

# Drivers and inhibitors for outsourcing financial processes – a comparative survey of economies of scale, scope, and skill

**INDUSTRIALIZATION TENDENCIES WITHIN THE CREDIT BUSINESS ARE IN PARTS BROADER SOPHISTICATED THAN WITHIN FINANCIAL PROCESSES OF OTHER INDUSTRIES. CREDIT PROCESS MANAGERS OF BANKS ESTIMATE ECONOMIES OF SCALE AND SKILL ACHIEVABLE BY OUTSOURCING TO BE HIGHER THAN CHIEF FINANCIAL OFFICERS OF NON-BANKS DO. FURTHERMORE, ECONOMIES OF SCOPE, WHICH INHIBIT SELECTIVE SOURCING, ARE EVALUATED AS LESS PROBLEMATIC.**

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## Introduction

Global competition requires a continuous quest for efficiency improvements. Outsourcing IT and/or business processes promises to yield efficiency improvements by rearranging the value chain. Focusing on core competencies, outsourcing of non-core parts is frequently proposed.

Cost savings by outsourcing are in general driven by the trade-off between economies of scale, scope, and skill. Based on two empirical surveys in Germany among banks and non-banks, the differences in the perception of economies of scale, scope, and skill between primary and secondary financial processes are shown.

*Primary processes*, in the literature also known as *core* or *customer processes*, are defined as value creating and customer oriented activities which form a firm's core business, whereas *secondary processes* show a firm-internal and supporting character (*support process*). They enable the core business, e.g. by providing technical, financial, and human resources, without being an original part of the value chain (Griese et al. 2001; Porter et al. 1985). Primary and secondary processes can not be differentiated in general; it depends on the firm's business (Becker et al. 2002); e.g. the process of funding usually is a secondary process in an industrial company while it is one of the core processes of a bank.

## Methodology

The results shown in this article are drawn from two empirical studies conducted by the E-Finance Lab. In 2003, the first study ("Financial Chain Study") investigated secondary financial processes in the Financial Chain of German Fortune 1,000 firms (according to their total assets; financial institutions were excluded from this study). The Financial Chain covers financial activities which come along with market transactions, such as pricing, customer qualification, insuring, financing, billing, reclaiming, and paying. A questionnaire incorporating 35 different, mainly closed questions on varying topics (e.g. process analysis, outsourcing) was developed and validated in several pretests to improve comprehensibility and to remove ambiguities. Before mailing the questionnaire,

the addressees (Chief Financial Officers (CFOs)) of this study were identified and contacted to enforce a high response rate and to assure high data quality. After an initial mailing, a follow-up was conducted and the questionnaire was mailed a second time. Furthermore, all addressees lacking response were contacted a second time and asked for participation. Finally, a response ratio of 10.3% had been achieved by 103 analysable questionnaires returned (Skiera et al. 2004).

In 2004 the second study was realized focusing on primary financial processes ("Credit Process Study"). This study focused on banks' credit processes issuing loans for small and medium sized enterprises (SME). A questionnaire consisting of 33 open and closed questions was sent to the 500 largest banks (according

Financial Chain Study (Fortune 1,000)		Credit Process Study (Fortune 500)	
n=103		n=129	
industry	48.5%	savings banks/federal banks („Sparkassen und Landesbanken“)	59.7%
ICT providers	13.6%	cooperative banks („Genossenschaftsbanken“)	30.2%
business services	11.7%	private banks	10.1%
retail	9.7%		
financial services	4.9%		
energy and water supply	4.9%		
construction	2.9%		
other	3.8%		

Table 1: Financial Chain and Credit Process Study, branches and bank types

to their total assets). Special attention was drawn here on assuring the similarity between particular parts of the two questionnaires to enable a comparison of the results. This questionnaire has also been refined in several pretests and interviews with experts. The managers responsible for the banks' credit processes were contacted by phone before receiving the questionnaire, whereas 519 questionnaires were sent in total. A follow-up by resending the questionnaire and a second contact by phone was conducted. 129 analyzable questionnaires were returned, which refers to a response rate of 24.9%.

#### Related Research

Generally, three interdependent factors play a major role in determining whether an outsourcing arrangement is advantageous or not. These factors refer to economies of scale and skill as driving factors for outsourcing and economies of scope as inhibitor.

*Economies of scale* are frequently cited to be one of the main reasons for outsourcing. The service provider is able to provide a given service at lower costs as similar processes of multiple organizational entities are bundled, reducing average costs per unit (Cachon et al. 2002; Gurbaxani et al. 1991; Matiaske et al. 2002; Schott 1997). Contrariwise, it can be argued that especially very large organizations are not able to realize additional economies of scale as they already have exploited the total potential of cost savings (Earl 1996; Lacity et al. 1996).

*Economies of scope* refer to the advantages resulting from the shared utilization of common resources (Panzar et al. 1981). Access to centralized client data in different organizational units with different views or knowledge of particular employees which has to be applied within different processes are examples for such an advantage resulting from economies of scope. These effects impose an inhibiting factor for outsourcing parts of business processes because economies of scope might get lost. If large economies of scope are observed, a joint sourcing of all parts to one service provider might be the best. Unfortunately, isolating parts of specific processes is often impossible or results in severe coordination costs (Bruch 1998).

Another source of making outsourcing arrangements advantageous are *economies of skill* on the provider side as being a result of the development of core competencies in firms in the past (Langlois 1995; Levinthal 1995; Prahalad et al. 1990). Economies of skill can be realized by the service provider because (from his point of view) the insourced process represents a primary process (Dibbern et al. 2001). The service provider is able to proceed on the learning curve and to provide a given service with lower costs (even when "producing" the same quantities). In contrast, the outsourcer himself loses competence in long-term. There is a trade-off between realizing economies of scale and skill by transferring parts of the business versus economies of scope that can be realized when processes are kept in-house.

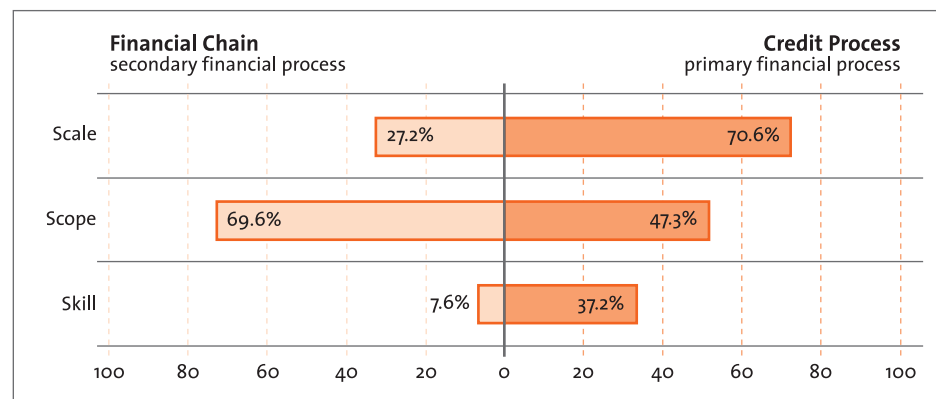


Figure 1: Economies of scale, scope, and skill in primary and secondary financial processes

#### Selected Results of our Research

In the following, both studies are analyzed according to the perceived economies of scale, scope, and skill. Specific deviations are highlighted.

##### *Economies of Scale*

For secondary financial processes, 27.2% of the CFOs expect achievable economies of scale if they outsource (parts of) their financial chain. For primary processes, this question was subdivided into economies of scale realized by reducing the human resources and economies of scale as a result of efficient IT utilization. In both dimensions results differ significantly from the Financial Chain study. For human resources and IT, the overwhelming part of the respondents state that the service provider would be able to realize economies of scale (HR: 72.7%, IT: 69.5%). 70.6% did not agree with the statement, that a service provider could not achieve

additional economies of scale. Indeed respondents for the banks' credit process state that there are economies of scale that can be realized. Nevertheless, the operational cost savings required by the respondents for rendering outsourcing a valid option are in the mean 30.8% (cp. Figure 2), putting a great burden on service providers to meet this expectation.

##### *Economies of Scope*

More than two thirds (69.6%) of the responding firms claimed that there is such high task interdependence within the Financial Chain that outsourcing of selected process parts could not be efficient. On the contrary, in the credit process survey less than half of the participating banks (47.3%) had the same opinion about economies of scope within the investigated process. Comparing these values gives an indicator that the managers responsible for the credit business

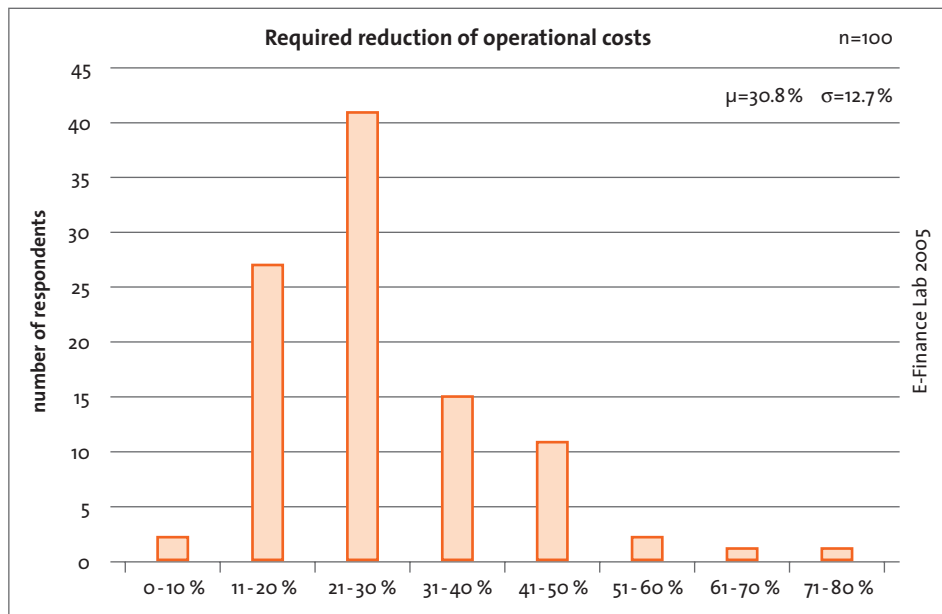


Figure 2: What level of operational cost reduction will have to be realized by the insourcer, if outsourcing should be an attractive option?

are increasingly thinking in terms of industrialization (e.g. modularization of processes, business process outsourcing etc.), even if they have not realized many of the resulting business process optimization strategies yet. Surprisingly, in the opposite, the industrial managers responsible for the Financial Chain have significantly less industrial concepts of modular services in their mind.

Due to regulatory issues, there exist additional constraints in the financial industry which would outlaw complete outsourcing. Therefore the only valid option here is selective sourcing. In accordance with this constraints,

we also asked if it would be at least possible (not necessarily efficient) to outsource credit process parts. This was only negated by 22.7%. In the credit process survey we did some more detailed investigation regarding the reasons for economies of scope. 64.8% of the respondents agreed with the statement that the common use of shared resources (IT and employees resp. their expertise and competence) enables competitive advantages.

The most preferred sourcing model for credit processes is still to control and to operate the whole process in-house (40.0%), followed by selective outsourcing of back office processes

(esp. servicing and workout) (35.2%). This sheds light onto the beginning industrialization and modularization even in this primary financial process. Near-core processes such as servicing and workout will be the first modules that are cut out and provided by professional service providers, e.g. credit factories. By accepting the potential of modularization, bank managers have undertaken a first step towards breaking up this process and restructuring the banking value chain as a whole.

#### *Economies of Skill*

Besides economies of scale, an important argument in favor of outsourcing throughout the literature is using the higher competencies of a service provider (Dibbern et al. 2001) or a lack of particular competence in-house. Since outsourcing can be an important mean of improving a firm's value chain with regard to specialization and scale advantages and therefore to utilizing the partners' expertise, the question of the extent of appreciation of that competence has become crucial for a firm's readiness to redesign its value chain. There is a famous saying in the automotive industry "don't raise the cattle for your leather seats". It describes the experience that focusing on core competencies and thereby a substantial reduction of the vertical range of integration can be a key source of value. In contrast to these prominent examples, our empirical studies reveal some surprising differences between the perception of the service providers' competence in the primary and

secondary financial processes. For secondary financial processes, only 7.6% of the CFOs consider that service providers have superior competence concerning financial management. On the opposite, the respondents for the banks' credit processes accept a little bit easier that the service provider may have a higher competence (37.2% agree).

In the Financial Chain study the impact of former outsourcing experience on the perception of the service providers' skills is evident: only 28.5% of the CFOs *with* outsourcing experience consider their own process competence superior to that of the provider, compared to 66.7% of the managers *without* outsourcing experience. Managers of the credit process seem to more easily accept that external providers may have superior skills, even without prior outsourcing experience.

#### **Summary**

Taking outsourcing into account, the responses differ heavily among the two studies. Economies of scale realized by a service provider are recognized to be much stronger by the credit process managers in banks and are merely not stated by CFOs in non-banks. Both processes tend to be highly repetitive in their back-office parts. This heavily relies on shared resources (HR and IT) and should therefore have a similar production cost structure. Both types of managers should therefore have stated similarly to economies of scale.

Most participants of the Financial Chain study have been industrial companies, which should usually have a much higher expertise regarding process modularization and selective outsourcing. Anyhow, these firms evaluated existing task interdependencies (economies of scope) much higher than the financial institutes in the Credit Process study. Credit process managers on the contrary see much less interdependencies within their processes. They evaluate them at least as less problematic when it comes to selective outsourcing. Therefore, a first cultural barrier towards modularization and restructuring the banking value chain seems to be conquered.

The most surprising differences between both surveys were found between the evaluations of own competence compared to the sourcing providers' capabilities. While the managers of the secondary process, which is normally not classified as part of the company's value chain, consistently evaluated their own competence higher than the one of a possible sourcing provider, the picture completely turns around when looking at the credit process.

In contrast to the proposition of the core competence view, the studies reveal that managers responsible for a primary financial process are much less reluctant to the potential benefits of outsourcing in terms of economies of scale and skill. Those managers accept that the service provider can realize economies of skill and might have a higher

competence than the in-house unit. In addition to that, credit process managers consider the economies of scope inhibiting selective sourcing of process parts much less important than financial chain managers. As the credit process represents a primary process and the financial chain a merely secondary process, an inverse view would have been expected.

Those results are indicators for a beginning industrialization in banking credit processes. Actually, only few financial institutes in our credit process survey have outsourced parts of their processes. However, the responding managers see selective outsourcing as a feasible way to rearrange the banking value chain.

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