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OUTSOURCING AS A MODERN METHOD OF BANK RESTRUCTURING

Abstract

The article deals with the essence and types of banking outsourcing, positive effects and risks of its application. The conditions of effective introduction of outsourcing banking functions and processes in Ukraine have been analyzed.

Key words: banking outsourcing, innovative restructuring, offshoring

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Introduction

The world financial and economic crisis has had a dramatic impact on banking institutions. It has forced them to reconsider and adjust the established approaches, forms of activities, business models, general corporate and innovative strategies. However, most banking experts argue that complete refusal from innovative activities would mean lack of foresight, as innovations have always been the main source of development and business growth in an increasingly creative modern economy. At the same time, in a situation of a sharp fall in profitability of financial institutions, their innovative strategies should be aimed not so at expanding their range of products and services offered to customers, which requires substantial investment, but at reducing costs and increasing their operational effectiveness.

One of the ways of achieving this aim is transformation of banking institutions business models. Banks are currently changing their structure through mergers, acquisitions, divisions, or conversion, and, more often, through a complete change of their functioning methods. All these transformations reflect the process of banks' reorganization, and restructuring accompanied by a considerable change in their strategies.

The innovative method of business restructuring in a modern economy is considered to be outsourcing, the transference of particular business functions or parts of business processes to the outside company. Rapid development of information technologies led to swift spread of outsourcing worldwide over the last decades. It was in this field that it got to be originally introduced. The idea of outsourcing was initially developed in 1963 by Electronic Data Systems (EDS) which still keeps on dealing with IT outsourcing. However, only in 1990s outsourcing has become the object of research, when there appeared scientific publications attempting to find by building models an optimum strategy for its practical application (R. Aalders (2001), B. Heywood (2001), S. Calendzhyan (2003), S. Clements, M. Donnellan, C. Read (2004), J.-L. Bravard, R. Morgan (2006) etc.).

Problem definition

At the same time, there has practically been no theoretical research on banking outsourcing, the causes and risks of applying this model. Whereas, a considerable amount of factual information on the subject available in the Ukrainian and foreign printed and electronic sources proves the fact the substantial practical experience has been gained and needs to be systematized and theoretically generalized.

Thus, the aim of the article is to identify the main theoretical aspects of outsourcing in banking and reveal its opportunities and limitations as a method of innovative restructuring of credit and financial institutions in the globalized information economy.

Methods

Swift development of outsourcing, its attractiveness for business practitioners were caused by gradual cardinal changes in the nature of modern economy, which increasingly tends to get network character. A network, in this case, means a group of companies combined to use their particular resources and specific advantages in common projects and might be located in different parts of the world. Therefore, outsourcing has become one of the ways of forming organizations of the type.

Summarizing the definitions of outsourcing available in scientific literature one can conclude that it means partial or complete transfer of functions providing certain supporting or concomitant business processes to outside specialized organizations under long-run agreements in order to focus one's own efforts on the main activities. The point is that big companies often get into a situation when the costs of attendant business processes become disproportionately high. It cannot be put up with particularly under the crisis conditions when the assets value, as well as the revenue and demand are plummeting down. At the same time, firms-outsourcers reduce costs due to the economies of scale, specialization, use of innovative technologies and management ideas, expertise etc.

Outsourcing mechanism arose in production sphere, and the theoretical foundations of its development were agency theory, the theories of transaction costs, core competences, and the concept of economies of scale. However, the banking sector began to use outsourcing much later. Only in the early 1990s the banks of developed countries started transferring growing amounts of work to outside companies. Moreover, some innovative financial institutions are now considering the possibility of becoming providers of several back-office operations which are as a rule unprofitable, for other banks.

The use of outsourcing in banking (or banking outsourcing) is characterized by strict control of banking activities by regulatory bodies, necessity of this kind activity licensing and increased risks connected with it. As a result there arises the need to shape the position of the regulatory bodies as to the essence and mechanisms of implementing this method of banking business restructuring. Currently there exist the following official definitions of banking outsourcing:

- Basel Committee on Banking Supervision defines 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" [1];
- Committee of European Banking Supervisors describes outsourcing as "an authorized entity's use of a third party (the "outsourcing service provider") to perform activities that would normally be undertaken by the authorized entity, now or in the future. The supplier may itself be an authorized or unauthorized entity' [2];

- due to the European Central Bank outsourcing is "the supply to a credit institution by another entity of services and facilities that form part of the business processes that are necessary for the provision of banking or other financial services" [3].

As it is noted by the ECB a very important bank outsourcing feature is that direct control of transferred activities is exercised by an outside provider represented by a specialized company inside a banking holding, an independent organization or a joint venture of the bank with a third party.

Results and discussion

Therefore, outsourcing is a complex strategic solution, aimed at bank restructuring with the transfer of separate functions or business processes to outside providers. It permits to focus on key business, decrease investment into minor areas, and flexibly respond to changes both on the market and inside the company. It is, in fact, a mechanism of using outside resources, increasing the effectiveness of a banking institution performance, as well as for providing the customers with a broad range of high quality services.

Thus, the major benefits of transferring certain functions to an outside company include:

1. structural and managerial advantages which help:
- concentrate attention and resources on the main activities, strategic objectives of the banking institution, as well as on the meeting the customers needs;
- free some resources for the major business, and innovative developments,
- improve process management,
- eliminate technical limitations of the bank growth.

2. Technological benefits which help:
- get access to resources unavailable inside the bank,
- get access to innovative technologies and experience available to the provider,
- provide expert services at a lower cost,
- increase reliability of servicing guaranteed by the outside firm.

3. Economic advantages which help:
- cut the costs of servicing business process and increase business profitability
- cut regular costs.

This conclusion can be confirmed by the research data gained in 2004 by the European Central Bank. It proves the fact that the main motives for the banks to transfer a part of their own operations to outside providers were cutting costs, getting access to innovative technologies and improved management, as well as possibility to focus on their major operations [3, p.28].

The full scope of banking outsourcing models could be divided into three types: functional, business process, and resources ones; information outsourcing being sometimes one more type. All of them are in a way mutually complimentary, and can be simultaneously used. Functional outsourcing is transferring some of the functions necessary for the major business to outside providers. In case with banks, it might be providing print outs of clients bank accounts, maintenance of computer hardware etc. Process outsourcing means full transfer of some business processes to outside firms, such as processing credit card accounts, acquiring etc. Resource outsourcing is doing business with resources provided by outside firms (renting premises, hiring personnel, consultants etc.).

A"two-factor" matrix is offered to identify a business system elements which could be outsourced we suggest to use. The factors of analysis are strategic importance, as well as evaluation of the potential object for outsourcing as compared to market situation, competitors operations (the quality, professionalism and cost level). The decision to transfer a business element to an outsourcing entity depends on how important the element is for the strategy, and how problematic is its performing with the company's own efforts. The less important for the strategy of the company is a business element, and the more problematic is its performing by the company's own efforts, the likelier is the decision to transfer it for outsourcing. And, on the contrary, the greater is the importance of this element in forming the key competences of the bank, and the stronger is the organizational ability of the latter as to the process running, the likelier is the performing of the business processes by the bank itself. It is worth saying that for the banking business the standard two-factor model, in fact, must turn into a three-factor one, taking into account the impossibility of transfer to outside providers operations which need licensing. A solution to the problem might be creating by the bank strategic alliances with the institutions which also have licenses for some banking operations.

One more limitation for the banks in making decisions related to using services of outside providers are special requirements to ensuring confidentiality, as the information about the clients activity and financial status which banks acquire while servicing them is confidential. In our opinion, the problem cannot be solved through simple insertion into outsourcing agreements provisions on confidentiality. It is necessary to identify the fundamentals of banking outsourcing by the state regulatory bodies. In this connection, a note should be taken that banking regulatory bodies of many developed countries have already elaborated appropriate documents - standards, guidelines etc. reflecting their vision of the ways of implementing outsourcing in banking, managing arising risks, and fixing full responsibility of banks for performing business processes transferred by them to the third parties [1, p. 9-10; 4, p. 34-35]. The international normative guidelines for banking outsourcing is formed by Guiding Principles developed in 2005 by Basel Committee on Banking Supervision [1], as well as Guidelines on Outsourcing prepared in 2006 by the Committee of European Banking Supervisors [2].

The identification of tactical and strategic outsourcing, suggested by J. Barthelemy [5], has become topical under the crisis. The tactical outsourcing is more mobile in performance; it means transfer of minor functions and areas of activity of financial institutions (servicing automatic teller machines, and hardware, cash operations etc.). It is carried out on the basis of short-term agreements, which are regularly revised. The strategic outsourcing takes much more time to be developed and performed, as it covers the functions around the core ones e.g. IT provision or R&D. It embraces a longer period of time from seven to ten years and envisages establishing partnership relationships between the bank and the outsourcing company.

In addition to the traditional national outsourcing, when the outsourcing firm is based in the bank's home country, globalization and IT development encouraged the emergence of another type of banking outsourcing, the foreign one. It is known as offshoring and which means that operations are transferred to the overseas companies, where the costs, first and foremost personnel costs, are much lower. India, Sri Lanka, China, Malaysia, the Philippines, the Republic of South Africa, Australia are considered by the leading foreign banks as the areas acceptable for outsourcing.

Due to the experience of foreign and Ukrainian financial institutions the main areas of banking outsourcing are:

- support and development of information and communication systems; the latest data indicates that outsourcing costs make about 30-40% of total banks information costs;
- call centers performance;
- development and support of bank web-sites;
- development and support of decisions for the Internet banking;
- emission and acquiring of bank cards;
- processing and technical servicing self-service devices;
- attracting new clients (credit brokers);
- credit servicing, mortgage ones in particular;
- claiming missed payments (collector firms);
- servicing operations with securities;
- collection servicing and cash transportation;

- market research, PR campaigns preparation;
- premises cleaning etc.

Taking into account the main economic objective of using outsourcing as being an increase in operational effectiveness, greater importance is attached to identifying the economic of transferring by the bank particular processes for outside performance. It can be measured by the ratio of achieved economy to costs on all stages of outsourcing from choosing the acceptable processes, finding and evaluating the providers, rebuilding inside processes to be adapted for outsourcing, to monitoring the outsourcing firm performance and managing risks, as well as paying the outside company for the services. The analysis shows that not all costs components are taken into consideration by the bank management when the appropriate decision is being taken.

Furthermore, it is necessary to refuse from outsourcing if the competence and reputation of the service provider is not good enough, if there is potential possibility of monopoly, or the effectiveness is decreasing and costs with the lapse of time are increasing.

It is necessary to take into account that in addition to the evident advantages of outsourcing there are additional risks which require building effective mechanisms to minimize them. The major risks of banking outsourcing were identified in 2005 by The Joint Forum at Basel Committee on Banking Supervision as being strategic risk, reputation risk, compliance risk, operational risk, strategic risk of project exit, the other party risk, the country risk, the contract risk, concentration and system risks [1, p. 11-12]. The reality of these risks is proved by the recent fact that the US Financial Industry Regulatory Authority (FINRA) imposed penalties equivalent to $425,000 on investment divisions of three big banks (Citigroup, UBS and Deutsche Bank) for improper communication with customers in the process of IPO provided by an outside company [6].

The Ukrainian banks have already started mastering the technology of arranging outsourcing. In our opinion, they will get even more interested in this method of restructuring their activity under the financial and economic crisis. Currently the most widespread type of outsourcing in Ukraine is software and hardware servicing outsourcing, as well as outsourcing of credit and debit cards operations. The Ukrainian Processing Center (UPC) is the absolute leader in the latter field. Its customers include about sixty Ukrainian banks and two big banks in Eastern Europe. The services offered by the UPC range from technological aspects of card personalization, development and maintenance of ATMs and POS-terminal networks, monitoring and processing of transactions, keeping an eye on fraud etc.

The major problem on the way to a wider use of outsourcing in the banking sector of Ukraine and greater diversification of its areas lies in imperfection of an appropriate normative base, e.g. the legality of collector firms activity has particularly been discussed recently. The market of outsourcing companies servicing the banking business is also not properly developed. Many services are not just available. In addition, this market is characterized by a low level of trust between the participants. The banks lack the experience in managing the process of "entering" an outsourcing project and "going out" of it, they are unable to control the performance and arising risks. Though, on the whole, the existing problems can not stop in Ukraine the modern global trends of banking business development.

Conclusion

Thus, the analysis of theoretical framework of banking outsourcing gives grounds to state that it can be considered as a method of innovative restructuring of banks, under the economic crisis in particular, which allows to increase their business effectiveness and strategic focus of business. The important conditions here are taking into account peculiarities of banking activity and providing of outsourcing formal regulation in the banking sector.

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