

BUSINESS PROCESS OUTSOURCING IN IDENTIFIED FINANCIAL SERVICES SUB-SECTORS

THE POTENTIAL FOR OFFSHORE BUSINESS FLOWS INTO SOUTH AFRICA AND CONSEQUENT
RECOMMENDATIONS FOR TARGETED GOVERNMENT SUPPORT

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Tracy van der Heijden
083-651-2400
tracy@heijdens.co.za

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*Please note: This project is concerned with the potential for **offshore** BPO in South Africa. Therefore, when we are discussing issues such as market potential, it is specifically intended to refer to the potential for attracting foreign business, even though the text may not always make that perfectly clear.*

PROJECT DESCRIPTION AND SCOPE OF WORK

The BPO market (which includes contact centres) has been identified as one that could have enormous potential to support economic growth and employment in South Africa. As a result, it has recently been the subject of much attention, research and debate, by various levels of government. However, to date the focus has increasingly narrowed to contact centres, and, for various reasons, BPO is increasingly seen as a market where South Africa does not enjoy a significant comparative advantage.

This assessment does not reflect actual market developments in asset management and related financial services, and there are good reasons to believe that there is, in fact, significant potential benefit in supporting this part of the market.

However, in order to convince policymakers of the merits of this avenue it is necessary to undertake an assessment of this part of the market that is more strategic, more detailed and more focused on actual potential interventions than the work that has been done to date.

The brief for this project is to conduct an investigation, covering the following in respect of the asset management and related services (offshore) outsourcing market:

- An analysis of the key drivers of this part of the outsourcing market, in order to draft a strategic framework.
- An understanding of the potential economic benefits of growing this part of the BPO market.
- A detailed assessment of the local and foreign companies currently engaged in setting up or running BPO operations in the South African markets.
- Interviews with companies to determine the key business and other factors that influence the decision to be based in South Africa, as well as understanding the decision about where to be based
- Initial assessments of the potential of this segment of the market

This information will be used to draft:

- A comparative advantage framework for the sector, highlighting the issues that are particularly relevant and then rating the local market offering in terms of that framework.
- An analysis of the critical barriers/dis-advantages that government could address, and that in so doing would support the sector.
- A list of what government priorities in this sector should be, and how they should best be implemented.
- A more detailed understanding of how these companies are making decisions about country and regional location, and the permanence or otherwise of these decisions.

This will then be used as a basis to:

1. Determine whether or not South Africa actually has a comparative advantage in these sub-sectors; and
2. If so, what would be the most effective way for government to provide support.

BUSINESS PROCESS OUTSOURCING (BPO)

BPO VERSUS CONTACT CENTRES (CC's)

BPO is both a much used and much misused term, largely because it encompasses so many different business activities in so many different sectors of the economy. Therefore, it is often used in a vague fashion and general statements are made about “BPO” when they could never be applicable to all these activities at the same time. For the purposes of this report we need to arrive at a definition of BPO that is relevant to South Africa, and in particular, to the economic sub-sectors that we are looking at. The latter will be discussed further later in this report. However, some general definitions are first required.

BPO refers to the outsourcing of a business process, where “outsourcing” means that the responsibility for executing this business process has to date resided within the buyer company, and it is now handed over to a third party – the supplier, who receives a fee for performing this service. (Therefore, simply using a third party to provide a service does not automatically entail an outsourcing agreement – the service/process in question must be one that was being provided in-house, or could easily be provided in-house). The BPO decision by the buyer will be made after an examination of the forecast costs and benefits.

In general, outsourcing contracts are long-term (expected to last at least three years) and are governed by complex service level agreements, detailing the duties, obligations and rights of both the buyer and the seller.

Under most outsourcing agreements, the buyer (the person who has outsourced) will still carry the consequences (risk) of the business process not being executed properly, although he will obviously try to manage/hedge the risk by including penalty clauses in the service level agreement. The result is that the regulatory authorities in many markets do not see an outsourcing arrangement as reducing in any way the buyer’s statutory or client obligations. (This is a particularly important point for the asset management and related industries, since the risk associated with outsourcing would generally be perceived as far greater than say for a contact centre. This is both because (i) regulatory compliance requirements in potential target countries, such as the UK and US, are *very* onerous; and (ii) in general, errors carry direct financial consequences.)

Under most outsourcing agreements, the underlying business flows and/or client relationships remain the property of the buyer, and no agency arrangement between the buyer and the supplier is intended or implied.

As stated above, BPO refers to an enormous range of business activities. The general useful definition is that BPO excludes the following outsourced activities:

- Software programming and development (since that is not generally considered a process that companies would undertake in-house as part of their regular business).
- Management of physical IT infrastructure, such as computer hardware

- Physical manufacturing and/or production of goods (since that is not classified as a service)

Therefore, BPO refers to the provision of services, as opposed to goods. (Offshore BPO would be classified as foreign trade in services).

One important part of the BPO universe is the contact centre (CC) market. Over the past decade or so CC's have become an indispensable part of customer service, and almost all medium and large businesses in the industrialized world make use of them. As a result, the CC market has grown exponentially in a relatively short period of time. Increasing costs (due in large part to a rapidly tightening labour market) make the outsourcing option look attractive to many companies. In addition, a CC is (in most cases) a fairly easy activity to decide to outsource, for the following main reasons:

1. It is a truly non-core activity to many companies. Most managers do not want to add the responsibility for managing a CC to their list.
2. Although companies obviously want to keep their clients happy, the risk associated with something going wrong in the CC is generally viewed as far less serious for the business than, say, something going wrong in the accounting and finance area.
3. The technology associated with an efficient and effective CC can be expensive – outsourcing to a specialist provider can save a company a lot of money, but still allow them to provide quality service.

For much the same reasons, the decision to offshore CC services was a relatively easy one. After all, it's just someone answering the phone or replying to e-mails and look how much we have saved! India, already with a proven outsource market in software development and various processing functions, saw the gap in the market, and took full advantage.

Therefore, when people talk about offshore BPO success and market potential to create jobs and income, they are often referring to the CC market in India. This is the case in South Africa too, where many people use the term "BPO" to mean CC activities. However, there are very important differences between the CC market and the BPO sectors that we are discussing, particularly in terms of the key factors that drive the outsourcing decision. Therefore, the terms cannot and should not be used interchangeably.

The details of these differences have been discussed further in the next chapter. The main implication to note at this point is that one market condition in the CC market (such as the basic level of wages) can have a completely different impact in another BPO segment, in terms of competitive advantage. Likewise, it can never be assumed that an incentive designed specifically for the CC market (or any other market for that matter), will have exactly the same impact on other BPO segments. The corresponding analogy would be an assumption that an incentive scheme that is specifically designed to reduce the cost of providing retail banking services will have the same impact on the cost of providing life cover, since both banks and life companies are in the financial service sector.

KEY RELEVANT TRENDS

A vast amount has been written about developments in the global markets for offshore outsourcing. Without repeating all of that, the following key trends are of particular importance for this study:

1. The scope and depth of the offshore BPO market is increasing, and is forecast to increase for the foreseeable future. This means that additional (new) services are being outsourced, plus “traditional” outsource markets are seeing increased volumes. The implication is that successful BPO suppliers must be able to anticipate new directions for the BPO market, rather than just focusing on current activities.
2. Most of the new services that are being outsourced are further up the “complexity” chain. That is, increasingly buyers are choosing to outsource high value-added processes, rather than the simple and basic ones near the bottom of the value chain. The implication is that a different set of skills and a different service offering will be required to capture this news business, compared to the “old” business.

Another important application is that what we refer to as “BPO” is rapidly becoming a highly diversified market, with an enormous range of services, buyers and clients.

3. As a result of the maturing of the outsourcing market, plus the different risk/reward perception that goes with outsourcing higher value-added services, cost is becoming a less important factor when making the outsourcing decision. Although quantifiable cost obviously almost always plays a role in any decision made by a for-profit business, when you are entrusting high-value and important business processes to a third party, monetary cost cannot be the only criteria. In these situations, companies will put an implied cost to factors such as the ability of the supplier to do a good job, business continuity, and factors that will contribute to the buyer having a competitive advantage in the market. The analogy would be the increased trend among institutional investors to focus on risk-weighted returns as a means of selecting a good investment manager, rather than absolute returns only.

The basic services are increasingly becoming a commoditised service, and we would expect in many instances to see automation replacing tasks such as data capture.

4. Globally, reporting and statutory compliance requirements are increasing in the asset management and related sectors. This is due to greater anti-money laundering legislation, and global risk management and reporting initiatives, such as Basle II. In addition, clients are becoming more demanding, particularly in terms of having access to real-time information, and demanding complex hybrid products from their service providers. All of these factors are making back-office operations more expensive (more technology is required), more dependent on specialist skills (to administer and manage complex products correctly) and riskier (the cost of making a statutory compliance error through say, an incorrect valuation, is growing). This has a significant effect on the outsourcing decision. On the one hand it increases the attractiveness of

outsourcing, but on the other it also makes customers much more focused on non-price considerations when choosing a supplier.

The implications of these trends for our focus target markets will be discussed in more detail in the next chapter.

BPO AND THE SOUTH AFRICAN ASSET MANAGEMENT AND RELATED INDUSTRY

From this point forward, we have narrowed our focus on BPO considerably, to look only at selected parts of the financial services sector. Just as we have made the point that observations drawn and recommendations made in respect of the CC market should not be applied blindly to the remainder of the BPO market, so the conclusions drawn about this focus area of the market are not intended to be general statements. From our point of view, these conclusions are relevant ONLY to the section of the market that we have identified. Additional research is required before they can be automatically applied to another part of the BPO market.

MARKET COMPONENTS AND OVERVIEW

For the purposes of this report we have focused on a selected part of the financial services sector. These sub-sectors, plus the main BPO activities that are associated with each of them are included in the table below. Where we have indicated "BPO activities", this is our assessment of what services, currently performed by more than one company in the sub-sector, could be the basis of an outsourcing supply. It does not indicate whether or not these services are currently being performed on an offshore basis or not. This is not intended to be an exhaustive list of possible activities in the financial services sector, but indicates where the focus of the report lies.

Sub sector	BPO Activities	Clients
Custody services	Custody services, including portfolio evaluations, collection of income, management of corporate events and securities lending administration.	All liquid, traded asset holders, primarily asset managers and retirement funds
Asset management: wholesale and retail (such as mutual fund administration)	Portfolio valuations, processing and reporting transactions (on the portfolio or for individual clients), portfolio reporting, unit pricing and distributions, statutory reporting, fund accounting, value-added reporting (such as performance analysis).	Investment managers, unit trusts, mutual funds, retirement funds who manage their own assets
Employee benefits	Management of individual member records, processing of member transactions (contributions, withdrawals, etc.), valuations, fund accounting and statutory reporting.	Retirement Funds

The basis on which these sub-sectors were chosen was:

1. Although the services are not identical in terms of the details of the service offering, both the business processes and the majority of skills that are required are fairly similar. The business processes tend to focus on regular (generally daily) asset/portfolio valuations, processing of transactions (buy, sell or switch), statutory accounting requirements, statutory tax calculations, valuation and performance reporting, and consolidated reporting to clients. The use of technology in these sub-sectors tends to be high and focused on large, expensive and international (i.e. used around the world) systems. The general skills that are required are around accounting and related numeracy skills. At the higher levels, specific industry knowledge around tax and statutory disclosure and reporting is required.

2. The scalable potential of these businesses is fairly similar and very different from that of many other BPO sectors, such as contact centres. Most suppliers will begin with a large infrastructure and more staff than are probably required at that particular point. As business flows increase, so additional staff will of course be required, but this increase will be at a much lower pace than the increase in business. Scale is how these companies make money, since the infrastructure required to service two clients is much the same as that required to service ten. They tend to be unprofitable at low volumes of business (where “low volumes” can mean assets under administration of less than R200 *billion*). The fact that all clients operate in similar statutory regimes that determine reporting and disclosure requirements helps to standardize the service offering.

The need to create scale also means that there is generally a high focus on automation of basic transactions, and consequently a limited number of low skilled staff. It also means that there are very few small companies in this global BPO market.

As a result, we believe that what is applicable to one business activity in terms of BPO will be broadly applicable to another, within our narrowed focus.

(Similar services that could be included in further research could include policy administration, treasury management services and medical scheme administration).

One key factor is that many of the service offerings will have a common client. For example, a life company may require custody services for the assets it holds, asset management services for its wholesale portfolios, and employee benefits administration if it is offering combined linked retirement fund products (which they often do). Likewise, a self-administered retirement fund holding its own assets requires custody, some kind of asset management service (depending on how much of the investment management is outsourced) and employee benefits administration. Although it is generally not the case that they can access all these services from one service provider, it does mean that service providers tend to have similar operating processes in place, and must have at least a basic understanding of how the other services are done, because the client requires an integrated solution across multiple service providers.

In addition, the local outsource market across these sectors has considerable depth, with many companies buying into the outsourcing model. This is not the case in the policy administration market, where the bulk of the administration is still done in-house (although this may change over the next few years). As we will argue below, we believe that the approach towards supporting sectors that already have a well-developed local base may be different from those that do not.

A factor that is particularly relevant for this report is **who** is providing these services, since increasingly traditional service providers in one area are leveraging off that offering to offer a range of related services. In this context “related” has two meanings: Firstly, the services are related by the client that is using them (i.e. companies cross sell more services to an existing client base); and secondly the services are related in terms of the basics of the service offering. For example, a supplier that is providing fund accounting and consolidated reporting can, with a little extra

expertise, offer unit pricing and life reporting. The life companies have been in this “combined” market for some time – offering a combined asset management and employee benefits administration package to retirement funds through a linked policy. As we shall discuss below, the custodians are aggressively expanding the “related” service offering, to maximize income from existing clients. In this case they are using their reputation in one area to increase business in another.

KEY MARKET PLAYERS IN OUTSOURCED SERVICES

The major banks (both local and international) are the most important providers of custody services. As a rule, all owners of assets have a third party custodian who provides services such as income and dividend collection, settlement of trades, etc. In fact, the role of the custodian is so entrenched that most people do not even consider it an outsourcing agreement, but just the normal way of doing business. Although the systems, skills and processes required for providing a comprehensive custody service are very similar to those required to provide asset management services, until fairly recently most custodians were not looking in that direction for new business. Outsourced services were generally provided by third party specialist administrators. This has now changed, with several large banks actively looking for asset management administration work. Their main motivation is to push higher-margin business through their large existing administration infrastructures, and thereby increase profits. (Higher fees can be charged for value added services such as fund accounting and performance reporting.)

However, not all banks that are active in the local custody market are looking for additional BPO business in related fields (and some of those that are looking are not finding it). Whereas the international norm is that custody is often part of a bundled service offering, this idea has been much slower to catch on in South Africa. This may be in part due to the more conservative nature of South African banks, the fact that high interest revenues have reduced the pressure to find other sources of income, plus the presence of specialist service providers. What is now clear is that many want to “catch up” in this market.

The main participants in the asset management BPO market currently are JP Morgan, Standard Bank, State Street and Nedcor. All either already have or are actively pursuing BPO opportunities in the asset management area..

JP Morgan Chase & Co owns one of the largest custodians in the world - JP Morgan Investor Services. The company provides investor related services in more than 80 markets to mutual funds, investment managers, pension funds, insurance companies, endowments, foundations and banks throughout the world. JP Morgan Investor Services has \$10.2 trillion in assets under custody. The banking division have had a niche merchant banking operation in South Africa for some years, but are relatively small players in the local custody market. However, they have now entered the South African asset management BPO market with a bang through their purchase of Tasc – see below.

State Street is one of the world’s largest asset managers and custodians, with more than \$9 trillion under administration. They provide a wide range of investor and value-added services in 24 countries. State Street has had a presence in South Africa for some time (initially offering global

custody services to South African companies), and a joint venture agreement with Nedcor was put into place in 1998. State Street took a lead in the value-added services market when they were appointed by the Government Employees Pension Fund (GEPF) to perform value-added services such as fund accounting and reporting.

Standard Bank entered into a working agreement with the Bank of New York (BNY) in 1998, largely to facilitate a global custody service offering. However, several large retirement fund clients were also signed up to BNY's value added services (offered through Standard Bank to existing custody services clients), such as fund accounting and compliance reporting. Unfortunately, the US dollar-denominated fees became increasingly onerous after 2001, and by early 2003, Standard no longer had any asset management administration clients. However, since then Standard has established their own asset management administration capacity, and now have a number of clients signed up.

Other (smaller) players include the French Bank Societe Generale (SG), which runs a fairly small custody and securities lending operation from their head offices in Johannesburg. They too have expressed interest in the local BPO market, and have made several failed attempts to purchase an existing business. To date, they have not been willing to start a business from scratch (due to the possibility of a very long lead time to profit), and their inability to buy a book of business has kept them out of the market. However, it should be noted that SG GSSI currently ranks 4th among securities custodians in Europe, and 10th worldwide with more than USD 1.5 trillion in assets held (March 2005). SG GSSI provides custody & trustee services to around 2,300 funds and its subsidiary Euro-VL provides valuations for nearly 3,700 funds representing assets of USD 348 billion (March 2005).

The asset management services sector in South Africa also has a number of specialist third party administrators, and a number of (mostly smaller) local asset managers have outsourced their "back office" functions, such as valuations, fund accounting and compilation of statutory reports. Most retain client management in-house. Until recently (see below for more detail on recent developments) three companies were active in this market: Tasc, Finsource and AOS. Tasc is by far the largest (some R300 billion under administration) followed by Finsource with AOS as a distant third. Of the three, Finsource has always been the truest to type of an independent third party administrator – a "traditional" outsourcing model if you will. Although the company was initially spun out of the back offices of Coronation Asset Managers and Nedcor Asset Management, and still retains some of its original clients as shareholders, it has diversified ownership structure and client base. In contrast, Tasc, which was formed out of the Sanlam Asset Management back office was 100% owned by Sanlam, and the latter's assets still make up the vast majority of Tasc's business (although this is changing quite rapidly under JP Morgan's ownership). Similarly, AOS's assets under administration were almost entirely contributed by its sole shareholders – MCubed Holdings.

All three companies have been competing for business in a local market not really large enough to accommodate so many suppliers until fairly recently. In addition, fees in the local market tend to be fairly low. Another problem has come from the custodians, who are now aggressively marketing value-added services to retirement funds – a good potential source of business. The custodians have a lot going for them in the marketing campaigns: They have a good solid reputation as banks, are often already providing custody services to the fund, have large investments in technology and

infrastructure, and sharply priced products if the client takes a combined custody/other services offering.

All three companies have also been aware of opportunities presented by the massive growth in the offshore BPO market. However, their attempts to attract offshore business have generally amounted to nothing. Any business obtained (such as AOS and Tasc) has been from offshore subsidiaries of their parent companies. (See the next section for more details on the reasons for this.)

A different success story can be told by Silica Financial Administration Services, which is focused on the administration of retail investment products. The company was spun out of Silica Software Solutions, a company within the Investec Group. The company uses its own proprietary software, and so has come into the market from a different angle than the three companies above. It also has a greater focus on the retail market (more than 60% of the SA unit trust market is using Silica software). Silica administers around 20,000 transactions per month and has R138 billion in funds under administration. Working off a South African company platform (i.e. South African asset manager with foreign-domiciled funds), the company has successfully entered the offshore market. Currently around 25% of Silica's business is offshore. The company employs 220 administration staff, in addition to the software staff.

The Employee Benefits administration market in South Africa is an interesting one. There are approximately 15,000 registered retirement funds in South Africa, and 12,000 of these are underwritten funds. This means that they are linked to a life policy, and the life company performs the benefit administration as part of the package of services (together with asset management and provision of risk benefits). The leaders in this market are Sanlam, Old Mutual and Liberty Life. The remaining approximately 3,000 funds are divided between self-administered funds and those administered by the third party company. Very large pension funds (such as the GEPPF, Eskom Pension Fund and Transnet Pension Fund) tend to be self-administered – the administration function is performed in-house. However, most smaller funds outsource their administration to a third party, since it is generally cheaper and easier than performing the function in-house.

The outsourced administration market is dominated by a few large companies, such as Alexander Forbes, but there are around 250 registered (with the FSB under Section 13 (b) of the Pension Funds Act) retirement fund administrators in business. This seems to be a very high number for relatively few funds, and it is. The main reason why there are so many registered administrators is the way in which fees for retirement fund business are structured. Administration fees tend to be fairly low, and the market is very competitive. However, almost every retirement fund provides its members with death and/or disability benefits, underwritten by a life office. The commission earned on broking these benefits can be considerable, and the broking is usually done by whoever administers the fund. Therefore, many insurance brokerage businesses have set themselves up as administrators, in order to tap the flow of brokerage commissions.

COMPARATIVE SECTOR ANALYSIS: THE POTENTIAL FOR MACRO-ECONOMIC BENEFITS

An important issue from Government's point of view when considering the case for intervention and focused support mechanisms is the potential of a particular sub-sector to contribute to wider economic goals and policies. This is the basis on which decisions around prioritisation of the allocation of financial and other resources are made. Therefore, it is important to understand the potential impact that growth in the sub-sector can have, and the likely quantum of that impact.

When making the case for supporting the Contact Centre industry, reference is generally made to the potential for significant job creation. Since employment creation is a cornerstone of government growth and poverty reduction strategies, the ability of a sector to create a large number of jobs will move it up the priority rankings. In comparison, the relatively small number of jobs in the asset management BPO market (currently around 2,500) and the prospects for future employment are often used as a reason for why the sector does not deserve a higher support profile. None of the companies in this sector employ more than 300 people, and the scalable nature of most operational structures (discussed above) implies that a large increase in the volume of business is not necessarily associated with a commensurate increase in employment. Most market participants believe that a figure of around 5,000 new jobs over the next five years is probably the top end of the forecast range. The employment potential differential with contact centres (often put in the 100's of thousands of potential jobs) is usually put forward as the key reason why the latter sector "deserves" more support than the asset management BPO market.

Most market participants believe that this perceived lack of interest by Government is unjustified, for the reasons set out below:

1. **Job stability:** As discussed elsewhere in this report, the decision to outsource asset-management type administration is an important and long-term one. Buyers choose their suppliers in this part of the market very carefully, with a view to a long-term relationship. The result is that jobs created in the asset management BPO sub-sector are much less mobile than those in other sectors, such as contact centres, and not as subject to shorter-term cost differentials. The buyer decision to shift offshore location is much easier in the contact centre market than in the asset management BPO market. The time frames for implementing a contact centre decision can also be relatively short, which is not generally the case in the asset management market.
2. **Skills levels:** The skills required by most of the asset management sub-sector are fairly high, and in most cases a higher skills level is required by employees than in the contact centre industry. Most of the skills are around accounting and other technical areas. This implies that people who have been employed in the asset-management BPO market often have the skills required by other parts of the economy. Training in the asset-management BPO market thus has a positive impact on the wider economy, not just on that sector.
3. **Income levels:** The higher skills levels implies that wage levels tend to be higher (and in some cases significantly higher) than in the contact centre market. Higher individual incomes have a multiplier effect through the remainder of the economy, through higher consumer expenditure and asset accumulation.

If we consider all three of these factors it is clear that a job created in the asset-management BPO market cannot be directly compared to one created in the contact centre industry, and thus direct employment potential comparisons should be viewed with caution. Instead, employment creation should be more accurately be weighted by certain factors, particularly the long-term sustainability of those jobs and the long-term impact on the wider economy. This would indicate that a secure long-term job, which will create additional jobs through increased domestic expenditure should in fact be assigned a higher weighting than one with a “migration” risk and a lower income. On this basis the job creation potential of the asset management BPO market should be viewed much more favourably than the numerical forecasts suggest.

4. **Impact on other sectors:** Most of the work around the contact centre industry indicates that the greatest potential for expansion lies in the financial services market. This is also a more specialized part of the market, and so should be associated with higher job stability levels. Clearly, the larger and better developed the asset-management BPO market in South Africa, and the higher the international profile of the participants, the greater the likelihood that South Africa will be viewed as a financial services “centre of excellence”. The positive impact on the contact centre industry could be significant.
5. **Impact on FDI:** In many ways, the outsourcing decision in the asset management BPO market is similar to a FDI decision, and many of the same factors are taken into account. Therefore, a flow of asset management-type BPO business is an indication of a high level of business confidence in South Africa. The long-term nature of the outsourcing decision also indicates a belief that the positive factors will continue in the medium- to longer-term. The flip side of this coin is that a thriving asset management BPO sector can send strong positive signals to long-term foreign investors in other sectors. This would contribute greatly to perceptions of South Africa as a high-value, low-risk location to do business.

It is also important to remember that the biggest players in this market are the world’s largest banking and financial services groups. They have a key role to play in creating positive perceptions about South Africa as an investment destination for their global clients. Locating a vital part of their own business in South Africa would send a very positive message.

All of these factors suggest that, in many important ways, the asset management BPO sector has the potential to contribute to long-term sustainable economic growth. Thus, it deserves a higher level of government attention than basic job creation forecasts suggest.

THE CURRENT STATE OF THE BPO MARKET & RECENT DEVELOPMENTS

The local market

As we will discuss in more detail below, the state of the local market for outsourced services (such as market size, number of suppliers and acceptance of the outsourcing model) is an important factor in attracting offshore business flows. Therefore, it is necessary to have a good understanding of the current market *status quo*, as well as the expected trends over the next few years. If we look at the asset management and EB administration sectors, it is clear that the market is fairly well developed. The table below sets out the sub-sectors, and the current state of the outsource market:

Sub-sector	State of the Market
Custody Services	World-class service offering by local custodians, based on global technology and supported by various strategic alliances with the main international players. A good size local market (in the top 20).
Asset Management administration (wholesale)	<p>The outsourcing model is fairly well accepted. Most smaller asset managers have outsourced their back office, probably in order to avoid the substantial costs associated with the purchase of the appropriate technology. However, many of the larger asset managers have preferred to keep this function in-house.</p> <p>A newer part of the asset management outsourcing market is the provision of value-added services to retirement funds. This is potentially a rapidly growing market. The traditional custodians appear to have a significant advantage in this market, probably because of their superior technology infrastructure, market reputation and position as existing service providers to retirement funds.</p>
EB Administration	The outsourcing model is well accepted, and the market is very competitive. Very few funds are self-administered, and face increasing pressure to outsource. The standard of administration in the market is low, and many administrators are doing a truly dreadful job. Many retirement funds seemed happy to live with that state of affairs, but a spate of PFA rulings and increased responsibility for trustees is changing that position. New regulatory requirements will impose better controls over administrators, and should improve the general standard of services offered.

We expect that the size of the local asset management administration market (in revenue terms) will increase further over the next few years, due to the following factors:

1. The market is maturing as one would expect, and much of the focus now by both buyers and sellers is on high value-added services, such as performance reporting, rather than basic activities such as fund valuation. This represents a new source of income for suppliers, particularly from the retirement fund industry.
2. We believe that one reason why the bigger asset managers have not seriously considered outsourcing to date is because of the relatively small size (in both volumes of business and access to capital measures) of suppliers. However, the entry of the big international companies is likely to change those perceptions.

3. Over the past few years there has been a big increase in statutory compliance requirements for asset managers. This is as a result both of local regulatory initiatives (such as a higher level in transparency of reporting to both the SARB and the FSB by institutional investors) and the international trend towards greater disclosure in the interests of managing illegal activities. The introduction of capital gains tax has also had an effect. The result of all these is that in-house administration becomes more expensive, and outsourcing more attractive.

We would also expect that the size of the EB administration market (in revenue terms) will increase further over the next few years, due to the following factors:

1. Very few funds are self-administered, but these contain a large proportion of total members, and offer very good potential to grow the market further. As more funds convert to DC, we believe it likely that a number of them will seriously consider outsourcing as the most effective means of controlling costs in the more complex DC environment.
2. If regulatory requirements result in the large life companies looking for alternative administration solutions (see above), this could result in a significant flow of new business.
3. Liberation of financial markets in several Southern African countries has resulted in their (generally government) retirement funds looking for administration solutions for a more complex environment.
4. The increase in reporting requirements imposed on retirement funds by the FSB and the SARB will result in funds requiring more value-added services.

Unlike the asset management industry, the EB administration market has no standard core system (or 2 or 3) used across all suppliers. There are almost as many systems in use as there are administrators, and a significant number of these are locally developed systems with limited functionality. This is of course a reflection of the fact that there are so many small suppliers, who cannot afford pricey international systems.

Developing offshore opportunities and business flows: A mixed bag of results

Asset management services

For at least the past five years, the local BPO suppliers (i.e. the third party suppliers discussed above) have been aware of and discussing the potential for offshore business. Most of their focus was on the UK market, where they identified a significant cost differential (particularly when the Rand collapsed in the second half of 2001). However, they have had very limited success, beyond small offshore business flows from existing South African clients (usually their shareholders). The main reasons for this lack of success can be attributed to:

1. After the fact it was clear that these companies did not have a good understanding of their target market, in terms of how offshore BPO decisions are actually made. The general perception was that a 30% cost saving would be sufficient to convince a UK asset manager to shift his back office halfway around the world. They under-estimated how the buyers would view the risk versus reward relationship.

2. None of these businesses (including Tasc and its parent Sanlam) had the business volumes or balance sheets to be taken seriously in the international market. When you are a UK asset manager with £50 billion under management, you will never be serious about outsourcing to someone whose existing business volumes are only a fraction of that. Given the risk considerations around asset management administration, no company would choose price over substance and track record.
3. There was no integrated marketing effort across the sector. Each company on its own attempted to get business, largely through direct approaches to potential clients.
4. After 2001, the Rand gained in real terms against the £Sterling, and wage costs in South Africa rose at a faster pace than their equivalents in the UK. This reduced the pricing arbitrage, making any sell even more difficult.
5. What local suppliers also failed to understand (or they underestimated its importance) is that asset managers will very seldom, if ever, adopt a totally offshore outsourcing solution. That is, they may be happy that the administration work is done in a remote location, but they want somebody to talk to around the corner. Given the key role of correct administration in the success of an asset management company (higher client service, the ability to implement complex products, and the very high cost of compliance failures caused by poor administration), the outsourcing supplier assumes a strategic role in the business, far greater than say your contact centre. Management must be readily available for consultations and/or to address problems. In addition, most buyers would prefer to contract with a company based in the same jurisdiction. The South African suppliers did not set up large offices and/or infrastructure in the client's home location.
6. They did not see or understand the trend towards consolidation of service provision around the custodians. Thus, they could have taken the opportunity to enter into strategic alliances with the custodians, but didn't.
7. They did not properly understand the implications (for outsourcing) of the very complex and onerous compliance environment in the UK. Outsourcing does not relieve the asset manager of any of his compliance requirements, and so the responsibility passes to the administrator. The financial implications of errors are considerable (and denominated in foreign currency). The compliance regime also makes it difficult to run a "true" offshore model, since certain legislation requires that certain administration functions must be done onshore. Data protection rules and legislation are also an issue.

The end result was negligible new offshore business flows to local suppliers.

Tasc has now been sold to JP Morgan, AOS has all but disappeared in the re-structuring of the MCubed Group, and Finsource is widely rumoured to be looking for a buyer.

In comparison, Silica has successfully entered the offshore market, and is growing its book of offshore business (see above).

We do not believe that this mixed success reflects the inability of South Africa to be a serious contender in the offshore BPO market, but rather that we have not had the correct conduit/market structure to facilitate that business. It is now clear that South African companies need to become "suppliers of suppliers" rather than contracting directly with end clients. For example, a large international administration company (or a company with a large administration division) will set up

a foreign office in order to reduce its internal cost of administration. This is a different business model from the South African company that is looking for offshore business flows. The former scenario is becoming more prevalent and has positive implications for the market, as discussed below.

Silica's success indicates that a South African company can enter the market by using local companies with offshore business as a platform for getting non-South African business in the same centres. Their proprietary software has also contributed to the value of their service offering, by reducing costs.

The main reasons why we believe that there is potential for offshoring of outsourced asset management administration business to South Africa are:

1. The local product market is very complex for a relatively small group of consumers. The range of products is considerable, and as a result local administrators have good experience across many products. This is in contrast to a country like India, which has a comparatively unsophisticated investment products market, and consequently little skill in this area. This type of administration is not like answering the telephone in a contact centre – it is difficult to teach to a group of “novices” in a short period of time. In many ways, this is contributing to a growing perception that South Africa is an expert in complex products. In certain niche areas, such as linked products, the country is viewed as a market leader.
2. The regulatory, compliance and accounting environment in South Africa is similar to that of many other markets, such as the United Kingdom.
3. As a general rule, South African administrators are using core systems that are used around the world, such as DST's HiPortfolio system. This means that data migration is made easier, plus it provides a higher comfort level for the client.
4. There is a cost differential associated with South Africa, due to lower salaries, lower operating costs (such as premium office rentals) and much of the non-core technology (such as middleware and reporting tools) is sourced from South African suppliers at a lower price than would be paid in many other centres. Given that the market operates on enormous volumes, the ability to reduce costs by even 1 basis point (0.01%) represents an enormous additional profit if the amount under question is \$1 trillion.
5. The risk rating of South Africa is more favourable than many other potential destinations.

The **quantum** of this potential will be determined by South Africa's comparative advantage in drawing business over other locations.

It is important that we differentiate between the activities “pure” South African suppliers (such as Silica) and foreign companies, such as State Street and JP Morgan. It is clear that the latter have slightly different agenda's with respect to **offshore** BPO. They are more concerned with facilitating an internal reduction in costs than in building an offshore business based in South Africa.

In March 2004, JP Morgan announced that its Investor Services division would acquire Tasc from Sanlam. Tasc was created in January 2000 from the administration division of Sanlam Investment

Management. It focuses on institutional asset administration, has a staff compliment of 155 (and growing) and more than R300 billion in assets under administration. The alignment in terms of people, process and platforms between Tasc and JP Morgan's international business is good.

In June 2004, State Street announced that it has been appointed by Investec Asset Management ("Investec") to provide investment operations, global custody and fund accounting services for \$34 billion of Investec's assets under management. Approximately 66 Investec staff members based in Cape Town and London have become employees of State Street.

As a result of these developments with leading multi-national companies South Africa has the same skills and capabilities as before, but wrapped in a different package that looks far more attractive to potential offshore clients.

In 2004, Standard Bank and BNY entered into negotiations with Old Mutual Asset Management to outsource the latter's back office to a third party administrator, to be jointly owned by Standard and BNY. However, the deal was vetoed by the FSB, on the basis that Standard's position as the largest trustee for unit trusts in South Africa (they have around 50% of the market) would create an apparent conflict of interest if it were to provide asset management administration services to the same parent companies.

It is interesting to note that these big players are adopting a much more cautious stance toward foreign business than companies like Finsource, although they are in a much better position to attract such business. In part, this is a reflection of a better understanding of the BPO market in the high-end asset management services. A big volume of work done successfully in the local market provides the "track record" for attracting foreign business, as well as a scalable platform. Therefore, it makes good business sense to first grow your local business.

EB Administration

As regards employee benefits (EB) administration, there has been some interest from suppliers, although, as discussed above, the vast majority of administrators have only been in the business in order to increase brokerage fees, and have no interest in (or capacity for) attracting foreign business. In addition, the market is dominated by small companies who obviously would have no capacity whatsoever to attract foreign business.

This is a particularly interesting market for potential offshore BPO flows, for the following reasons:

1. The sophistication of the retirement fund product market in South Africa is ahead of that of other countries such as the UK and Europe. For example, South Africa is far ahead of the curve in terms of DC funds with multiple portfolios and member choice structures. As retirement funds in the UK and other places move towards DC structures (largely as a result of grossly under-funded DB arrangements), so South Africa will be in a good position to demonstrate a track record.
2. Although the market currently has a wide range of suppliers and appears over-traded, increasingly regulation of the market, much more onerous disclosure and reporting

requirements, and more sophisticated products are making it difficult for the smaller administrators to continue to service their clients.

3. Increased regulatory requirements are also having a considerable impact on the large life companies with big books of underwritten business. For example, to date these funds had quite basic statutory disclosure requirements, and did not have to be individually audited each year. However, this has now changed – each fund must be individually audited (which implies that the life company must be able to produce an individual set of accounts than can be audited), and the reporting requirements have increased. Most of the life companies do not have the systems in place to accommodate these changes. Although most appear to be looking at internal re-engineering to meet the regulatory requirements, the situation must almost certainly make outsourcing a more interesting alternative.
4. Many of the large self-administered funds are defined benefit (DB) funds, but the general trend in the market is to convert DB funds to defined contribution (DC) funds. As a rule, the administration of DB funds is far simpler than administering a DC fund, particularly when the latter allows different members to hold different investments, and to make switches among these investments. The systems required for DC administration are quite different from those required for DB administration, as are certain of the skills. Therefore, the cost associated with moving to a different in-house administration platform to accommodate a DC fund can be considerable. This makes the outsourcing prospect much more attractive.
5. The growing trend towards umbrella funds will create fewer funds with more members. This will make administration a more attractive business, since there are a number of fixed costs associated with running a fund that can now be allocated to more members.
6. The local EB administration market has the reputation of being a “bad” low-margin business. However, administration fees in South Africa are quite high, compared to places like the UK. One conclusion that can be drawn from this is that South African administrators are fairly inefficient, and that a more efficient business model could make the local market much more profitable. Margins would also tend to increase as the number of funds declines (i.e. average fund size increases.) Factors such as these are important for attracting foreign suppliers.

All of these factors suggest that we could expect some considerable consolidation among suppliers over the next few years, as smaller players exit the market and their clients need to appoint a new administrator. This will not only strengthen the position of local suppliers (they can demonstrate capabilities with a large volume of business), but could also attract new offshore entrants into the market. This will allow foreign companies to purchase existing books of business and create some critical mass. (Fewer bigger players present a more interesting opportunity for foreign investors.)

To date we are only aware of a few initiatives that have focused on attracting offshore business in the EB market. AON is an international employee benefits administration company with a very

large business in the UK. AON South Africa is a much smaller operation, started some years ago. Approximately three years ago, AON South Africa decided to set up an administration joint venture with a South African company called IQ Group. IQ would provide the technology part of the equation (although they had no specific experience in EB administration, IQ did have some in medical scheme administration) and AON would provide their existing clients to the joint venture. The idea was that if they could demonstrate a good administrative capability, there would be the possibility of receiving business from AON UK.

Unfortunately, IQ Group under-estimated the current state of AON South Africa's administration, and the alliance was dissolved before any offshore business flows materialised.

A more interesting prospect may be Meridian Consulting Actuaries, a UK-based firm with offices in Cape Town. They are investigating setting up a South African business with the long-term goal of leveraging their UK client base into offshore administration services. However, they would first look at establishing a critical mass of local business. They believe that the current state of the market plus increased regulation will support their efforts to build a local book.

As a general conclusion, we can state that although retirement fund products in South Africa are much more sophisticated than those in markets such as the UK, the general standard of administration in South Africa is quite low. In addition, most administrators are not using international systems, and operating inefficiencies make them price uncompetitive. This is not to say that there are no opportunities in the market, but we believe that it is more likely to be new and/or foreign entrants who will take advantage of these, rather than existing local companies.

A PROPOSED FRAMEWORK FOR DETERMINING COMPARATIVE ADVANTAGE IN THE IDENTIFIED SUB-SECTORS

THE CURRENT FRAMEWORK

Although there has been a great deal of discussion about the potential for South Africa in the global BPO market for some years now, until recently most of the discussion was not based on any concrete analysis of how South Africa actually compares to other destinations. The increasing maturity of the global BPO market, plus the proliferation of new destinations has made such a framework important. Those companies that have simply headed into the international market on the basis of their assumptions about competitive advantage have had a surprise.

A clear and objective framework to assess exactly where South Africa's strengths and weaknesses lie will benefit all market participants:

1. Suppliers will have the means to make an objective assessment of their offering, and make adjustments accordingly. It will also ensure that suppliers knew whether or not it is worth investing in a particular part of the market, on the basis of how much of a chance of success the business actually has.
2. If the regulatory authorities want to support the industry, then a framework will provide them with information about what sub-sectors have the greatest chance of success, plus give a good idea of what type of interventions will be most successful (i.e. target interventions to address specific shortcomings identified by the framework).

There have been several independent attempts to document such a framework, often initiated by government organizations. However, the most comprehensive attempt was the recent combined McKinsey/Paladin and others work, under the overall auspices of the DTI. The work contains a model for assessing comparative country advantage in the BPO market (hereafter referred to as "the Framework"), as well as listing the resulting actions that are required by government to improve South Africa's comparative advantage.

Although the Framework is very relevant for certain BPO sectors, our main concerns with applying it to the sub-sectors we are looking at in this report are:

1. The determinants of the Framework are almost exclusively the determinants of comparative advantage in the CC market. But the CC market is not the BPO market. This is not to say that these conclusions are incorrect or invalid, but it must be emphasised that they are particularly relevant to the CC market, and that conclusions about what is good for the rest of the BPO market should not simply be based unquestioningly on this Framework. The main differences relevant for the Framework are:
 - a. CC's, by their very definition, are labour intensive – particularly when they handle voice calls (as opposed to e-mail and letters). Therefore, although start-up costs can contain a high percentage of technology costs, the biggest variable/ongoing cost is labour. Many other BPO sub-sectors are less labour intensive, if we define that as the cost of labour as a percentage of the total cost of providing a service.

- b. In addition, there tends to be a very close relationship between the volume of business that a CC can deal with, and the number of people that it employs. Therefore, once we allow for the (fairly) limited efficiency improvements that can be made through a better quality of staff and better technology, a CC tends to be a business with limited scalability. That is, as the business grows, so the volume of staff and variable costs also grows, since (at present) automation options are still limited. (The impact of intelligent “talking” software – not that far from reality – poses an interesting potential threat to the offshore CC industry. There are already a number of fully automated applications, such as accessing information through a unique account number). A different scenario is seen in many BPO sectors, where scalability can be significant, due to a high level of automation technology and (particularly) good and innovative business processes. This has important implications for competitive advantage in these sectors, as well as the type of government support mechanisms that might be most appropriate.
- c. Finally, the way in which the client (the buyer) views the role of the outsourced service in his business is a key determinant of the perceived risk of outsourcing. We believe that the perceived risk of outsourcing a CC activity is different from (and in many instances lower than) the perceived risk of outsourcing certain other BPO activities. This is particularly the case when we are considering high value services such as those in the asset management and related sectors. A different perceived risk will result in a different set of criteria being applied to the outsourcing decision by the buyer. Therefore, we cannot have one view of the buyer and his requirements and/or decision-making criteria that is equally valid across all BPO markets.

We believe that these differences are so significant across various components of the BPO market that they can make one analytical framework of very limited use as a universal application. As a result, the recommendations around what government can do to support one sub-sector cannot automatically be expected to have the same impact on other sub-sectors.

- 2. We believe that the pricing model used in the Framework is a little basic, and does not take into account fully how buyers would value non-price factors, such as expertise and country risk. Although the CC outsourcing decision tends to be made with a very strong emphasis on the cost element (as discussed above) this is not necessarily the case with the BPO sectors we are considering. It would not be incorrect to state that in this particular part of the market price is a necessary, but not sufficient condition. The important point to make here is that the *required* pricing differential will differ from sub-sector to sub-sector. Therefore, a certain percentage differential that is uncompetitive in one sub-sector, may be competitive in another.
- 3. We believe that the Framework is based on market analysis and conditions that were prevalent a few years ago – that is, in the environment that made India successful. Now it is becoming clear that parts of this model are outdated and need to be adapted, but it remains the basis of recommendations for government intervention. The

acknowledgement that India now has problems should result in a critical re-look at the framework that country used, not an endorsement.

As a result of all these factors, we have proposed a slightly different way of looking at the asset management and related BPO markets in order to determine comparative advantage, and therefore, the most appropriate government interventions. It is intended that this framework will be read in conjunction with the McKinsey/Paladin framework, and only replace it in those areas where it is quite clear that different market factors are at work.

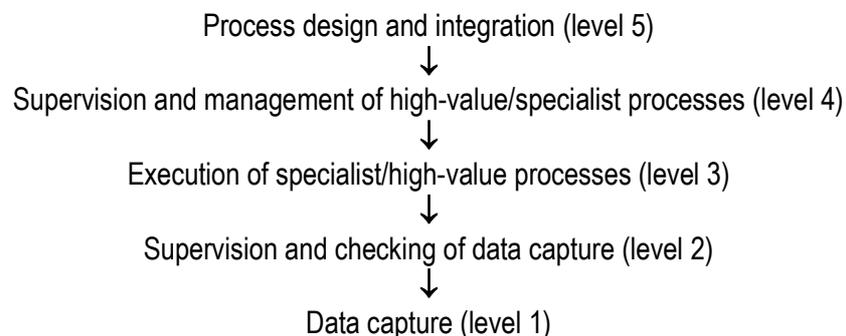
A HIERARCHY OF BPO SERVICES: SOME SERVICES ARE MORE EQUAL THAN OTHERS.

One of the most important points that we are making in this report is that not all BPO services are the same: In fact they can be quite different. They can be differentiated not just in terms of the industry into which they are classified, but also into the type/classification (our word) of service. We believe that this is a much more useful way of looking at BPO services than the more usual way of looking at them across industry classifications (such as McKinsey and Paladin do). Very often, the same type of skills and expertise are required *across* various industry segments. However, there are so many “layers” of skills within the potential BPO services of one industry (such as asset management) that it is difficult to lump them all into one category and come to conclusions equally valid for all just because they are in the same industry.

Different services have different factors that determine comparative advantage. The relative importance of each factor (such as wages) can change at various levels:

1. The more scarce the service, the higher the comparative wage rate that the market will bear; and
2. Different types of services have different operations scalability structures: The more scalable the operational structure, the less important wages are in the final costing

If we drew up a simplistic “hierarchy of services”, with the highest-value, most specialized services at the top, for our selected sub-sector of asset management and related activities, it would look something like this:



Examples of the specific activities contained within each service level in the asset management and related industries is set out below:

Service	Activities
Level 1: Data Capture	Entering the details of trades manually on a back office system.
Level 2: Supervision and checking	Checking and signing off that trades are entered correctly.
Level 3: Execution of specialist processes	Drawing up monthly fund accounts using the core back office system and supporting technology.
Level 4: Supervision and management	Checking and signing off final client statements.
Level 5: Process design and integration	Setting up the back office systems(s) and processes to automatically interface with the client's accounting system.

The value to the client and the scarcity of the skill increases up the scale. In addition, the complexity of the client's business, the use of specialist technology and the demands/sophistication of the end-client increase as the focus climbs up the ladder. Most asset management BPO suppliers in South Africa, and all the bigger ones, have a strong focus of human resources at level 3 and higher. A good operation has almost no staff at level 1, and those working at level 2 are largely focused on handling exception reports generated by the back office system.

The outsourcing decision can kick in at any one of these levels, with the proviso that whatever level is chosen, the associated lower levels are almost always automatically included. That is, if the supplier chooses to outsource level 3, then level 2 and level 1 will invariably be included (although the main supplier could in turn outsource these to another provider). Even in circumstances where the client outsources a particular value-added service (a level 3 and 4 service), but keeps the underlying data functions in-house, the outsourcing supplier will often have to replicate those functions and outputs in order to ensure data integrity.

Another important factor is that the demand for outsourced services is moving up the value chain, as the market matures and deepens. This is particularly the case with the demand for offshored services. So, whereas a few years ago a client may have only considered outsourcing the data capture function to take advantage of wage differentials in a low risk manner, now levels 3, 4 and even 5 are being seriously considered. This has important implications for ranking the factors that buyers will consider when making a decision:

1. In the asset management administration environment, a proven track record in successfully administering similar products on similar systems is key. No one would seriously consider outsourcing the administration of a complex product, bearing in mind the considerable penalties for any sort of failure, without the assurance of experience. This implies that countries with less developed financial markets and less

sophisticated products do not enjoy a comparative advantage. Countries like South Africa do.

2. In a similar vein, the higher up the value chain the client wants to outsource, the more likely it is that they are looking for a strategic business partner, rather than a source of cheap staff. In a partner they are looking for someone who has experience dealing with companies whose clients have similar requirements, and whose products are fairly similar. They are far more likely to find that sort of partnership with a South African administrator than with an Indian or Malaysian one.
3. The labour focus is not on the cost of a data capture clerk, but on the cost and availability of suitably skilled and experienced staff. It has been well documented that South Africa enjoys a comparative advantage in niche skill markets over most competitors, as a result of our well-developed product markets.

What are the factors that make a supplier competitive/attractive at each of these levels? The table below sets out the main criteria for each:

Service “level”	Key factors for buyers *
Level 1	Cost of labour (it is the major input) Overall absolute cost Location risk
Level 2	Some track record in these areas Cost Location risk
Level 3	Proven ability to manage similar products at low error rates Some cost differential Location risk Client must be able to have regular physical contact with the supplier through a local office
Level 4	Proven ability to be a strategic business partner Proven track record in complex products Some cost differential required Availability of staff and low staff turnover Ability to meet onerous regulatory and compliance requirements Location risk
Level 5	As above Proven track record of innovative solutions in similar environment Proven track record of innovative products Familiar with client systems and applications High risk weighting (assessment of the risk of the supplier and his location)

NOTES:

* This is based on a qualitative assessment of the industry, including input from suppliers.

CONCLUSIONS: KEY FACTORS THAT DETERMINE COMPARATIVE ADVANTAGE

We must remember that one key issue, highlighted as an important constraint by the McKinsey/Paladin report, is less important in this market – wages. As discussed above, in a scalable operating environment, wages become less important as an overall cost driver. The ability of management to create economies of scale and efficiencies with a combination of resources is the key factor. In addition, the sophisticated and specialised nature of many of the products in question imply that the correct centres to compare wages with are Europe and the United States, rather than locations like India.

The issue of the cost and availability of bandwidth in this market is not as straightforward as in the contact centre market. The reason for this is the current Telkom pricing structure, which is biased in favour of very large corporate clients – in terms of total numbers of users and volume of business, rather than the value of the outsourcing business only. The result is that those outsourcing service providers that are part of a much larger domestic company (such as Standard and the other big banks) enjoy a lower telecoms cost than companies such as Silica, even though the size of their outsourcing businesses may be very similar. Therefore, the importance of telecoms in overall costs is very different for the two companies, and the effective result is that big South African financial services companies are given a cost differential over smaller companies and foreign suppliers. For the smaller companies, capacity and cost are important issues, and they would like to have the same advantages offered by Telkom to the big financial services companies.

From a buyer's point of view, the key factors that determine comparative advantage in the asset management and related markets are:

1. A developed and fairly large domestic outsourcing market: Discussions with industry participants have shown that this is a key factor in building an offshore capability. It is also in complete contrast to the development of the CC market in India, which was developed specifically to service foreign clients. The strong local market has a two-way impact: Firstly, it provides the experience necessary to prove capability to foreign clients. Secondly, the opportunity to make money in the local market adds to the attraction for large multi-national suppliers. Companies we spoke to said that, given the costs associated with running this type of business, big international companies will not set up shop in South Africa just for the offshore BPO potential. Although they believe that there is merit in this opportunity, it must be combined with another potential revenue flow – the opportunity to get local business.
2. A well-developed and fairly sophisticated local end-product market (to demonstrate relevant experience).
3. The presence of large multinational suppliers. As discussed above, the risk associated with asset management administration outsourcing is of such a nature that clients want (i) to deal with suppliers with well-established reputation and substantial resources, and (ii) to be able to interact with their supplier on a daily basis in their

home location. The client's perception is that he is dealing with JP Morgan, and the South African part of the equation then becomes JP Morgan's risk.

4. A *sustainable and reasonably predictable* pricing differential. Although cost has a lower weighting in the overall decision than in other BPO markets, if there is no cost differential, then it is very difficult indeed to make the offshore case (under current risk considerations). It is important to remember that "cost differential" in the asset management administration market is not simply calculated by adding up the costs of running a business in South Africa, and comparing that to the same costs in the UK. Although input costs such as wages and rental are taken into account, in this market, the single most important determinant of the cost is the supplier's position on the scalability ladder. New (offshore) business will be put through an existing operational structure, i.e it is marginal business. When the supplier has achieved scalability, then the marginal cost of new business should decline. Although it is difficult to calculate a scalability ratio for each South African supplier, in general terms scalability is determined by the volume of business already on the books and the similarity of the new business to the existing business. That is, the greater the volume of business currently managed by South Africa suppliers, and the more similar that business is to expected new business, the more efficient and scalable we would expect their operations to be.

The "sustainable" and "reasonably predictable" part is associated with the long-term strategic partnership that the buyer is anticipating. This implies that the cost differential must be the result of some sustainable advantage, rather than a temporary government incentive. There is also some requirement of currency stability (as opposed to strength or weakness).

5. Risk: Given the potentially devastating impact on the buyer of a substantial administration error or business disaster, the issue of risk is a very important one. The main risks that the buyer will be concerned with include:
 - a. Country/location risk, in terms of how that could affect the likelihood of a business disaster or the ability to maintain regular operations.
 - b. Risk that the supplier will not be able to meet all of the buyer's detailed requirements (i.e. the service capability has been "oversold").
 - c. Data integrity – covering both clients and portfolios.

All of these will be reduced if the buyer contracts with a well-established multi-national.

How does the local BPO industry, in its current format, compare against these considerations?
Looking first at the asset management administration market:

Factor	South Africa “rating”
Size and maturity of the local outsourcing market.	SA should score highly here. The local BPO market is well-developed, and has potential to grow further as larger asset managers re-look outsourcing.
Well-developed and sophisticated markets and products	South Africa has a financial services sector far more advanced than its socio-economic development would indicate. There is a wide range of sophisticated and complex products currently being administered in the market. We believe SA has a significant <i>comparative</i> advantage here, particularly over places like India.
Presence of multi-nationals	State Street and JP Morgan are two of the largest market players, and both are entrenching their position in SA. The third big company, BNY, is reportedly looking for opportunities. These three companies have almost \$30 trillion under administration.
Sustainable and reasonably predictable pricing differential.	The recent stability of the Rand cannot be guaranteed, but it has boosted sentiment. South Africa does enjoy a cost advantage (although this is difficult to quantify accurately as discussed above), and this is in place despite zero government incentives. As the volume of local administration business increases so we would expect that scalability in these companies would increase, and make their pricing more competitive. As discussed above, the different telecoms “packages” offered to different market participants impacts on the pricing differential that can be offered, and is biased in favour of large South African financial services companies.
Risk	On most measures it can be argued that SA’s risk profile is better than destinations like India or Malaysia, given the relative political calm and absence of natural disasters. A growing volume of business also reduces risk for new clients, as it provides a track record of experience. However, it may be that the <i>appearance</i> of risk is more important than the actual risk for buyers – as we shall discuss below.

However, if we apply this comparative advantage framework to the EB administration market, things do not look as rosy:

Factor	South Africa "rating"
Size and maturity of the local outsourcing market.	Although there is a large market of retirement funds, and most have chosen to outsource, the structure of the market means that there is a relatively small third party administrator market. The supplier market is also fragmented.
Well-developed and sophisticated markets and products	South African retirement fund products are more advanced and complex than those in many other countries, such as the UK. However, this positive factor is probably largely cancelled out by the low standard of administration.
Presence of multi-nationals	None currently active in volume in the market.
Sustainable and reasonably predictable pricing differential.	South Africa does enjoy a cost differential, but it is not as high as one would expect. If we compare the actual price charged (generally a percentage of the contribution), then the pricing differential is less than 20%. However, SA should be cheaper than it is, and it will be up to foreign companies to show that they can create a low-cost platform in South Africa.
Risk	On most measures it can be argued that SA's risk profile is better than destinations like India or Malaysia, given the relative political calm and absence of natural disasters.

In conclusion, we can make the following comments:

1. The McKinsey/Paladin Framework certainly has merit, but it is difficult to apply that framework to other specialized parts of the BPO sector, particularly where operational structures imply different pricing models.
2. In the asset management market, the question of cost and availability of bandwidth is clouded by differential pricing and access granted by Telkom, which favours large South African companies and does not specifically consider the value of the company's outsourcing business.
3. The asset management administration industry is clearly poised on the brink of good things. The challenge now is how to turn what appears to be a solid competitive advantage into real business flows.
4. The EB market is well behind that curve. It is slowly attracting the attention of foreign players (such as Meridian) but the local industry is too fragmented. We believe that one of the main attraction for foreign companies in the asset management industry was the opportunity to purchase a large book of business. However, for the reasons outlined above we believe that there is a great deal of potential in the market, and would expect to see increased activity over the next two years. The pressure to re-structure retirement funds in Europe and to reduce costs should increase the attractiveness of the outsourcing option.

A MODEL FOR SUPPORTING OFFSHORE BPO IN THE ASSET MANAGEMENT AND RELATED SUB-SECTORS

If we agree that the asset management administration market has a competitive advantage in the international BPO market, can we also make a case for government support of the sector? If, so how should that support be structured to maximize its effect?

THE BUSINESS CASE FOR AND AGAINST INTERVENTION

In a country with high unemployment rates and a level of economic growth that is expanding, but still below what is required to generate big increases in the standard of living, the potential from an “outside” source of business such as offshore BPO can look extremely attractive. In this situation, regulatory authorities will almost certainly think about what can be done to cash in on the opportunity. However, government policies to intervene in specific sectors can be a double-edged sword, often achieving little long-term payoff to justify short-term focus and expenditure.

In general terms, we can state that an intervention that will result in a sustainable increase in competitive advantage is a good thing, but one that does not result in a sustainable improvement is undesirable. This may seem to be the most obvious of statements, but unfortunately it is often ignored. The main reason is that when governments take input on interventions, that input generally comes from companies in the relevant sector(s). Those companies have three-year profit ambitions for their own companies in mind, rather than how a particular intervention will play its way through the overall economy over a much longer period of time. One good example is a subsidized wage. This may help to get business in the short term, but it is only effective until another government with deeper pockets can offer a bigger discount. When that happens, government is locked into a vicious cycle – they must increase the value of the intervention to protect those jobs that have been created.

The principle of sustainability in interventions can be compared to the US carmaker GM’s current attempts to win market share. They have deeply discounted several of their models in an attempt to win back falling market share. But most commentators agree – the problem is not that their cars are too expensive, the problem is people don’t like them. No amount of discounting can get away from that issue. Instead of subsidizing prices, GM should be developing new cars.

The key to structuring a good intervention is to understand what is really a comparative advantage, and what is something that a company (or group of them) would like changed in order to make more money. Successful interventions will focus on the former, not the latter. This is a lesson that countries like India are beginning to learn: They assumed that the advantage would be found in price, and concentrated interventions in that area. They are now realizing that the real comparative advantage is in quality of service.

The relevant identifying characteristics of comparative advantage in a particular industry or sector can be listed as the following:

1. It must be something that you already do. In the global market, it is almost impossible to manufacture a comparative advantage in an industry or sector that is currently alien to your economy. The resources required to do that are so considerable that they can

usually be better spent somewhere else. The most sustainable comparative advantages in the global BPO market are based on vibrant and successful local businesses.

2. Private, for-profit companies should already have identified that advantage, and be investing in it. If no entrepreneur has already identified the market gap, there is a very good chance that it doesn't exist.
3. Intervention will enhance the advantage, not create it.

In terms of what makes a good intervention, the following "rules" can be applied:

1. The best interventions create enabling environments where good companies and good business ideas, will succeed. They do not directly support particular companies, where "direct support" can be defined as something that will have an audit trail back to a company's financial statements.
2. The construction of interventions should be based on the principle of leverage: What is the comparatively small effort that will yield the comparatively large result?
3. If we accept the argument that there are so many differences among the various components of the BPO market, then it is difficult to construct very specific interventions. Thus, the most effective interventions with the greatest impact will be those that support as many sectors as possible at the same time.

INDUSTRY POINTS OF VIEW

One of the most interesting things about the asset management administration sector is how much has happened over the past two years *without* any overt government intervention. Of course government has had an indirect influence, through the positive influence that policy has had on economic stability, a steady currency and reduced perceptions of country risk. In this way, government has already contributed to a better enabling environment for the sector.

One important factor is that companies in this sector are happy to take a conservative approach towards building an offshore business, on the basis that they have a sustainable business model. This is important: If they do not want to rush into a market, then interventions designed to get them to do that will not succeed. This attitude is quite different from the CC market, where most companies appear convinced that there is a temporary opportunity that they could easily miss. Thus, they are very focused on "now" incentives that will assist next week's sales pitch. (This conviction that there is only a short-term market gap should raise some concerns about sustainability in this sector.)

The key industry points of view relevant to interventions are:

1. They do not see a specific labour supply restraint. This may be a result of the different demand for skills in the sector, as discussed above. It could also be that big companies such as Standard and Sanlam (until recently Tasc's parent company) traditionally hold positions as key trainers in their markets, and therefore, suppliers of skills. Most large financial services companies have considerable resources for training, and provide a steady stream of skilled staff for smaller niche players. This

puts them in a very different position regarding training than comparatively smaller CC companies.

2. There are issues around telecommunications, but these are a little different from the CC industry. The main concern is that foreign companies (and specialist South African service providers such as Silica) would like to enjoy at least the same access and cost advantages offered to the large South African banks. There are also issues around the service levels received by smaller companies. Most suppliers believe that liberalisation of the market, together with a firmer regulator, will address most of the issues.
3. Without requesting specific monetary incentives, they do see that there is an apparent disparity between the support that secondary sector activities such as manufacturing receive, and those that are made available to the service sector. Given the key role of services in the local economy, they do not understand why so many incentives exclude these sectors. They believe that this sends confusing signals to foreign investors about government priorities and prejudices a key growth sector.
4. It is clear that foreign buyers do not appreciate the capabilities of South African suppliers, and generally are pleasantly surprised when they visit. (This is interesting because it supports one finding of the McKinsey/Paladin report: There is quite a big discrepancy between how South African suppliers view their offering, and how foreign buyers see that offering. This suggests that the discrepancy has more to do with lack of knowledge by buyers, than over-estimation of capabilities by suppliers.) In general, companies believe that there is a lack of knowledge about SA's technical abilities, and they believe it is the government's job to address this.
5. The former point is related to how country risk is measured and/or perceived. Most local suppliers believe that India should have a higher risk weighting than South Africa. Instead, they are surprised to note that India's risk factor seems to be discounted by buyers. It is not clear exactly why this is the case, but it appears that the presence of other multi-nationals helps to reduce risk perceptions – some sort of “safety in numbers” argument. In this scenario, companies will discount risk issues on the basis that everybody can't be wrong. If this is the case, then a country's success in BPO could have a significant impact on how its risk profile is viewed in practice.
6. Most of the foreign market participants believe that the government has no interest in supporting this part of the market. They cite the non-availability of key officials to meet with head office representatives (from some of the largest financial services companies in the world), and a general lack of knowledge about the details of the market. They ascribe this to the one-dimensional method used by government to assess the “value” of an industry – total number of jobs created.

RECOMMENDATIONS

Based on the assessment above, the following appear to be actions that will support the asset management sector in attracting offshore BPO flows:

1. It is critical that government looks at this sector in a more favourable light, for all the reasons discussed above. The asset management outsourcing sector has enormous potential to impact positively, in a sustainable and long-term way, across the South African economy. Ignoring the sector and its participants is not only missing an opportunity, but is sending very negative signals to some of the world's largest and most influential financial services companies. These companies have a vital role to play in advising other clients about foreign investment decisions, and the current approach of the DTI and other institutions is not assisting in selling "brand South Africa". Government needs to look beyond the narrow field of vision created by a five-year employment forecast and realise the key role of companies such as JP Morgan and StateStreet in long-term sustainable growth.

Meeting with and encouraging these companies to do business in South Africa should be a priority.

2. A key factor in this sub-sector's success is its ability to attract large international companies, since they are most likely to get the initial business that will result in offshoring. As discussed above, and highlighted by companies interviewed, the larger the pool of business in the local market, the more attractive the proposition for foreign companies. And the larger their business in South Africa, the more likely it is that they will take advantage of cost differentials and offshore other clients. Government has a considerable amount of business that could be outsourced, with positive results. (Keep in mind that the GEPF business kickstarted State Street in this country). One example of this is the PIC, which is in need of an administration solution. Rather than setting up another administration company (which seems to be the current thinking), this business could be put up for tender, with conditions around offshore business attached.
3. There is a key business promotion role for government. The more that decision makers in other countries are aware of the sophistication and capacity of the local market, the more likely they are (i) to approve a proposal by their supplier to offshore part of their business to South Africa, and (ii) to investigate business opportunities in South Africa. This type of country promotion does not work by having a stand at a global outsourcing exhibition. It is about comprehensive and targeted public relations work, raising the profile of South Africa in the financial services community around the world.

For example, if we believe that a portion of a country's risk rating can be reduced by the "safety in numbers" idea, then government should emphasise who is already here, over and over again. Their presence gives a tacit stamp of approval to the country as an attractive location.

4. Enforcing regulations and high compliance and disclosure standards will increase confidence that locally-based suppliers can meet the requirements of companies in other jurisdictions.
5. Some market participants have commented that it appears that the government is determined to keep its business support and incentive programmes secret, and makes it difficult for companies access comprehensive information. Clearly this must change.
6. There appears to be a general issue around officials (both in South Africa and overseas) not arriving for scheduled meetings. Clearly this sends a negative signal to potential investors. We would recommend that the DTI set up a monitoring system to track these issues and to take corrective action.