Chapter V: ISSUES AND CHALLENGES IN OUTSOURCING OF FINANCIAL SERVICES.

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Outsourcing has become the latest mantra for companies to stay ahead of competitors in this highly competitive business environment. Banks too are not lagging behind in this latest mania. There has been a drastic change in the way banks operate in recent years. The growing competition in the banking sector has forced banks to outsource some of their activities to maintain their competitive edge. Of late Indian banks have also started outsourcing their non-core services to safeguard themselves from the increasing competition. The outsourcing services include maintaining of hardware and software, hosting, managing data centers, software application support, disaster management and management of ATM networks across the country. This chapter also opines that decision to outsource arises from the fact that many banks do not have the required human and personnel resources that can cater to these activities.

The increasing competition in the banking sector has forced banks to protect their eroding margins by retaining their customers by providing value-added services through outsourcing. Outsourcing helps in attaining strategic objectives by reducing cost and increasing the efficiency through the unburdening of the non-core service activities. In effect, the outsourcing of banking activities is accelerating at a rapid
pace. In order to have a competitive edge, banks have started outsourcing huge volumes of their non-core services. A recent study by Deloitte revealed that about $356 bn worth of US financial services will be outsourced to offshore locations in the coming years.¹

Most of the banks creates in-house working center known as Captive BPO’s. The term 'Captive" means "In captivity". Hence, A Captive BPO signifies "A BPO Owned and Managed by Parent Company”. Captive BPO is like Company, creating their own delivery centre in-house which is a captive (fixed) cost for them.

However, there are numerous risks involved in the process of outsourcing to a third party, as it requires a complete security mechanism to deal with the voluminous amount of data that they have with them. Relying too much on the third party may also lead to certain risks such as complying with regulations, loss of control over the business, leakage of important data, etc.

The Raison d’être

The key driving force behind outsourcing activities by any firm, irrespective of its nature and business is cost saving. Initially, foreign banks were involved in outsourcing their activities in order to leverage India’s significant cost advantages. Companies like GE, American Express, Standard Chartered, ANZ Grind lays, HSBC, ABN Amro, and Fidelity, to name a few, have been outsourcing their Information Technology Outsourcing (ITO)/Business Process Outsourcing (BPO) requirements to

the Indian companies such as Tata Consultancy Services (TCS), Wipro, Infosys, Cognizant, and Satyam. The only reason for the move was to capitalize on the huge talent pool, which can provide quality service efficiently at a low-cost. The National Association of Software and Services Companies (NASSCOM) revealed that companies outsourcing back-office work to India save as much as 60% of their cost every year. In addition to this, they perceive Indian call center agents to be more productive than agents of both the UK and the US. It has been observed that an Indian agent makes on an average 98 correct transactions compared to 95 by an agent from the UK in a day. It has also been seen that Indian call center agents make approximately 120 transactions an hour while an agent from the UK makes only 100 calls. Moreover, the average speed of answer by an Indian call center agent is about 8 seconds while compared to the US agent’s speed of 20 seconds.2

Some Key Risks in Outsourcing

Strategic Risk: -

* The third party may conduct activities on its own behalf, which are inconsistent with the overall strategic goals of the regulated entity.

• Failure to implement appropriate measures/oversight from the part of the outsourcing service provider.

• Inadequate expertise to oversee the service provider.

2. Evans, R.: “Outsourcing: The regulatory challenge for financial services firms”.

Reputation Risk:-

- Poor service from third party.
- Customer interaction is not consistent with overall standards of the regulated entity.
- Third party practices not in line with stated practices (ethical or otherwise) of regulated entity.

Compliance Risk:-

- Privacy laws are not complied with
- Consumer and prudential laws not adequately complied with
- Outsourcing service provider has inadequate compliance systems and controls

Operational Risk:-

- Technology failure
- Inadequate financial capacity to fulfill obligations and/or provide remedies
- Fraud or error
- Risk that firms find it difficult/costly to undertake inspections.

Exit Strategy Risk –

- The risk that appropriate exit strategies are not in place. This could arise from over-reliance on one firm, the loss of relevant skills within the institutions, preventing them from bringing the activity back in-house, and contracts, which make a speedy exit prohibitively expensive.
• Limited ability to return services to home country due to lack of staff or loss of intellectual history.

Counterparty Risk: -
* Inappropriate underwriting or credit assessments
* Quality of receivables may diminish

Country Risk: -
* Political, social, and legal climate may create added risk.
* Business continuity planning is more complex

Contractual Risk: -
* Ability to enforce contract
* For offshoring, choice of law is important

Access Risk: -
* Outsourcing arrangement hinders ability of regulated entity to provide timely data and other information to regulators
* Additional layer of difficulty in making the regulator understand activities of the outsource provider

Concentration and Systemic Risk; -
* Overall, industry has significant exposure to outsource provider. This concentration risk has a number of facets including:
* Lack of control of individual firms over provider; and systemic risk to the industry as a whole.  

**Risk Management Practices for Banks that Outsource Services**

Banks that outsource are exposed to many risks. They have to put in place many safeguards to protect the interest of their customers.

- **Outsourcing does not reduce the obligation of the bank to its customer:**
  
  If a bank has decided to outsource certain financial services, it should be conscious of the fact that ultimately it is responsible to its customers. The bank should never enter into a contract with a service provider where a clash of interests is likely. The customer should not be compromised in the process.

- **Adequate control over the service provider vital:**
  
  The ability of the banks or of the governing bank of the country to manage its matters should not be compromised. For instance, the Reserve Bank of India (RBI) is responsible in regulating the public sector banks in the country. Outsourcing of financial activities should in no way obstruct the RBI from carrying out its functions and duties.

- **Consider relevant rules and regulations:**
  
  The banks must make meticulous efforts to see pertinent laws and regulations are not violated.

- **Rights of the customer against the banks:**

A bank customer has certain rights against the banks. These rights are inviolable and sacrosanct. They include the right of the customer to get compensations in certain situations. The bank is obliged to its customer in this regard.

- **Certain activities should not be outsourced:**

Certain crucial activities like opening of accounts, loan sanctioning, management of investment portfolios, and internal audit are core management decisions. They cannot be outsourced.

- **The service provider should not have any stake in the bank.**

Any employee, officer, director, or board member of the outsourcer bank, or their relatives should not have stakes in the service providing company. This will ensure that there is no unwarranted influence or control of bank activities.

- **The board and senior management should be responsible:**

The senior management should be vested with powers to decide and evaluate the risks involved in outsourcing while the board will be responsible for the approval of its framework. It should periodically review the outsourcing arrangement and the strategies, and make sure they are still relevant and safe. In addition, the senior management has to take the board into confidence by proper communication, especially regarding the material outsourcing risks.

- **Correct assessment of the capabilities of the service provider:**

The competence and capabilities of the service provider should be assessed accurately and they should match the standard expected by the bank with regard its customer service operation, reputation, finance and profit. The service provider should be
engaged after adequate research of into its antecedents. Feedbacks may be sought from other banks. It is inadvisable to let the concentration of outsourcing arrangements with a single service provider by a large number of banks.\footnote{N. Saravana Bhavan: “Business Process Outsourcing: An Overview of Financial Sector”; Deep & Deep Publications Pvt. Ltd, New Delhi 2003.}

- **Outsourcing Agreement:**

  The contract between the bank and the service provider has to flexible to enable the bank to control and intervene if need arises. Due diligence is necessary in drafting the contract with the help of the bank’s legal counsel. It should be legally enforceable. It should tackle the risks involved.

- **Confidentiality of the bank customer’ information:**

  The dealings of the bank with the customers are meant to be confidential. The service provider should ensure that information like records of assets; deposits and withdrawals are not leaked.

- **Code of conduct for sales and recovery agents:**

  The sales agents working for the service provider should be trained and sensitive especially while soliciting potential customer. They have to convey the correct information regarding new policies and services of the bank, and make sure that they do not inconvenience the potential customer in any way. Recovery agents should never resort to intimidation or harassment in their debt recovery efforts.

- **Contingency Plan:**

  The bank should always have an alternate plan to ensure that its service is not affected.
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It can be that the bank will have to change the existing service provider for a new one or even bring back the hither to outsourced activity in-house.5

Indian Banks: Capitalizing Opportunity

Of late, the Indian banks have also started outsourcing their non-core services to safeguard themselves from the increasing competition. Their outsourcing services include maintaining of hardware and software, hosting, managing data centers, software application support, disaster management, and managing ATM networks across the country. In addition to all these activities, banks are also giving contracts to third parties in order to manage other non-core support services such as call-support services, help-desk support, credit card processing and printing, cheque processing and clearing, ATM Cash replenishment, cheque box clearing and collection, loan servicing, data processing, etc.

On the other hand, Axis Bank has even started outsourcing its technical services. For instance, it handed over the management and maintenance of 80 of its off-site ATMs in Mumbai to NCR Co. NCR Co, is also managing the ATM network of SBI. Centurion Bank has also given the contract for the management of its 152 ATMs to Euronet. These service providers have a team of experts who take care of the performance of ATM network from a remote center. Needless to say, then, that banks do also get benefited from the domain expertise of these service providers.

The public sector banks are also not very far behind nor are they untouched by the

world of outsourcing. They have resorted to outsourcing in order to improve their efficiency, reduce costs, and focus on core banking activities. Increasing competition has changed the perception of PSU banks, leading them to strategically outsource in order to cater to the increasing customer base by offering wider portfolio of services. Indian banks save around 30-40% through third party outsourcing compared to their captive outsourcing units.

Outsourcing service providers do reduce the burden of day-to-day activities so that the banks can focus on their core activities like marketing of services. It also reduces the cost of operation because the cost for outsourcing the service is fixed, which saves banks from Skyrocketing real estate price and other additional operational and technological costs. Banks remain free from deployment and management of ATMs, security, currency management, and transaction processing.

It is a win-win situation for both customers and banks. Outsourcing helps not only in focusing on the core activities, but also reduces the total cost of ownership by reducing the capital investment in developing infrastructure. Service providers also offer economies of scale because they cater to the whole gamut of the outsourcing services of various banks or companies. Banking giants like SBI (State Bank of India), BOB (Bank of Baroda), etc., have also started outsourcing their services.

SBI has outsourced its networking services and maintenance of more than 1,500 branches and 3,000 ATMs in 49 cities to Data craft. Bank of India also gave its outsourcing contract to India Switch Company in the year 2002.  


[135]
Yes Bank, one of the private banks, has signed a seven-year outsourcing deal with Wipro InfoTech. The imperative behind outsourcing complete IT infrastructure is to quickly set-up its base and gain acceptance against ICICI Bank, HDFC Bank, Axis Bank, SBI, etc. Wipro InfoTech will support the bank’s operations in rolling out its branches, networking, managing the data center, and back-up support for disaster management. However, as per RBI directives, banks have to exercise due diligence while appointing third parties to carry out banks’ non-core outsourcing activities.\(^7\)

**Challenges Ahead -**

Selecting the right vendor is one of the most critical aspects for any bank because of the nature of complexities such as potential to transfer risk, management, and compliance to third parties who may not be regulated, and who may operate offshore. Also, the legal contract should be approved after the quantification of benefits, which can be done by analyzing financial and infrastructure resources. The vendor’s domain knowledge about a particular industry is important for customizing its IT requirements. It is because reliable service, timely delivery, data privacy and security, and adherence to quality, are of strategic importance to banks while looking for outsourcing partners. The major concern for banks is security. Security-phobia is more perceived in public-sector banks. Risks such as ineffective service, service providers acquiring knowledge of the banking system and misusing it for other benefits, are

always there. Recently in India, some employees of a UK-based BPO company stole the passwords of that particular firm’s customers and misused it. Relying too much on the third party can also lead to leakage of confidential information of clients. Such leakage can result in severe damage to the bank’s reputation. Banks should also have realistic expectations from service providers because overestimation of the economic benefits can put single service providers in trouble.

Outsourcing arrangements present four key challenges, which if not addressed adequately, introduce significant risks for the Banking institutions. While other risks exist and the primary concerns are:

i) **Selecting a qualified vendor and structuring the outsourcing arrangement** –

Failure to choose a qualified and compatible service provider and to structure an appropriate outsourcing relationship may lead to on-going operational problems or even a severe business disruption. These events may result from service provider employees not having the necessary skills or familiarity with the industry, or from service providers lacking an adequate technical capacity or financial stability. The contract needs to clearly articulate the structure of the outsourcing arrangement and the expectations of both sides; otherwise excessive amounts of management time may be consumed with dispute resolutions or with managing a contentious relationship.

ii) **Managing and monitoring the outsourcing arrangement** –

As management focus shifts from direct to indirect operational control over an activity, there is a risk that undue reliance may be placed upon the service provider by the Banking institution. Without active management and monitoring of the

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relationship, sub-par service may occur or, at the extreme, loss of control over the outsourced activity. Given the customized nature of the service contracts, changing service providers in the face of unsatisfactory responsiveness may not be a viable option. Even when alternatives are available, switching service providers is likely to be a costly option that adds to operational, legal and other risks.

iii) **Ensuring effective controls and independent validation** –

Given the reliance on a third party for the performance of critical activities, there is the risk that without independent validation of the control environment the institution cannot determine that the controls have been effectively implemented. A sound control environment in an outsourcing arrangement encompasses many of the same management concerns as when the activity is performed in-house. However, if not independently validated, the Banking institution risks receiving performance monitoring reports that are overly optimistic. The service provider also may not always maintain the necessary capacity, employee skill set or financial capability as agreed to in the contract.

iv) **Ensuring viable contingency planning** –

Given the dependency on a third-party service provider, Banking institutions face the challenge of ensuring adequate contingency planning to avoid business disruptions. What contingency plans does the service provider have in place? What contingency plans does the Banking institution have in the event of non-performance by the service provider? Recurring performance problems coupled with the absence of comprehensive contingency plans by the service provider and the Banking institution may result in unintended credit exposures, financial losses, missed business
opportunities and reputational concerns. The supervisory assessment of outsourcing risk at a Banking institution will depend on several factors: The size and criticality of the outsourced activity, how well the institution manages, monitors and controls outsourcing risk, and how well the service provider manages and controls the inherent risk. In principle, outsourcing may enhance or weaken an institution’s overall risk profile. For example, overall risk may be reduced when the service provider’s expertise is superior to that of the financial institution and/or when prudent risk mitigating practices are utilized by the financial institution.

To cope with the challenges, RBI has proposed that the board of directors must be held responsible for the outsourcing policy as well as activities undertaken by a bank. Meanwhile, the government and the banking industry are taking proper initiatives to curb unethical practices of misusing data collected by making and amending cyber laws. To curb the lacunae in the existing outsourcing operations, RBI is going to formulate a policy of check and balance for each bank by seeking approval of its board on outsourcing. These regulatory norms will cover operational risk and data security related to outsourcing.  

Banking is an activity observed all over the world. Certain families develop an association with a particular bank and become loyal banking partners. But did we know that outsourcing financial services has also managed to reach the banking industry? It was a huge risk but bank officials stood by their decision claiming that it

was a step in the right direction. Now, the number of customers physically heading into local bank branches have been significantly reduced since the work load has been outsourced.

The decision wherein banks opted for outsourcing financial services hinge on two main reasons: the ability to reduce costs and to cater to a wider range of customer base. Both of these components enable a banking institution to gain a competitive edge in the market. The IT-enabled banking services have now come to represent the new age of banking formats in the industry.

Despite the initial concerns, several banks have managed to handle banking and outsourcing financial services quite well. In fact, they have been able to enjoy improved efficiency and effectiveness using the said method. However, you cannot take it away from bank clients to show concern over the fact that a stranger might accidentally gain access to their account or financial information.

It therefore leads one to look into main challenges and concerns involved with banking and outsourcing financial services. The most primary concern involved language and accent issues. And eventually, difficulty in language and communication will result to delays in the service. Over the initial run of banking outsourcing, many customers have opted for banks that did not outsource to enjoy better quality service.

As noted above, data security is one of the most prominent concerns among bank clients and customers. The possibility of BPOs gaining access to their account details poses risk of data theft. This was exactly the case in various countries in the past, which only goes to show that there was not enough data security provided for by
outsourcing firms that offer banking and outsourcing financial services. In the case of
the bank, something bigger is at stake and that is the reputation.

But despite of the concerns indicated above, many banks still see the potential in
banking and outsourcing financial services. According to statistics, banks that opt to
outsource their services have the ability to save up to 60% in cost on an annual basis.
In addition, Bank can enjoy more productivity with more transactions being completed
in an hour in comparison to traditional banking methods.

This is why banks and BPOs are working together in producing more efficient banking
services to its clients. They want to build better channels for banking that is secure and
efficient. All of these efforts are done to replace traditional branch banking with
virtual decentralized banking models.

In the end, it will all turn out to be beneficial for both parties. Customers can enjoy
better service and banking experience, while the bank institutions can enjoy cost-
effectiveness and increased productivity.\textsuperscript{10}

\textbf{Outsourcing of Financial Services:}

The RBI has issued guidance by way of its circular dated 22 April 2009 (the
Services) for banks outsourcing financial services. Although Indian banks do not
require prior approval from the RBI, necessary safeguards to address risks inherent in
outsourcing are detailed in these guidelines. Outsourcing arrangements must neither

\textsuperscript{10} Source: \url{http://www.services-outsourcing.org/challenges-banking-outsourcing-financial-services}. 

[141]
diminish a bank’s ability to fulfill its obligations to customers and the RBI, nor impede the effective supervision of the RBI. Banks remain responsible for the actions of their supplier, and for ensuring the confidentiality of customer information. Banks are advised not to engage in outsourcing that would weaken their internal control, business conduct or reputation. The RBI has also issued instructions concerning outsourced services relating to credit cards. A bank that has entered into, or is planning, material outsourcing, or intends to vary any such outsourcing arrangements, must notify the RBI of these arrangements. Banks in India are not allowed to outsource core management functions, for example, corporate planning, organisation, management and control and decision making functions, such as determining compliance with know your- customer norms for opening deposit accounts, according sanctions for loans and the management of investment portfolios.

**Business process:**

Internally, whether through a regulator or otherwise, there are no specific laws or regulations in respect of business process outsourcings (BPOs). However, a BPO unit may need to be registered with the Department of Telecommunications as an Other Service Provider (OSP) before commencing operations, particularly if it is engaging in services relating to tele-banking, tele-medicine or tele-trading e-commerce.\(^{11}\)

**IT:**

Where a unit is acting as an Internet service provider (ISP), then the exposure and liability of the unit may need to be verified under the Information Technology Act

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11. [www.nasscom.in/ITES-BPO](http://www.nasscom.in/ITES-BPO).
2000 before operations commence. Section 70 of the Information Technology Act 2000 provides that an ISP is exempt from liability for any third-party data or information if the ISP can prove either that:

- The offence or contravention was committed without his knowledge.
- He had exercised all due diligence to prevent the commission of the offence or contravention.

**Telecommunications:**

Companies providing telecommunications outsourcing services must be registered with the DoT as an OSP. This includes call centre operators, tele-marketers, tele-banking operators, network operation centres and so on. There are some restrictions on foreign investment in the pure telecom space that must be considered.

**Public sector:**

Public procurement guidelines apply to the procurement of outsourced services from the private sector. Government policies dealing with public procurement include the General Financial Rules 1963 and the Delegation of Financial Powers Rules 1978 (both issued by the Ministry of Finance). Further, the Directorate General of Supplies and Disposals (DGSD) Manual on Procurement, and the Central Vigilance Commission (CVC) Guidelines, prescribe the procurement procedure to be followed by all federal ministries. In August 2006 the Government issued three manuals governing the procurement of goods, works and services. These manuals are used as guidelines for government ministries and departments, and public sector undertakings.
Other:

The National Association of Software and Service Companies (NASSCOM), an industry association, plays a critical role in ensuring India’s prominence in the global outsourcing space. In addition to playing a significant leadership and lobbying role, NASSCOM also provides industry certifications, organizes conferences and collates industry reports. The Business Software Alliance (BSA) is also a critical player in the Indian market. The BSA has had some success in obtaining Anton Piller orders from Indian courts and conducting raids on distributors of pirated software.  

a) Due diligence of the supplier

It is important to thoroughly evaluate the Indian supplier’s facilities, credentials, information security practices and procedures. Among others, it is advisable to:

- Conduct a site visit of the facilities.
- Ensure the supplier has a plan to address any identified gaps or deficiencies.
- Obtain independent reviews and market feedback on the supplier.
- Conduct due diligence and evaluate the supplier’s:
  # Expertise, past experience and competence to implement and support the proposed activity over the contracted period;
  # Financial stability and ability to service commitments even under adverse conditions;

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# market intelligence, reputation and culture, compliance, complaints and outstanding or potential litigation;
# internal policies and procedures, including security and control, audit coverage, reporting and monitoring environment and business continuity management;
# locational factors including tax benefits, political, economic, social and legal factors;
# Employees, recruitment process, benefits, attrition plans, contingency plans and sub-contractor issues.

b) Sub-contractor issues

It is not unusual for suppliers to use sub-contractors, and it is good practice to include the following provisions in relation to sub-contracting:

* Customer’s consent must be obtained.

* Minimum qualifications, capabilities and so on of any subcontractor should be outlined.

* Customer’s right to review any sub-contracting terms.

* Supplier’s liability for the actions of the sub-contractor.

* Sub-contractor IPR and liability issues should be outlined.

* Customer’s right to inspect a sub-contractor and his premises.\(^\text{13}\)

Outsourcing documentation

The outsourcing agreement determines the success of the underlying relationship. The

more clear, precise, detailed and carefully drafted the document, the easier it is to allocate risks, anticipate and prevent potential problems, and set realistic expectations. Some drafting tips include:

* Take time to understand, negotiate and finalise the document, even if there is business pressure to close the deal.

* Clearly address risks and risk mitigation strategies, particularly those identified at the gap analysis and due diligence stages.

* Incorporate flexibility into the agreement to cater for changed circumstances.

* Clearly state the nature of the legal relationship between the parties, whether principal to principal or otherwise.

* Require that the supplier complies with laws, regulations and provisions that apply to the customer in different jurisdictions.

* Include an obligation that the supplier complies with industry standards.

* Clearly document the supplier’s obligations in the event of a breach, and any transition issues.

* Don’t concede an important issue just to close the deal.14

Key provisions that should be addressed in the contract include:

* The contract’s scope, clearly defined. Service and performance standards should be stated.

* Audit rights: the customer must be able to access all books, records and information

relevant to the outsourced activity with the supplier. Audits can be conducted internally by the customer or through external auditors or agents.

* Monitoring rights: continuous monitoring and assessment by the customer is necessary to erase long-term issues and ensure that any necessary corrective measures are taken quickly.

* Termination: notices, procedures and consequences should be addressed.

* Policies and procedures for data privacy. The supplier should have adequate controls to ensure customer data confidentiality and a statement of liability in the case of a breach of security and/or any leak of confidential information.

* Business continuity.

* Sub-contractor issues: the agreement should clearly state if customer approval is required, and how a sub-contractor’s suitability is to be ascertained.

* Compliance with law: both domestic and other applicable laws should be covered.

* Confidentiality of customer information. This issue cannot be overstated, and the agreement should seek to ensure the security and confidentiality of customer information in the supplier’s custody or possession.

* Indemnities, fall-back and other remedies. The agreement should contain the customer’s specific non-compliance related remedies, fall-back and indemnities.\(^{15}\)

**Business continuity and management of disaster recovery (DR) plan**

The supplier should have a robust framework for documenting, maintaining and
testing business continuity and recovery procedures. The customer must ensure that the supplier periodically tests the DR Plan. Often customers consider joint testing with the supplier.

**Termination and change of supplier issues**

Customers tend to retain a degree of control over outsourcing to mitigate against the unexpected termination of the agreement or the supplier’s liquidation. To establish a viable contingency plan, customers should consider the availability of alternative suppliers or the possibility of bringing the outsourced activity back in-house in an emergency, and the costs, time and resources involved in those activities.

**Segregation of facilities**

Customers should decide whether or not they are willing to allow the supplier to share its facilities with its other customers. Some level of segregation of the customer’s information, documents, records and other assets is certainly advisable, particularly to ensure that the customer can easily reclaim those items following a breach or termination of the agreement.

**Audit, monitoring and control**

It is wise to include robust audit rights in the agreement to ensure that the customer can verify that the supplier is complying with the contract. The customer should continuously monitor and control its outsourced activities, either internally or using external auditors. The customer should periodically review the supplier’s financial and operational conditions to assess its ability to continue to meet its outsourcing obligations. Periodic audits highlight any deterioration or breach in performance standards, confidentiality and security, and in business continuity.
Outsourcing to a third party

If the foreign entity does not want to establish itself in India, it can undertake outsourcing transactions by contracting with a supplier in India. Even where the involvement of the foreign entity remains at the contracted level, additional care must be taken to ensure that this involvement does not constitute a service Permanent Establishment (PE) for the foreign entity in India. If a service PE is established, the foreign entity is liable to pay taxes in India for income that may be attributable to India. This option:

- Is the most cost-effective.
- Raises concerns regarding confidentiality, people and performance control.
- Works best where the work is of an intermittent nature, the volumes are small, and varying expertise is required for different pieces of work.
- Provides flexibility, both in terms of the work outsourced, and allowing the work to be done by different suppliers.\(^\text{16}\)

The agreement plays a very critical role in this type of outsourcing. It should cover issues relating to data protection, security compliance, confidentiality, IPR assignment, audit rights, reporting requirements and change control.

The outsourcing relationship between a customer and supplier can take several forms, including:

**Build operates transfer (BOT).** The supplier sets up, builds and operates the outsourcing unit for the customer and ultimately transfers it to the customer at an

agreed date or event. The terms of transfer are also generally agreed upfront. The advantage of this structure is that the customer becomes the owner of the outsourcing unit without having to bear the initial set-up burden.

**Procurement processes**

The procurement process should examine various matters, including supplier reputation, technical specifications, expertise, pricing, updates, after-sales support and service, SLAs, and so on. While the procurement process can vary, the following provides a general outline of the process:

- *Tendering process.* It is not common to undertake a Request for Proposals (RFPs) during every tendering process for nongovernment outsourcing. However, for large projects foreign companies do send out RFPs to a select group of suppliers. This effectively starts the procurement process. In the event that a formal RFP is not sent out, the shortlisted suppliers are sent a brief so that they can put forward their proposal and initiate their due diligence.

- *Supplier due diligence and evaluation.* The suppliers due diligence and evaluation should first address their technical capabilities, knowledge levels and market share. Supplier credibility can then be checked through referral sources.

- *Assessing supplier capability.* Infrastructure, technical capabilities, leadership, team size, human resource management, locations, client focus, processes, tools and certifications are all relevant in assessing the supplier’s capabilities. India has many capable vendors, and it can be difficult to select a particular
supplier. A supplier should not be selected purely because of its company name or the number of multinationals who have outsourced work to it. Evaluation of the people is as critical as evaluation of the company.

- **Referral checks on supplier reputation.** This can be done simply by contacting some of the supplier’s other customers, or requesting that the supplier provides a capability statement based on past experience. A visit to the supplier’s facilities allows the customer to study their processes and ensure they meet the customer’s internal quality and regulatory requirements.

- **Gap analysis/SLA signing.** Ask the supplier to do a gap analysis so that issues can be identified. An SLA should only be signed after a level of reassurance is established with the supplier. The scope of the gap analysis/SLA should be clear, concise and simple. It should contain objectives, and define the scope of work, final deliverables and any resource allocation details.

- **People involved.** Both the internal staff of the foreign entity planning to outsource to India and external consultants can be used, depending on a project’s requirements. When selecting external consultants care must be taken to ensure that they have adequate exposure to India and doing business in India.

- **Continuous evaluation of supplier performance.** Keep evaluating the supplier even after the agreement has been awarded to them. This can be based on both feedbacks from the people involved and active assessments. Evaluation is particularly useful where there is a subsequent engagement.
• *Negotiating the transaction.* The team negotiating the transaction should be practiced in negotiating with Indians. The Indian style of negotiation is quite unique, and negotiators should be sensitive to the nuances of this style of negotiation.\(^\text{17}\)

**Future Outlook**

Outsourcing in the Banking sector is in its nascent stage, but it has a promising and bright future ahead. To make the outsourcing industry more vibrant and competitive and to overcome the issues associated with it, proper participation is required from the government, academic, and industry sectors. For IT, banking is considered to be the second largest segment, next to manufacturing. So, there is a huge potential for the third party outsourcing service providers in the banking segment. More and more banks are embracing this growing trend of outsourcing to stave off competition. Indian companies need to capitalize on the size of their economy and growth potential, besides leveraging their strong IT infrastructure and cheap labor. The government has to speed up its infrastructure development efforts to maintain the momentum of growth in the outsourcing industry. Besides, the industry and regulators the government should draft proper data privacy and security norms. The industry needs to move up the value chain, and infrastructure bottlenecks and data security issues must be resolved. All these measures will help the banking industry to unleash its full potential for outsourcing.

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There are several actual and psychological barriers to the growth of financial BPO. Several successful experiences and research studies are required to overcome these barriers. The barriers to the growth include security of customer and product information, Protection of intellectual property, Viability of providers, quality of service, Environmental and labour practices of BPO providers, Reliability of technological infrastructure, etc. Some of the important issues are:

**PSOR**

The principal risks are PSOR- Poaching, Shirking and Opportunistic Renegotiation. Frequently one finds companies under committing and over delivering. These risks can crop up when the market matures.

*Ownership of customer information*

The third party to whom the banks have outsourced work takes ownership of their customer information, which greatly increases its bargaining leverage. The third party can develop a systems to do customer information tracking and acquire the ability to take ownership of the user firm’s customers. Outsourcing firms that have this information can start renegotiating prices or contracts.  18

*Process level lock in*

The greater risk is process-level lock in. if employees of the principal get used to seeing the same screens and doing the same things while someone supports them from back office, it is a tremendous bargaining advantage for outsourcing company’s

Vis-à-vis the principal. Even if the outsourcing firm hikes its fees, if becomes difficult for the principal to discontinue operations or change the way things are done. The human level lock in –of the person, the process and the information producing system– is more dangerous and costly. Disruption of those processes is usually unaffordable and that gives outsourcing firms tremendous advantages.

**Lack of Control**

Company can lose control over the work process an output. With special emphasis on the financial sector, banks need to understand that they can outsource the delivery of strategy, but not strategy itself.

**Effective Management**

Every outsourcing relationship begins with a well defined relationship arrangement, contract and expectation/delivery management. Active mutual management of the relationship is crucial.

**Integration of outsourced process with business**

Good documentation a process maps will help integrate processes. Also ensure business rules and process interfaces are well defined, documented and understood. Murphy’s Law in outsourcing states that “if the process you outsource is not in control before you outsource, it will only get worse after outsourcing”. 19

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Service Agreement Disputes

In most instances, service agreement disputes arise because businesses, in general, change rapidly. Therefore, companies need to understand that in any outsourcing agreement, flexibility in terms of how the service levels are going to change as the business changes, or simply flexibility in effectively benchmarking those services against best practices in necessary to stay competitive.

Legal Risk

Outsourcing arrangements are binding contractual relationships with another legal entity, typically an unaffiliated third party. The duration of contracts may be fairly lengthy, often five to ten years, during which time business needs and environments can change significantly and in unanticipated ways. Consequently, there is a risk that financial institutions may be locked into agreements that reflect outdated business realities. The contractual basis of outsourcing coupled with this intrinsic business uncertainty contributes to legal risk.

Operational Risk

Outsourcing almost inevitably results in changes in the financial institutions business practices and processes, which contributes to operational risk? These changes may be required to capture economies of scale and operational efficiencies, or simply reflect a different way of doing business by the service provider. 20

Dependency

Outsourcing creates a potential dependency on the third party service provider, which raises several issues. One concern is ensuring adequate responsiveness from the service provider. Further, this potential dependency on the service provider may increase over time since organizational learning is based mostly on experience and therefore the financial institutions capacity to learn may be diminished.

Reputational Risk

Outsourcing also poses significant reputational risk. A problem at the service provider is potentially a problem for the client financial institutions. For example, if the service provider has a highly visible problem with one client institution, the adverse publicity of that situation may have contagion effects for other client institutions. Also, in some situations, such as customer service call centers, the service provider’s employees interact directly with the financial institutions customers as if they were employees of the financial institution. This direct interaction poses reputational risk for the financial institutions if the interaction is not consistent with the financial institutions policies and standards.

Confidentiality

One of the initial obstacles in outsourcing has been the issue of confidentiality. While this concern has somewhat been allayed through the proven professional handling by service providers in more developed countries that have not taken to the growing trend of outsourcing.
Vendor selection and structuring the outsourcing arrangements

Failure to choose a qualified and compatible service provider and to structure an appropriate outsourcing relationship may lead to on-going operational problems or even a severe business disruption. These events may result from service provider employees not lacking an adequate technical capacity or financial stability. The contracts need to clearly articulate the structure of the outsourcing arrangements and the expectations of both sides.

Managing and monitoring the outsourcing arrangement

As management focus shifts from direct to indirect operational control over an activity, there is a risk that undue reliance may be placed upon the service provider by the financial institution. Without active management and monitoring of the relationship, sub-par service may occur or, at the extreme, loss of control over the outsourced activity.

Effective Controls

Given the reliance on a third party for the performance of critical activities, there is the risk that without independent validation of the control environment the institution cannot determine that the controls have been effectively implemented. However, if not independently validated, the financial institution risks receiving performance monitoring reports that are overly optimistic.21

Contingency Planning

Given the dependency on a third-party service provider, financial institutions face the challenge of ensuring adequate contingency planning to avoid business disruptions. Recurring performance problems coupled with the absence of comprehensive contingency plans by the service provider and the financial institution may result in unintended credit exposures, financial losses, missed business opportunities and reputational concerns.

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

Technology has become a part of all walks of life and across all business sectors, and even more so in banking. There has been massive use of technology across many areas of banking business in India, both from the asset and the liability side of a bank’s balance sheet. Delivery channels have immensely increased the choices offered to the customer to conduct transactions with ease and convenience. Various wholesale and retail payment and settlement systems have enabled faster means of moving the money to settle funds among banks and customers, facilitating improved turnover of commercial and financial transactions. Banks have been taking up new projects like data warehousing, customer relationship management and financial inclusion.
initiatives to further innovate and strategise for the future and to widen the reach of banking.

**Exhibit 5.1: Generic Value Chain for Financial Service Providers**

<table>
<thead>
<tr>
<th>Marketing &amp; Sales</th>
<th>Products:</th>
<th>Client Services:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deposits</td>
<td>Help center</td>
</tr>
<tr>
<td></td>
<td>Loans</td>
<td>Account mgmt</td>
</tr>
<tr>
<td></td>
<td>Transfers</td>
<td>Advisory</td>
</tr>
<tr>
<td></td>
<td>Investments</td>
<td>Other</td>
</tr>
<tr>
<td></td>
<td>Insurance</td>
<td></td>
</tr>
</tbody>
</table>

**Cross-cutting support services:**

<table>
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<tr>
<th>Financial, treasury and internal control</th>
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<tbody>
<tr>
<td>Risk management</td>
</tr>
<tr>
<td>Technology management</td>
</tr>
<tr>
<td>Human Resource</td>
</tr>
<tr>
<td>Firm infrastructure: governance, legal, regulatory</td>
</tr>
</tbody>
</table>

Exhibit 5.1 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. Market and regulatory factors may limit the Financial Service Providers 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. 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. 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.

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, Banks often market and issue credit cards but outsource the related data-intensive and high transaction operations associated with bank’s non core activity. Figure 2 shows the reasons for outsourcing by Bank considering the various activities.


Exhibit 5.2: Considering reasons for Outsourcing:

<table>
<thead>
<tr>
<th>Reason</th>
<th>% of responses</th>
</tr>
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<tbody>
<tr>
<td>Improve Banks focus</td>
<td>55</td>
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<tr>
<td>Reduce and control operating costs</td>
<td>54</td>
</tr>
<tr>
<td>Free resources for other projects</td>
<td>38</td>
</tr>
<tr>
<td>Gain access to world class capabilities</td>
<td>36</td>
</tr>
<tr>
<td>Resources not available internally</td>
<td>25</td>
</tr>
<tr>
<td>Accelerate reengineering benefits</td>
<td>20</td>
</tr>
<tr>
<td>Reduce time to market</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: BIS (2004).

The above mentioned exhibit 5.2 shows the banks considering the reasons for outsourcing of financial services and survey shows that 55% banks outsource services due to improve banks focus and reduce & control operating costs.