Global Sourcing
Market Vista: Special Edition June 2009

Topic: Impact of Regulatory Changes on Offshoring in Financial Services

ERI-2009-8-PD-0349

Background and scope of research

Background for research

- The economic crisis that began in October 2008 in the United States led to several actions by the U.S. government. These actions included enacting new legal provisions to support the U.S. financial services industry by means of capital injections into several financial services companies
- These legal provisions have implications for how U.S. financial services companies manage their offshoring programs. This has led to significant concern as the U.S. financial services industry has been one of the leading adopters of offshoring
- Further, media attention on the activities of financial services companies has been heightened. Several negative reports have been targeted at the continued use of offshoring by these companies

Scope of research

- This report provides a fact-based view of the implications of the regulatory and legal provisions on offshoring by U.S. financial services companies. Specifically, the report focuses on the impact of the Troubled Asset Relief Program (TARP) and related regulations on offshoring activities
- In addition, the report also provides a forward-looking perspective on potential regulations and associated implications for the offshoring industry
- Everest Research Institute conducted interviews with sourcing leaders at several financial services companies that have been affected and with a leading law firm to understand and assess the impact of regulations

Executive summary

- The U.S. financial services industry has been one of the leading adopters of offshoring. We estimate that, as of the end of 2008 approximately 250,000 offshore employees (including third-party suppliers and offshore captives) supported IT and BPO operations of U.S. financial services companies. Constraints imposed by TARP, negative media reporting, and other proposed regulatory changes have led to concern on the continued leverage of offshoring by U.S. financial services companies

- Our research concludes that there has been limited impact of recent regulations on the offshoring plans of leading financial services companies. Specifically, companies will continue to leverage offshoring, continue to grow offshore operations, and expand across multiple geographies

- The key impact has been in terms of increased complexity of managing offshoring. Increased regulatory oversight, heightened media sensitivity to offshoring by TARP recipients, and increased executive attention have led to greater complexity and efforts in managing offshoring programs

- The Durbin-Grassley bill and the proposed change to the U.S. tax code have potential implications for offshoring, albeit not restricted to financial services companies
  - The proposed tax on offshore profits is unlikely to impact offshoring. The proposed change has limited impact on the business case for offshoring and is more likely to impact third-party suppliers
  - The Durbin-Grassley bill, **if** enacted in its current form, would lead to significantly higher cost and complexity for offshore suppliers leveraging foreign staff
  - Both of these changes are important to watch because they could have meaningful impact depending on which provisions are enacted (if enacted at all)

This research report includes an assessment of the impact of current and potential regulations on offshoring

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Timeline of key events

TARP[1] (Oct 2008)
The Troubled Asset Relief Program (TARP) allowed the U.S. Treasury to make capital injections into banks. Banks receiving TARP funding come under significant scrutiny on financial stability and performance and are accountable to the TARP Oversight Board.

ARRA[1]; H1B regulation (Feb 2009)
The American Recovery and Reinvestment Act ("stimulus bill") outlines investments in several sectors.
H1B regulations are modified to preclude ARRA and TARP recipients from hiring new H1B workers.

Sallie Mae repatriation (Apr 2009)
Sallie Mae announces that 2,000 jobs offshored to India, Philippines, and Mexico would be repatriated to the U.S. The move is reported to increase costs by $35 million annually. Reports indicate that the move may be be driven primarily by political motives.

Potential changes in tax regulations (Present - May 2009)
Proposed changes to "tax code" target profits earned outside U.S. President Obama's "Bangalore-Buffalo" remarks raise concerns in the offshoring and outsourcing community.

Potential immigration changes (Q3/Q4 2009)
The Durbin-Grassley bill and a rumored comprehensive immigration reform may further restrict the ability of companies to leverage foreign workers. These actions may be broad based in nature and not limited to TARP or stimulus recipients.

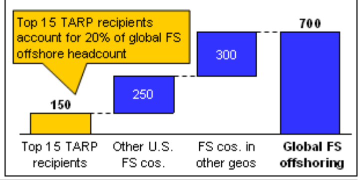
Oct 2008 | Feb 2009 | Apr 2009 | Present - May 2009 | Q3/Q4 2009

Companies impacted and scale of impact

The largest recipients of TARP funds...

American Express, Bank of America, Citi, Goldman Sachs, JPMorganChase, Morgan Stanley, Wachovia, Wells Fargo

...leverage offshoring significantly...
Number of offshore positions supporting bank operations (thousand)



...and have encountered significant media and regulatory backlash

Your Taxpayer Dollars At Work: TARP Cash Still Funding Job Outsourcing
...US banks that have taken billions of dollars in taxpayer bailouts are still shipping thousands of jobs overseas...

BoA, Wells Fargo, TARP Recipients, Forcing U.S. Workers to Train their Foreign Guest Worker Replacements Before Being Fired

Kilroy, Colleagues Blasts TARP Recipient JP Morgan Chase over Outsourcing Plan
Representative Mary Jo Kilroy authored a letter today signed onto by 42 other members of Congress calling for JP Morgan Chase CEO Jamie Dimon to explain his company's plans to spend US$400 million on outsourcing work to India. JP Morgan Chase received US$25 billion from the taxpayer funded Troubled Assets Relief Program.

Dimensions of impact and type of impact

A – Scale of offshoring
- Companies plan to continue to maintain offshoring as a cost and effectiveness lever. No reports of repatriation or reduction in offshore headcount
- Companies view offshoring benefits as a significant component of long-term strategy and are keen to continue to leverage this model

B – Demand for offshoring
- Line of Business (LoB) users who are focused on critical operational activities (e.g., unwinding high-risk portfolios) are less focused on offshoring leading to deferrals and delays in initiatives
- LoBs that are facing significantly higher cost pressures are actively pursuing offshoring as a means to reduce costs and move towards profitability

C – Captive vs. third-party
- Current captive operations are unaffected
- However, new investments to scale up captives or set up new centers are being deferred temporarily to guard against negative media attention

D – Geographies leveraged
- Companies continue to strongly leverage India and other geographies (e.g., Mexico, Philippines)
- Organizations continue to find ways to explore onshore options. In a few instances, this is to gain positive public perception

E – Management complexity
- Management complexity has increased significantly on account of regulatory oversight
- In addition, heightened sensitivity to media reports has led to increased interaction between Sourcing and Communication groups to manage messages to market

F – Executive sponsorship
- Executive engagement with offshoring activities has increased. Increased scrutiny and accountability, and heightened media sensitivity are key drivers forcing executives to be more closely engaged with offshore plans and activities

Potential impact of proposed tax changes

Proposed changes target overseas income of U.S. companies

Current tax regulations
- U.S. companies earning profits in a foreign country can deduct expenses for overseas operations and defer payment of U.S. taxes until those profits are repatriated back to the U.S.
- U.S. multinational companies are alleged to be evading taxes by shifting earnings into low-tax offshore havens and enjoying tax advantages

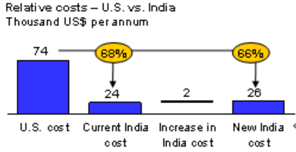
Proposed changes to tax regulations
- The new code aims to curtail U.S. multinationals from receiving deductions for overseas expenses until they pay U.S. taxes
- The government estimates that this change will generate an additional tax revenue of US$210 billion over 10 years (2011-2019)

This change will impact several sectors and is not focused on those companies that are leveraging offshoring
- U.S. Treasury estimates indicate that the tax change would impact ~US$700 billion overseas income earned by U.S. companies. U.S. companies in financial services, manufacturing, and technology, are likely to be impacted, all of which have substantial overseas operations
- However, experts believe that the impact will be very limited on pure services firms as deferring taxes or moving profits to low-tax geographies is difficult for services businesses

In the worst-case scenario, the impact on the value proposition for offshoring is limited because cost arbitrage outweighs additional tax

Relative costs – U.S. vs. India
Thousand US$ per annum

BPO EXAMPLE



Assumes that entire profit margin[1] of offshore delivery operations is taxed at U.S. corporate tax rates

Additional taxes, if implemented, will impact all offshore destinations and are unlikely to be targeted at India

MARKET VISTA

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This report is published as part of the Market Vista research service

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Market Vista includes quarterly reports capturing developments across three key areas

1 Market overview

- Outsourcing transactions trends
  - Transaction analysis – By industry, geography, etc.
  - Listing of major BPO/IT outsourcing deals
  - Large offshore deals
- Captives analysis
  - New captive set-ups, divestures
- Focus on Financial Services players
  - Transaction analysis
  - Developments across global majors

2 Location trends and risks

- Key location developments
  - Establishment of new offshore delivery centers
- Risk dashboard capturing key current and emerging risks
  - Geo-political / economic changes
  - Government initiatives
- Q1 focus – Fact-base on Eastern European cities
  - Sustainability of arbitrage
  - Operating costs across 9 leading cities, inflation rates and currency trends

3 Supplier developments

- Key developments among 20 leading global suppliers
  - Financial performance
  - Transaction activity
  - Changes in delivery footprint
  - M&A and alliance activity
- Q1 highlight
  - Satyam update
  - Key observations from suppliers financial results
- Detailed profiles for each player capturing key developments across dimensions

Appendix: Additional research references

The following documents are recommended for additional insight on the topic covered in this Research Report. The recommended documents either provide additional details on the topic or complementary content that may be of interest

1. **Market Vista: 2008 Year in Review** (ERI-2009-8-R-0320); 2009. This forthcoming report summarizes the key trends and developments for the year 2008 in the global offshoring and outsourcing market.

2. **Market Vista: Q1 2009** (ERI-2009-8-R-0339); 2009. Market Vista Q1 2009 captures key developments across outsourcing transaction trends, health of captives, location risks and opportunities, and supplier developments. Focus section on Eastern Europe and spotlight on key takeaways from suppliers' earnings announcements.

3. **Satyam Situation Analysis** (ERI-2009-2-R-0318); 2009. This report is Everest's comprehensive analysis of the Satyam situation and includes recommendations on how both buyers and suppliers should respond. This report contains timeline of key events in the unfolding of the Satyam crisis, risk assessment for Satyam clients and other industry players, recommendations for current Satyam clients on effective crisis management, facts and analysis on supplier alternatives. Since this is a rapidly changing situation, this analysis is updated as necessary.

For more information on this and other research published by the Everest Research Institute, please contact us:

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