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As published in

Human Resource Executive

March 16, 2007

Avoiding the Trap

Although recruitment-process outsourcing (RPO) is considered “hot” these days—consider, for instance, that India-based consulting firm Elixir Web Solutions estimates RPO will account for \$30 billion of what the Yankee Group predicts will be an \$80 billion HR outsourcing global market by 2008—it is not, strictly speaking, new. What is new is that many vendors are marketing RPO as another type of business process outsourcing service, without acknowledging that there are certain aspects unique to recruitment.

Indeed, HR leaders who view RPO through this BPO “lens” can unwittingly fall into a trap that has potentially negative consequences for their companies. Examining the historical models of recruitment-services procurement, and analyzing the types of risks inherent in RPO, can light the way to a successful relationship between buyer and provider.

The Hire’s the Thing

Why is the HR world suddenly abuzz with interest in RPO? One reason is that the oft-predicted war for talent is finally real, making it increasingly difficult for most companies to elevate the talent management function to the level of a core competency. In response, more and more companies are turning to third party specialists whose primary competencies lie in the processes, systems and talent networks necessary for building a workforce that will provide competitive advantage.

Additionally, as the broader world of HRO continues gaining more acceptance as a model, RPO increases in popularity too. In particular, because recruiting eats up such a large portion of HR budgets, the function is coming under increasing scrutiny, with many companies benchmarking their in-house recruiting function against performance and cost metrics achieved by commercial providers. The economic gains from adopting an RPO model can be very great, since not all in-house staffing functions can measure up to these commercial standards. Therefore, we are increasingly seeing recruitment offered as a component in large-scale HR BPO contracts.

However, RPO is fundamentally different from other BPO services. It does not behave as simply as other processes within HR, or the processes most often outsourced in other types of BPO. That’s because a risk exists at the core of recruiting that is not present in other business processes.

Other BPO services are generally based on substitution, in which the outsourcer substitutes its people, processes or technology for those of the client. Because an outsourcer operates at a greater scale, focusing solely on these competencies, it can perform tasks for less money, and often more effectively. These tasks usually consist of back-office operations such as answering employee phone calls, processing payments, or

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making changes to employee records. These tasks are definable, repeatable, and susceptible to large scale process and systems leverage.

In a typical BPO arrangement, when clients assume the risk that the outsourcer or third party will fail to perform the function (e.g. make a 401(k) change or pay raise on time) as accurately and as efficiently as expected, they tend to assume that the problem can be remedied through a fairly straightforward process within the provider’s control. We call this type of risk the “process risk.”

A similar type of process risk, often based on a substitution principle, also exists for *some* of an RPO provider’s activity—for example, the sourcing or initial screening of candidates. As such, it is tempting for parties to look at the spectrum of recruiting tasks as a series of connected transactions, all of which are capable of being viewed through a “BPO lens.” This lens sees “open a requisition,” or “schedule an interview” as activities similar to “process a pay raise request,” or “make 401(k) deferral-percentage change.” And, in many respects, they are equivalent with one key exception. All of the sub-activities of recruitment are aimed at a principal result: the hire. Without the hire actually occurring, all of the predecessor activities are for naught.

Buyers instinctively know this, but they need to be careful when examining provider proposals that would seek payment—whether directly or indirectly—for completion of the component transactions of hiring, but not necessarily for the hire itself.

Providers have reasons for adopting this strict “BPO” way of thinking and pricing. Some of the current RPO providers come from BPO backgrounds (rather than from the recruiting industry) and have priced this way because that’s how they measure their internal costs. Another reason providers seek to price RPO this way is to reduce their own risk in not delivering the ultimate result, one over which they have less control than other BPO processes. After all, you can’t force the ideal candidate to accept the job, no matter how efficient your recruiting operations. Thus, customers should be particularly wary of the risk-reward balance in any RPO deal.

Efforts vs. Results

All of this leads to the central challenge in most RPOs: determining how the so-called “fill” risk should be allocated between the buyer and provider of RPO services (through pricing and other commercial terms). This fill risk is different from “process risk” in that it is an execution risk with a capital “E”—executing the ultimate goal of producing a hire.

The simple distinction between paying for level of effort (with its associated “process risk”) and paying for results (with its “fill” risk) lies at the heart of structuring the correct deal for both parties. Buyers who fail to comprehend this during the negotiation phase are more likely to find themselves on the losing end of the risk-reward tradeoff than those who do understand this distinction. Such misunderstandings also can lead to misplaced incentives for providers.

The question then becomes: How do we price “fill” risk and “process” risk fairly in an RPO? Because recruitment outsourcing is not new, some long-standing models can help us answer that question.

We're all familiar with contingency firms, which compete either exclusively or in open competition with each other to successfully fill a company's job postings. The "headhunter" model is one of perfect Darwinian balance: If you don't fill the job and fill it first, you don't eat (get paid). The buyer pays for results, period. This is as close as we are likely to get to an easy-to-grasp and perfectly fair hunting model where "fill" risk is borne by the contingency firm, and the only real risk that the company carries lies in whether it selects the right contingency firm, or firms, to work on the job posting.

Perhaps the best example of paying for effort lies in the "research" model, wherein the client company pays a specialist third-party firm to collect data on certain job postings, such as where the candidates for the posting may be found, how many of them there are, what they would need to be paid to come work for the client company, etc. In this model, a company pays for the firm's research activities, regardless of whether those activities ultimately lead to a hire. Such activities are more akin to most BPOs, in that the third-party research firm performs a discreet task and is not taking on the "fill" risk. Indeed, it is an almost perfect example of a pure "process risk" model, in which the researcher is paid based on level of effort expended.

RPO buyers, especially those with recruiting backgrounds, will appreciate these two models and understand that elements of both need to exist within a full RPO agreement. The key for a successful RPO is to strike the right balance between what these two models have to teach us about pricing the two types of risk, because almost all RPO buyers are giving the provider responsibility for both transactional work and traditional contingent recruitment.

Who Assumes What

As with all outsourcing contracts, HR departments must make a business case for an RPO, demonstrating that it will save costs and/or improve processes and increase the speed at which projects get completed. Generally speaking, the more process improvement required of the provider, and the more substitution of buyer employees who manage the process, the more "level of effort" pricing may be considered. Similarly, the more a buyer wants to shift responsibility for actually filling positions to the provider, the more "fill-to-bill" pricing (i.e., paying the provider based on fills) needs to be included.

Thus, all RPO buyers must understand that this two-tiered risk profile is embedded in every end-to-end RPO. As a result, buyers may see that providers propose "fill to bill" pricing, but include some combination of minimum volume commitments, forecasting imprecision penalties, sharing of third-party agency costs and requisition cancellation payments. These components effectively create a hybrid results-driven/ risk-sharing approach. You need to be particularly careful in such cases because provider price proposals often do not make clear that they have signed up for only limited "fill" risk. Therefore, if you're offered inexpensive, seemingly fill to bill pricing that appears too good to be true, it probably is. Conversely, if provider pricing is closer to your internal cost-per-hire metrics, you need to ensure that the provider has, in fact, assumed a large portion of fill risk.

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Buyers generally expect fill-to-bill pricing because they often consider RPO providers to be a form of contingency firm. Meanwhile, most RPO providers see themselves more in the “research” model and would like to be paid for level of effort, either directly or through other price protections. Balancing these views and needs on both sides of the outsourcing relationship comprises the challenge of constructing the right contract.

Risk Allocation

Although we’ve focused primarily on how RPO pricing should capture the risks inherent in the recruitment function, several other commercial provisions addressed in a typical contract bear directly on the realities of the risk/reward balance unique to an RPO. These include:

- **Service Level Agreements:** SLAs provide another method of allocating “fill” risk (e.g., there is more fill risk in an SLA measuring time to fill than an SLA measuring time to slate).
- **Transition and Governance:** Because the RPO provider’s risk is so dependent on the buyer’s organization (its hiring practices, in particular), determining the contractual standards may require a longer transition period, and the parties’ methods of interaction need to be constantly monitored and verified throughout the relationship.
- **Termination for Convenience:** Because buyers and providers of an RPO are dealing with the critical task of supplying the future talent of an organization, getting it right cannot be left to chance. Parties that find the relationship simply isn’t working (often through no fault of either) should contemplate exits more carefully than is perhaps the case with other BPO arrangements.

In conclusion, there is no one right answer regarding which methodologies are used to allocate the process and fill risks between a buyer and provider in an RPO. However, it’s absolutely critical to understand these two risks—how they’re being allocated and how they’ll affect the charges, the provider’s incentives, and the buyer’s overall risk.

We believe that good contracts don’t happen by accident. Good outsourcing relationships come from both parties being as clear as possible about their expectations and understandings, and then structuring a transaction in which neither party takes more than its fair share of risk.

If you’re considering an RPO, remember that the industry is evolving and that no one has mastered all of its aspects yet. Although you must go about the process carefully, don’t let the relative newness of the industry dissuade you from the very real gains to be realized in such transactions, and consider using experienced advisers to help you enter into a functioning and fruitful RPO relationship.

John Haworth is a consulting principal at New York-based Pillsbury Winthrop Shaw Pittman’s Global Sourcing consulting practice, which designed the first-ever large-scale IT outsourcing agreement in 1988. Michael Steinig is an attorney with the firm’s Global Sourcing Practice. Send questions or comments to hreletters@lrp.com