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When outsourcing is not an option: International relocation of investment bank research — Or isn't it?

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Abstract

Outsourcing is high on the agenda of firms seeking to cut costs. Based on an enhanced value-chain concept we develop a model that determines the conditions under which outsourcing and offshoring are not expedient. The model allows for an integrated analysis of horizontal and vertical links to actors within and outside the firm. Equity and country research in investment banks and their outsourcing potential are used as case studies. We draw mainly on qualitative evidence from interviews with investment bank analysts, as well as data on locations of research units of foreign investment banks in India. The option of outsourcing certain stages of business processes and offshoring parts of the value chain within firms to low-wage locations depends crucially on how processes are 'embedded' in relation to other departments within and to corresponding actors outside the firm. Our analysis shows that there is little, if any, scope for outsourcing but some potential for low-level research activities to be offshored to low-cost regions.
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1. Introduction

Outsourcing and offshoring are high on the strategy agenda of firms seeking to cut costs. Based on an enhanced value-chain concept we develop a model that determines the modularity of business processes, and apply it to two activities in investment banks – institutional equity and

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country research – as illustrative case studies. Our model allows for an integrated analysis of horizontal and vertical communication links to firms, customers, and additional sources of information and knowledge in order to establish the conditions under which outsourcing and offshoring are not expedient. The options of outsourcing certain stages of business processes and offshoring parts of the value chain within firms to low-wage locations depend crucially on how processes are 'embedded' in relation to other departments within and to corresponding actors outside the firm.

The financial services industry, in particular investment bank research, is an intriguing case in point for a host of other service industries and their spatial economic organization in an ever globalizing world. At present, wholesale financial activity and the accompanying financial research in banks are highly concentrated in Western financial centers (Clark, 2002). Increasing competition and regulatory pressure are important drivers of possible organizational changes in investment banking. For the first time even complex tasks at the core of financial services firms, embodying high value-added, such as equity and country research, are considered to be outsourced or offshored. However, despite outsourcing and offshoring being high on the agenda of financial institutions (Deloitte Research, 2003), investment banks are reluctant to rely fully on outsourced and/or offshored analysis only. This indicates some hidden obstacles for the restructuring that we carve out in this paper.

We analyze two aspects of sourcing strategies for investment bank research, i.e. possible reorganization of research departments and location decisions contingent thereof. The analysis shows that there is only limited potential for some low-level research activities to be offshored to low-cost regions – if they possess specific prerequisites – but even then these activities are predominantly kept in-house, i.e. with little if any outsourcing occurring.

Research in investment banks differs from the basic scientific or applied R&D-type research that has been so extensively studied by innovation scholars. Basically, institutional equity analysts cover a small number of firms that they analyze, in order to provide investment recommendations regarding stocks of these companies to institutional investors. Therefore, they use input from primary company sources, as well as secondary data. They present to investors written research reports, but also trading ideas they generate while writing a report. Thus they are supporting stock-traders of their bank's sales department with whom they work closely together. Investment banks' equity research on firms is distributed to investors. Contrary to that, commercial banks keep their information about the quality of firms private in order to prevent free-riding of other creditors and thus are reluctant to outsource that research.

Research is an important cost factor in the financial industry: the total equity research budget for seven large investment banks amounted to 2.7 billion USD in 2001. Equity analysts are paid top compensation, with salaries accounting for up to three quarters of the total costs of research (see CGE & Y, 2004). Salaries for analysts with a comparable background, e.g. in India, typically are only 10–20% of an US-based analyst. Intensified competition and re-regulation lead to increasing pressure on the costs of financial services firms, especially now that banks are no longer permitted to subsidize sell-side research with investment-banking fees (Walter, 2004; The Economist, 2005). Underwriting units of investment banks were profiting from analysts research coverage which has been used to help win business. For instance, analysts "hyped" companies before and after their initial public offerings, and in other cases did not – contrary to their findings – issue "sell" recommendations in order to keep their corporate clients happy and maintain investment banking business with them. Accordingly, analysts' salaries were depending to a considerable extent on the investment banking revenues they contributed to. These issues have been addressed by the Sarbanes–Oxley-Act and especially the "Spitzer settlements" in 2002 and 2003, respectively.

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