

Outsourcing Opportunity – Strategic and Operational Level

I compliment Indian Merchants Chamber for holding this seminar on such an important topic as outsourcing and to discuss a wide range of issues that are pertinent to Indian banking in the context of emerging global financial system and the opportunities and challenges thrown open by it.

2. When we talk about global, one thing that comes ready to mind is outsourcing. An important outcome of globalization apart from FDI and FIIs is the growing outsourcing industry. Global players in the background of having access to the cost efficient and productive centers all over the world are relocating a host of their functions, more importantly those relating to their back offices deriving a number of benefits in terms of costs and productivity. The frenzy of this trend which is more popularly known as outsourcing has even become a hot political issue in many advanced countries and nations like us are trying every endeavor to defend our turf by improving our competence and competitiveness in this segment. Worldwide outsourcing today is a multi billion-dollar business to which India has a sizeable stake and share.

2.1 The same features and functions, one may find in global perspective of the outsourcing, will be evident in the domestic context also. If in developed countries, outsourcing is opposed by some section of the political system and labour unions, it is similar experience with domestic situation as well. Outsourcing as a subject is spilling into the social arena as well, since it is creating significant spending power for the youth and the very young, some times causing some concerns about the living styles and patterns.

Notwithstanding these causes and concerns, business is beginning to love and like outsourcing very much and we hope to see strong growth in this segment in the years to come. Obviously, when we see so much growth in this segment, it is natural to look at threats and opportunities. It is in this context, let me share with you a few of the opportunities in outsourcing of banking functions in India with specific reference to and some aspects of strategy and operational aspects..

3. Given the fact that the two others speakers of this session; Mr. Srikrishnan and Mr. Sailesh Haribhakthi will be speaking on the same topic, and in view of their experience in the subject, it would be my endeavour to flag off a few issues with special reference to rural markets to ensuring greater financial inclusion and increasing the outreach of the Banking sector, by using the services of NGOs, SHGs, MFIs and Civil society organizations as intermediaries in providing financial and banking services through the use of Business Facilitation and Correspondent Models.
4. First and foremost, why do we need outsourcing? Simple logic and rationale will explain this.
 - 4.1 Banking is becoming intensely process driven. Technology enabled banking to assume huge number of transactions and customers of diverse range seeking different requirements. Electronic banking connected the whole country and a banking institution, which was once offering segmented and segregated function through branching is now emerging as an institution with single interface.
 - 4.2 This transformation envisages very active engagement of the customers with various facets of products and services offered by banks and thus

involves a huge amount of back office functions. For many banks, it would not be possible to handle this rush and rapid growth on their own. Outsourcing is an important solution. According to Gartner, a market research firm, the size of the global outsourcing is about \$200 billion and the business is growing at a rapid rate because of the benefits, a few of which include;

4.2.1 Cost reductions -

Cost reduction is done through process improvements, reengineering and use of technologies that reduce and bring administrative and other costs under control.

4.2.2 Concentration on core business -

With the day-to-day back office operations taken care of, the management is free to concentrate more on the core business of the company.

4.2.3 Outside expertise -

Company is saved from the hassles of recruiting and training personnel. BPOs ensure that experts from another company provide the needed guidance and skills.

4.2.4 Cater to changing customer demands -

It is another great advantage of out sourcing the business processes. Many BPOs provide the management with flexible and scalable services to meet the customers' changing requirements, and to support company acquisitions, consolidations, and joint ventures.

4.2.5 Revenue increase-

As stated above, by outsourcing non-core processes, companies can concentrate on increasing their sales and market share, develop new

products; spread out into new markets and increase customer service and satisfactions.

5. Financial services sector has been using outsourcing as a means of enhancing operational efficiency at lower operational costs, and gaining access to state-of –the-art technology. Even in the early 1970s banks used agents to collect small deposits and provide loans the introduction of computer technology in the mid-eighties saw large scale outsourcing activities from data entry, software development and maintenance etc. Major opportunities for outsourcing by banks include;

- **Technology support**
- **Customer services, credit rating and client servicing**
- **Direct marketing**
- **Product Development**
- **International Business**

5.1 Recovery efforts are also an area that holds promise. An area where banks lack expertise is skip tracing of delinquent borrowers. Specialized agencies will play a dominant role in skip tracing in the near future.

6. One thing that clearly emerges is that, outsourcing is not something some banks have thought of to dispose of some hard work, but it is an accepted and credible international practice that has been endorsed by international financial policy.

6.1 Basel Committee on Banking Supervision (BCBS), the global institution that designs banking practice, has defined Outsourcing as a ‘regulated entity’s use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform

activities on a continuing basis that would normally be undertaken by the regulated entity, now or in the future’.

7. While we could see enormous benefits from outsourcing, at the same time, it would be pertinent to consider a few issues involved in evolving successful outsourcing strategies and solutions.

7.1 Maintaining the privacy of customers’ financial information.

A few recent instances of leaking of customer information has put some inconvenient questions on the business of outsourcing. How to contain it is a major challenge.

7.2 Managing Risks

7.2.1 While the outsourcing of certain activities can create a number of benefits to a financial service organization, there are a number of risks, which need to be managed effectively.

7.2.2 The risks that attend outsourcing are too numerous to discuss individually, but in broad terms they tend to fall into three general categories: Operational, Reputational, and Legal Risks.

7.2.2.1 Operational risk has been defined as the risk of monetary losses resulting from inadequate or failed internal processes, people, and systems or from external events. Outsourcing agreement to a third-party service provider introduces new concerns on operational risk elements that the firm might not be aware of and certainly will not have direct control over.

7.2.2.2 Similarly, financial service firms face reputation risk directly in their day-to-day operations, but outsourcing arrangements introduce newer and unique concerns. For example, the transfer of customer financial

information to a service provider introduces the risk of potential violations of confidentiality, either on account of security issues during the transfer itself or due to a provider's imperfect control environment. While the legal responsibility for such a violation may clearly reside with the service provider, the financial service firms would not easily be able to avoid damage to its reputation and related consequences.

7.2.2.3 Legal risk can take several forms, since outsourcing arrangements are based on binding contractual relationships and can arise out of specific contractual details. For example, the outsourcing contract might have a long duration during which the firm's business needs and environment could change in important, but unexpected, ways. Consequently, firms might get locked into agreements that reflect outdated business realities. Where outsourcing involves customer interface like in the case of DSAs, Recovery Agents etc, issues of third party liabilities may arise besides risks of mis-selling and or wrong selling.

7.2.3 The outsourcing may lead to other key risks such as Strategic Risk, Compliance Risk, Exit Strategy Risk, Counter Party Risk, Country Risk, Contractual Risk, Access Risk Concentration and Systemic Risk.

7.3 *Safeguarding the data*

The foremost issue is one of safeguarding the confidentiality of the bank's data and information, particularly as large outsourcing agencies may handle assignments of more than one bank at a time. Segregation of data, measures against potential abuse / mis-use of one's data are issues that need to be addressed in-depth.

7.4 *Compatibility with bank's systems*

Where outsourcing is of a technology application, compatibility of software and other systems with that of the bank's own technology set-up and knowledge of bank's staff of such software and systems is a very critical area. This should form a key element of Business Continuity plans in case of temporary failure on part of outsourcing agency or break-down of outsourcing arrangement itself.

7.5 Integrity and knowledge of staff

Integrity and knowledge of staff of outsourcing agencies of the bank's products and services and sensitizing such staff to the highest standards of behaviour and conduct expected of them is also important. In these days of growing awareness of customer rights, wrong selling or mis-selling may expose a bank to compensation claims at a later date. Recovery agents need to be aware of the standards of behaviour expected of them and of the legalities of their approach and methods as this may lead to claims of damages against the bank itself.

7.6 Activities to be outsourced

The most critical issue is one of identification of activities to be outsourced – a financial service firm stands the temptation of outsourcing activities for performance of which the firm does not have internal expertise. This approach could lead to over dependence on outsourcing and over a period of time, inhibit development of requisite skills within the organization. A more logical approach would be to ensure that the firm has necessary internal skills and expertise and outsource any activity only from the angle of operational efficiency and lower costs. Optimal allocation of available scarce resources (of manpower, technology etc) among

competing demands should be the benchmark to identify outsourcing requirements.

8. It is in this regard, that the banks need to step up monitoring and evaluation of outsourcing activities and also adopt international best practices and guidelines in designing effective outsourcing strategies.
9. Before a financial service firms embarks on Outsourcing arrangements, it needs first to evaluate the most applicable outsourcing model. The following factors merit consideration:
 - *What aspect of the entire business process can or should be outsourced?*
 - *What is the most efficient and effective delivery model e.g. shared services, partial outsourcing or total outsourcing?*
 - *Are there reliable Service providers for Outsourcing in the market?*
 - *What is the cost-benefits involved and financial viability of outsourcing?*
 - *What are the potential roadblocks in transitioning to each proposed delivery model e.g issues of operational efficiency enhancement, union issues, management resistance etc?*
10. Once a company has made the strategic decisions on whether to outsource, and what to outsource, a firm can proceed to appoint service providers. Usually service providers are selected through a formal Request for Proposal (RFP) process. Companies also appoint independent advisors to assist in the review and pre-qualification of candidate firms, to establish performance goals and benchmarks, manage contract negotiations and to establish service level agreements (SLAs). One of the critical success

factors in successful outsourcing arrangements is the appropriate management of the outsourcing partnership. In this respect SLAs will serve to determine the constituents of superior performance by both the organization and the Provider. SLAs should also define issue resolution mechanisms, equitable sharing of risk based revenues, clear roles and responsibilities, balanced scorecard measures supported by the appropriate incentives and sanctions, and finally clear, transparent reporting of results.

11. A potential unintended impact of outsourcing that should not be underestimated is the impact on the organization's human capital. Improper and insufficient communication and dissemination of rationale and intent can result in perceptions of job loss and unintended attrition of talent. In an extreme scenario, badly managed outsourcing initiatives can inadvertently trigger mass employee exodus. This and related issues are discussed separately elsewhere.

12. International supervisory principles

- 12.1 Government supervisors and Regulators of financial service firms need to monitor and react to the risks posed by outsourcing core financial services activities. In recognition of these concerns, the Joint Forum, a financial services policy group established by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors have issued a consultative paper outlining high-level principles about outsourcing. The principles apply across the banking, securities, and insurance sectors of the financial services industry worldwide, and they can be grouped broadly into three categories.

12.1.1 The first category refers to the Policies that regulated financial services firms should have in place even before entering an outsourcing agreement. For example, a firm should establish a comprehensive policy for assessing whether and how certain activities can be outsourced, and the firm's board of directors should retain direct responsibility for that policy. In addition, firms should establish a comprehensive outsourcing Risk-Management Program to monitor and address issues arising from the outsourced activities and relationships with service providers.

12.1.2 The second category addresses concerns surrounding specific outsourcing arrangements. Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities, and expectations of all parties. The firm should also maintain adequate contingency plans and take appropriate steps to require that service providers protect the confidential information of both itself and its clients from intentional or inadvertent disclosure.

12.1.3 The third category addresses concerns specific to supervisors. Supervisors should take into account outsourcing activities as an integral part of their monitoring responsibilities. Supervisors should assure themselves that outsourcing arrangements do not hamper the ability of the firm to meet its supervisory requirements; that is, supervisors should be able to obtain promptly any relevant materials regarding outsourced activities.

12.2 Reserve Bank of India has recognized the above issues and has recently come out with draft guidelines on “Outsourcing of Financial Services by Banks” which intends to provide direction and guidance to banks to adopt

sound and responsive risk management practices for effective oversight, due diligence and management of risks arising from such outsourcing activities.

13. Strategies

13.1 For Indian banks, outsourcing could be looked into two perspectives. One is to carve out non-core business so that bank management could concentrate more on developing core business and better credit control. The other aspect is to consider whether they could become centers of outsourcing for some international business. International business in the realm of financial services, setting up industries, vendor acquisition and development etc., are looking for local support and banks have very good access to the information on these aspects. Banks could also provide useful information to their customers on the emerging business opportunities based on international business and provide suitable financial support. This way banks can leverage their access to vital economic information on the command areas they operate which could be structured in such a manner that sharing of information could itself by an emerging business.

13.2 An important aspect of outsourcing is to develop better practices. If Walmart, the global retail giant gives a work order to any firm, it looks at various conditions prevailing in the vendor such as worker conditions, compliance with regulatory and environmental issues etc., which over a time would lead to building of better economic and social environment. When banks outsource their work, it should not be just a cost cutting exercise, but also ensure that over a period, no time social tensions and issues of social insecurity arise. These issues are of great significance for the success and sustainability of the outsourcing.

14. Banking sector will have to prioritize its outsourcing requirements . As a principle, banks should desist from looking at outsourcing as substitute for developing internal skills. The strategy should focus on identifying potential applications that could provide, once outsourced, maximum enhancement of operational efficiency at lower costs.
15. Contractual arrangements for outsourcing should be well-documented covering confidentiality clauses, Systems, Processes and Compatibility audits, back-up arrangements for valuable databases, disaster management and other vital aspects. Business Continuity Plans should be well documented to take care of temporary or permanent disruptions to operations at the level of the service providers. The arrangements and documentations should be very elaborate particularly where customer interfaces are envisaged.
16. As the outsourcing arrangements will be looked through Principal & Agent relationship in law, banks have to ensure that the outsourcing agencies are well aware of the limits to their approaches to customer. Arrangements to verify and document integrity and knowledge levels of staff of outsourcing agencies must exist. Where necessary, the staff of outsourcing agencies needs to be put through vigorous training programmes on the bank's products and services to safeguard against the perils of wrong selling and mis-selling. The evaluation of the financial strength and past experience of outsourcing agencies need to be evaluated in the same manner and with same vigor with which a bank would apprise a project financing proposal.
17. In sum, outsourcing is a great opportunity for banks in India to improve productivity, cut costs and attain several efficiencies. At the same time there a number of issues that need to be addressed to make outsourcing as a useful



tool and I am sure that the banking industry in India will greatly benefit from this opportunity.

(MV Nair)
Chairman & Managing Director
Dena Bank