**Performance management of suppliers of outsourcing projects in the financial services industry**

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**Abstract**

This study investigates the characteristics of an effective performance management framework for outsourcing projects in a UK-based financial services organisation and how this can contribute to the sustainable success of its outsourcing project arrangements. The analysis draws on outsourcing and performance management theory, and uses both primary and secondary data. A Balanced Scorecard is suggested as a measurement tool and a service credit system and a continuous improvement schedule used to enhance supplier performance.

**Key words:** Performance management, Outsourcing, Financial Services

**Introduction**

In the last twenty years, service outsourcing has become very popular (Amiti & Shang-Jin, 2005). Many different service industries now outsource business processes including the financial services sector, where most back office operations can be outsourced easily, giving institutions the opportunity to improve their process efficiencies (Tas & Sunder, 2004), (Busi et al 2008).

However, there is a trend for outsourcing projects not to meet expectations or even to fail. Many researchers have engaged in finding the reasons for failure of outsourcing projects. Post-outsourcing supplier management was named one of the major issues with regard to poor outcomes in contracting-out (Fan, 2000).

The focus of the paper is to examine how an effective performance management framework for suppliers in outsourcing projects is developed and how this management approach can contribute to its sustainably. This included the following objectives;

* To elaborate on the implications of the use of performance management on the outsourcing process and the outsourcing contract and vice versa
* To identify key success factors and frameworks for effective performance management in outsourcing from literature
* To develop a best practice framework for performance management in outsourcing for the financial services industry, including how to set up goals, measure performance and initiate actions for improvement

**Literature Review**

### *Outsourcing in the financial services industry*

Tas and Sunder (2004) identify major drivers for outsourcing as well as offshoring in the financial services industry. Improvements in communications make it possible for financial institutions to outsource processes without losing control. Outsourcing management systems involves the outsourcing of more complex business processes where skilled labour in countries like India or China and globally accredited standards such as ISO, promote the application of this business strategy.

## *Performance management of suppliers in outsourcing projects*

To be able to develop an effective performance management system in outsourcing, actions have to be taken at the correct step of the outsourcing process, also called the outsourcing lifecycle. Many authors have subdivided the outsourcing lifecycle into various phases. The number of phases and their scope and definition depends on the research study, varying between two and four (Fill & Visser, 2000; Marshall et al., 2004; Weimer, 2009), the most prevalent being Weimer’s three phase Model.

Weimer’s Outsourcing Lifecycle Model firstly contains an assessment phase involving setting up the right outsourcing strategy, goal-setting to signing of the outsourcing contract (Dittrich & Braun, 2004). Weimer’s second, transition phase, concerns the processes or services which are moved from the organisation to the supplier according to the transition plan established in the assessment phase (Dittrich & Braun, 2004), the aim being to shift the outsourced operations efficiently to the service provider. Weimer’s third, operations phase, commences when the service level agreements are met for the first time and ends when the outsourcing project is over and the process or service is handed back to the parent organisation or an alternative supplier. Throughout this phase continuous improvement and the adjustment of the processes are of major concern (Weimer, 2009). Additionally, the performance measurement of the supplier, according to the service levels, is performed with measurement tools (Hodel, Berger, & Risi, 2006) and based on the results of this, actions are planned and implemented.

McIvor (2009) developed a framework for performance management in outsourcing to give an organisation a guideline for the implementation of performance management throughout the course of the outsourcing process. The design and implementation process is split into four stages, the first stage, process importance analysis, identifies the process’s contribution to corporate success where core competencies that contribute to competitive advantage should remain in-house. The second stage, process capability analysis, is concerned with the evaluation of whether the outsourcing organisation is capable of performing the process on the same or a higher level compared to potential external suppliers, using cost analysis and benchmarking. Once the first two steps are accomplished the third stage, choosing the sourcing strategy based on the analysis results, can be executed. The decision will then be whether to outsource or to perform internally. Although McIvor gives some indication on how to manage and evaluate the supplier, a clear tool or guideline for design and implementation that could be adapted for the majority of outsourcing projects is not given. This gap in the literature was closed by Weimer (2009) with his approach to transform the Balanced Scorecard for internal use as a performance measurement tool for outsourcing projects.

*The Outsourcing Contract*

In general, an outsourcing contract should set out in clear and precise terms the scope of the work to which it applies and define clearly the roles, responsibilities, liabilities and expectations of the parties governed by the contract (Gay & Essinger, 2000).

The most important elements to include in the outsourcing contract are specifications for service levels and quality to encourage vendor performance and discourage underperformance (Platz & Temponi, 2007) including guidelines that explain the measures taken in case of poor performance by the supplier (Gay & Essinge, 2000) as well as measures for over-performance (Sadler, 2000). Gottschalk and Solli-Saether (2005) describe stakeholder management as the second most important factor for success in outsourcing, after the correct selection of the process or service to be outsourced. They suggest that the relationship between buyer and vendor has to be managed efficiently and effectively to secure the success of the project.

Regarding key success factors, Aron and Singh (2005) stress the importance of internal measurement before the outsourcing decision, to later compare whether the outsourcing service provider is performing better than when the process or service was still performed in-house. Benchmarking within the industry should be used to get to know what performance and cost levels should be achieved after outsourcing (Schoeninger, 2004).

Basu (2001) regards the selection of appropriate performance metrics a critical success factor for the outsourcing project which require regular review. Dittrich and Braun (2004) stress the importance of hard and soft measures.

The most commonly used tool in the outsourcing environment is the Balanced Scorecard (Würz & Blankenhorn, 2010), providing executives with a comprehensive framework that translates a company’s strategic objectives into a coherent set of performance measures (Kaplan & Norton, 1993). Pai and Basu (2007) suggest a practical approach; the Service Credit System. Service credits are payments to the outsourcing service buyer, when the supplier does not meet the service levels. Service credit is not to compensate the buying party for its losses; rather it is used as an incentive tool. A further area of concern with regard to the design and implementation of performance management in outsourcing is communication management.

In financial services outsourcing, the process has to be evaluated with regard to the internal business risk (Büchner et al., 2008). The best measures to execute the analysis are found by classifying risk according to the four risk perspectives identified by Gewald und Dibbern (2009); performance risk, financial risk, strategic risk and psychological risk.

**Methodology**

Research undertaken included secondary data collection (Collis and Hussey, 2003) through a literature review in order to compare and contrast recent approaches to managing outsourcing. Following this, the authors compared the findings to the practical application of outsourcing in a case organisation. The organisation delivers services to its customers in the fields of savings, investments and pensions. Although headquartered in UK, it has spread its services globally to approximately 6 million customers and employs approximately 10,000 employees globally. For this case study analysis, a multi-million pound IT-outsourcing project that was currently in the transition stage and its corresponding performance management system was investigated.

Data collection methods used included semi-structured interviews with senior management team (eight people in the team) of the aforementioned outsourcing project, company reports and information from their webpage (Saunders, 2009). A best practice performance management framework was proposed using the primary and secondary data to set up goals, measure performance, identify key success factors and to initiate actions for improvement for suppliers involved in outsourcing projects.

**Case Organisation**

The case organisation is a financial services institution in the savings, investments and pensions markets, situated in the UK, with a global customer base. They have recently developed an outsourcing strategy in their organization - this case analysis relates to a multi-million pound IT-outsourcing project which was in the transition stage, and its corresponding performance management system.

Problems in the area of information technology came to light in the form of a capability gap for project execution, both with regard to skills and number of workers. Following that, a business case was developed by the procurement and finance departments to find options the organisation could pursue to solve this situation.

Off-shoring the IT process to India was the most appropriate action, resulting in a study tour to India to get to know the suppliers and their facilities, capability, capacity and the cultural fit to perform the service. After this visit, the request for a proposal was developed and sent out to the potential suppliers; scores were assigned to a number of criteria including capacity, geographical location, quality, KPIs; site visits, including facilities, cultural fit, quality, personnel, confidence and their capability and cost. Further field trips were made to explore the technical capabilities of these suppliers which took ten months but ensured the correct final decision was taken having summarised all criteria into two categories, capability and pricing, to meet objectives and close the capability gap in the organization.

The outsourcing contract consisted of a number of documents, including a rough timeline for the outsourcing project, a governance schedule and manual and the service level agreement, signed for a time-frame of five years. A transition phase of 18-24 months was planned before service delivery fully moved to the supplier, implying an operations phase of three years where the process could be adapted and improved.

KSF’s related to the continuous measurement of processes or services benchmarked for the contract duration. The second success factor related to the effective management of the contract by the supplier manager. Thirdly, the selection of the right performance measurement system and the underlying performance metrics were critical for outsourcing success, using a logic scorecard as its primary performance measurement tool to measure performance. A very recent additional category in the logic scorecard was innovation, discussed with the supplier on an on-going basis to ensure motivation and continuous improvement, by the addition of a clause regarding shared best practice.

A fixed communication infrastructure was used through the introduction of a triple-layer communication network to handle the supplier relationship; an operations manager which is a very technical role, the supplier manager to communicate with the supplier regarding performance measurement and upcoming problems, and the executive level.

A last significant factor was risk management, described as especially important in the financial services sector, both due to the impact that an insufficiently screened project could have on the operations, and due to the compliance with legal requirements imposed by the Financial Services Authority (FSA).

**Analysis**

Segmentation of the outsourcing lifecycle was confirmed by the research conducted. What was neglected by literature but emphasized by the interviewees was the importance of defining requirements and supplier selection prior to proceeding with the outsourcing project, particularly in terms of performance management.

Literature suggested that the contract should define the role, responsibilities, liabilities and expectations, fix the service levels and give a clear guideline on actions taken for good and poor performance (Gay & Essinger, 2000). The outsourcing contract in place in the case organisation incorporated these aspects in its entirety. With the help of a governance schedule and manual, the legal document elaborated on the roles and responsibilities during the operations phase.

Literature stressed the importance of continuous measurement of the process before and after the outsourcing decision (Schoeninger, 2004; Aron & Singh, 2005). The research has proven that this to be a very common practice in outsourcing projects in the financial services industry.

Contract management is a critical success factor in both literature and practical application in financial services. According to a number of authors, contract management is concerned with dealing with adjustments to the contract, using change requests (Hodel et al., 2006; Dzierzon, 2005; Würz & Blankenhorn, 2010).

The Balanced Scorecard was identified as the most suitable performance measurement system for outsourcing projects in the literature (Basu, 2001; Weimer, 2009; Würz & Blankenhorn, 2010). The IT-outsourcing project re-enforced to this view. The case organisation introduced the logic scorecard as their performance measurement tool for the outsourcing suppliers. This was effectivelly a Balanced Scorecard adjusted to the requirements of the outsourcing environment.

For the conversion of the gathered data into actions for improvement, a number of authors from the field of outsourcing have suggested a causal analysis and a service credit system (Dzierzon, 2005; Mullin, 1996; Pai & Basu, 2007).

For performance management in outsourcing projects to be successful, communication between the two contractual parties is another key for success. The case organisation followed this suggestion and implemented a triple-layer communication infrastructure with the supplier manager the key point of the outsourcing relationship.

## Development of an effective performance management framework

Following the comparison of literature with the findings of the case organization, a ten-step performance management framework for outsourcing projects (Figure 1) was developed. Both frameworks for performance management in outsourcing projects developed by McIvor (2009) and Weimer (2009) played an important role in this updated framework. The framework developed provides detailed propositions on implementation for practitioners.

**An effective performance management framework**

Problem detection

*Stage 1*

Process importance analysis

Process capability analysis

*Stage 2*

*Stage 3*

Business case

Outsourcing decision

*Stage 4*

*Stage 5*

Requirement definition

Supplier evaluation & selection

The outsourcing contract

Performance management considerations

* Contract management
* Performance measurement
* Risk

management

* Continuous

improvement

* Communication

managment

Performance management at an operational level

*Stage 6*

*Stage 7*

*Stage 8*

*Stage 10*

*Stage 9*

**Figure 1: Performance Management Framework**

Stage 1: Problem detection

The first stage of this framework concerns problem detection to identify areas of concern within the business needing a solution. This step is not part of McIvor’s (2009) outsourcing process. In the case organisation, outsourcing was considered after a capability gap within the IT-infrastructure was observed. Acting after the detection of such a problem is another way of commencing the outsourcing process.

### Stage 2: Process importance analysis

Stage two is part of McIvor’s (2009) outsourcing framework and is associated with detecting whether the service under consideration for outsourcing can be given to a supplier without losing competitive advantage. This analysis was not a part of the outsourcing project conducted by the case organisation, but is very essential for the sustainable success of both the outsourcing project and the outsourcer’s future company performance.

### Stage 3: Process capability analysis

The third step was also suggested by McIvor’s (2009) outsourcing framework and evaluates the capability of the organization to perform the potential process for outsourcing at the same or higher level than the market at the same or lower cost. This internal analysis also plays an important role for performance management of the supplier, as it gives an indication about cost and service level targets during supplier selection and the management process.

### Stage 4: Business case

Stage 4 is to state the business case. This step is not a part of the framework developed by McIvor (2009) but has been covered by Weimer (2009). The case organisation did implement this step for the financial analysis of the outsourcing project.

### Stage 5: Outsourcing decision

Having accomplished the first four steps of this Framework, the data to enable a decision in favour or against outsourcing has been gathered. While in McIvor’s (2009) framework only process importance and capability were named as criteria for the outsourcing decision, the research conducted in this study has indicated that the business case has to be considered as well to maintain the same level of competitive advantage and to satisfy financial requirements.

### Stage 6: Requirement definition

The performance management framework by McIvor (2009) fully neglects stages 6 and 7. However, for the case organisation, the definition of requirements was a vital aspect and is therefore included.

### Stage 7: Supplier evaluation and selection

The research conducted in the case organisation provided a number of factors indicating how to evaluate and select the supplier. The evaluation of the potential suppliers should be carried out using two criteria, capability and price. Selecting an incapable supplier can have a serious impact on the overall business performance; capability normally receives a higher weighting than price. The supplier selection process should be divided into two steps. Firstly, potential suppliers need screened on capability, capacity and cultural fit and then a detailed analysis conducted on capability and price until the final decision is taken.

### Stage 8: The outsourcing contract

As the outsourcing contract is the legal basis for the outsourcing relationship, it should include as much detail about roles, responsibilities, liabilities and expectations as possible.

### Stage 9: Performance management considerations

After the outsourcing contract has been signed, and by that the basis for a successful outsourcing project established, the outsourcing organization has to consider a number of issues to manage the performance of the supplier in the transition and operations phase effectively.

* + - * Contract Management. For effective performance management the contract has to be managed after signature. Therefore a supplier manager has to be incorporated to manage the service level observance period and the benchmarking procedures during operations and to implement potential changes into the contract
* Performance measurement. The implementation of a Balanced Scorecard as a performance measurement tool is required using appropriate performance measures including cost, quality and delivery
* Continuous Improvement. Performance measurement is only worth doing when the results lead to improved actions. This study has shown four actions that can improve the supplier’s performance and the procurement process in general; monthly governance meetings with the supplier to analyse and improve action plans, a service credit system to motivate the supplier to deliver at or above service levels and to improve the process, a continuous improvement schedule, should be implemented.
* Communication management. A triple-layer communication infrastructure with a supplier manager as a centre point is required
* Risk management. This is of major importance in the financial services industry. This study suggests a risk analysis throughout the assessment, transition and operations phases.

### Stage 10: Performance management at an operational level

To convert all these considerations into actions, a governance schedule and manual have to be part of the outsourcing contract.

**Conclusions and Recommendations**

The research findings from the interviews conducted at the multinational financial services case organization have mostly confirmed the literature review findings and supplemented the theoretical information with practical suggestions for contract implementation. By combining both of these information sets, a Performance Management Framework was developed. The particular focus of this ten-step framework was to develop a process-style model to implement performance management into outsourcing projects, from problem detection to the implementation of performance management in day-to-day operations.

Both literature and the primary research emphasize the importance of performance management for outsourcing projects in general and underline their use by referring to research that has identified a major increase of transaction costs in case of a poorly managed supplier. With regard to the performance management system itself, the study closed a gap in literature by providing practitioners with a step-by-step framework that can be easily applied to a great variety of outsourcing projects. The performance management considerations give a practical guideline for application in a number of areas, including contract management, performance measurement and improving supplier performance.

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