Outsourcing for financial service providers:  
A decision framework

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Abstract

Globally, financial service providers (FSPs) face greater competition from national and international banks and specialized financial service firms such as card services, money transfer companies, and new electronic and mobile banking firms. In response, FSPs must consider innovative business models to survive and grow their operations. This paper analyzes outsourcing theory, reviews its potential role in the financial services industry, and provides strategic and operational guidance for FSP managers.

Keywords: financial services, outsourcing, competition, electronic banking, new technology, financial service providers, access to finance.

INTRODUCTION

Globally, financial service providers (FSPs) face greater competition from national and international banks and specialized financial service firms such as card services, money transfer companies, and new electronic and mobile banking firms. In response, FSPs must consider innovative business models to survive and grow their operations. In this paper, outsourcing theory is analyzed, its potential role in the financial services industry is reviewed, and strategic and operational guidance for FSP managers is provided.

Three important trends are combining to fundamentally alter national and international financial services. Market structure and competitive forces are changing as deregulation allows broader scope of services, fewer restrictions on geographic locations, and greater numbers of mergers and new market players at the national and international level. Second, new technologies in back-office systems and front-office interactions with clients are increasing efficiency and opening new frontiers in financial services (Isern, 2007). Electronic banking is thriving in Japan, Europe, and the US as customers click their mouse, press telephone keys, and slide cards to conduct their banking. These new technologies for electronic banking and electronic money, well established in certain markets for more than a decade, are now spreading to emerging markets. Indeed, some emerging markets have leaped ahead of developed markets such as the US. For instance, mobile banking is thriving in South Africa, Kenya, and the Philippines. Third, clients are becoming more discerning given the increased availability of financial services. Consequently, clients are increasingly willing and able to compare offers and shift accounts more readily.
Given increasing competitive pressure, FSPs are increasingly seeking ways to improve efficiency. Outsourcing is not a new business concept (Friedman, 2006; Harland, Knight, Lamming & Walker, 2005). In the US, estimates of outsourcing grew from $100 billion in 1996 to $340 billion in 2000 (Outsourcing Institute, 2000). Estimating current levels of outsourcing in the US and globally is difficult given how pervasive the practice has become.

Starting in the 1980s, FSPs began outsourcing back-office functions such as data processing, and call centers to reduce fixed costs and focus on core competencies. Outsourcing has a mixed record, especially in financial services with call centers and relationship banking. Further, outsourcing can be controversial at several levels including the firm, the industrial sector, and the nation (Harland, Knight, Lamming & Walker, 2005). After many years of experience, academics and practitioners are developing guidance and honing their skills in setting outsourcing strategy, selecting vendors, managing relationships, negotiating contracts, and defining the overall business value of outsourcing. As financial services become more competitive, firms will need to integrate outsourcing decisions as a core strategic issue.

This paper begins by framing the context of the problem for FSPs. Section two reviews literature on outsourcing. Section three provides strategic and operational guidance on outsourcing for FSP managers. Section four concludes and highlights areas for future research.

CONTEXT OF THE PROBLEM

Banks and other regulated financial service providers mobilize deposits, allocate credit, process money transfers, and provide other related services. The health of the financial services industry affects the economy at many, including individuals, households, firms, and overall national development (Cameron, 1967; Levine, 2004; Levine, Loayza & Beck, 2000; Stiglitz & Weiss, 1981). Until recently, banks in many emerging markets faced little competition and focused primarily on clients with higher profit margins such as international firms, large national firms, and government agencies.

Access to financial services varies widely across countries, although in many lower-income countries, a tiny minority of the population holds a bank account or has access to formal financial services (Beck, Demirguc-Kunt & Martinez-Peria, 2005). Alternative financial service providers have developed to serve niche markets such as low- and middle-income clients who are often the majority of a country’s adult population (Isern & Porteous, 2005). Over time, however, more international banks and a broader range of national financial service providers are entering national markets, and competition is increasing (Beck, Demirguc-Kunt & Levine, 2006; Isern & Porteous, 2005).

Few FSPs are able to manage in-house every aspect of each financial service transaction for all clients. Examples of FSP transactions and services that are routinely outsourced include data processing, ATM maintenance, credit card management, payments processing, and customer service centers. For example, Western Union and Money Gram, the two largest global money transfer firms, strategically select agents in high-volume remittances countries to extend their payments network globally. Western Union and Money Gram assure all of the back-office transactions, while their agents accept payments on their behalf and make final payments to receiving clients (Isern,
In a 2002 survey of North American banks, nearly 75 percent of bank respondents reported willingness to outsource more functions such as loan documentation, customer servicing, and collections (Gursel, Joseph & Krishna, 2002).

As competition increases and FSPs face pressure to improve service quality, offer a broader range of services, and manage costs to improve FSP profitability, FSP managers may decide to outsource more functions. Outsourcing all or part of the value chain of providing financial services is a core strategic decision, and FSP managers must understand the issues and tradeoffs involved.

LITERATURE REVIEW

Outsourcing can be difficult to define in a meaningful way. Gilley and Rasheed (2000) offer a basic definition of outsourcing as substituting internal activities with external purchases. Stevenson (2007) expands the definition to obtaining a product or service from outside the organization, although this seems too broad and therefore less useful. A more nuanced definition provided by Gilley and Rasheed (2000) considers outsourcing as procuring a good or service either i) originally sourced internally, e.g., vertical disintegration; or ii) that which could have been sourced internally, e.g., ‘make or buy’ decision.

For purposes of this paper, the more nuanced Gilley and Rasheed (2000) definition will be used. A firm outsourcing a function will be referred to as the outsourcer, while a firm that receives an outsourced function will be referred to as the vendor.

Outsourcing evokes an image of millions of outsourced jobs moving overseas, however vendors who accept outsourcing contracts may be in the same town or country, or they may be located internationally. Vendors may be firms or individuals working onsite with the outsourcing firm, at the vendor’s home or business, or in a third location depending on the type of work involved.

While outsourcing is not new, it has received greater attention since the 1990s. Initially, academics and firms put more emphasis on outsourcing in manufacturing, although professional services are increasingly outsourced in whole or in part. Examples of services that are commonly outsourced include facilities management and security, IT development and support, service (call) centers, human resources administration, accounting and tax preparation for firms and individuals, and health services such as analysis of lab results and x-rays.

Public sector functions in some countries are also being outsourced, and these functions include garbage collection, street and building cleaning, grounds maintenance, catering for public agencies, and maintenance for vehicles owned by public agencies (Harland et al., 2005).

Outsourcing may be less common in continuous process operations such as chemical or metal production, highly automated firms where low-labor costs have less significance, and/or production of heavy or bulky products where higher transportation costs would affect a firm’s overall profitability (Harland et al., 2005).

Literature on outsourcing includes theoretical concepts of vertical integration, vertical disintegration and ‘make or buy’ decisions. Earlier theoretical work focused on vertical integration (Bain, 1968; Jacquemin, 1987), especially acquisitions and mergers in the 1960-80s, that laid the stage for outsourcing theory. Based on vertical disintegration
theory, outsourcing was considered a new organizational form (Coase, 1937; Porter, 1988; Williamson, 1975). Starting in the 1980s, criteria for make or buy decisions were applied to outsourcing (Child, 1987; Dirrheimer & Hubner, 1983). Factors in the make or buy decision include available capacity and expertise within the firm, quality considerations, the nature and location of demand for the goods or services, cost of the various options, and strategic, operational, and reputation risk (Stevenson, 2007).

Taking the analysis a step further, researchers have studied the business case for outsourcing and report several motivations for outsourcing. The bottom line drives many firms to outsourcing in hopes of increasing profits (Uttley, 1993) or identifying the most cost-effective make or buy solution (Ellram & Billington, 2001).

Many studies have concluded that increasing profits is a key driver for outsourcing decisions, where firms can reduce assets, decrease operational and capital expenses, and decrease overhead on personnel whose functions are outsourced (Harland et al, 2005; Uttley, 1993). Other firms see outsourcing as a business strategy where they can focus more effort on core competencies (Gewald & Dibbern, 2005; Harland et al., 2005; Miles & Snow, 1986), leverage complementary assets and capacity of other firms (Doz, 1988; Harland et al., 2005), or improve flexibility to respond to market changes (Greaver, 1999; Harland et al., 2005). Finally, firms report outsourcing as a strategy to improve quality of goods or services in situations where existing staff, technology, or systems are under performing (Elmuti & Kathawala, 2000; Gewald & Dibbern, 2005).

As outsourcing has become more common, researchers, practitioners, and governments have taken a harder look at the results. Initially, firms may only focus on short-term benefits, especially since most firms lack an adequate decision framework to weigh the tradeoffs involved in outsourcing (Lonsdale, 1999). Given the significant public focus on improving profitability, financial benefits to outsourcing firms may be surprisingly lower than original expectations (McIvor, 2000). Firms report concerns with quality of the goods or services when outsourcing all or part of the value chain (Quiggin, 1996). Managing the outsourcing relationship requires new management competency, decision making processes, training, and quality controls (Harland et al., 2005). Over the long term, firms may hollow out their overall capacity, fail to catch market shifts, and lose their ability to respond to fundamental changes in the industry (Lei & Hitt, 1995).

At a sector or national level, industry leaders and government officials have expressed concern over changing patterns of employment, reduced government control, especially when outsourcing public functions, and loss of national strategic capacity (Harland et al., 2005).

As banks and other FSPs decide how to expand their services to a broader range of clients, they consider their business goals, competitors, the regulatory environment, the market size, their infrastructure and systems, and other factors (Isern & Porteous, 2005). FSPs may provide services directly or outsource certain functions to existing, often specialized, providers already working with the target client and/or financial product. Outsourcing could enable FSPs to grow dramatically through business alliances. For example, ICICI Bank in India works with more than 300 specialized community lenders as sales agents to expand the ICICI client base.

Outsourcing decisions must be made within the market context, including geographic concentration of financial institutions and their points of service. The
geographic dispersion of banking facilities and the services they provide can have a significant impact on economic development and client access to financial services (Burgess & Pande, 2003; Strahan, 2003). Physical branch presence has been a cornerstone of bank strategy in providing financial services. However, advances in new technology may change a bank’s geographic strategy and impact the effectiveness of branching regulations (Degryse & Ongena, 2004). Customers now have many options to make payments—in person or remotely by mail, phone, internet, ATMs, and other points of service with retailers and other businesses (Isern, 2007; Isern et al., 2006).

Faced with increasing competition for financial services, rapidly increasing prevalence of e-banking technologies, and rising pressure for greater customer service, most financial service providers will face a decision about outsourcing. Given the prevalence of outsourcing, firms need effective guidance to decide which functions to outsource and how to manage the new outsourced relationships. The section below offers guidance for financial service providers to make strategic and operational decisions on outsourcing.

FINANCIAL SERVICES VALUE CHAIN

Increasingly, FSP managers must consider what functions, when, and how to outsource. FSPs often select service (call) centers as the first function to outsource, and FSP experience to date has been mixed (Bendixen, 2006). Given a more competitive market, FSPs must take a broader and more strategic view of possible outsourcing options. Further, if the FSP is planning significant growth, outsourcing may be even more crucial to the FSP’s strategy, as it may be more effective for the firm to outsource functions rather than rapidly grow internal capacity. To succeed, FSPs must understand how to properly execute their plans based on the right mix of people, strategy and efficient operations (Bossidy & Charan, 2005).

Before making any decisions, the manager must fully understand the FSP’s operations. The first step is to analyze the firm’s value chain of core functions and transactions. Figure 1 below outlines a simplified and generic financial service provider value chain and builds on previous models (Hamoir, McCamish, Niederkorn & Thiersch, 2002; Isern et al., 2006; Lammers, Loehndorf & Weitzel, 2004; Porter, 1988). Distribution consists of marketing and sales, including promotion and advertising, branding the firm and products, managing sales channels such as sales personnel, and providing sales support onsite and through service (call) centers. Outsourcing at this level could include external advertising and sales teams, retail agents working on behalf of the FSP, and service (call) centers. For example, a mortgage company may outsource its sales function to independent brokers working on commission to identify clients and refer them to the mortgage company.
Figure 1: Generic Value Chain for Financial Service Providers

Cross-cutting support services:
- Finance, treasury and internal control
- Risk management
- Technology management
- Human resources
- Firm infrastructure: governance, legal, regulatory

Figure 1 is greatly simplified; product management is represented as a single broad function ranging from product development to product maintenance. Financial products typically include deposits (checking, savings, time deposits, etc.), loans (consumer loans, credit cards, vehicle loan, mortgage, education loan, etc.), domestic and international money transfers of varying types, investments such as stocks, bonds and mutual funds, and insurance (life, health, property, vehicle, etc.). Market and regulatory factors may limit the FSP from offering all products or services.

Product offering involves at least three basic steps of originating the product with a client, processing the product, and then servicing the product. Using a loan product as example, an independent broker acting as loan officer may originate a mortgage loan with a client by evaluating the collateral, rating the client, and pricing the loan. The vendor may transfer the file to a processor (either internal to the FSP or to a third external firm) to ensure final credit approval, creation of the account, and disbursement of the loan amount to the relevant legal party. The FSP could then sell the loan to another firm to directly service the contract as the client makes regular mortgage payments over the life of the loan.

Client services typically include support in opening and closing accounts, resolving problems both on-site and through service (call) centers, and other services such as safety deposit boxes and investment advice. As noted above, FSPs already have experience with service center outsourcing, and some firms are analyzing whether other client services could be effectively outsourced.

Support functions span the range of the FSP’s operations and include finance, treasury, internal control, risk management, technology management, human resources, legal and regulatory compliance, and governance. Many firms outsource some aspect of their technology management, including developing software, training staff in technology applications, maintaining hardware including ATMs and other electronic points of
service, ensuring transaction clearing and payment settlement, and/or data storage. Depending on the complexity of the FSP’s operations and market environment, other support functions may also make sense as outsourced services.

Analyzing each section of the FSP value chain allows a manager to analyze the cost, quality, and effectiveness of each function for possible internal improvements or outsourcing. The generic value chain in Figure 1 should be adapted to the specific functions and overall operations of the FSP.

When considering each step of the value chain, all or part of each function can be outsourced. For example, midsize banks often market and issue credit cards but outsource the related data-intensive and high transaction operations associated with credit cards (Gursel et al., 2002). When outsourcing credit card functions, the banks share fees and revenue with Visa, MasterCard, or similar firms. As the vendor firm, Visa and MasterCard manage credit card payments and settlement, data and reporting, debt collections, systems and technology, and service (call) centers.

Managers with prior outsourcing experience generally have a more positive view of outsourcing and intend to outsource more functions (Gewald & Dibbern, 2005). FSP managers generally focus on the perceived risks and benefits of outsourcing, although peer influences also significantly influence an FSP’s outsourcing (Gewald & Dibbern, 2005).
RISK ANALYSIS

When analyzing functions for possible outsourcing, some functions clearly carry more risk for the firm’s long-term survival. Catering or basic security services probably will not affect the FSP’s core operations. However, decisions on loan approval and branch network management cut to the heart of an FSP’s raison d’être. An FSP’s operations could be considered along a risk continuum, as seen below in Figure 2.

Figure 2: Continuum of FSP operational functions and risk level

<table>
<thead>
<tr>
<th>Lower risk</th>
<th>Medium risk</th>
<th>Higher risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplemental functions: e.g., janitorial, security, catering, printing, mailing, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transactional functions: e.g., human resource management, service (call) centers, IT support, transaction processing, marketing strategy, card management, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Core functions: marketing and sales, product design, client origination, processing and servicing, internal controls, regulatory compliance, etc.</td>
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</tbody>
</table>

Depending on the FSP’s specific operations, a function may be rated as higher or lower risk. For example, IT, credit card services, or transaction processing may be core functions for some banks, while others may see these as transactional functions.

For simplicity in the following section, the continuum in Figure 2 is represented as three categories of functions: Core functions, transactional functions, and supplemental functions. Functional category can be mapped according to its level and type of outsourcing risk for the FSP.

Perceived outsourcing risks include performance risk, financial risk, information risk, regulatory risk, and strategic risk (Chopra & Sodhi, 2004; Faisal, Banwet & Shanker, 2006a & b; Wu, Blackhurst & Chidambaram, 2006). FSPs must compare these risks with the perceived benefits when calculating the overall potential impact of outsourcing compared to maintaining a function in-house. Figure 3 below summarizes the categories of functions with their type and level of outsourcing risk for an FSP.

Figure 3: Outsourcing risk by functional category

<table>
<thead>
<tr>
<th>Risk categories</th>
<th>Performance risk</th>
<th>Reputation risk</th>
<th>Financial risk</th>
<th>Information risk</th>
<th>Regulatory risk</th>
<th>Strategic risk</th>
<th>Management risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core function</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Transactional function</td>
<td>High</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Supplemental function</td>
<td>Low if a short-term problem</td>
<td>Low if a short-term problem</td>
<td>Low if a low-expense area of operations</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>
Performance risk and reputation risk

Performance risk is the possibility that a vendor may not fulfill the FSP’s performance expectations given lack of capacity or experience, operational shocks, a different work culture that clashes with the FSP’s culture, or other factors. International outsourcing could expose the FSP to even more performance risk given greater complexity of operations, time zone differences, foreign exchange fluctuations, foreign labor requirements, contract enforcement across two (or more) legal jurisdictions, import restrictions, and political, economic, or other uncertainty associated with country risk. However, a well-performing vendor could also enable the FSP to overcome its own performance limitations that prevent it from providing new services and/or reaching new client groups.

Reputation risk is closely linked to performance risk. Reputation risk is the threat that the vendor performs poorly, and this in turn reflects badly on the FSP vis-à-vis clients, regulators, and other stakeholders. Should a vendor demonstrate better performance than the firm was able to do previously, however, the FSP may enjoy a stronger reputation. For example, an FSP may outsource service (call) center functions that were previously generating significant client complaints. Should the vendor provide superior service, this would likely enhance the FSP’s overall reputation with clients.

To mitigate performance and reputation risk, the FSP should conduct rigorous due diligence on potential vendors to ensure quality service, strong reputation and relevant experience, capacity to take on new volume of work, and a work culture that matches that of the FSP. The FSP should also detail responsibilities of the FSP and the vendor for each function in the service level agreement (or contract).

As part of the contract, performance indicators should be developed for key functions and include financial or other incentives for superior performance. Examples of performance indicators for financial services include client acquisition and retention, cross sales of products (clients with more than one product), loan portfolio quality, volume and tenor of deposits mobilized, and client satisfaction ratings. Clear triggers and procedures must be defined to specify when and how the FSP can intervene should service quality decline.

Both the FSP and the vendor should agree to a schedule of external audits to verify the vendor’s information, systems, and operations. In addition, regular performance reviews should be scheduled, especially prior to renewing the contract. Finally, the FSP and the vendor should agree on provisions for contract arbitration and triggers that require renegotiating and/or eventually terminating the contract.

Financial risk

Financial risk is the likelihood that the FSP faces higher costs than originally anticipated given hidden costs, budget overruns, contract renegotiations, longer transition periods, or other events (Gewald & Dibbern, 2005). Financial risk can be offset by possible greater financial benefits from outsourcing such as reduced internal overhead, fewer internal fixed assets, and economies of scale with a specialized vendor. To manage financial risk, the FSP should require full disclosure of all outsourcing costs in the initial bids from vendors, including upfront and ongoing costs. The financial proposal should be comprehensive to take account of any project planning, recruitment, training, hardware and software, implementation, monitoring, maintenance, and other
costs. As part of the call for proposal, the FSP should outline information required from the vendor to monitor costs and thereby increase transparency of the overall financial risk or benefit to the FSP.

To control ongoing financial risk, the FSP should set specific benchmarks or incentives for medium- and long-term cost management and timing for eventual increases in the vendor’s service price. The service agreement (or contract) must assign responsibility and procedures for budget overruns.

Information risk

Information risk is the possibility that the vendor may compromise the FSP’s information security. As with any company, firm data is a valuable asset and must be protected from loss, errors, or competitors. Information is even more crucial for FSPs, however, as most national regulations also require absolute security of client financial information.

To mitigate information risk, the FSP should conduct a rigorous due diligence of the vendor’s experience and reputation for information security. The service agreement must be clear and legally binding to give the FSP full legal ownership, and if necessary copyright, of all relevant data.

On an ongoing basis, the vendor should perform regular backups of information, and depending on the type of information, data backup may also be needed for the FSP. A third-party data storage facility may also be required. The FSP should stipulate the security level of each category of information, and the vendor must ensure adequate internal controls and security management. Both the vendor and the FSP should have the means to track and reconstitute information that is entered, modified, or deleted by vendors. Finally, the FSP should conduct periodic information audits to verify the vendor’s systems and information security.

Regulatory risk

Regulatory risk consists of uncertainty about the FSP’s and vendor’s ability to comply with relevant national and international regulations. Given policymakers’ attention to the safety and soundness of the financial system, the financial services industry is among the most heavily regulated across the globe. Financial regulations are designed to protect depositors, promote healthy banks, monitor against financial fraud, and prevent money laundering and the financing of terrorism. For international outsourcing, the FSP must manage the added complexity of which country’s regulations apply—where the FSP is headquartered or operates, where the vendor is headquartered or operates, and/or where the client lives or uses the financial services. EU and US regulations on outsourcing require banks and other financial service providers to be fully responsible for their operations, even if certain functions are outsourced (Evans, 2005; McCormack, 2003). Key areas of prudential and non-prudential regulatory compliance for FSPs include capital adequacy, liquidity, information technology capacity, skills and experience of the management team and board, internal control systems, risk management procedures, and business continuity plans.

To mitigate these risks, the FSP should ensure compliance with all relevant national and international laws and regulations on information security, confidentiality, and provisions for anti-money laundering or combating the financing of terrorism (Isern, Porteous, Hernandez-Coss & Egwuagu, 2006). The FSP must establish specific contract provisions with the vendor detailing the financial standards, systems and control
Outsourcing for FSPs

procedures, performance requirements, and personnel to be involved in the outsourced functions. The FSP should schedule periodic reviews of the vendor’s regulatory compliance, with frequency dependent on the risk level of outsourced functions. Finally, the FSP should provide adequate communication about the outsourcing arrangement with relevant national and international regulatory officials.

Strategic risk

Strategic risk consists of the FSP’s possible loss of market intelligence, inability to respond to changing industry trends, reliance on the vendor, and loss of core competence and capacity. In the direst case, the firm may lose control of its core services by outsourcing them. Further, vendors can grow into serious competitors.

Depending on the outsourcing arrangement and vendor, however, the FSP may experience unexpected strategic benefits. The FSP may be able to access a broader range of financial services for clients, faster execution of transactions, lower error rates, access to specialized vendors with established systems and quality monitoring, and better market intelligence.

To manage strategic risk, the FSP should conduct periodic reviews to analyze the impact on client satisfaction and the firm’s overall strategic positioning. Since the FSP may no longer have direct market intelligence from daily operations, it must give more attention to monitoring market intelligence and schedule formal reviews with the vendor to track market trends, customer preferences, and competitor behavior.

To reduce its vulnerability, the FSP must have a contingency plan for disruptions in service from the vendor or possible shifts in strategy to change to another vendor or to bring the functions back in-house to the FSP. Finally, the contract must include provisions to end the relationship including data ownership and disposal, intellectual property, confidentiality agreements, informing customers, and transfer of records and files.

Management risk

Managing the risks outlined above is necessary but not sufficient. Successful outsourcing, like many aspects of business, requires appropriate attention to people, operations, and strategy (Bossidy & Charan, 2002). While outsourcing may increase efficiency and reduce operational costs, it also adds more complexity to the firm’s value chain by introducing another relationship to manage.

Since outsourcing involves a relationship between at least two parties, the FSP manager must consider the mix of people, operations and strategy within the FSP and between the FSP and the vendor. When considering outsourcing, the FSP manager should select a team of dedicated people with a range of experience from across the firm including operations, corporate strategy, finance, and legal departments. The team must balance big picture strategy from headquarters with the operational realities from branches and field locations. The FSP must give appropriate attention to establishing and managing the vendor relationship.

The FSP’s outsourcing strategy should be clearly defined with specific objectives. Management should proceed systematically through analysis of the context and options, design of the outsourcing strategy, implementation, and ongoing management of the relationship.

Between the FSP and the vendor, the mix of people, strategy and operations is also critical. Both the FSP and the vendor must invest in ongoing relationship.
management and monitor results (Evans, 2005; Harland et al., 2005). Effective communications combined with mutually-beneficial outcomes help to build trust over time, and this increases the likelihood of a positive outcome for the FSP.

Figure 4 below summarizes guidelines for FSPs to mitigate outsourcing risk for each type of function in the value chain.
## Figure 4: Mitigating outsourcing risk by functional category

<table>
<thead>
<tr>
<th>Functional type</th>
<th>Risk type</th>
<th>Risk type</th>
<th>Risk type</th>
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<th>Risk type</th>
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<tbody>
<tr>
<td>Core function</td>
<td>Risk type</td>
<td>Risk type</td>
<td>Risk type</td>
<td>Risk type</td>
<td>Risk type</td>
<td>Risk type</td>
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<tr>
<td></td>
<td>Performance and reputation risk</td>
<td>Financial risk</td>
<td>Information risk</td>
<td>Regulatory risk</td>
<td>Strategic risk</td>
<td>Management risk</td>
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<tr>
<td></td>
<td>Rigorous due diligence</td>
<td>Thorough call for proposal specifying comprehensive expense information</td>
<td>Due diligence of vendor’s experience and reputation for data security</td>
<td>Compliance with relevant national and international laws and regulations</td>
<td>Ongoing reviews of client satisfaction</td>
<td>Select team of experienced people to balance strategy with operational realities</td>
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<tr>
<td></td>
<td>Detailed service</td>
<td>Ongoing cost monitoring with benchmarks and incentives for cost management</td>
<td>Clear legal ownership of data</td>
<td>Regular reviews of the vendor’s regulatory compliance</td>
<td>Rigorous ongoing monitoring of market intelligence and the firm’s overall strategic positioning</td>
<td>Provide incentives to establish and manage the vendor relationship</td>
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<tr>
<td></td>
<td>Authorized thresholds</td>
<td>Clear responsibility and procedures for cost overruns</td>
<td>Regular data backup by relevant actors</td>
<td>Clear communication with regulatory officials</td>
<td>Regular formal reviews with the vendor to track market trends, customer preferences, and competitor behavior</td>
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<tr>
<td></td>
<td>for routine operations</td>
<td></td>
<td>Rigorous internal controls to track and reconstitute changes in data</td>
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<td>Contingency plan for service disruptions or change in outsourcing arrangement</td>
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<tr>
<td></td>
<td>(e.g., volume of lending, volume of payment transactions)</td>
<td></td>
<td>Regular information audits</td>
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<td>Contractual provisions to protect the FSP when the relationship ends</td>
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<td></td>
<td>Clear limits for authorized transactions with incentives that gradually increase flexibility and responsibility of vendor over time.</td>
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<td></td>
<td>Regular performance reviews</td>
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<td></td>
<td>External audits of vendor performance</td>
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<td></td>
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<tr>
<td>Transactional function</td>
<td>Due diligence targeted to the specific function</td>
<td>Thorough call for proposal specifying comprehensive expense information</td>
<td>Due diligence of vendor’s experience and reputation for data security</td>
<td>Compliance with relevant national and international laws and regulations</td>
<td>Periodic reviews of client satisfaction</td>
<td>Select team of experienced people to balance strategy with operational realities</td>
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<tr>
<td></td>
<td>Detailed service</td>
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<td></td>
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<tr>
<td>Agreement with performance indicators, service incentives, and provisions for contract arbitration</td>
<td>Ongoing cost monitoring with benchmarks and incentives for cost management</td>
<td>Clear legal ownership of data</td>
<td>Regular reviews of the vendor’s regulatory compliance</td>
<td>Market intelligence and the firm’s overall strategic positioning</td>
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<td>Authorized thresholds for routine operations (e.g., volume of lending, volume of payment transactions)</td>
<td>Clear responsibility and procedures for cost overruns</td>
<td>Regular data backup by relevant actors</td>
<td>Clear communication with regulatory officials</td>
<td>Regular formal reviews with the vendor to track market trends, customer preferences, and competitor behavior</td>
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<tr>
<td>Clear limits for authorized transactions with incentives that gradually increase flexibility and responsibility of vendor over time.</td>
<td>Regular performance reviews</td>
<td>Internal controls to track and reconstitute changes in data</td>
<td>Contingency plan for service disruptions or change in outsourcing arrangement</td>
<td>Contractual provisions to protect the FSP when the relationship ends</td>
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<td>Give attention to establishing and managing the vendor relationship</td>
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<tr>
<th>Supplemental function</th>
<th>Review of quality and capacity</th>
<th>Clear call for proposal specifying expense information</th>
<th>Background check if data involved, clarify legal ownership and conduct backups</th>
<th>Regulatory compliance depending on the outsourced function</th>
<th>Give attention to establishing and managing the vendor relationship</th>
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<tbody>
<tr>
<td>Clear responsibilities and performance indicators</td>
<td>Ongoing expense monitoring and incentives for vendor to manage costs</td>
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<td>Regular formal reviews with the vendor its performance and relevance given FSP’s strategy</td>
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<td>Annual performance reviews</td>
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<td>Contingency plan for service disruptions or change in outsourcing arrangement</td>
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CONCLUSION AND AREAS FOR FUTURE RESEARCH

Competition is increasing, and FSPs face pressure to improve service quality, offer a broader range of services, and manage costs to improve profits. In response, outsourcing all or part of the value chain of providing financial services may be a viable solution. In making this core strategic decision, FSP managers must understand the risks and tradeoffs, as outlined in this paper.

By taking a broader and more strategic view of possible outsourcing options, FSPs can improve their existing operations. Further, if the FSP is planning significant growth, outsourcing may be even more crucial to the FSP’s strategy, as it may be more effective for the firm to outsource functions rather than rapidly grow internal capacity. However, FSPs must understand how to properly execute their plans based on the right mix of people, strategy and efficient operations (Bossidy & Charan, 2005).

The long-term effects of competition and outsourcing in the financial services industry are unclear. More research is needed to understand the efficiency of various FSP strategies for outsourcing. Outsourcing will affect the structure of financial services industries, including competition, consolidation, and the roles of various private-sector players, and these intertwined effects should be analyzed. Cultural differences including foreign and national ownership and client preferences will likely affect outsourcing results across countries, and this presents a further extension of research possibilities. Operational pressures for FSPs in the midst of a rapidly changing market suggest the need to study consumer rights, privacy, and consumer protection issues related to outsourcing.
References


