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Relational Governance Mediates the Effect of Formal Contracts on BPO Performance

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Abstract

Research on outsourcing governance has focused on two modes: formal governance based on a legally binding contract, and relational governance based on a psychological contract between the vendor's relationship manager and the client's project manager. Some researchers argue that the two forms of governance are substitutes for each other. Others model them as complements. Here, we find empirical support for the complementary model and extend it to explain the sequential relationship between formal and relational governance, with relational governance mediating the effect of formal governance on BPO performance. The formal contract is the initial and necessary platform for the outsourcing relationship. If it is well structured, it shapes a good outsourcing relationship, which then supports high BPO performance. The mediated relationship between formal and relational governance extends theory and prior research, which focused on either a substitutive or a complementary relationship between the two forms of governance.

Keywords: business process outsourcing, BPO, formal contract, relational contract, governance, outsourcing, PLS, mediating effect.

1 INTRODUCTION

Outsourcing of business processes has experienced significant growth over the last few years and continues to be an important issue on the agenda of corporate IT executives (Luftman and Kempaiah 2008). Since its early days, more than three decades ago, the outsourcing market has developed and diversified with practices ranging from short-term selective outsourcing contracts to long-term strategic alliances, business process outsourcing (BPO), and transformational outsourcing (Willcocks et al. 2004; Dibbern et al. 2004; Lee et al. 2003). However, many contracts continue to fail to deliver on expectations, are renegotiated, or even terminated (Kern and Willcocks 2002; Lacity and Willcocks 2003).

With this failure to deliver on expectations, the governance of outsourcing ventures remains an unresolved issue (Cohen and Young 2006). Early research on IS outsourcing recognized the effects of the contract and service level agreements on performance (see Lacity/Willcocks 1998). Subsequent research focused on the effects on performance of post-contractual factors, including trust and other relationship-based mechanisms (Kern and Willcocks 2000; Willcocks and Kern 1998; Koh, Ang and Straub 2004; Goles and Chin 2005).

Recent research on governance has combined formal governance, based on a legal contract, and relational governance, based on a psychological contract (Miranda/Kavan 2005). This raises the critical question as to whether relational and formal governance are substitutes for each other or whether they function as complements. Drawing on Poppo and Zenger (2002), we accept the latter and investigate the specific form of the relationship between formal and relational governance, and its effects on BPO performance. Specifically, we show that relational governance mediates the effect of formal governance on BPO performance.

2 LITERATURE REVIEW

The extant outsourcing research has focused on outsourcing IT operations. In contrast, little is known about the specifics of business process outsourcing (BPO) (Dibbern et al. 2004; Willcocks et al. 2007). Therefore, researchers have argued for a full investigation of BPO to identify the drivers and inhibitors influencing BPO decisions and their effects on performance (Dibbern et al. 2004; Gottfredson et al. 2005; Mani et al. 2006; Willcocks et al. 2004). Unlike, for example, the operations of data centers, business processes are complex, are not subject to well developed standards, and are closely integrated with other business processes in an organization (Aron et al. 2005; Davenport 2005). These differences between IT outsourcing and BPO pose significant challenges for BPO clients to specify, monitor and control their vendors' behavior (Aron et al. 2005; Mani et al. 2006).

To investigate that challenge and explain the effects of both formal contracts and relational governance on performance, we derive three hypotheses. Sections 2.1 and 2.2 extend to the BPO domain the accepted main effects of formal contracts and relational governance on IT outsourcing performance (Poppo and Zenger 2002; Miranda and Kavan 2005). With limited research on BPO, the literature review draws heavily on the research results for IT outsourcing, treating BPO as a sophisticated extension of the outsourcing domain. Hypotheses 1 and 2 extend the research on outsourcing to BPO. Hypothesis 3 extends that research, modelling the relationship between the formal and relational governance and their effects on BPO.

2.1 Formal governance

Transaction cost economics (TCE) (Williamson 1979; Williamson 1985) explains how to design formal governance mechanisms for managing outsourcing contracts (Ang and Beath 1993; Lacity and

Hirschheim 1993; Lacity and Willcocks 1998). The intent is to minimize the costs of such governance processes while ensuring the delivery of the desired quantity and quality, and reducing the cost of the outsourced service. Within TCE, formal agreements are treated as mechanisms to specify expectations, obligations, responsibilities and processes for dispute resolution (Macneil 1974, 1978).

Typically, research on outsourcing governance has focused on the legal contract, linked to a penalty/reward system (Poppo and Zenger 2002). In this context, a contract is defined as *a formal, outcome-based governance approach that represents promises or obligations to perform particular actions in the future* (Macneil 1978). Essentially, formal governance comprises legal engagements that focus on structured results and use explicit policies to monitor and reward desirable behavior (Das and Teng 2001).

When an organization transfers decision rights to external vendors, the client must ensure that the vendors act in the client's best interest. Therefore, formal contracts are written to limit opportunistic behavior by vendors. Developing penalty-reward-systems and introducing change clauses, including an early termination clause, reduce the financial and quality-related downside risks resulting from opportunistic behavior (Willcocks and Kern 1998; Jurison 1995; Fitzgerald and Willcocks 1994).

By setting tight service level objectives and negotiating competitive prices, the client contractually specifies the desired quality levels and cost savings. Contracts also deliver quality improvements and stimulate innovation (DiRomualdo and Gurbaxani 1998; Miranda and Kavan 2005). In addition, annual renegotiations of service levels and scope, and performance-based incentive payments increase an IT outsourcing contract's flexiblity (DiRomualdo and Gurbaxani 1998). Here, we extend these arguments about IT outsourcing in general to the specific case of BPO. Formally:

Hypothesis 1: Formal contracts have a positive effect on BPO performance.

2.2 Relational governance

Specifying long-term, technology-based contracts, including outsourcing arrangements, is both complex and uncertain. The contracts must cover unanticipated obligations and anticipate rapid future changes in technology and organizational environments. Therefore, they are inherently incomplete with asymmetric information (Koh, et al. 2004; Jahner et al. 2006).

The extant literature recognises the limitations of adopting a legal contract as the sole governance mechanism. Instead, it advocates the use of additional informal governance mechanisms, such as relational governance, based on the establishment of a psychological contract between the vendor and the client (Goles and Chin 2005; Klepper 1995). This changes the form of governance from a traditional contract-based system to a relationship-based form that operates 'within the spirit of the contract' (Kern and Willcocks 2000). For the purpose of this paper, the terms informal, relational and psychological contracts are treated synonymously to describe relational governance mechanisms. Based on this approach, an important research stream has developed, which focuses on the relational governance mechanisms, capabilities, and best practices associated with successfully managing IT outsourcing contracts after the formal decisions to outsource have been taken (Willcocks and Lacity 2009).

Relational governance is defined here as an informal governance approach that focuses on social ties and inter-personal contact between the involved actors to monitor and encourage desirable behavior. In contrast with formal mechanisms, rules and expectations are not necessarily explicitly defined and codified, and, frequently, the vendor's behavior cannot be observed directly. Research shows that good client-vendor informal relationships lead to IT outsourcing success (Lee et al. 2004; Poppo and Zenger 2002; Kern and Willcocks 2000).

In a cooperative environment shaped by trust, flexibility, commitment, communication and other relational attributes, clients and vendors develop a better understanding of the nature, scope and intent of the contract that they have entered into and the expectations of both parties relating to that contract (Sargent 2006). The duration and ongoing character of the relationships create personal bonds and ties between the parties. These foster mutual commitments to the expectations (Rousseau and Tijoriwala 1998; Robinson et al. 1994), which have a significant effect on the delivery of outsourcing benefits (Koh et al. 2004). Again, we extend these arguments about IT outsourcing in general to the specific case of BPO. Formally:

Hypothesis 2: Relational governance has a positive effect on BPO performance.

2.3 Integrating formal and relational governance

While there are well developed research streams on both formal and relational governance, research on their relationship and its effect on outsourcing performance is limited. The exceptions include Poppo and Zenger (2002), Miranda and Kavan (2005) and Goo et al. (2009). The first two explore the critical question of whether the two forms of governance are substitutes for or complement each other. The third accepts that they are complementary and examines the effects of service level agreements (SLAs) on relational governance and IT outsourcing performance.

The research based on substitution argues that the presence of one governance mechanism reduces the necessity for the other. Specifically, relationship factors, such as trust, reduce transaction costs by “replacing contracts with handshakes” (Adler 2001). These relational norms are assumed to be a less expensive alternative to contracts. Against this, Sharma et al. (2008) show why success on one outsourcing contract does not necessarily reduce the cost of negotiating a subsequent contract.

In contrast, the complementary approach suggests combining formal and relational governance because their joint effect generates higher performance than either governance process alone (see, for example Poppo and Zenger 2002). The contract is.a mechanism for developing relational governance and relational governance supports open communication, joint problem solving and increasing mutual support between the vendor and the client (Poppo and Zenger 2002). Goo et al. (2009) provide evidence for the complementary approach. They show that SLAs have a significant positive effect on both relational governance and performance.

The complementary view is also consistent with research on human resource management practices, which emphasize the importance of complementarities between different governance arrangements (see, for example, Ichniowski and Shaw 1999). It is inconsistent with the speculations by Ghoshal and Moran (1996) that contracts can be interpreted as a sign of mistrust, stimulating opportunistic behavior, instead of protecting against it.

Here, we agree that formal and relational governance are complementary rather than compensatory. Consequently, we adopt a complementary analytical framework to develop and extend the arguments of Poppo and Zenger (2002). We assume that, rather than replacing or hindering relational governance, well designed formal contracts enable long-term, cooperative, and trust-based social relations by discussing and agreeing to service objectives and related contractual terms before signing the contract. This helps develop a mutual understanding of expectations and capabilities, and creates an atmosphere of consensus and commitment through which to capture BPO benefits (Miranda and Kavan 2005).

Vendors and clients are able to build social and personal bonds while discussing contractual obligations. These bonds are helpful during the outsourcing contract, especially in conflict situations. Well-defined contracts also limit opportunistic behavior of the vendor, through detailed SLAs (Goo et al. 2009). This encourages trust-based behavior and decreases the frequency of conflict situations, while delivering the expected IT outsourcing benefits.

In addition, relational governance can overcome time and granularity limits of formal contracts by building commitments between the two parties (Poppo and Zenger 2002). Through on-going collaboration, parties are able to identify the limitations of formal contracts and add to or modify their contractual obligations. This improves the effectiveness of the contract and makes it a viable instrument for delivering BPO benefits, while protecting both parties over the lifetime of the contract.

Within a complementary model of formal and relational governance, the two forms of governance mutually reinforce each other. However, the two forms of governance are not developed contemporaneously. Frequently, in the initial negotiation, the parties do not know each other and, therefore, begin by basing their relationship on the formal contract. The formal governance is thus the initial act in an outsourcing venture.

During the negotiations and the subsequent implementation of the contract, the parties get to know each other and build a relational governance structure, which supports high BPO performance. We speculate that a “well designed” contract supports a positive relational governance structure and a “poorly designed” contract supports a negative structure. Effectively, the emergent relational governance structure is based on the formal contract. This begins to answer the issue raised by Poppo and Zenger (2002): ”Disentangling sociologists’ more emotive and backward-looking concept of trust from economists’ more calculative, forward-looking concept remains an important and presently unresolved empirical question.”

This pattern of behavior is consistent with the general finding that, in work relationships, increases in task interaction precede increases in social interaction. For example, in Homans’ (1951) theory of group dynamics, members of a group who have frequent task interaction “grow sentiments of liking” and develop friendly social interaction that leads to “further interactions, over and above the interactions of the external (task) system” (Homans 1951, p.112). In other words, task interaction among individuals precedes their social interactions, with the latter evolving out of the task interaction. Similarly, Crouch and Yetton (1988) show that task interaction precedes and influences social interaction in pair-wise relationships within organizations.

It follows that formal and relational governance mechanisms, while complementing each other, are developed sequentially. Relational governance is a function of the formal contract and, therefore, mediates the effect of the formal contract on BPO performance. Consistent with the findings of Homans (1951) and Crouch and Yetton (1988), we assume that formal governance is established *before* the relational governance is developed and not the other way around. Formally:

Hypothesis 3: Relational governance mediates the effect of formal governance on BPO performance.

2.4 An integrated model

Typically, the extant research investigates the effect of either the formal contract or relational governance on BPO performance. In Figure 1, Hypothesis 3 formally models the interaction between the two forms of governance and their joint effect on BPO performance. The dotted relationship, the independent effect of the formal contract on BPO performance, depends on whether relational governance fully or partially mediates the effect of the formal contract on performance.

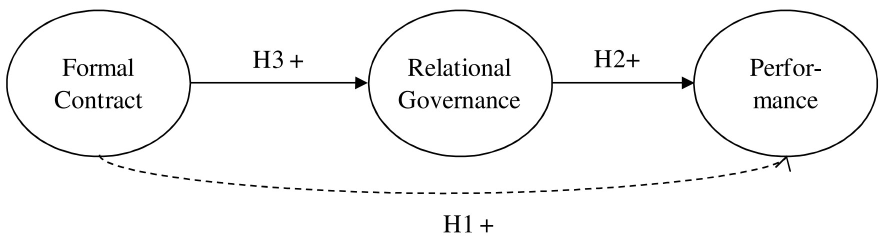


Figure 1. Research model

3 METHODOLOGY

A paper-based questionnaire survey was adopted to test Hypotheses 1, 2, and 3. The research model was operationalized as a structural equation model (SEM) within a Partial Least Squares (PLS) analytical framework (Chin 1998; Wold 1985). Each construct is represented by a set of indicators measured on a fully anchored 7-point Likert scale. Whenever possible, the measures used in the model were derived from other studies and adapted to the specific research domain. The questionnaire was pre-tested with 25 managers from eight banks. These subjects were not included in the final sample. Based on their feedback, the questionnaire was modified to improve both its technical properties and its user friendliness.

3.1 Data collection

The sampling frame consists of the 500 largest banks in Germany, based on their total assets as reported in their 2005 Balance Sheets (latest available figures at the time of preparing the survey). The banking industry was chosen for three reasons. First, it is the second largest buyer of outsourcing services (Gartner 2004) and, therefore, the subjects are well informed about outsourcing. Second, banking business processes are digitally enabled and, therefore, are frequently outsourced (Tas and Sunder 2004). Third, BPO has played and is playing a critical role in the restructuring of the banking value chain (Kumar and Hillegersberg 2004; Lammers et al. 2004).

Four banking back-office processes were selected for investigation: settlement of securities, consumer credits and credit cards, and domestic payments. Generally, these processes are not regarded as areas of core competence for banks (Lamberti and Pöhler 2004). Each bank was contacted by telephone to identify the responsible process manager. The questionnaire was then sent to those managers. A few banks did not offer the full range of services. Thus, only 1,931 questionnaires were mailed out. Eliminating respondents who did not outsource business processes left 335 usable questionnaires from 215 banks.

3.2 Measures

The indicators used to measure the constructs were based, where possible, on existing measures. For both relational and formal governance, existing scales were adopted. A measure of BPO success was not available in the literature. Naturally, clients regard IT outsourcing as successful when it delivers the expected benefits (Aubert et al. 1999). The most frequently cited benefits are financial, technological, and strategic benefits (Grover et al. 1996, Kern et al. 2002, Lee et al. 2004, Mahnke et al. 2005). Therefore, research frequently uses client satisfaction on these dimensions as the measure of IT outsourcing success (DeLone and McLean 1992, Ives and Olson 1984). This is followed here.

Following Oliver (1996), satisfaction can be defined as “a judgement of outcomes compared to a set of goals or standards resulting in a sense of fulfilment” and can be characterized broadly as “a post-purchase evaluation of product quality given pre-purchase expectations” (Anderson and Sullivan 1993). However, most studies do not compare those benefits to the agreed objectives and measure success in terms of the benefits realized (Lacity and Willcocks 1998, Lee and Kim 1999, Loh and Venkatraman 1992, McFarlan and Nolan 1995, Rouse et al. 2001, Saunders et al. 1997).

One of the few empirical studies of BPO benefits was conducted in the German banking industry. Gewald (2002) reports that managers associate BPO with cost and quality improvements, and with an improved focus on core competencies. Within these two domains, Gewald reports the effect of four factors on BPO performance. Cost advantages include reduced process costs and improved cost transparency and quality improvements include reduced error rates and process cycles. Drawing on these insights, we model BPO performance as the difference between expected and achieved benefits on those four factors. The indicators used for measurement are presented in Table 1.

Construct	Item	Question	Related literature
Relational Governance	a222	We can trust the commitment of our service provider.	(Goles 2001, Lee and Kim 1999, Lee et al. 2004, Poppo and Zenger 2002)
	a242	We cooperate well with our supplier and we are both willing to help each other.	
	a244	Overall, we have a good relationship with our service provider.	
	a245	The relationship with our service provider is positive and beneficial for both sides.	
Formal Contract	a258	Through our performance measures and performance targets, we were able to clarify our expectations for our service provider.	(Aubert et al. 2003, Goo et al. 2006, Poppo and Zenger 2002)
	a269	The outsourcing contract covers all our requirements and expectations.	
	a271	The outsourcing contract is very detailed and precisely defined.	
Performance (achievement of BPO benefits)	Please assess the following outsourcing objectives and indicate to what extent they were a) expected at the start of the contract and b) achieved:		(Gewald et al. 2006, Goles 2001, Grover et al. 1996, Lee and Kim 1999, Lee et al. 2004, Saunders et al. 1997)
	a299a307	Reduced process costs	
	a300a308	Increased cost transparency	
	a301a309	Quality improvements (e.g. lower error rate)	
	a305a313	Access to more capable staff	

Table 1. Construct development

3.3 Partial least squares data model

3.3.1 Formative measurement model

BPO performance is operationalized as a formative variable. Its indicators satisfy the criteria for formative measurement (Jarvis et al. 2003), including the design of the constructs (Diamantopoulos and Winklhofer 2001) and the relevance of the indicators (Chin 1998). According to Diamantopoulos, Winklhofer and Chin, five critical issues determine measurement quality. These are content specification, indicator specification, indicator reliability, indicator collinearity, and external validity.

First, content specification is concerned with the scope of the constructs, i.e., “the breadth of definition is extremely important to causal indicators” (Nunnally and Bernstein 1994). Studies frequently measure performance in terms of the benefits realized, without comparing those benefits to the originally intended objectives. Kern et al. (2001) found a significant negative gap between anticipated and actual benefits of outsourcing. Therefore, both expected and achieved outcomes of the outsourcing venture are measured and performance is defined as the difference between them.

Second, the aggregation of all formative indicators underpins the specification of the formatively measured construct. The indicators used in this model were selected from theory and also validated in pre-tests with senior bank managers who were knowledgeable about this research domain.

Third, indicator reliability depends on the importance of each indicator that forms the relevant construct. Two criteria must be satisfied. One is that the signs of the indicators are consistent with the hypotheses. The other is that the weighting for each indicator is equal to or greater than 0.2 (Chin 1998). The properties of the four indicators of BPO performance are presented in Table 2.

Fourth, formative measurement models are based on linear equations. Therefore, significant indicator collinearity affects the stability of the indicator coefficients. Inspecting the correlations between indicators and the calculation of the variance inflation factors (VIF), all indicators fall below the conservative VIF threshold of 3.3 (Diamantopoulos and Siguaw 2006).

Fifth, following Diamantopoulos and Winklhofer (2002), external validity is analyzed by creating a phantom construct that is measured using reflective indicators.The correlations of the construct within the model were all strong (> 0.3) and significantly different from zero at the 0.001 level. The formatively measured construct strongly and significantly correlates with the reflectively measured construct and the conditions for external validity are satisfied.

3.3.2 Reflective measurement model

Tests were conducted to investigate the validity of the reflective model constructs. This is a function of three factors: convergent validity, construct reliability and discriminant validity (Bagozzi 1979, Churchill 1979, Peter 1981). Convergent validity is determined by indicator reliability (Peter 1981), which is examined by inspecting the construct loadings. In the model presented in the results section below, loadings are both significant at the 0.001 level and above the recommended 0.7 parameter value. One indicator measuring the contract construct criterion has a marginally acceptable loading of 0.69, which satisfies the less demanding criteria for new constructs proposed by Hulland (1999).

Construct reliability was investigated by inspecting the composite reliability (CR) and the average variance extracted (AVE). Table 2 reports that the indices are above the recommended thresholds of 0.6 for CR and 0.5 for AVE (Bagozzi and Yi 1988). Discriminant validity of the construct items was investigated by inspecting the cross-loadings. The criteria for discriminant validity are satisfied. All items load higher on their respective constructs than on any other construct. In addition, the square root of the AVE for each construct is higher than correlations between constructs.

3.3.3 Control variables

The validity threat arising from multi-group behavior was investigated by running bootstrap re-samplings for the four back-office process groups and testing differences across the standard error estimates from each re-sampling (Chin 2000). The findings reported below are not subject to a potential internal validity threat: Applying a Bonferroni correction (Miller 1981), there are no significant differences in path coefficients due to process effects.

3.4 Mediating effects

Following Iacobucci and Duhachek (2003), a construct is a mediator if it satisfies three conditions: Changes in the exogenous variable have significant effects on the mediating variable; changes in the mediating variable have significant effects on the endogenous variable; and the path coefficient between the exogenous and endogenous variable is significantly lower than the path coefficient in an alternative model that excludes the mediating variable. This is investigated in the results section by inspecting the z-value and the VAF value (Iacobucci and Duhachek 2003, Sobel 1982).

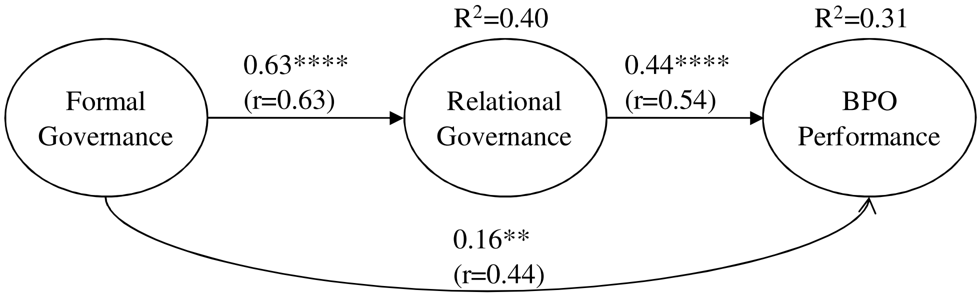
Construct	Item	Sample (n=335)			
		Load. / Weight	Sign. Level	CR	AVE
Relational Governance Type: reflective	a222	0.75	0.001	0.93	0.77
	a242	0.88	0.001		
	a244	0.93	0.001		
	a245	0.94	0.001		
Contractual Governance Type: reflective	a258	0.69	0.001	0.81	0.60
	a269	0.90	0.001		
	a271	0.71	0.001		

Construct	Item	Sample (n=335)			
		Load. / Weight	Sign. Level	CR	AVE
BPO Performance	a299a307	0.59	0.001		
(achievement of BPO benefits)	a300a308	0.22	0.05		
Type: formative	a301a309	0.29	0.01		
	a305a313	0.25	0.01		

Table 2. Indicator and construct reliability

4 RESULTS

The model is presented in Figure 2. Thirty one percent ($R^2=0.31$) of the variance in BPO performance is explained by the model (p<=0.001). Hypothesis 1: Formal contracts have a positive effect on BPO performance, is supported. The path coefficient, 0.16, is positive and significantly different from zero (p<=0.05). Hypothesis 2: Relational governance has a positive effect on BPO performance, is strongly supported. The path coefficient, 0.44, is positive and significantly different from zero (p<=0.001).



Level of significance: ** p <= 0.05; **** p <= 0.001;

Figure 2. Formal governance, relational governance and BPO performance

Hypothesis 3: Relational governance mediates the effect of formal governance on BPO performance, is strongly supported. The three criteria set out in the Methodology section are satisfied. First, Figure 2 reports that forty percent ($R^2=0.40$, p<=0.001) of the variance in relational governance is explained by formal governance. Second, the correlation between formal governance and BPO performance is r = 0.44 (p<= 0.001). Third, z = 5.99 (p <= 0.001) and VAF = 0.63. Sixty three percent of the effect of the exogenous variable, formal governance, on the endogenous variable, BPO performance, is explained by the mediating variable, relational governance. Figure 2 shows that relational governance strongly and partially mediates the effect of the contract on BPO performance.

5 DISCUSSION

Hypotheses 1 and 2 are supported. Formal governance has a weak, positive significant effect on BPO performance, and relational governance has a strong, positive significant effect on BPO performance. Hypothesis 3 is also supported. Relational governance strongly and partially mediates the effect of formal governance on BPO performance. Rather than following Poppo and Zenger (2002), who model the two forms of governance as complementary with formal governance influencing relational governance and relational governance influencing formal governance (Poppo and Zenger 2002), we conclude that formal governance is the basis on which relational governance is built. This draws on a research stream in managerial psychology in which task interaction precedes and influences social interaction (See, for example, Homans 1951, Crouch and Yetton 1988).

The mediated relationship presented in Figure 2 is also consistent with the timing and development of the governance mechanisms. The two governance mechanisms are subject to a natural sequence and timing in their development. The nature of an outsourcing venture or relationship is not static, but changes and evolves over time (Argyres et al. 2007, p.6). Typically, the contract negotiation and the emergent informal relationship between client and vendor do not occur at the same time. Rather, after the contract is signed, the relationship between the parties develops as the outsourcing contract is being implemented. Consequently, relationship governance evolves both after, and as a consequence of, the contract.

A well-designed contract shapes a supportive outsourcing relationship (Poppo and Zenger 2002, p.713), which leads to a successful BPO project. Negotiating a well-designed contract is a necessary, but not a sufficient, condition for developing good relational governance and a successful BPO project. However, when the contract is poorly designed, client and vendor find it difficult to build a good working relationship, resulting in an unsuccessful BPO project. This need for a well designed contract becomes even more obvious when contrasting ”the period of action and impact” of both the formal contract and the actual relationship. While there is only one contract over the life of the outsourcing agreement with relatively minor changes and little evolution, there may be multiple management teams from both the client and vendor side over the period of the outsourcing relationship. Therefore, even if different client and vendor teams try to shape the outsourcing relationship over time, having in place a poorly designed contract will still result in poor task interaction and hence poor social interaction.

5.1 Validity threats

The findings are subject to three validity threats. First, the data is cross-sectional. The direction and nature of causality cannot be tested. Second, the data is limited to the perspective of the client’s manager responsible for the process. In future research, data should be collected on both the client’s and the vendor’s perceptions of the contract, the relational governance, and the level of BPO performance. In addition, single-source data collected at one measurement point increases the effect of common methods variance (Podsakoff et al. 2003). Therefore, there is a potential construct validity threat to the findings reported above. Third, the findings are limited to the effects of formal and relational governance on BPO in German banks. Therefore, the findings may not generalize to other contexts. However, the findings are consistent with the general findings reported for IT outsourcing (See, for example, Poppo and Zenger 2002, Goo et al. 2009). Therefore, they are likely to generalize across industries in developed economies.

5.2 Implications for research and practice

In the extant literature on outsourcing governance, some researchers have ignored the role of formal governance (See, for example, Saxton 1997). Others have compared the relative costs of formal and relational governance within a substitution model of governance. Typically, that research stream assumes, without presenting any evidence, that relational governance is a lower cost form of governance than is formal governance (See, for example, Uzzi 1997). In addition, with the formal contract grounded in an adversarial legalistic framework based on a ’buyer beware’ market place, it has been questioned whether a formal contract could be the building block for relational governance based on trust (See, for example, Ghoshal and Moran 1996). Poppo and Zenger (2002) and Goo et al. (2009) resolve this debate and show that, for IT outsourcing, formal and relational governance are complementary. We extend this finding to BPO.

In addition, drawing on the research of Homans (1951) and Crouch and Yetton (1988), we respond to Poppo and Zenger's (2002) conclusion that: "At a minimum, these results suggest a need to explore more carefully and predict more cautiously the relationship between formal contracts and relational governance." (p. 721). To do that, we refine their complementary model of governance. Instead of an unconstrained complementary approach in which formal governance affects relational governance and vice versa, we model the formal governance as the basis for the subsequent development of relational governance, which mediates the effect of formal governance on BPO performance.

Poppo and Zenger (2002) speculate that effective relational governance leads to the development of more complex future contracts. They do not consider the effect of poor relational governance and poor performance on future contracts. Given the short history of BPO, the contracts researched here are too new for a bank to have completed its first round of BPOs and to have negotiated and implemented the next round. However, some of the contracts sampled here may have been renegotiated. The issue is whether those contracts were renegotiated because the initial contracts had generated either good relational governance and high BPO performance, or poor relational governance and low BPO performance. Choudhury and Sabherwal (2003) investigated five major IT outsourcing projects. Contracts were renegotiated in three out of five cases. The reason was always a failure to deliver the expected IT outsourcing benefits. In all three cases, the contracts were renegotiated to include more extensive controls. Poor outsourcing performance led to an improvement in formal governance, which, consistent with Figure 2, resulted in improved performance. Intuitively, it is unlikely that either a bank or a vendor would have renegotiated a high performing BPO project.

However, Poppo and Zenger's (2002) arguments may be valid when a client negotiates a new contract. Mayer and Argyres (2004) and Argyres et al. (2007) show that contracts include more contingencies over time as clients get to know each other and transaction costs decline. There are two alternative explanations. One is that clients and vendors learn that more contingent contracts are more successful than less contingent contracts. The increased level of contingency is a result of increased cognitive understanding about contracting and not of the relationship between the two parties. The other is that clients do not negotiate new contracts with vendors who failed to deliver on the previous contract. Observed changes over time may be a function of selection effects within the sample and not development effects within the clients. These explanations should be the subject of future research.

The findings presented in Figure 2 and the conclusions drawn above have three important implications for practice. First, both clients and vendors should focus on writing a well designed contract. Negotiations should not be cut short or under-resourced. As the vendor is likely to be more experienced than the client, the vendor should guard against the temptation to exploit the client's lack of experience, because the resultant asymmetric contract would be the basis for poor relational governance and low BPO performance. This could be the source of a significant loss of reputation to the vendor and, subsequently, a loss of business.

In addition, while a well designed contract is not a guarantee of good relational governance, weak relational governance can be corrected within the context of a well designed contract with low cost changes to the project team management or processes. In contrast, renegotiating a poorly designed contract, while working as normal on the project, is complex, delay or preclude the emergence of good relational governance, and so delay completion of the project.

Second, drawing on Crouch and Yetton (1988), clients and suppliers need to invest in both the right mix of skills and the continuity of those skills. The mix of skills involves capabilities both to negotiate a legal contract as the foundation of the outsourcing venture and to develop the ongoing interpersonal relations to support effective relational governance. These two sets of skills differ. Even with the right mix of skills, a lack of continuity in the membership of both client and vendor teams limits the development of the trust and commitment required for effective relational governance.

Third, we speculate that future relational governance is influenced by the style with which the contract is negotiated. Involving both the supplier's relationship manager and the client's project manager in the contract negotiations could support the development of effective relational governance at the earliest stage. Their involvement would also guard against any tendency to treat the contract negotiations as adversarial, damaging the potential for developing effective relational governance.

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Due to paper length restrictions the authors will gladly provide the full list of references upon request.

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