A CRITICAL REVIEW OF OUTSOURCING, OFFSHORING AND OFFSHORE OUTSOURCING OF FINANCIAL SERVICES

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Abstract :

The extant literature on outsourcing, offshoring and offshore outsourcing is elaborate and vast. It deals with complexity in the definition to multiple theories to supplier-client relationships, applicable both in national and international context. This study critically reviews the various theories, models and definitions and suggests that there is a need to focus on the trust and control relationship between supplier-client in offshore outsourcing of financial services' project. Earlier studies focus on the role of trust and control using 27 variables in project quality, irrespective the type of data transferred involved in offshoring project. Researchers propose a model with an inclusion of Critical Data Transfer (CDT) risk as an additional variable to understand project quality.

Keywords: *Offshoring, outsourcing, Trust and Control, Critical data transfer (CDT) risk*

The extant literature on the outsourcing, offshoring and offshore outsourcing is elaborate and vast. It entails complexity in understanding the differences in these areas. Various researchers have defined the outsourcing in the context of the global phenomenon of the outsourcing. The academic literature and the media debate refer to the offshoring phenomenon under different terms. Besides "offshoring" these include "outsourcing" (e.g. Kakabadse and Kakabadse, 2000), regardless of whether the business process is located at home or abroad, "global sourcing" (e.g. Kotabe, 1992), "international outsourcing" (e.g. Mol et al, 2004) and the "globalization" of manufacturing or services tasks (e.g. Dossani and Kenney, 2007). The definition made by UNCTAD in the 2004 version of the World Investment Report provides some clarity over the terms. This definition and the distinction between offshoring and outsourcing are reproduced in Figure 1 below.

	Internalized production	**Externalized production**
Location		
Home country	Domestic in-house production	Domestic outsourcing
Foreign country ***"Offshoring"***	(Captive) offshoring	Offshore outsourcing

Offshoring and outsourcing – some definitions (adapted after UNCTAD, 2004)

Figure 1: Difference between Internalized and Externalized production

The figure clearly shows that there are two main dimensions underpinning the phenomenon. One is the ownership dimension, or the make-or-by decision, which is a classic topic that dates back to Coase's (1937) discussion on the nature and boundaries of the firm. The other is the spatial dimension that concerns the location of the business process, either in the home country or in a foreign country.

An offshore location can be any other location outside the home country (Carmel and Tjia, 2005). More recently, however, the word 'offshoring' has taken on a new meaning. From being used for describing tax havens such as the Cayman Islands offshore the coast of the US, it is nowadays understood as the shifting of tasks to low-cost destinations (Carmel and Tjia, 2005). Low-cost destinations would typically be those falling into the economic grouping of 'developing nations' or 'emerging nations', such as India, China and Russia (also known as the "Big Three"), Brazil, Romania and Israel.

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Outsourcing, on the other hand, has two implications. First, it means that tasks and processes are contracted to be performed outside the boundaries of the firm. Second, it is understood as an entire process being delegated to an outsider. To date, there are a number of definitions describing IS outsourcing. For example, Cheon et al (1995) define the term as "...the organizational decision to turn over part or all of an organization's IS functions to external service provider(s) in order for an organization to be able to achieve its goals" (Cheon et al, 1995, p. 209).

While the terms 'outsourcing' and 'offshoring' are often used almost as synonyms, in this paper I distinguish between the two. Here, offshoring is about location – when an activity is offshored it is performed in a different location to the main operation (which is then the onshore location). Outsourcing, on the other hand, is about governance – when an activity is outsourced it is performed by another organization – a third party – as opposed to in-house by the organization itself. Consequently, any particular activity can be performed either offshore or onshore and can be performed in-house or be outsourced.

In looking at research on offshore sourcing, Levina and Ross (2003), suggest that the leading reason behind sourcing is the need to reduce and control IT operating costs. This is supported by Goles and Chin (2005) who recognize that sourcing practices began with a heavy emphasis on cost drivers. Over time, however, the emphasis in research has broadened to include studies describing variations in orientation (Nam et al, 1996) and extent of sourcing (Lacity et al, 1995).

Furthermore, new modes of operation such as "multi-sourcing" (Lacity and Willcocks, 2001), "near-shoring" (Lapper and Tricks, 1999) and "best-shoring" (Fruitman, 2003) are gaining prominence in response to changes in the type of work being sourced – and to political and market pressures (Thiagarajan, 2000).

According to Bie (2005) there is no official definition of what constitutes outsourcing, offshoring or offshore outsourcing. The terms are used interchangeably to describe the way some American firms relocate some of their domestic operations abroad or replace American production with foreign imports. Business process offshoring is defined as 'a process moving across a geographic boundary' and outsourcing is defined as 'a process moving across a firm boundary' (Pujals, 2005).

The term 'offshore outsourcing' is comprised of two distinct terms: 'offshore' and 'outsourcing'. The terms offshoring and outsourcing are often used as synonyms in literature, but offshore is about location (onshore or offshore), and outsourcing is about governance (in-house or outsourced) (Agerfalk & Fitzgerald, 2008).

This review indicates that most of the existing literature differs in the definition of "offshoring". In fact, a paper by Bhagwati, Panagariya and Srinivasan (2004), claims that there is a "set of serious muddles" concerning the definition of offshoring which lead to confusion in the public debate. These authors present a very tight and clear definition of offshore outsourcing as the "purchase of services abroad with the supplier and buyer remaining in their respective locations."

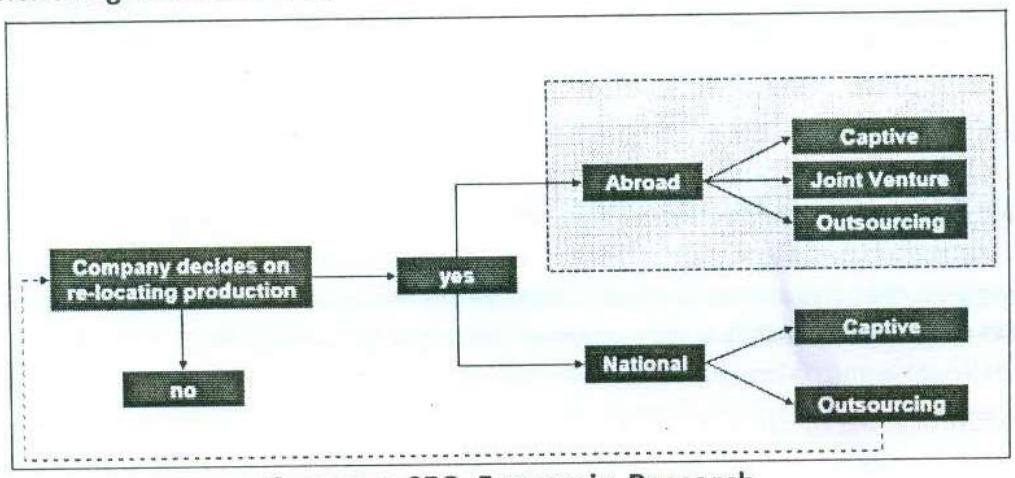
Some definitions consider firms as regulated entity and define outsourcing as a regulated entity's use of a third-party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the regulated entity, now or in the future (Business Credit, 2005).

Biermans and Leeuwen (2006) define offshoring as the relocation of production abroad irrespective of whether it is done in-house or by a third-party and regardless of whether the country is underdeveloped or industrialized. This terms covers all types of employment, be it high skilled or blue collar jobs. Finally the production which is moved abroad must be as a replacement for the one in the home country. Further the authors describe outsourcing as the act of obtaining services and/or goods from an external firm.

In the USA, the term offshoring has been used to describe the relocation of production abroad whether at arms length or within the firm itself. According to Bahrami (2009) outsourcing is conducting certain business functions at a different location or contracting those functions out to another firm. When those business functions are done overseas, it is called outsourcing offshore.

A more precise description of offshoring decision tree (below, adapted from SEO Economic Research) illustrates the various types of offshoring/ outsourcing.

Figure 2 : Offshoring Decision Tree



Source : SEO Economic Research

On the basis of relocation/ownership matrix, offshoring is categorized as shown in the table below:

Location / Ownership	Onshore	Offshore
Outsourcing	National outsourcing	International outsourcing (Offshore outsourcing)
Captive (in-house)	National investment	Direct Foreign Investment (Captive offshoring)

Source: SEO Economic Research

Figure 3: Difference between Onshore and Offshore

Critical Evaluation of theories relevant to outsourcing/offshoring :

The academic literature supporting BPO dates back to early nineteenth century when Ricardo (1817) proposed that countries differ with respect to resources available for the production of goods, and that a country will export the goods that it produces most efficiently and import goods that it produces least efficiently. More recently, Krugman (1985) developed this idea and suggested that production efficiency seekers will operate in foreign countries where one or more of the factors of production are relatively under priced and similarly knowledge seekers will operate in foreign countries where the workforce is relatively more knowledgeable. He argued that the real world suffers from imperfect market conditions where factors of production are somewhat immobile; this is an incentive for organizations to seek out foreign opportunities and capitalize on foreign countries' resources.

At the firm level, transaction cost economic theory (TCE) (Coase, 1937; Klein, 1978; Williamson, 1979) has been widely used by academic colleagues to explain various aspects of BPO and outsourcing. In its simplest form, TCE suggests that a company would outsource a business process if the costs associated with the outsourced process are less than the costs of performing and managing the process internally.

The costs of transacting with an outsourcing supplier would be included in the analysis, for example, the costs of selecting a supplier, negotiating and agreeing a contract, and managing the supplier and service delivery. TCE, however, takes no account of the resources or capabilities that are available to a company from offshore BPO suppliers through the sourcing decision.

An alternative theoretical perspective suggests that the decision to outsource a business process is a strategic one and that outsourcing can be used to fill gaps in the firm's resources and capabilities (Penrose, 1959; Barney, 1991). This 'resource based view' (RBV) suggests that a company can develop a competitive advantage by developing resources which are rare and valuable if they can be sustained over time, and that companies may outsource a business process to a supplier if it perceives the supplier has better resources and capabilities than those available internally.

RBV suggests that companies should only carry out activities internally where the company has a distinctive or core competence (Hamel and Prahalad, 1994; Coyne, Hall and Clifford, 1997; Mascarenhas, Beveja and Jamil, 1998), and other activities that are non-core or peripheral to the organization should be outsourced. Knowledge based view (KBV) (Nonaka and Takeuchi, 1995; Grant, 1996) goes one step further than RBV and suggests that knowledge is the most significant resource within the firm in terms of developing competitive advantage and that it is a very complex resource to manage because it exists in both explicit and tacit forms (Nonaka and Takeuchi, 1995).

Different theoretical perspectives have also been used to explain the governance mechanisms that are best employed for managing a third party BPO supplier, once a decision has been made to outsource. Agency theory (Alchian and Demsetz, 1972; Jensen and Meckling, 1976; Eisenhardt 1985, 1989), for example, suggests that if a company (the principal) outsources processes to a third party supplier (the agent); an agency problem may arise where the principal and the agent have different goals and it proves difficult or expensive for the principal to measure what the agent is doing (Eisenhardt, 1985). Contracts between the principal and supplier are widely used in business process outsourcing to safeguard the interests of both parties; however, MacNeil (1980) argues that a formal contract guided by promissory norms do not play a substantial role in most relationships. Instead it is the set of understandings among exchange partners (organizations and suppliers) or the 'implicit contract' guided by non-promissory norms that substantially affects the relationship (Anderson and Weitz, 1992). According to Andaleeb (1992), parties which engage in exchange, based upon implicit contracts, are less in need of monitoring their exchange partners or building safeguards in the relationship.

The theory of real options has been recently applied to BPO (Myers, 1977) to explain the build, operate, and transfer (BOT) option that has recently been selected by some companies as their preferred governance structure for offshoring. BOT is a contractual arrangement between a client and third party offshore supplier wherein the supplier builds and operates a facility on behalf of the client, but the client has a contractual option to transfer ownership of all or part of that facility back to the client after a pre-specified period of time.

Trust and Control between Outsourcing Partners :

In the outsourcing arrangement both sides are locked in a contract that specifies roles, responsibilities, payments and other operational details associated with the outsourcing arrangement. Setting up an appropriate set of formal controls through a well-crafted contract and the implied control mechanisms (formal processes) is assumed to reduce operational and production costs, and risks, on the one hand, and also to reduce the outsourcing partner's potential opportunism (Barthélemy 2003). Formal controls are also expected to establish a balance of power between the outsourcing partners (Lacity and Hirschheim 1993) as well as to provide incentives for value creation. However, such a set of management techniques implied by the contract is inherently complicated to apply in a real outsourcing setting (Mao et al. 2008), while overreliance on the

outsourcing contract and/or forms of formal controls will not necessarily deliver successful outcomes (Willcocks and Kern 1998). This may produce an overly complicated, prohibitively expensive arrangement, and ultimately have a detrimental effect on the client-vendor relationship. Hence, trust should be one of complementary centerpieces of the good outsourcing relationship. With trust and the ensuing establishment of personal bonds, organizations could cooperate and collaborate beyond the system of formal rules and legal norms. Thus, trust together with formal controls is essential to the successful development of relationships. It is particularly important for the client to exert control over his service provider and build trust in that relationship while ensuring quality and delivery of the service. Firms in the alliances tend to be more confident with partner when they feel they have an adequate level of control over their partners (Beamish, 1998).

Tiwana and Keil (2007) show that peripheral knowledge and alliance control are imperfect complements: peripheral knowledge complements outcomes-based formal control but not process-based control. Mao et.al (2008) found that trust had a significant effect on project quality but little on cost adherence while the effect of control on two performance parameters was opposite.

Das and Teng (1998) argue that the sense of confidence in partner cooperation comes from two sources: trust and control. Trust and control are two separate routes to risk reduction in alliances. While trust can be seen as a more intrinsic source for lowering the perception of risk, control may be viewed as a more overt and active way of reducing risk. The two can and should be combined in specific ways for best risk management results (Das and Teng, 2001).

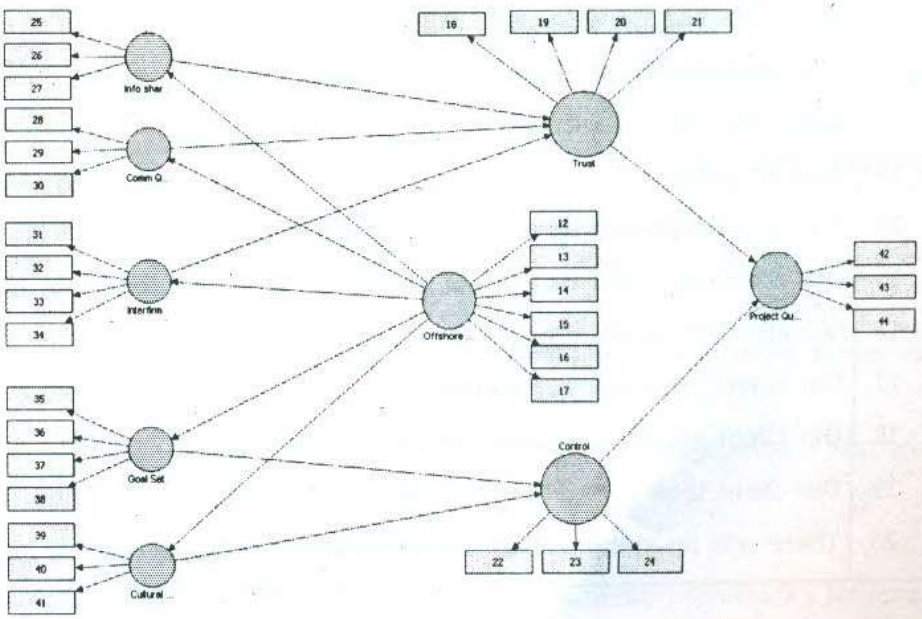
Recent research in the IS outsourcing field supports the opinion that trust and formal controls are both required (e.g. Barthélemy 2003; Sabherwal 1999) and should be served as complements (Woolthuis et al. 2005). However, scholars have not yet gained a thorough understanding of the nature of these conjoint actions nor explained the complexity of such a combination.

Based on the above critical review of the literature, it is observed that information sharing, communication quality, inter-firm adaptations influence trust. On the other hand, goal setting and cultural blending affect the control mechanism in offshoring relationships (Das and Teng, 1998, Sabherwal 1999, Das and Teng, 2001; Barthélemy 2003; Woolthuis et al. 2005).

The above studies do not distinguish the role of trust and control in performance of projects between routine data transfer and critical data transfer in offshore outsourcing. Therefore, the researchers proposed the following model to study the impact of critical data transfer risk in offshore outsourcing.

Figure 4:

Proposed Revised Model



Source :

Composed by researchers

The researchers propose to include an additional variable that explains the risk arising due to the transfer of critical data and its impact on the trust and control. This new variable is named as Critical Data Transfer (CDT) Risk by the researchers. The proposed revised model includes 27 variables (Annexure I) along with additional 6 variables (Annexure II) due to CDT risk that contribute to overall project quality.

Conclusion :

It has become essential for companies to look into the advantages of offshore outsourcing in the context of cut-throat competition due to globalization and survive the varying demands of consumer markets. The review of the academic literature reveals that outsourcing, and in particular, offshore outsourcing is important to firms to improve their performance through comparative advantage theory of specialization. There are various definitions, models, and theories of outsourcing/offshoring in international context explaining the supplier-vendor relationship phenomenon. However, after critical review it is found that the literature on role of trust and control in supplier-vendor relationship needs more focus and there is a need to further understand the dynamics of relationship between supplier and client in offshore outsourcing during the implementation period of project. The researchers propose to include the Critical Data Transfer (CDT) risk as an additional variable to understand the relationship between supplier and client.

Annexure I

Table I. Variables considered for the study

S.No.	Factors
1	Our client was honest when it tried to resolve differences of opinion with us
2	Our client was willing to provide assistance to us without exception
3	Our client reliably provided support as pre-specified in the contract
4	Our client was sincere in dealing with us at all time
5	Our client arranged process control to achieve its objectives
6	Our client tried to routinized our work procedures
7	Our client emphasized process management
8	Our client shared project management experience with us
9	Our client shared with us business domain knowledge
10	Our client shared with us background information related to the project
11	With this client, the manner and methods of communication were timely
12	With this client, the manner and methods of communication were effective
13	With this client, the manner and methods of communication were complete and thorough
14	Our client modified its work procedures while working with us
15	Our client modified its project schedules in order to suit our delivery capability
16	Our client modified its process standards in order to suit our situation
17	Our client modified our contract to accommodate our situation
18	Our client and we reached consensus on the goals.
19	Our client took measures to make sure our two parties had a common understanding of the goals
20	There was no ambiguity in our mind about the deliverables of the each stage of the project.

21 There was no inconsistency in our two parties' understanding of the deliverables

22 Our client and we organized activities for our employees to socialize or train together

23 Our client and we created opportunities to learn each other's culture, e.g., manner of communication.

24 Our client encouraged and facilitated our employees to learn their language and culture.

25 To your knowledge, to what extent was the client satisfied with the project quality? ((1) not at all to (7) extremely)

26 According to the client specific quality standard for the project, this project is: (1, far below; 2, a bit below; 3, close; 4, reached standard; 5, slightly exceeded; 6, exceeded substantially; 7, exceeded a great deal)

27 What is your overall assessment of the project quality? (1, total failure to 7, complete success)

Annexure II

Table2. Variables considered under Critical Data Transfer Risk

Sr. No.	Reasons
1	Intellectual property risks
2	Confidentiality risks
3	Compliance and regulatory risks
4	Geopolitical risk
5	Operational risk
6	Reputation risk

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