

"Thousands of Miles Before You Sleep..."

By Mark P. Dangelo

In a "galaxy long ago and far away, before the age of enlightenment," proven business practices and personnel were used to create some of the largest, most profitable outsourcing firms in the world. Today, these old methods appear stale and potential liabilities in the outsourcer's effort to capitalize on existing contracts, while expanding into new areas (like mortgage processing). The successful thinking of the past along with large profits, have created "barriers against change" allowing more nimble players to gain market shareⁱ. For mortgage bankers, the adoption of these "future" delivery models utilized by nimble outsourcers has never been more perplexing. With globalization efforts maturing, their offerings are now being transformed into complex product and service capabilities in regions once shunned by international businesses and investors.

The baseline

As globalization has accelerated, we have experienced reallocations in manufacturing jobs, IT positions, and most recently back-office functionality to foreign locales. The ubiquitous nature of communications, granular delivery disciplines, and our increasing ability to efficiently leverage international resources, has produced a turning point for services based firms and customer-facing organizations.

New higher value product and service opportunities are being created in areas once thought immune to globalization's advancement. To illustrate this point, initiatives are now underway to create "international enterprises" in biotechnology, petrochemical engineering, and even legal services (including the lawyers themselves). Additionally, comprehensive functional solutions involving supply chain management (SCM), collections, compliance, finance and accounting, and currency exchanges are being offered with increasing frequency and success.

However, according to a recent global study conducted by the advisory group TPIⁱⁱ, the market valuation for outsourcing appears to have flattened out during the last three years at roughly \$72 billion USD. In fact, outside of a significant one-year top-line revenue dip in 2001, the outsourcing marketplace size has remained nearly constant since the change of the millennium. What's more, the study points out that the traditional large outsourcing firms like ACS, IBM, EDS, HP, Accenture, and CSC have witnessed their combined market share plunge from 71% to 44% from 2003 to 2004ⁱⁱⁱ.

While this study is primarily focused on information technology outsourcing (ITO) and business process outsourcing (BPO), it supports the market dynamics that are having profound implications on the mortgage industry. Moreover, even General Electric (GE) recently sold a 60% share of its ITO/BPO back-office operations, which was once a core competency of the conglomerate to a group of investors^{iv}. Why? Does this mean that outsourcing is maturing with increasingly specialized services dominated by niche players? What should we expect next?

Within history, we may find the answers...

In 2004, N. Gregory Mankiw, the head of President Bush's Council of Economic Advisors, testified that "outsourcing is just another way of doing international trade."^v With the presidential elections now behind us, the open discussions surrounding continued expansion of global outsourcing is being embraced by senior executives once again. Indeed, the discussion and utilization of outsourcing has become almost passé' in corporate offices and boardrooms.

The United States and European corporations fully recognize the high cost of labor involved in identifying, originating, and servicing financial instruments like mortgages and equity loans. With an easing of the standards for mortgage originations, new complex products and credit scorings have kept the initial deal flow high^{vi}, while providing a significant foundation for future customer-initiated actions and fees. With a projected heavy-deal pipeline as a result of refinancing, defaults, or foreclosures, mortgage executives realize that they must be preparing now for increased cost-efficiencies surrounding an emerging and multifaceted array of origination and servicing issues^{vii}.

Lester Dominick, President of MortgageFlex states, "Within the mortgage industry, we have not been driven by competition to perfect systems and processes that are as mature as those found in the manufacturing sector. So if these immature processes are then moved to a new environment before they are allowed to mature, you may see some cost saving from reduced labor costs but still retain the same inefficiencies that existed in the old environment. Before you can attain real benefits from outsourcing we must first make sure that we have streamlined our current business processes for maximum efficiency."

Historically, outsourcing organizations within the mortgage industry were responsible for contact centers, customer-facing Internet portals, and information technology services. In some cases, industry domain knowledge offshore was applied to loan artifacts, forms processing, and business processes. The benefits of using lower cost resources has allowed our organizations to be globally competitive, while bestowing upon our product and service offerings the ability to adapt quickly to pricing pressures and profit margin requirements.

However, if we examine the evolution of the three decade old outsourcing phenomenon, we can clearly see the challenges and opportunities facing our lending organizations. Today, mortgage outsourcers are adopting two primary strategies to deal with the shifts in customer buying habits, market demands, and competitive threats (see *Figure 1*).

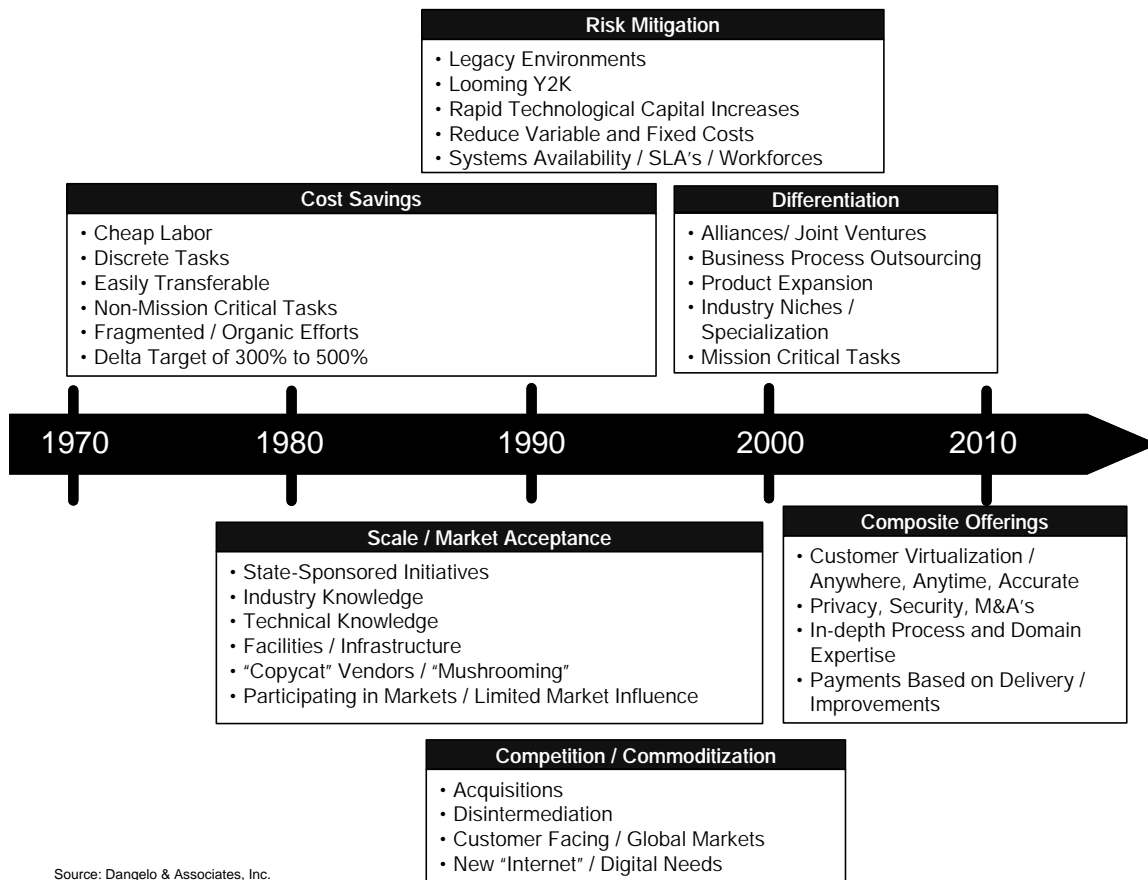


Figure 1—Evolution and Challenges of Outsourced Offerings

In support of the latest moves to outsourced "Differentiation" and "Composite Offerings," a study jointly released by Trinity BPM and Aventus claims that the US mortgage BPO market size is between \$6 and \$7.4 billion and growing^{viii}. Other anecdotal evidence involves an analysis released by the Yankee Group, projecting the aggregated BPO growth in 2005 to increase 43% in the US with a global market size of nearly \$52 billion^{ix}. Even traditional enterprise software vendors (e.g., ERP, CRM, and SCM) are licensing their architectures and "composite applications" to the aforementioned large outsourcers and others in an effort to increase revenues and customer relevance. Needless to say, this area will be a strong source of M&A activity during the next several years.

With the outsourcing industry in transition and expansion, what are the pressures facing our mortgage decisions? How should we conduct our dialogues and due diligence to determine delivery capacities and capabilities, while allowing flexibility for future business adjustment?

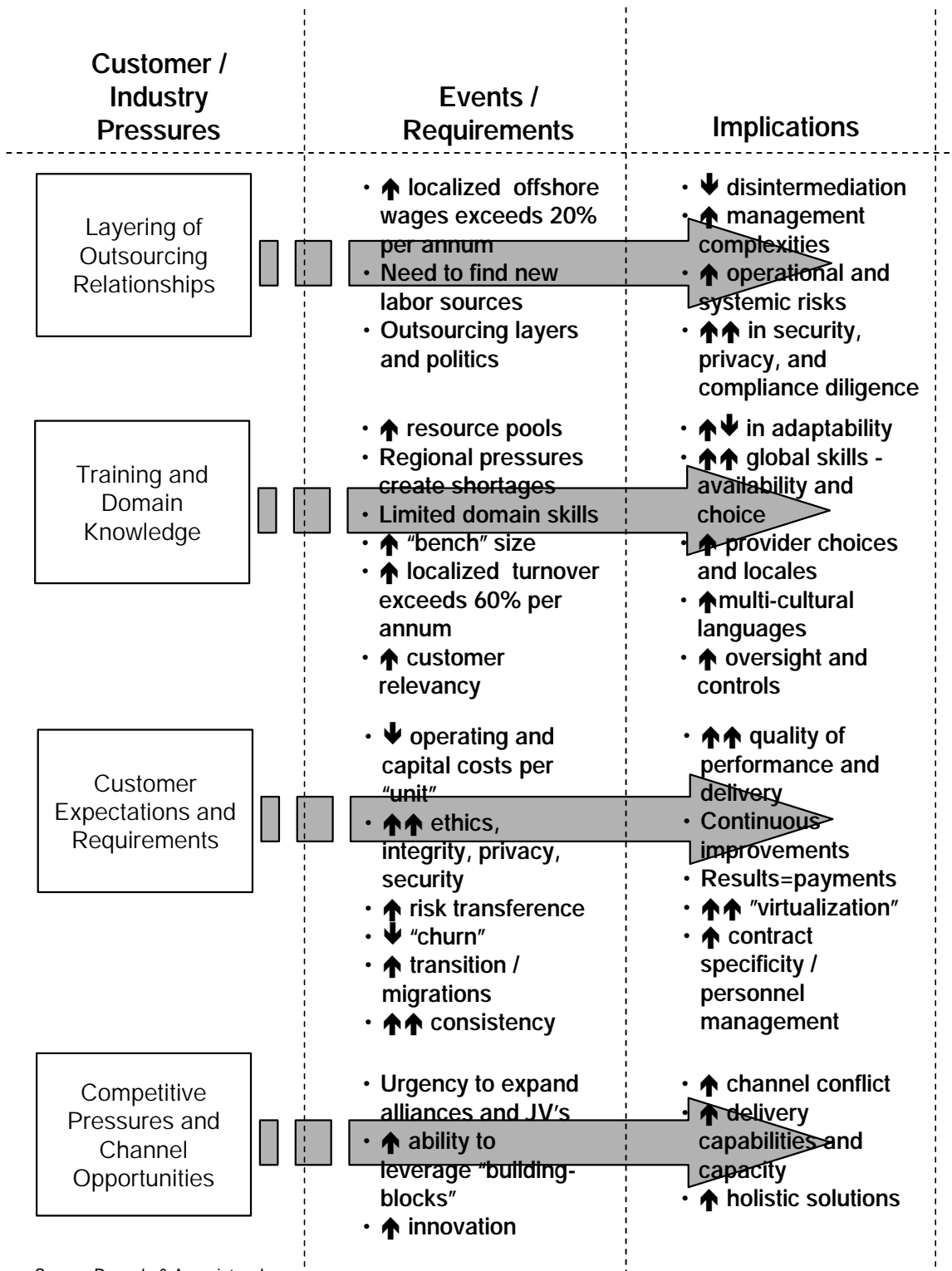
Current Market Pressures

"The outsourcing industry performs best when executing defined functions over and over. As they gain more experience these functions can become more complex. Performing full back office functionality on vanilla loans is certainly attainable. However, the increasing popularity of loan programs customized to the individual borrowers' circumstances is going to be much more difficult for an outsourcer to handle successfully. These deals require much more interaction with the originator and

customer and flexibility is a key ingredient to getting the loan closed. How well this is executed will define the success or failure," adds Dominick.

Innovation, adaptability, virtualization, and domain knowledge have become the battle cry for outsourcers seeking to capitalize on changing market needs and perceptions. With pricing and cost pressures on traditional ITO services taking place domestically and internationally, the once seemingly endless annuities are yielding to a retrenchment within all established providers. For mortgage firms, this means increased leverage and negotiating power. In some cases, rumors surround the pricing of ITO services as loss-leaders for more lucrative offerings such as BPO, industry specialties, and management consulting.

Viewed in its entirety and based upon the trends, we are inclined to believe that offshore outsourcers and BPO specialists should be basking in the new and expanding market projections and opportunities. However, they also have pressures and challenges fundamentally changing their markets and margins (see *Figure 2*).



Source: Dangelo & Associates, Inc.

Figure 2—Pressures, Events, and Implications

The acceptance and leverage of the outsourcing pressures, events, and implications can yield positive change and profitability for your mortgage operations. Conversely, failing to confront the outsourcing status quo and the unfolding challenging events will result in

suboptimal solutions for your product and servicing needs. Therefore, if we welcome the changes within the mortgage industry outsourced offering, what lessons learned should we embrace? How can we be assured that the decisions made today can be supplemented or undone as business and outsourcing events unfold?

Our Fortunes?

It's critical that we recognize and understand the shifts taking place within the outsourcing markets both domestically and globally. Combined with an increased regulatory scrutiny, potential for loan defaults, and escalating home-price inflation^x, the complication within outsourced operations and customer servicing has substantially been enlarged. Consequently, our onshore and offshore relationships must also meet our shifting commerce needs and operating parameters.

To promote success while reducing multiple forms of risk, there are 12 key imperatives that can be learned from others as we engage prospective outsourcers.

<ul style="list-style-type: none"> Definitive process integration and delineation to iteratively implement BPO, ITO, domain, and mission critical obligations. 	<ul style="list-style-type: none"> In depth review and validation of all relevant (third-party and internal) certifications, assessments, audits, IV&V's, and methods of operation.
<ul style="list-style-type: none"> Task level review of transition activities (e.g., 100 day plan), governance models, staff training, operational reporting, and escalation processes and procedures. 	<ul style="list-style-type: none"> Clear actions and "consequences" for all missed service levels, operational guidelines, security breaches, and privacy disclosures up to and including contract terminations and treble damages.
<ul style="list-style-type: none"> What "continuous" methods and recovery efforts will be employed to deal with natural disruptions, terrorism, economic collapses, and political / government "restrictions?" How will they be validated and tested? Repeated and improved? 	<ul style="list-style-type: none"> Define three to five economic models to quantitatively analyze and project scenarios from best case to worst case. Update every quarter and/or with the exceeding of predefined risk thresholds.
<ul style="list-style-type: none"> While traditional outsourcing models were fees for services, structuring of future contracts needs to be based upon a collaborative relationship where fees = continual performance improvements based on process, profits, and costs. 	<ul style="list-style-type: none"> Comprehensive due diligence in examining not only capabilities, but also expansion plans, alliances, and tiered relationships. Non-domestic governments do not consistently adhere to or enforce US standards of privacy and protection.
<ul style="list-style-type: none"> Be prepared, with the adoption of service oriented architectures, to cooperatively adopt new business processes, methods, and technologies (e.g., ERP vendors licensing architectures to BPO and ITO firms). 	<ul style="list-style-type: none"> Holistically examine personnel placement, skill levels, and domain knowledge. Not just historical perceptions, but current and projected results and trends. Older models of operation are proving difficult and expensive to maintain at current quality levels.

<ul style="list-style-type: none"> • If anticipated market problems are experienced with loan portfolios, the downstream affects on the sector will materially alter the contractual needs with the outsourcer. Processes, unstructured data, system functionality, and skill level will all require rapid adaptability and conformance. 	<ul style="list-style-type: none"> • Transparency of operations and performance must be the norm. While exposure to regional mores and laws should be mitigated by the outsourcer, oversight and control will be necessary to protect the direct interest of your company and customers. Accountability and responsibility will rest with you (e.g., Sarbanes).
<ul style="list-style-type: none"> • The “bubble” of “new” outsourcing models and vendors will experience consolidations and M&A activities. The time of a single long-term relationship has passed in favor of flexible, multi-vendor integrated business services. It will be up to your organization to manage. 	<ul style="list-style-type: none"> • If a vendor is “intellectually arrogant” regarding your needs, or only sees the solution as offshore, onshore, or as “their model of operation”, then reassess your business relationships.

Table 1—Key Imperatives

The intent of this article was to examine the facts and statistics, which have been published to demonstrate potential benefits, challenges, and industry changes. We all recognize that the discussions and emotions surrounding outsourcing can result in heated viewpoints being raised by the participants. Irrespective of our personal beliefs, outsourcing is here to stay. Consequently, we need to embrace the good, while mitigating the less desirable. It is only with continual analysis and removal of market hype can we achieve the full value outsourcing has to offer.

In our ever expanding global relationships, we must invoke new rules of engagement if we are able to survive and succeed in our future outsourcing transactions. Business and commerce changes are forthcoming. Customers and their ability to sustain the increasing levels of debt will affect our volumes and market reputations. The last thing we need as we increase our adoption of globalization, are relationships and contracts that make matters worse. For when our outsourcing relationships are poorly structured for business processes and profitability, you will have *“thousands of miles to go before you sleep.”*

ⁱ Rediff.com, “All’s Not Well with Indian BPO’s,” Prasad Sangameshwaran and Amit Ranjan Rai, March 15, 2005

ⁱⁱ The Deal, “Outsourcing Takes Off Worldwide and Opens Opportunities,” February 14, 2005

ⁱⁱⁱ *ibid*

^{iv} CFO, “The Future of Outsourcing, An Exclusive Look inside GE’s Back-office Machine,” Abe De Ramos, June 15, 2005

^v Foreign Affairs, “The Outsourcing Bogeyman,” Daniel W. Drezner, June 2004

^{vi} The Wall Street Journal, “S&P, Citing Option ARMs, Sees Growing Risks for Home Loans,” James Hagerly, June 22, 2005

^{vii} The Wall Street Journal, “ARM Holders Face Decision When Fixed-Rate Period Ends,” Terri Cullen, June 9, 2005

^{viii} Express Computer Online (www.expresscomputeronline.com), “US Mortgage Outsourcing Will Grow to \$1 Billion in 5 Years,” May 2, 2005

^{ix} SearchSAP.com, “Outsourcing Threatens SAP, Other large Vendors,” Robert Westervelt, June 2005

^x The Wall Street Journal, “S&P, Booming Local Housing Markets Weigh Heavily on Overall Sector,” Greg IP, June 20, 2005