Outsourcing of Banking Activities; Emerging Trends and Challenges

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Background

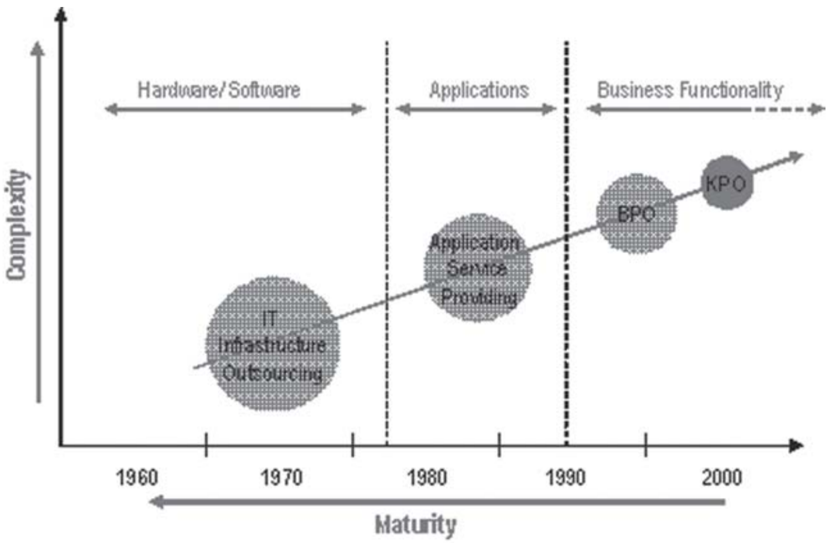
Banks traditionally have been major proponents of outsourcing. Although the banking industry was using outsourcing as a means of reducing operating costs for over three decades, until recently, IT related processes accounted for the majority of outsourced activities. However, this is changing; banks are increasingly considering many other different functions as possible lines for outsourcing. The commonly known 'rule of thumb' for selecting processes for outsourcing is "if the function is not mission critical – it can be outsourced". While outsourcing of banks' business functions has evolved as a sensible business practice, outsourcing typically introduces new risks that must be managed appropriately. The ever increasing scale of outsourcing in the banking industry has of late received the attention of the industry regulators in a number of countries, which has led to the publication of policies/ guidelines that have to be followed by financial instructions when outsourcing functions. The process of outsourcing is also a challenging one as there are many factors to be considered and managed. This article attempts to discuss the trends in the banking industry with regard to outsourcing, the risks, challenges and factors to be considered when outsourcing business processes and functions.

What is Outsourcing and Why?

Outsourcing can be defined as the use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) by an entity to perform activities on a continuing basis that would normally be undertaken by the entity, now or in the future. In other words, outsourcing is yet another tool that is available to managers to achieve greater flexibility, lower costs and enhanced efficiency – or so it is believed.

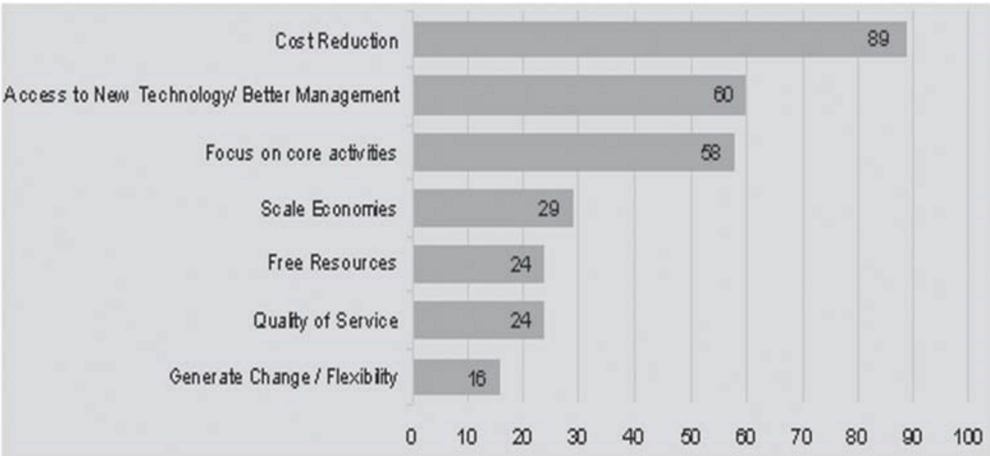
Although outsourcing in the services sector began with non-core functions such as programming and basic back-office functions, the list has grown over the years. Today, knowledge-based processes, such as research, are also outsourced by corporates in the industrialized economies to developing economies such as India, China and even Sri Lanka. The advancements in information and communication technology, the availability of skilled labour at relatively lower costs and increased English proficiency have played a pivotal role in outsourcing of various functions to these developing economies, which is also known as 'off-shoring'.

Outsourcing – Evolution Over Time



Virtually no industry is immune to the general trends of corporate management; as a result outsourcing is increasingly used in the financial services sector. Cost savings and efficiency enhancements are the main impetus behind outsourcing. For example, it is estimated that Bank of America has saved approximately USD100 million since 2001 by outsourcing certain functions previously carried out in US and UK to emerging economies. At the same time, outsourcing of certain non-mission critical functions can free-up management time and resources which can be better spent on core-functions and strategy of the organization. There are many more motivating factors, and usually a number of them are responsible for the decision of a corporate to outsource. A survey on EU banks' motivation for outsourcing has revealed that cost reduction, access to new technology, better management and freeing-up resources to focus on key activities, in that order, are the biggest motivators. However, a survey carried out by the British Bankers' Association among 330 institutions active in the UK market revealed somewhat a different order of these motives. For the majority that were surveyed, concentration of management on core functions and improvements to service levels were more important than cost control and head-count reductions as motives for outsourcing. In today's intensely competitive environment in the financial services sector, profitability is often a function of how competitive, customer friendly and adaptable an institution is – and outsourcing has become another tool for managers to achieve these goals.

EU BANKS' MOTIVES FOR OUTSOURCING



Source: European Central Bank – 2004

BANKING INDUSTRY AND OUTSOURCING

Outsourcing in the banking industry began with non-core areas such as basic support services and IT related services. However, the list has grown significantly over time and more and more business critical and strategic functions are being added to this list. The trend is now towards outsourcing of entire business processes; with respect to financial institutions these include payment transactions, credit application processing and securities transaction processing among others. The various processes are being 'industrialised' while banks concentrate on sales and relationships – their core business.

Among the common functions that are outsourced by the banking industry today include (aside from the non-industry specific basic services), customer care (through call centres), credit cards related services – sales, billing and collections, encoding of bank transactions and data processing, transaction statement printing and delivery, cheque clearing and replenishment of ATMs. Increasingly human resource related functions such as recruitment, payroll and HR administration processes are being outsourced by banks. Large outsourcing entities increasingly set-up their own offshore operations, which sometimes is in partnership with other parties. Apart from the various operational and regulatory challenges, off-shoring means the outsourcing firm (and the regulators) will have to be concerned of an additional risk – the 'country risk' attached to the service providers. Off-shoring requires the regular monitoring of political, social, economic and legal climate of countries from which services are obtained from and at the same time stronger contingency planning.

EMERGENCE OF CREDIT FACTORIES

Information technology is not banks' core-business; but granting credit facilities is. But some of the findings surrounding bank's credit process are astounding. For example, as per a study by the Re-financing Lab at the University of Frankfurt/ Main and TU Darmstadt, 70% of German banks still cannot execute a business process for a credit application within a single IT application system. The survey also found out that only 22% of Germany's banks have electronic credit files, while the remaining 82% still use paper.

In this backdrop, a new type of service providers are emerging – 'The Credit Factories'. Credit Factories are special institutes with a bank license specialising in granting credit and the related process. Here the credit factories look after the entire credit processing operation, from the processing of the loan application to the full repayment of the loan.

BANK OUTSOURCING – THE ASIAN SCENARIO

Asia too has picked up outsourcing. One of the industries that aggressively outsource is the banking industry. It has been found that many local and foreign banks established in the region are increasingly outsourcing regular bank related functions. The list of processes outsourced by Asian banks is not too different to that of American and European banks. A survey made by UNI APRO among its bank affiliates in a number of Asian countries revealed that most commonly outsourced function in Asia currently are marketing of banking products – credit cards, loan services etc, credit collection, customer service, statement renditions and payroll. The need of national banks to remain innovative and competitive in terms of cost and quality of services to effectively compete with a large number of foreign banks active in the Asian region is a major drive for outsourcing in the Asian financial services sector.

Sri Lankan banks too are in many ways seeking opportunities to outsource various functions, for the same reasons banks in other parts of the world started sourcing services from outside- i.e. to be competitive. The basic services were the first to go. One of the significant developments in the local banking scenarios was the formation of ‘Lanka Clear’ for clearing of cheques of all participating banks. Certainly this has been a great success story.

Why Should the Regulators Worry?

Outsourcing of banking services can worry regulators on two main fronts –

1. A possible threat to the sanctity of the banking industry – particularly maintaining confidentiality of transactions and personae of the banks’ clients
2. Outsourcing of certain services has the potential to transfer risk, management of these activities, attached risks and compliance with standards and regulatory requirements to third-parties who may not be regulated. This becomes more of an issue when the processes are off-shored. Can outsourcing create an unquantifiable and unmanageable risk?

Further, outsourcing can lead to large scale staff lay-offs, and as a result union action and organized resistance to outsourcing. The regulators / governments often need to get involved to address such issues as these can have implications both on the banking system and national politics.

Regulators and governments of many countries have understood that outsourcing is important, particularly if the local banks are to effectively compete with foreign banks – in other words a ‘necessary evil’. Such regulators’ stance towards outsourcing is that it will be permitted so long as it does not compromise a bank’s ability to continue to provide core liquidity, payment and transaction services both in good times and under stress and risks can continue to be managed. However, the question remains, can outsourcing impede the ability of a regulated entity to demonstrate that they comply with the regulations and appropriate measures are taken to manage risks; and if so, how can a regulator effectively monitor and regulate the industry. There is also the potential for over-reliance on outsourcing and/ or on one party for activities critical to the business continuity or obligations to its customers; such high reliance can significantly alter the risk profile of a financial institution.

Risks Associated with Outsourcing

There are many risks associated with outsourcing that have to be identified and addressed properly in order to benefit from outsourcing and to ensure that the overall risk attached to the business does not increase in an undue manner as a result of the decision to outsource. In fact, a survey has revealed that the main reason why some institutions decide not to outsource is the concerns over delegation of responsibility, which is both a major component and a risk attached to outsourcing.

Operational risk of banks has received a great deal of attentions with Basel II. The Bank for International Settlements ("BIS") recognises operations risk as one of the three pillars of this new capital accord. With outsourcing of banking related services taking place at full throttle, assessing the impact of outsourcing will be an important element in understanding banks' overall operational risk for capital purposes in the future. The Joint Forum established by the BIS consisting of the Basel Committee on Banking Supervision, International Organisation of Securities Commissions ("IOSCO") and International Association of Insurance Supervisors recognized the following as the main risks associated with outsourcing.

Some Key Risks in Outsourcing

Strategic Risk	? Activities of the third-party inconsistent with the overall strategic goals of the outsourcing entity ? Failure/ inadequate expertise to implement appropriate oversight of the service provider
Reputation Risk	? Poor Service from the third-party (quality and ethical standards) compared to those of entity outsourcing
Compliance Risk	? Non-compliance with privacy and consumer and prudential laws ? The third-party has inadequate compliance systems and controls
Operational Risk	? Technology failure, inadequate financial capacity of the third-party to fulfill obligations or provide remedies ? Fraud/ Errors
Exit Strategy Risk	? No exit strategies in place ? Limited ability to restore service facilities in home country / in-source due to lack of staff, loss of relevant skills ? Difficult contract terms
Counterparty Risk	? Non-fulfillment of obligations ? Inappropriate practices (eg poor credit assessments etc.)
Country Risk	? Political, legal and social factors – make planning more complex – (applies to off-shoring)
Contractual Risk	? Ability to enforce contract ? In the case of off-shoring, choice of law
Access Risk	? Access to regulators –timely data and other required information ? Regulators need to understand another layer of activities/ risks
Concentration and Systematic Risk	? If the industry has a significant exposure to a particular service provider, it could result in the lack of control over the service provider and at the same time increases the systematic risk

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Regulatory Developments

Regulators around the world have recognised the potential problems and risks introduced by outsourcing. A number of national regulators have already introduced regulatory standards or legislative controls on outsourcing; however, how detailed these guidelines/ legislations varies from country to country. The Basel committee continues to monitor emerging practices in the outsourcing arena and the regulatory responses to these developments. The Joint Forum, following its study, developed a nine point list of principles; seven of these are the responsibilities of the regulated entities that outsource services, while the remaining two are roles/ responsibilities of the regulators. Although risks associated with outsourcing cannot be entirely eliminated, these guiding principles can mitigate the above identified risks to a large extent.

Outsourcing in Financial Services: Guiding Principles – The Joint Forum

A comprehensive policy to guide outsourcing of services - The Board of Directors (or an equivalent body) should be responsible for the implementation and activities undertaken under such policy.

A comprehensive outsourcing risk management programme

Must ensure that outsourcing arrangements do not negatively affect obligations to customers/ regulators and impede effective supervision by regulators

Should conduct appropriate due diligence in selecting service providers

Outsourcing arrangements must be governed by written contracts that clearly define all material aspects of the arrangements and expectations of parties to it.

Both the outsourcing entity and the service providers should establish and maintain contingency plans

Should take appropriate steps to protect confidential information

Should take into account outsourcing as an integral part of their ongoing assessment of the regulated entities

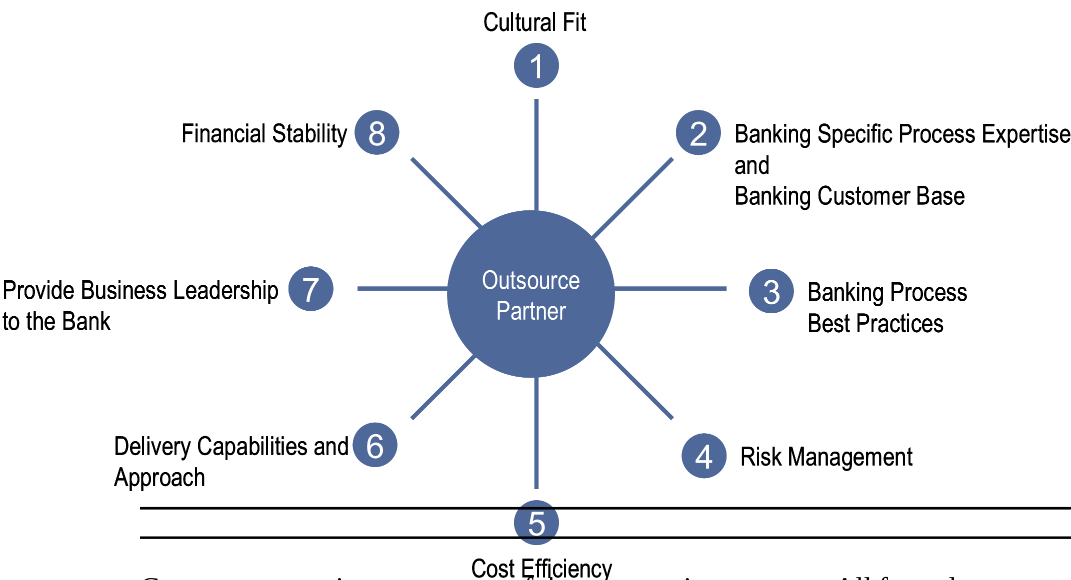
Should be aware of the potential risks posed where the outsourced activities of multiple regulated entities are concentrated within a limited number of service providers

Minimising Risks Associated with Outsourcing

Outsourcing of business processes usually involve routine tasks that are nonetheless of critical importance for financial institutions. The cost effectiveness of an outsourcing arrangement (while considering the additional risks introduced) depends on a number of factors – for example, the process selected for outsourcing, vendor chosen and how the contract was written.

The biggest challenge for financial institutions is to identify the right vendor and manage the service relationship. Aspects such as competency, knowledge or expertise of the supplier, culture, processes, regulatory compliance, financial stability and references must be considered when selecting a supplier. While cost effectiveness is certainly one of the strongest motives, the cheapest service provider is not always the right partner.

EVALUATING BPO PROVIDERS

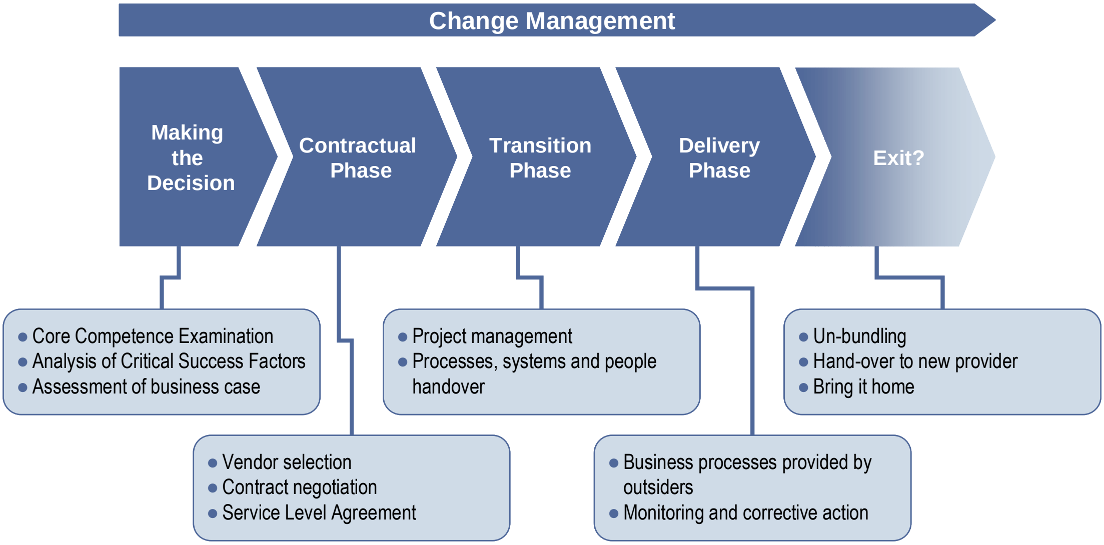


Contracts are an important part of the outsourcing process. All formal contract and service level agreement ("SLA") should cover management information, service penalties (or credits), fee escalation procedures, use of subcontractors and rights of access. In the case of knowledge-intensive high-end outsourcing, defining expectations and measurement are more difficult tasks. SLAs and contracts are seen the most effective means of control, and are used more often than other controls. Preparation of an effective SLA involves a thorough understanding of the industry benchmarks and requirements of the outsourcing entity – at the end of the day, a SLA is a mutually agreed document by the outsourcing company and the service provider that will shape their relationship and decide the success of the outsourcing arrangement for the outsourcing company.

For high-end functions of financial institutions, information security is a critical success factor along with information quality and regulatory compliance. These issues must be addressed in detail in the agreements. The outsourcing entities should continuously monitor for breaches and take corrective action where necessary. As it is the outsourcing financial institutions that are more aware of and familiar with these issues, it is they who should ensure that expectations with regard to such factors are addressed in the contracts/ SLAs.

Outsourcing is about making a change to the way an activity is performed. However, outsourcing involves many changes to many other aspects of the organisation; for example the overall risk profile, redundancy of employees – just to name a few. While change management is crucial during the transition phase, management of change is actually required from the moment a decision is taken to outsource and also in contingencies, which can be at any stage of the process. Hence, a team dedicated to change management with top management involvement is a must to manage risks associated with outsourcing.

CHANGE MANAGEMENT – A CRITICAL SUCCESS FACTOR



The post-implementation review that entails auditing for information security, service quality and compliance is an important element of ensuring the success of an outsourcing arrangement. All such arrangements should have in place an exit strategy along with contingency planning in the event that the project runs into unexpected problems. Exiting can be a difficult task that involves either replacing the service provider or bringing back the services in-house.

Handling Resistance to Outsourcing

Outsourcing has always been a serious concern to employees and trade unions. It is quite common for outsourcing of services in the banking industry to provoke resistance and labour disputes. In some countries however, unions now accept outsourcing of certain non-core functions as understandable. However, many unions question the outsourcing of functions that are directly related to banking. Even white collar employees are affected with the outsourcing of knowledge based activities. Unions often use the threat posed by outsourcing to secrecy of customer data in their protests against outsourcing of services directly related to banking. A regular complaint is that the employees are not consulted nor informed in advance regarding outsourcing of services and the potential headcount reductions.

Resistance to outsourcing from employees and trade unions is certainly not amongst the easiest of issues that have to be addressed by management when outsourcing. Managing reactions to outsourcing is a major part of the change management process. Labour disputes can be avoided or minimised by way of increasing awareness and giving adequate notice so that employees can be potentially re-trained for a different task or allowing sufficient time to find employment elsewhere.

Smart-sourcing

Outsourcing of services has now been around for over three decades; and we are certain it is not just a passing fad. While outsourcing can benefit an organisation immensely, this will only be true if the right activity is selected for outsourcing, the process well managed, the right partner chosen and performance and compliance continuously monitored.

Hence, outsourcing is the tactical use of a specialised external resource to perform activities which are/ can be carried out internally – perhaps a more appropriate term for this would be "smartsourcing". Smartsourcing or rightsourcing is about knowing what to insoucrce and what to outsource and how to do it the proper way.

There is much the Sri Lankan banking industry can learn from the experiences of other countries – the good, the bad and the ugly. In a nutshell, outsourcing requires a risk-based but flexible approach, where change management and identifying and controlling of risks are the essential ingredients of success. %

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