When key processes are outsourced, vital intellectual capital often leaves the organization, never to return. As a result, organizations can quickly lose control of their destiny. Here, four information management experts report on a new model for outsourcing, which not only preserves, but creates new intellectual capital, and they explain how the model was applied at BAE Systems and Lloyd’s of London.

VALUE-ADDED OUTSOURCING AT LLOYD’S AND BAE SYSTEMS

Creating a jointly-owned company to grow intellectual capital

By John Hindle, Knowledge Capital Partners, Leslie Willcocks, Warwick University, David Feeny, Oxford University, and Mary Lacity, University of Missouri

Outsourcing is currently one of the biggest trends in business, offering the promise of reduced costs, superior management and technical know-how for the outsourced function, in addition to access to strategic advice. However, research suggests that the promises often don’t live up to the reality. Most companies with traditional outsourcing arrangements have been frustrated by endless cost-service debates, and a significant loss of control over their own institutional knowledge and destiny. The situation is usually no better for vendors. Hampered by their lack of connection to the client’s long-term business strategy, they find it difficult to innovate and add value.

We believe there is a gap because traditional outsourcing arrangements eliminate vital intellectual and social capital that hold organizations together, but are more difficult to manage when crucial parts of the organization are suddenly hived off. This article describes a new model for outsourcing, which not only preserves, but creates new intellectual capital, and explains how it was applied between the outsourcing firm Xchanging and BAE Systems, and between Xchanging, Lloyd’s of London, and the International Underwriting Association (IUA).

Interplay is the key

Researchers have identified four kinds of intellectual capital that are key to organizational success:

- **Structural:** in Tom Stewart’s terms, “the codified bodies of semi-permanent knowledge that can be transferred” and “the tools that augment the body of knowledge by bringing relevant data or expertise to people;”
- **Human:** the capabilities required to provide solutions to customers;
- **Customer:** the shared knowledge about the relationships with people with whom it does business;
- **Social:** the inclination of people to do things for each other because of the strength of the social network they belong to.

The interplay between these four elements conveys a

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Study at a glance

From 2001 to 2003, researchers examined four Xchanging partnerships, including two examined in detail in this article:

- To provide HR services to BAE Systems’ 150,000 employees and dependents, a deal worth UK£250 million over ten years.
- To provide claims processing for Lloyd’s of London and the International Underwriting Association, which settle more than UK£20bn of business each year in a network of some 180 companies.
transforming processes, and thereby create a robust knowledge with Xchanging’s own expertise at transforming processes. This approach facilitates the combination of domain-specific knowledge from the beginning. Unlike most outsourcing vendors, Xchanging doesn’t claim “domain-specific” knowledge in HR, accounting, logistics, or claims processing. Its expertise is in turning back office cost centers into profit-making entities. The domain-specific knowledge comes from the employees being transferred, and from the professionals remaining within the client.

There are three key innovations:

1. The contracting mechanism: The client and supplier create a third company, with its own board of directors responsible to shareholders.
2. Knowledge is defined in seven competencies, each with a practice director responsible for implementing them.
3. There is a four-phased implementation model with a goal of managing expectations between transferred employees, the client, the supplier, and the new entity created in the outsourcing arrangement. This implementation approach stages the business transformation according to willingness and readiness to accept it.

By intentionally establishing a high degree of social capital at a very early stage in the relationship, these innovations preserve the transferred intellectual capital, facilitate the combination of domain-specific knowledge with Xchanging’s own expertise at transforming processes, and thereby create a robust platform for developing new intellectual capital in customer solutions.

Creating a new organization
Xchanging Insurance Services was set up in May 2001 as the Lloyd’s of London and IUA back-office. Instead of simply merging the outsourced assets into Xchanging’s own balance sheet, a new service-providing organization was created. It is jointly owned by client (Lloyd’s and IUA) and vendor (Xchanging), who both share in service improvements, cost savings and profits (See Figure 1, this page). Because the new entity assumes full responsibility for all transferred employees, the arrangement preserves transferred knowledge, service and relationships, and establishes an organization capable of delivering service seamlessly.

The enterprise partnership model has several joint governance bodies: a board of directors, a service review board, and, where a significant technology investment is required, a technology review board. In fee-for-service arrangements, there are committees, but without legal requirements to promote the growth of structural, human, customer, and social capital have frequently fallen short. When both parties have taken shares in each other’s companies, it has rarely changed operational behavior. Joint ventures to sell mutually developed products and services have often been too small a part of the overall outsourcing deal to attract the investment and risk needed to commercialize these offerings. Long-term outsourcing deals are often sealed with the rhetoric of partnership, but in the fee-for-service framework, both sides frequently negotiate down the risk-reward basis for joint action and gain. Is there a more informed way forward?

**Key Points**

- There is an apparent conundrum: if membership in the organization conveys such a powerful advantage in creating intellectual capital, how can outsourcing, which involves the externalization of huge swathes of people, systems, and institutional knowledge, possibly create greater advantage?
- Attempts at closer partnering to align client and supplier incentives to promote the growth of structural, human, customer, and social capital have frequently fallen short.
- By establishing a high degree of social capital at a very early stage in the relationship, the Xchanging outsourcing model preserves the transferred intellectual capital, facilitates the combination of domain-specific knowledge with Xchanging’s own expertise at transforming processes, and thereby creates a robust platform for developing new intellectual capital in customer solutions.

**Figure 1: The Enterprise Partnership Business Model**

<table>
<thead>
<tr>
<th><strong>Lloyd’s of London</strong></th>
<th><strong>IUA London Market</strong></th>
<th><strong>Xchanging Insurance Services</strong></th>
<th><strong>Xchanging</strong></th>
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</thead>
<tbody>
<tr>
<td>Ownership of intellectual property created by the enterprise</td>
<td>Guaranteed investment and cost of first year implementation (up to UK£5 million)</td>
<td>Joint non-executive chair</td>
<td>Xcellence toolset/software use under license</td>
</tr>
<tr>
<td>Five-year deal with 12 month termination notice thereafter</td>
<td>Management expertise seconded at cost</td>
<td>Five board members (Xchanging)</td>
<td>CEO + executive management team</td>
</tr>
<tr>
<td>Joint non-executive chair</td>
<td>“As-is” cost/service for six months</td>
<td>Two non-executive board members (Lloyd’s/IUA)</td>
<td></td>
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<tr>
<td>Стaff from Lloyd’s Policy Signing Office and IUA’s</td>
<td>Service Review panel (Lloyd’s four members/IUA three members) = approval for all price + service charges</td>
<td>Ownership of intellectual property created by the enterprise</td>
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<tr>
<td>London Processing Center</td>
<td>Termination for “chronic and consistent underperformance”</td>
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VALUE-ADDED OUTSOURCING AT LLOYD’S AND BAE SYSTEMS

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These governance mechanisms formally engage client and vendor in a continuous process of joint planning and decision-making, ensuring that business strategies are understood and decisions taken with full knowledge of both parties. A side benefit of this knowledge-sharing governance system is the creation of trust and mutual obligation, which reinforces the institutional relationship.

In Stewart’s terms, customer capital is clearly being created, but the Enterprise Partnership business model also has a social dimension, with governance networks and a jointly-held organization that can be appropriated by both parties to create new intellectual capital and value.

There is also an “anticipation of value” that arises out of the arrangement. By combining Xchanging’s back office transformational expertise with the domain-specific knowledge being transferred, the new entity can create products. Xchanging Insurance Services, for example, created and successfully sold an online document management system. Traditional arrangements wouldn’t have the necessary incentives for new product development.

Xcellence competency model
The second innovation is an “Xcellence Competency model,” which defines seven knowledge-based capabilities used to transform the back office into a profitable enterprise partnership. The capabilities are:
1. Service defines and measures “as-is” service, and agrees to improved service targets through a disciplined methodology called “Service1st.”
2. People gets staff from the client organization on board, manages the transition, and builds teams from transferred employees.
3. Process improves both costs and services through Six Sigma quality assurance.

Figure 2: Enterprise Partnership Implementation Model

<table>
<thead>
<tr>
<th>COMPETENCES</th>
<th>Critical activity</th>
<th>Preparation</th>
<th>Operational</th>
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<tbody>
<tr>
<td>Set-up</td>
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<td>Service</td>
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<td>People</td>
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<td>Process</td>
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<td>Technology</td>
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<td>Environment</td>
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<tr>
<td>Sourcing</td>
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<tr>
<td>Implementation</td>
<td>2-3 months</td>
<td>3-6 months</td>
<td>6-9 months</td>
</tr>
</tbody>
</table>

Implementation

Source: Xchanging Ltd.

4. Technology: builds, implements and manages technology, such as the eRepository at Lloyd’s in 2002, and the eHR portal at BAE Systems.
5. Environment: builds modern and well-branded physical spaces, such as shared service centers at BAE Systems and the Xchanging offices in the Lloyd’s building.
6. Sourcing: uses consolidated buying power and expertise, and a unit-based cost analysis discipline, to reduce procurement costs significantly.
7. Implementation: orchestrates the resources required and their timed, coordinated implementation with the other six competencies.

Each competency is led by an experienced Practice Director (an example of Stewart’s “human capital”), who is responsible for establishing and maintaining the competency’s explicit knowledge in the form of a detailed competency manual. These manuals often exceed 100 pages, and specify the methods, resources, and measurements required for implementation, representing, in Stewart’s terms, “structural capital.”

Practice directors are also responsible for establishing the competency in each of Xchanging’s enterprise partnerships (there were four as of this writing) using mainly transferred staff. This requirement ultimately builds a community of practice across all the enterprise partnerships, thus promoting development and knowledge sharing. These practice communities meet regularly, communicate online, and network with other practitioners inside and outside their organizations.

Mapping the process for improvement
Two Xcellence competencies in particular have early and significant impact – service and process. The service competency’s first task is to establish an “as-is” process map, which captures the major services performed by the enterprise partnership for the client organization. It identifies the customer groups for these services, and establishes delivery standards. The process map is the first stage in establishing a knowledge base and putting the back office onto a commercial footing, by identifying tasks, transactions and resources.

Subsequently, the process map is expanded into a detailed service definition. This specifies each individual service, its customers, and sets targets. This is a formidable exercise in knowledge creation, since few if any back offices ever examine what they do in such detail. It also establishes a cost benchmark for each service, identifying its value in the market for potential commercialization.

In parallel with the development of a service definition, the process competency completes a
rigorous Six-Sigma-based analysis to identify and prioritize opportunities for process re-engineering. The Xchanging version of Six Sigma is called CMADIS: contracting projects, measuring data, analyzing data, developing solutions, implementing solutions, and sustaining benefits. CMADIS is intensively focused on developing knowledge about processes, which can then be transferred to new projects involving more staff.

In Xchanging Insurance Services, the enterprise partnership with Lloyd's of London and the International Underwriting Association, some 37 projects were identified initially, and six staff assigned full time to lead project improvement teams. After intensive training and certification as “Black Belts,” they led successive projects and trained “Green Belts” who in turn trained others and led further projects. The knowledge generated from these projects is constantly shared, recycled, and codified.

**Phased implementation**

The final key element of the Xchanging approach that creates significant social capital is its four-phased implementation model (see Figure 2, previous page):

1. **Preparation:** achieve first-level mapping of the “as is” service, vision statement, and financial plan;
2. **Realignment:** transferee induction, confidence building, and changing attitudes among customers;
3. **Streamlining:** implement major improvements in service cost and quality when transferees and customers are prepared;
4. **Continuous improvement:** improve service offerings and acquire new customers.

The implementation model synchronizes the changes within the former employee population and the client community, and to establish and manage expectations between the partners.

This innovation contributes significantly to creating the “relational” dimension of social capital, which is the sense of common motivation, purpose and benefit. Recognizing that staff may initially feel powerless and resentful in an outsourcing situation, and that it takes considerable time to re-orient to new circumstances, Xchanging’s implementation approach carefully stages the business transformation according to their readiness to accept and support it.

All employees are transferred to the enterprise partnership on day one, and go through an intensive change program that lasts up to two years. Led by the people competency, the process focuses on the Tuckman developmental cycle of mourning, forming, storming, norming, and performing. Beginning with a series of three-day induction sessions, the program uses a range of meetings, counseling, group sessions, and communications techniques at each stage in the cycle to instill a sense of pride, professionalism, teamwork, and group identity in the new enterprise. The process provides management with guidance on appropriate behaviors, as well as the tools and techniques for helping staff through particular stages in the change process, and structured tools for measuring individual progress.

The result is a new culture – that of a dynamic, profitable business – to supplant the previous “neglected-cost-center” mindset. The process is not without cost, both direct cost in creating time for employees to make the transition, and indirect cost in deferring gains until staff are fully prepared. But this effort to build group identity and trust, establish norms of behavior and performance, and instill a sense of mutual obligation yields enormous benefits in the exchange and combination of knowledge.

So far the results from applying these innovative Xchanging models have been highly promising. In our study of the contracts at BAE Systems, Lloyd’s of London, and the International Underwriting Association, we found that each of these relationships supports the development of the social capital essential to knowledge sharing and creation.


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