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The Age of Outsourcing Mega-deals has Arrived

by Tim Wright

With outsourcing deals at record levels in Europe, Tim Wright, who heads Pillsbury Winthrop Shaw Pittman's sourcing practice in London, examines some of the outsourcing drivers in 2008 and identifies some of the challenges that may arise from the trend towards the mega-deal.

The second half of 2007 saw a huge rise in the total value of outsourcing deals in Europe, Middle East and Africa (EMEA), with the UK leading the way. After life insurance company Resolution's announcement in May 2007 of the largest deal in outsourcing partner Capita's history, the total value of outsourcing deals struck in the second half of 2007 increased by £724.2m (\$1.42bn) from the same period in the previous year, according to Forrester Research. UK-based companies closed 36% of all EMEA deals with the financial services and insurance sectors seeing the strongest growth, alongside the UK government, which still has a strong appetite for outsourcing.

The insurance sector is bucking the trend towards shorter and smaller "best of breed" arrangements, which are becoming increasingly prevalent in the broader market by favouring "mega-deals." Resolution's 12-year, £580m partnership with Capita saw around 2,000 UK-based staff transfer to Capita last August and will see a phased outsourcing of back-office customer services to India.

Royal & SunAlliance is another insurer which seems to favour a longer-term approach in its outsourcing arrangements. Its recently announced 10-year £92m IT and printing operations contract with T-Systems follows other big deals such as its 2003 10-year life and pensions administration outsourcing to Unisys as well as other long-term outsourced technology contracts with the likes of IBM and Accenture.

In similar fashion, Co-operative Financial Services recently went live on a major 10-year technology and business process outsourcing contract with Capita worth approximately £277m. Then, as if not to be outdone, Prudential provided the icing on the cake with the announcement of one of the largest-ever outsourcing deals inked in the insurance sector, a 15-year deal with Capita worth more than £750m. This contract, which sees 1,750 staff based in Stirling and Reading transfer to Capita, as well as another 1,250 staff in Mumbai, is expected to deliver £60m in savings per year.

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The insurance sector is bucking the trend towards shorter and smaller "best of breed" arrangements, which are becoming increasingly prevalent in the broader market by favouring "mega-deals."

Can we expect this to continue in 2008? Having advised insurance companies as customers of outsourced services in many significant strategic sourcing deals, including Abbey Life, Royal & SunAlliance, Resolution and Co-operative Financial Services, experience says that while a major driver in many recent outsourcing transactions has been the quest for improved quality and an ever-increasing focus on "treating customers fairly," cost pressures will make a marked return in 2008. These factor as the most significant outsourcing driver, as the sub-prime credit crunch bites and other factors of globalisation, such as currency movements and relentless increases in energy and other fixed costs, come increasingly into play. Right across financial services, credit meltdown and resultant write-off losses will put cost firmly back to the top of the boardroom agenda.

Given this, the service provider community is faced with opportunity - the potential to strike new deals - but is also presented with tough challenges, as customers adopt a relentlessly focus on driving costs down (impacting their previously healthy profit margins).

In 2008, the Indian outsourcing companies, such as TCS and Wipro, will continue to start to restructure their delivery models (through consolidation, acquisition and migration to lower cost geographies) as their cost advantage is eroded by high staff attrition and increased costs.

Of the home-grown service providers, Capita appears best placed to continue its fine run of mega-contract signings in the insurance sector, despite concerns that it may suffer a period of indigestion as it beds in its latest contract wins alongside existing ones with the likes of Zurich.

Compounded by ongoing sector consolidation, evidenced by Pearl's recently recommended takeover of Resolution, the appetite for outsourcing is healthier than ever before, as is the sector's ability to better govern its third-party relationships as lessons learnt from earlier experiences are put into play and best practices adopted.

The challenges of legacy systems (high running costs, poor inter-operability, lack of a single-customer view) means that organisations which have transformed their delivery model already (typically through outsourcing, sometimes through a system integration deal managed in-house) and have moved to modern cost-effective administration platforms are now primed to reap the greatest rewards. They will automatically adopt a smarter approach as they better understand where to find increased efficiencies. The transformation process for these more advanced players is more about driving service quality than trying to cut costs.

Contractual flexibility is valuable as the falling price of technology and services means that some long-term infrastructure contracts that are four to five years old are costing organisations more money now and are ripe for renegotiation. Flexible contracts price services on a variable basis, allowing services to expand or contract with the requirements of the customer.

All roads lead to Rome

One noticeable trend in today's outsourcing deal is the adoption of multiple sourcing relations by the more advanced players in the market. However, according to Forrester Research, in the second half of last year, deal sizes

increased, with 63% of all deals including more than one service, compared to 52% in the same period 12 months earlier. Relationships between different suppliers can be tricky and companies need to ensure that appropriate governance regimes are in place. Early adopters of multi-sourcing are now becoming aware that governance issues and increased service integration costs arise in a multi-sourcing environment. We therefore expect to see early adopters consolidating around a smaller number of providers in the next year.

As the insurance sector is acutely aware, corporate governance failure inspires increasingly punitive response from the regulator, as evidenced in growing levels of fines handed out.

The Financial Services Authority (FSA) is particularly attentive towards the security of customer information, a topical issue in light of the record £1.26m fine imposed by the FSA on Norwich Union for failing to have adequate checks in place within its call centres. Back in February 2007, the FSA also levied a £1m fine on Nationwide for loss of customer data.

Thus organisations undertaking multi-sourcing projects will need to increase management overheads in order to ensure that the supply chains are proactively and effectively managed. Some commentators suggest that such compliance concerns are creating hesitancy within companies in proceeding with the outsourcing deal. However, compliance should not present a barrier for insurers since, if negotiated correctly, outsourcing contracts should include a detailed schedule setting out core compliance objectives which the vendor must follow and which are generally the same as the insurer's own internal control regime. The most pressing concern for the FSA revolves around access to suppliers for audit purposes and all outsourcing contracts must include a right for any regulator to be able to audit the vendors at will.

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