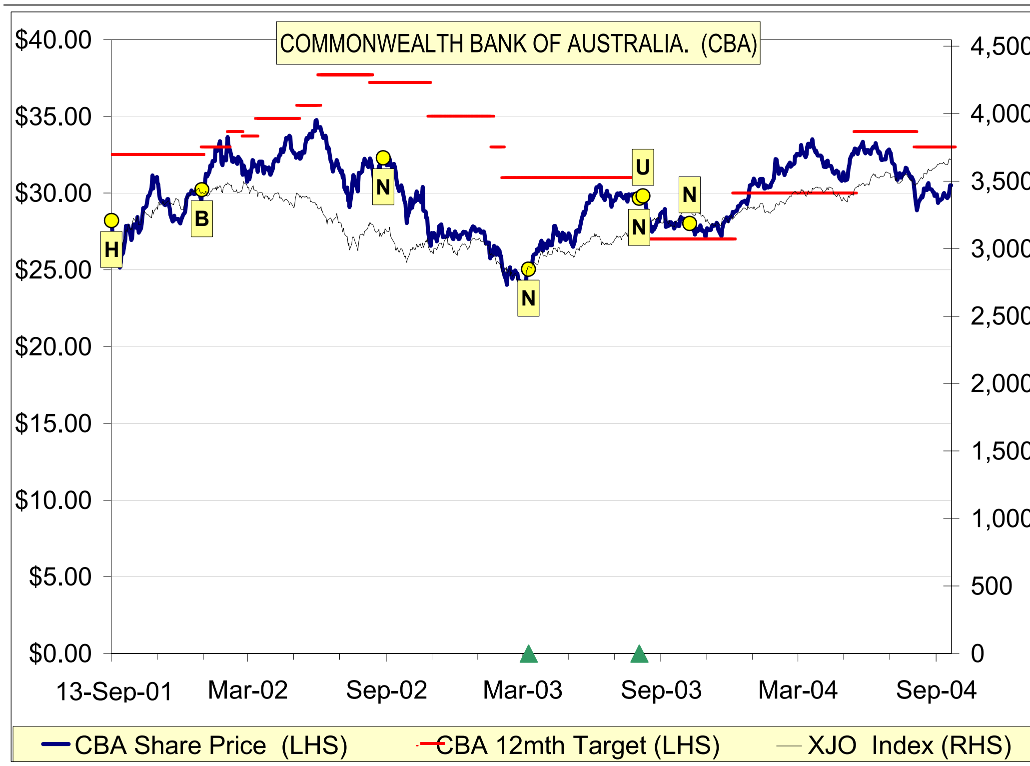
See the Companies Mentioned section for full company names.

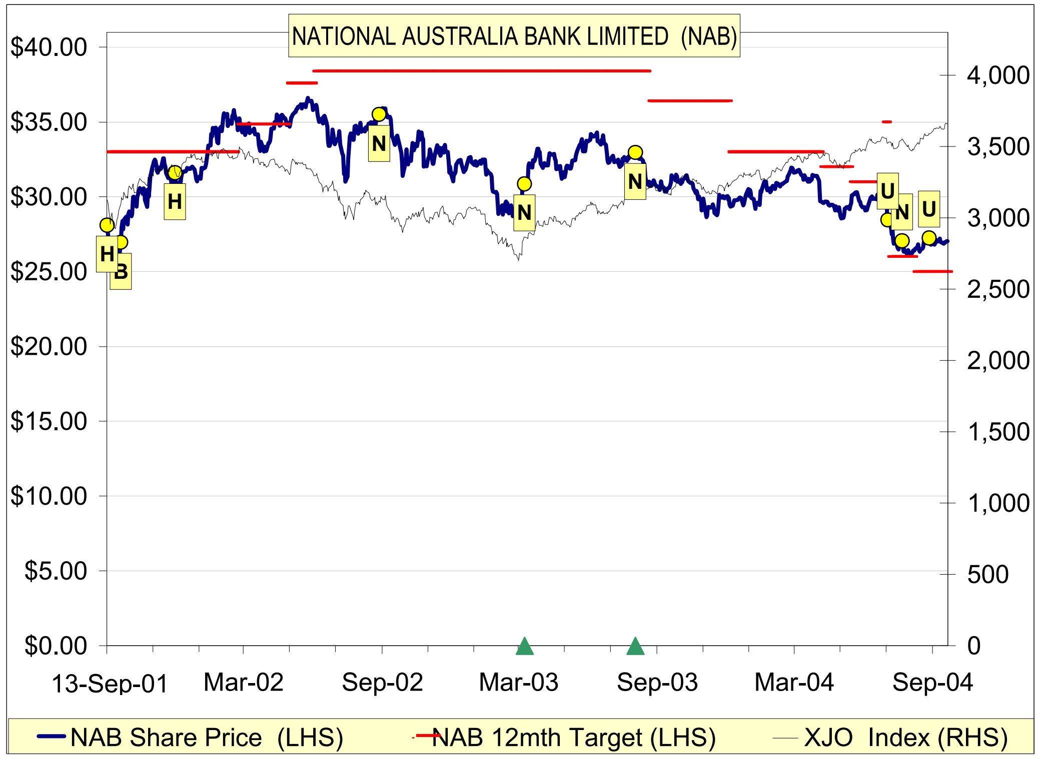
3-Year Price, Target Price and Rating Change History Chart for ANZ.AX



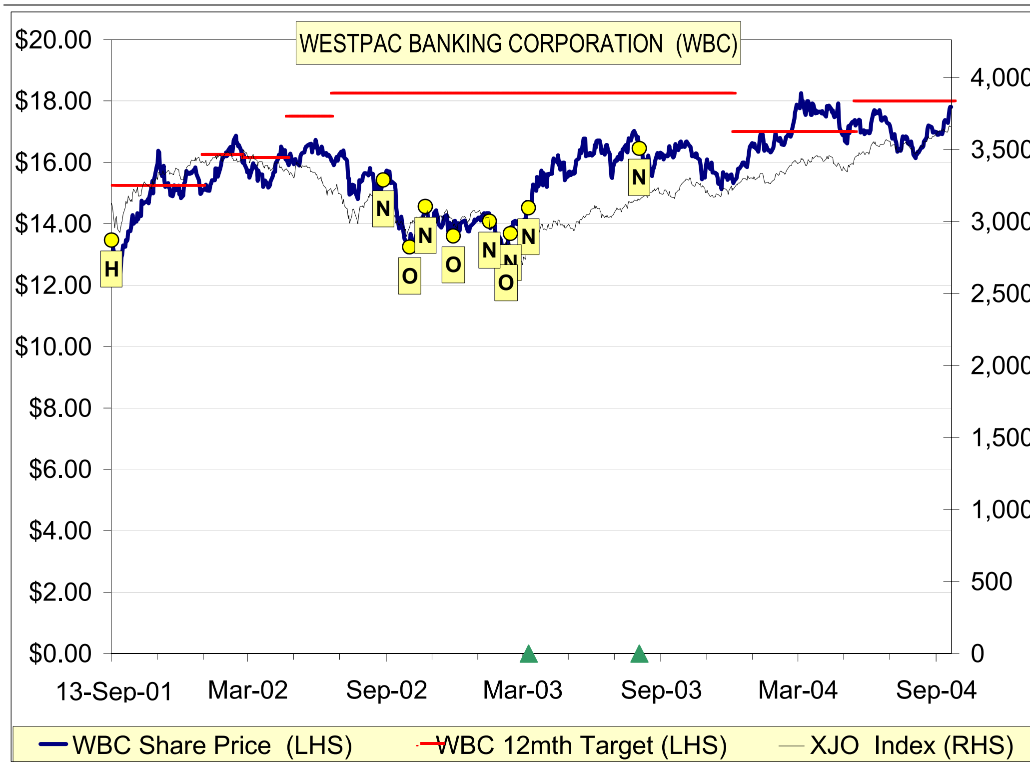
3-Year Price, Target Price and Rating Change History Chart for CBA.AX



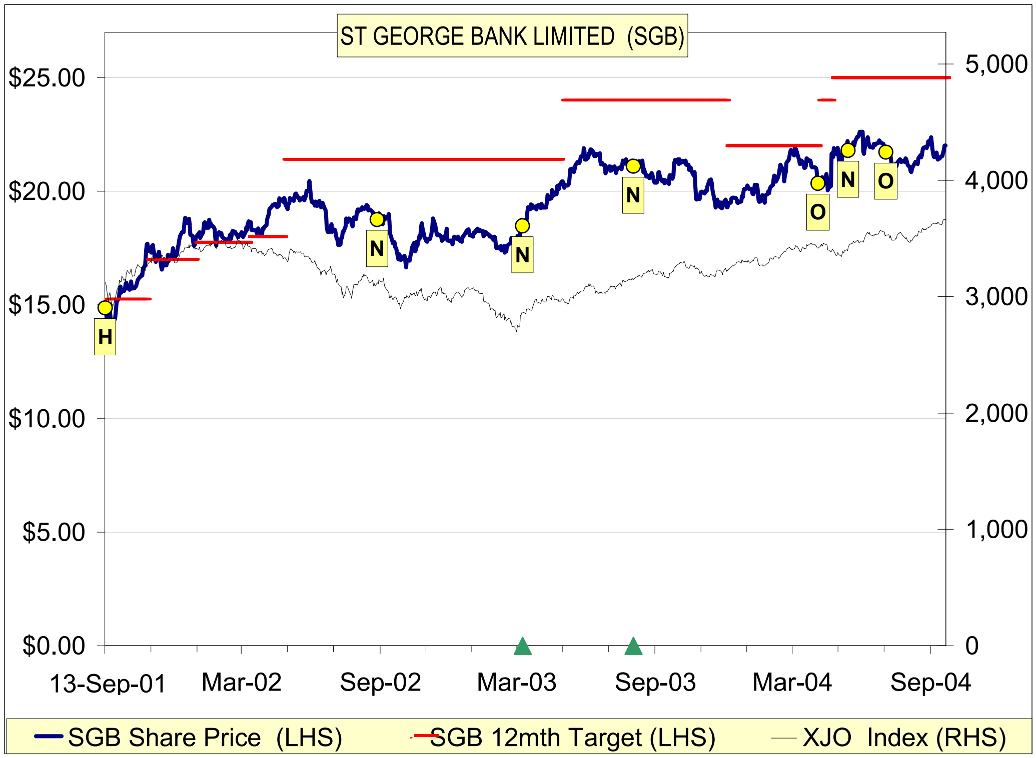
3-Year Price, Target Price and Rating Change History Chart for NAB.AX



3-Year Price, Target Price and Rating Change History Chart for WBC.AX



3-Year Price, Target Price and Rating Change History Chart for SGB.AX



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Restricted	2%	

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Price Target: (12 months) for (ANZ.AX)

Method: 1) BY/EY relationship by stock (50% weighting), 2) historical PE analysis relative to the all industrials ex-banks & the banks index (12½% weighting for each), and 3) historical PE band analysis (25% weighting).

Risks: NBNZ integration, mortgage volumes slowing, ING & ANZ JV, credit risk, energy & telco exposures and general macro economic risk.

Price Target: (12 months) for (CBA.AX)

Method: 1) BY/EY relationship by stock (50% weighting), 2) historical PE analysis relative to the all industrials ex-banks & the banks index (12½% weighting for each), and 3) historical PE band analysis (25% weighting).

Risks: Effectiveness of WNB resturcturing, slowing mortgage lending and market share maintenance, competition and margin pressures, credit quality, funds management performance and exposure to general macro-economic risk.

Price Target: (12 months) for (NAB.AX)

Method: 1) BY/EY relationship by stock (50% weighting), 2) historical PE analysis relative to the all industrials ex-banks & the banks index (12½% weighting for each), and 3) historical PE band analysis (25% weighting). Used in conjunction with SOP valuation

Risks: Strategic uncertainty, UK restructuring & ability to improve performance, mgt/board renewal, business risk flow-on from forex losses, mortgage mkt slowing, loss of business mkt share, contingent tax liabs, and exposure to general macro economic risk.

Price Target: (12 months) for (WBC.AX)

Method: 1) BY/EY relationship by stock (50% weighting), 2) historical PE analysis relative to the all industrials ex-banks & the banks index (12½% weighting for each), and 3) historical PE band analysis (25% weighting).

Risks: Mortgage volumes slowing, BT integration success, ability to gain AGC business bank clawback, credit risk and exposure to general macro economic risk

Price Target: (12 months) for (SGB.AX)

Method: 1) BY/EY relationship by stock (50% weighting), 2) historical PE analysis relative to the all industrials ex-banks & the banks index (12½% weighting for each), and 3) historical PE band analysis (25% weighting).

Risks: Credit quality, slowing mortgage market and general macro-economic risk.

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