CHAPTER-II

REVIEW OF LITERATURE

2.1 INTRODUCTION

Chapter one presented the scope, objectives and methodology of this present study by introducing outsourcing concepts and providing a brief overview of its history and application. The banking industry in India and its status with regard to outsourcing was highlighted as the subject of the research enquiry. Outsourcing is now an indispensable part of the global economy.

The purpose of the literature review is to identify and engage with previously published research, which is relevant to the topic of interest, in order to identify issues which may require investigation. This chapter elaborates on a detailed review of the literature related to outsourcing.

An extensive range of academic literature on outsourcing by banks has been reviewed for the purpose of this study. Apart from visits to libraries for references of research works on this topic, online databases have also been searched to provide a comprehensive listing of journal articles on outsourcing. These included research papers, conferences and selected journals which have been systematically reviewed and classified to provide background information and knowledge of the topic. Each one of these articles were further reviewed and classified to have conceptual clarity.
All the articles and research papers were allocated to the main and sub-categories based on their major focus of the subject. Accordingly, they were classified into the following five broad categories:

1) Outsourcing by banks ---- Meaning and Objectives
2) Reasons for outsourcing
3) Benefits of outsourcing
4) Risks in outsourcing by banks
5) Service providers of outsourcing

2.2 OUTSOURCING BY BANKS --- MEANING AND OBJECTIVES

2.2.1 Conceptual Interpretation:

The World Bank defines “outsourcing” as “the contracting of a service provider to completely manage, deliver and operate one or more of a client’s functions (e.g. data centers, networks, desktop computing and software applications)”. (E-commerce and Development Report (EDR) 2003, United Nations Conference on Trade and Development (UNCTAD), p135.1

According to Michael Corbett², it is difficult to define the term outsourcing, as there are many terms that were synonymous with outsourcing: They are, ‘sub-contracting, contracting-out, staff augmentation, flexible staffing, employee leasing, professional services, contract programming, facilities maintenance or management, contract manufacturing and contract services’. Corbett added that the difficulty was compounded by each term possessing other meanings, other than of outsourcing.
In defining outsourcing, numbers of scholars unanimously agree that the key feature of an outsourcing arrangement is the change from in-house service provision to service provision by an external provider. That is, in a fundamental sense, outsourcing consists of the purchase of goods and services that was previously provided internally. Outsourcing is the practice of hiring an external service provider to handle work normally performed within a company. It has been described as an act of predetermined subcontracting part or all of a company’s IT and related functions to one or more external vendors according to Sengupta and Zviran. According to Bardoloi and Sabyasachi (2004), it is the process of procuring services or products from an external service provider with a view to curb costs, replace inhouse capabilities and thereby reduce the time period of projects. Outsourcing of activities is thus a full transfer or delegation of an organisation’s facility management functions to an external firm. It is an agreement in which the outsourcing firm delegates an activity to another company, viz., the outsourcing provider.

Dominguez (2005), describes that, “Outsourcing is the practice of hiring “functions experts” to handle business units that are outside of a firm’s core business. It is also a method of staff augmentation without adding to head count”. Jae K.Shin and Joel G. Sieget in their book have defined outsourcing as “Contracting out manufacturing or service operations conducted by the business to reduce costs or to generate efficiencies”. According to them, the financial manager must identify problems within the business and suggest improvements. They have said that outsourcing in general is more suitable for “core activities” than “non-core” activities.
2.2.2 Conceptual Dimensions:

There are four schools of thought on outsourcing. An economic explanation of outsourcing, which states that firms outsource because, after weighing agency and transaction costs, they find outsourcing to be less expensive. A second explanation is that outsourcing decisions are the result of a political process in organizations. The organizational powers of the IT department are brought to bear in influencing top management’s outsourcing decisions. Third, outsourcing can be viewed as a strategic decision. This approach suggests that firms outsource because IT is not a core competence of the firm. Fourth, IT can be viewed as an administrative innovation. It suggests that firms outsource because they observe others around them doing so.

Christian Braun and Robert Winter have conceptualized a wide variety of outsourcing phenomena to the extent that they can be specified in descriptive dimensions, thus making it possible to differentiate between different outsourcing scenarios. This classification forms the basis for the subsequent development of scenario-specific methods. Only then according to them will it be possible for companies in the financial services sector to depart from their previous approach to outsourcing, which has largely been an individual case. Instead, they will be able to systematically analyze which outsourcing scenario applies to them and adopt methods developed for the respective scenario while drawing on the experiences of other companies in comparable situations. The authors based on interviews and the discussion of related work has proposed a four dimensional framework and appropriate scales. Using references to the “outsourced components”, “outsourced activities”, “service individualization” and “degree of independence” dimensions,
respectively, various current outsourcing phenomena are then classified in their study.

Outsourcing decision should be considered as a business issue and firms should invest time and energy in first improving the in-house IT operations. This not only results in a cost effective service-sensitive internal IT unit but can also be a basis for negotiating a successful outsourcing contract, or help organizations in determining which specific functions to selectively outsource (Butler). It has never been an easy task for those involved in the decision making process to decide whether to outsource or in source an activity (Yang and Huang, 2000). But for this, Outsourcing organizations turn over almost all part of the organisation’s information system operations to outside contractors (O’Brien, 1996). Business organizations outsource because of reduced costs and access to new technology (Lacity and Willcocks, 1998).

2.2.3 Operational Feasibility:

Organisations function in a competitive atmosphere. They have to improve their overall performance in the global competitive business environment. Hence, the emphasis has shifted from non core corporate activities to greater focus on business processes. This is likely to bring competitive advantage according to Ngwenyama and Bryson, 1999. Organisations have to produce results in a competitive world and towards achieving this they have to even outsource their business processes (Quinn, 1999). Thus, outsourcing is increasingly seen as a strategy that can be used by organizations to leverage skills and competencies. Consequently, organizations choose to outsource activities for which they lack special capabilities to do
themselves (Quinn and Hilmer, 1994). In general, the reasons for outsourcing may be economic-related, strategic-related and technological-related. Achieving economies of scale is the most cited reasons for outsourcing.

Outsourcing brings some clear economic advantages such as reduction in overhead expenses, eliminating the soaring costs associated with hardware and software maintenance and avoiding unexpected costs caused by the fast development of information technology (Gupta et al., 1992). Outsourcing has been extensively used by many organizations as a means to sharpen their strategic business focus and achieve competitive advantage. It is an effective way to achieve the alignment of business strategy and information technology, which will promote competitiveness.

One of the most familiar forms of outsourcing is business process outsourcing. It is transferring the operations of firm’s business processes to an external supplier. The external supplier who is the service provider, in turn administers the processes according to some predetermine rules and regulations. The transferring of business processes to an external service provider is essentially to accomplish increased shareholder value of the business entity.

Outsourcing involves transferring IT assets, leases, staff and management responsibility for delivery of services from internal IS functions to third party vendors. Recently, outsourcing is gaining importance as an essential strategic tool. Till recently, banks used to conduct their business before the lobbies closed at 3:30 in the afternoon. Today’s fast paced world coupled with a demanding market, place a premium on 24/7 banking services. Banks that provide round-the-clock availability
of services find it more feasible to outsource part of the customer services rather than
double the number of employees. Hence, ninety per cent of new banks choose to
outsource and there is high likelihood of this figure increasing in the long term to
focus on customer service. This is because, efficiency and ability to deliver sustained
quality of customer service are critical to any successful (Dennis Jones et al.)^{23}.

2.2.4 Definitions on Outsourcing:

Outsourcing is any task, operation, job or process that could be performed by
employees within an organization, but is instead contracted to a third party for a
significant period of time. Some important definitions by researchers on the nature of
outsourcing are presented below:

1. “Outsourcing takes place when an organization transfers the ownership of a
business process to a supplier. The key to this definition is the aspect of transfer of
control. This definition differentiates outsourcing from business relationships in
which the buyer retains control of the process, or in other words, tells the supplier
how to do the work. It is the transfer of ownership that defines outsourcing and often
makes it such a challenging, painful process. In outsourcing, the buyer does not
instruct the supplier how to perform its task, but, instead, focuses on what results it
wants to buy; it leaves the process of accomplishing those results to the supplier”
(Bendor-Samuel)^{24}.

2. Outsourcing is the use of external service providers to effectively deliver IT-
enabled business process, application service and infrastructure solutions for
business outcomes (Gartner.com)^{25}. 59
3. In general, outsourcing can be defined as an organisation delegating their non-core functions to an external organisation that provides a particular service, function or product (Hansen, 2009)\textsuperscript{26}.

4. According to Lawler & Mohrman\textsuperscript{27}, outsourcing is the delegating the activities of an organization, which are noncore to an outside third party for their performance.

5. Ashley\textsuperscript{28} gave the definition of outsourcing as “the allocation of risk and responsibility for performing a function or service to another entity”.

### 2.3 REASONS FOR OUTSOURCING

The main reasons for outsourcing in the banking sector are for saving costs and also to focus on core competencies. Banks outsource to reduce the risks and uncertainties of managing their own technology. In general, outsourcing offers many advantages. A recent survey lists cost cutting, strategic reasons, risk reduction and better quality as the top drivers.

In order to understand why and how organizations outsource, they need to know about the drivers of outsourcing\textsuperscript{29}. The major drivers of outsourcing are cost reductions due to lower wages (Kumar et al. 2007)\textsuperscript{30}, but, there are other reasons as well, such as standardization of processes, access to new markets and access to expert resources\textsuperscript{31}. Low overhead costs, low cash reserves and declining growth rates determine outsourcing decisions. Smith et al.(1998)\textsuperscript{32}, are of the view, that the main motives for outsourcing are cost reduction and cash generation. Fritsch and Wullenweber (2007)\textsuperscript{33}, analyzing determinants of outsourcing in the German banking market, have indicated that, while outsourcing is still an element of cost
cutting strategies it is also pursued by well performing banks with a high revenue diversification.

Research scholars who study the reasons behind outsourcing suggest that outsourcing decisions are generally motivated by expected benefits brought by outsourcing. A survey conducted by Cap Gemini Ernst & Young\textsuperscript{34} in 2004 listed cost cutting, strategic reasons, risk reduction and better quality as the top determinants for outsourcing.

According to James Brian Quinn\textsuperscript{35}, today’s knowledge and service based economy offers companies a chance to increase profits through strategic outsourcing of intellectually based systems. The author outlines an integrated knowledge and outsourcing strategy that can mitigate the risks and problems associated with outsourcing. Companies with successful knowledge strategies follow these well accepted principles. First, they concentrate on developing “best in world” capabilities that customers genuinely care about. An effective core competency strategy focuses on two to four cross-functional, intellectually based service activities or knowledge and skill sets. Second, they leverage the capabilities and investments of others by exploiting three areas of intellectual outsourcing: traditional service or functional activities performed in-house; complementary, integrative, or duplicate activities scattered throughout the company, and disciplines, subsystems or systems in which outsiders have greater expertise or capabilities for innovation. Third, they innovate constantly. Finally, they eliminate inflexibilities, such as fixed overhead, bureaucracy and a physical plant, by tapping resources of the downstream customer chain and the upstream technology and supply chain.
Outsourcing decisions should not only be based on the direct effect that it has on an organization’s profits, but also on the strategic effects that indirectly affect these profits (Buehler and Haucap). They give three outsourcing strategies: 1) if additional demand in the input market generates mild input price increases and the fixed cost savings from outsourcing are lower than the benefit that results from rivals sourcing out, a firm should not outsource. 2) Outsourcing will be profitable if the increase in input prices softens competition in the product market considerably. 3) If the input price increases due to outsourcing being substantial, a firm may avoid outsourcing.

Cronk and Sharp in an article on outsourcing discuss the reasons for IT outsourcing. According to them there are differing opinions about the usefulness of outsourcing. They advocate that organizations should make it more preferable for themselves to improve the efficiency of the internal IT department, rather than outsource.

The decision to outsource is generally taken on the premise that external supplier offers a more efficient and cost effective service than in-house department. Friedman discusses the growth of IT outsourcing. He states that there are four main reasons for outsourcing: Focus on core competencies, Speed to market, Saving money and Shortage of IT resources.

Gartner discusses two drivers of strategic sourcing. The first one is the competitive pressure of the market. This forces the management to try and remain
competitive in most areas and try for leadership in others. This can be done by focusing on core business. This impacts the IT systems because the IT systems and processes are expected to link and streamline internal and external processes. The second driver is the inadequacy of the traditional contractual mechanisms to deal with business changes and business relationships.

Kakabadse, A., & Kakabadse, N. (2005)\(^4^1\) based on a survey, state that cost control, desire to achieve best practices, focus on core competence and access to new technologies are some reasons for outsourcing. Banks outsource their financial services for a number of reasons, such as, enhanced performance, costs reduction, access to superior expertise and strategic reasons \(^4^2\).

In 2004, Federal Reserve Bank of San Francisco\(^4^3\) conducted a survey on outsourcing by financial services organisations and has noted a number of motives for outsourcing like operational efficiency, efficient use of resources and quick and reliable service delivery. A case study by Khalfan et al.\(^4^4\) suggest that cost reduction/cost control is not the only prime motivating factor in outsourcing in either the private or the public sector. The most emphasis is on developing skills in technology.

Organisations are driven by the need to reduce costs\(^4^5\), to develop in a changing market conditions (D’Aveni Richard and David J. Ravenscraft)\(^4^6\) and concentrate on
core activities or a combination of these benefits (Kern Thomas et al.)\textsuperscript{47}. In the beginning outsourcing was a means to lower costs of processes and even presently, economies of scale are cited as a major motivation to outsource.

Cost-effective access to specialized skills (Finlay Paul N. and Ruth M. King)\textsuperscript{48} has been regarded as one of the main reasons for outsourcing. According to one study, saving on overhead through short term cost savings (Klein Paula)\textsuperscript{49}, has been regarded as main reason for outsourcing. Until 1990, the driver for outsourcing was the potential for cost savings for the outsourcer. The burden of risk was shifted to the service provider in order to gain access to the cutting-edge technology\textsuperscript{50}.

The main reason for outsourcing was to access better skills according to a study by Cullen et al.\textsuperscript{51}. Another important driving force for outsourcing is management’s perception that by surrendering control of organisation’s IT functions to external service provider, they can concentrate their resources on core competencies (Grover et al.)\textsuperscript{52}. A significant segment of managers do indeed look beyond cost in choosing to outsource, focusing instead to concentrate broadly on a supplier’s commitment to innovation and complementarities of capabilities\textsuperscript{53}.

Arora et al.\textsuperscript{54} in their research paper discusses the growth of outsourcing, its benefits and costs. The paper cites reduction in operating costs, a focus on core operations and improvement in profit margins as the main reasons for outsourcing.

Case studies of UK commercial banks focused on cost management of paper and electronic processing through in sourcing and outsourcing arrangements to change the size/efficiency equation in banking. The analysis discusses the corporate strategy and core capabilities issues behind a number of innovations and illustrates how outsourcing and other third party arrangements alters strategic balance albeit as
a component of overall strategy. The paper elaborates on why outsourcing decisions have been concentrated in particular aspects of banking and discusses the competitive and environmental forces which have contributed to this focus. (Bernardo Batiz – Lazo, and Douglas Wood)

Beaumont has based his research on Australian IT outsourcing. According to him, the outsourcing application development and maintenance is most common. The 3 most important reasons for outsourcing according to him are access to skills, improved service quality and focus on core business.

Saving indirect costs may be one of the drivers for outsourcing. Having fewer employees requires less infrastructure and support systems. According to Hubbard, managing the affairs of an organization will be easier if less people are appointed and instead certain work can be outsourced. This may result in a more efficient organization. Some organizations outsource to achieve better cost control.

Sheehan is of the view that outsourcing is undertaken in order to reduce costs incurred in organizations due to investment in huge, costly equipments while others try to shift fixed costs into variable costs. To survive competition and recession, many companies implemented software outsourcing mainly to cut their costs. Since then cost savings has been found to be the most cited reason for outsourcing as per the views of Takac.

Software outsourcing costs were reduced by 10% to 50% than when software had to be developed in-house (McLaughlin). The capital expenditure involved in investing in software and hardware related equipments were very much high than when organizations outsourced them. Competition and recession made
organisations focus more on the core activities of their business (Prahalad and Hemel\textsuperscript{66}, 1990). The concentration on core activities motivated companies to outsource their non-core activities. One of such non-core activities were related to software. However, the concentration on core competence was not aimed at eliminating non-core activity. It is also reflected in Hendry’s(1995)\textsuperscript{67} argument that the core competence of an organisation should be found in the whole and must be cultivated and developed for competitive success. The importance of core competence gave motivation to software outsourcing (e.g. Gilley and Rasheed)\textsuperscript{68}. The most often cited strategic reason for outsourcing is to allow the organization to focus better on its core competencies (Sislian and Satir, 2000)\textsuperscript{69}.

Thus, it can be concluded that the main reasons for any organization to outsource is reduction of costs, making the best utilization of latest development in technology, concentration of resources on core work and performance of the activities at a cheaper cost and better quality.

2.4 BENEFITS OF OUTSOURCING:

Activities that were traditionally conducted in-house by banks are now being outsourced to specialized providers. The range and the relative complexity of these outsourced activities are increasing which increases the risks faced by banks. Another noticeable trend is the spread of operations of banks across multiple legal entities and jurisdictions. Many such banks pursue opportunities to achieve operational and cost efficiencies by centralizing and consolidating a range of internal activities. The main reasons for banks to outsource certain activities have traditionally been the potential for significant cost savings and the need to focus on
core competencies. Outsourcing allows organizations to enhance expertise, improve service quality, reduce staff, streamline the process, lower costs and reduce the administrative burden and saving time. Outsourcing in this sense, is beneficial to organizational performance.

Outsourcing is the new way of driving innovation, and should be regarded as so much more than a cost saving exercise: the most successful outsourcing strategies make the most of changes in technology, protect intellectual property and take added risk into account. Companies are seeking to innovate by assessing where they can best find the skilled labour to add value to their products. Their outsourcing strategies are reliant on new technology, using modern telecommunications to facilitate sending their back-office processes or projects abroad according to Prof. Ruth Taplin. In their study of German Banking and Finance Industry, Heiko Gewald et al. have said that driven by cost pressure and new competitors, outsourcing is a promising way to focus on core competencies and to restructure the corporate value chain.

Financial and cost benefits are often put forward as the reasons for organizations to outsource but according to L.P. Baldwin, Z. Irani and P.E.D Love, emerging patterns and trends indicate that today’s outsourcing decisions are often motivated by factors other than cost. Political perspectives as well as human and organizational issues, influence the bank’s strategic decision making to outsource certain aspects of its business. Soon Ang and Detmar W. Straub made a study on the US banking industry under the topic “Production and Transaction economies and IS Outsourcing. They argue that a focus on comparative economic theories and models
can improve our ability to explain outsourcing within the larger context of organizational strategy and environment. Specifically, the research talks of production cost, transaction cost and financial slack to understand what influences the outsourcing decision. To empirically test these relationships, information was gathered from senior IT managers in 243 US banks. Financial Indices from the archives of the Federal Reserve Bank were a second important source of data. A result of the study show that IS Outsourcing in banks was strongly influenced by production cost advantages offered by vendors. Transaction costs play a role in the outsourcing decision, but they were much smaller than production costs. Finally, financial slack was not found to be a significant explanatory, although firm size was a significant control factor. The paper has important implications for research and practice. For researchers, the findings provide evidence that financial criteria can be key factors in outsourcing decisions and compare the relative effects of production and transaction costs. For practitioners, the findings suggest that managerial sourcing strategies need to weigh both costs when hiring systems integrators.

The report presented by Alison discusses the benefits of outsourcing, e.g., how some firms use outsourcing as a vehicle to promote change, for instance, as part of a transformation designed to shift corporate structure from a more traditional organization divided along geographic lines to one organized globally along business lines. In a case study, it was concluded that outsourcing services offer sound financial benefits due to economies of scale or specialization.

The emergence of globalization has forced organizations to concentrate on their core activities to remain competitive. This leads one to believe that they have to outsource their non-core processes Chalos Peter and Jaeyoung Sung. Business
organizations have to give more importance to core activities to remain competitive in this present scenario\(^7\). Long term relationships between organizations and service providers can help them enhance their existing competencies and create new ones (DiRomualdo Anthony and Vijay Gurbaxani\(^7\)). Nidthida Perm – Ajchariyawong\(^8\) in a research work on the question of whether outsourcing is a good or bad organizational practice, has said that the positive financial impact of outsourcing overcomes the potential organizational liabilities.

According to a survey, many banks are of the opinion that outsourcing introduces new challenges and risks. The study highlights the benefits of outsourcing as cost reduction, access to better technology and infrastructure and strategy of focusing on core activities. There are both advocates and opponents to outsourcing. Outsourcing offers many advantages such as increased focus on core competencies and reduced costs according to Brian Thoms\(^8\).

Outsourcing for reducing costs may occur when service providers’ costs are low enough that even with added overhead, profit, and transaction costs, they can still deliver a service for a lower price\(^8\). Harler\(^8\), is of the opinion that outsourcers become often more efficient by doing repeated work for organizations thereby achieving efficiency and reducing costs to their clients.

An organization can achieve enough savings to cover an additional layer of overhead and still meet profit requirements\(^8\). It can perform a function for less cost
than another organization already doing the same function. Specialization and economies of scale are mechanisms used to achieve this level of efficiency\textsuperscript{85}. Division of labour leads to more specialization which in turn helps to cut costs and increase the level of efficiency, according to Roberts\textsuperscript{86}.

Saunders et al. (1997)\textsuperscript{87} used these three dimensions of benefits (economic, technological and strategic) and added overall satisfaction to determine the outsourcing success for their study. Lee and Kim (1999)\textsuperscript{88} explored outsourcing success on two dimensions, business perspective and user perspective. The business perspective focused on the sets of economic, technological and strategic benefits that the organization could achieve through outsourcing whereas the user dimension focused exclusively on user satisfaction with the outsourcing arrangement. Outsourcing vendors can provide lower production costs through economies of scale achieved by sharing computer hardware and software among multiple clients\textsuperscript{89}. Service providers are in a position to charge less when they share computer hardware and software among more clients (Krass, 1990)\textsuperscript{90}.

Thus, the motivating factors for the banks to outsource are the focus on core-competencies, turning non-profit activities into profit-generating activities and cost reduction. Competition and recession is considered as one of the main reasons for the growth in outsourcing by banks.

2.5 RISKS IN OUTSOURCING

While outsourcing can bring cost and other benefits, it is also a potential source of strategic, reputation, compliance and operational risks, and thereby increases the
risk profile of banks. Outsourcing is a two-edged sword, though. It harbours particular risks. Banks mainly hesitate to outsource because they fear to lose direct control. Moreover, there is the fact that confidential information is processed outside the firm as well as the risk and cost related to the migration process. Some of the major risks of outsourcing are explained below:

Strategic risks arise due to inadequate expertise or failure to implement appropriate action due to oversight of the service provider. These risks arise when the objectives of the bank and the service provider are incompatible.

The reputation of the bank is also affected when the bank is dependent on a service provider fully and the failure of the service provider adversely affects the ability of the bank to provide services to its customers. There may be the risk of loss of credibility due to inefficiencies of the service provider by which the reputation of banks may get affected.

Compliance risks otherwise known as legal risks arise when the service provider has inadequate compliance with privacy laws and other legal and regulatory provisions. Outsourcing does not diminish the obligations of a bank, especially those of its Board and senior management, to comply with the relevant laws and regulations involved. Banks have to protect secrecy of their customers’ transactions and due to outsourcing, there is the risk of loss of confidentiality of data shared with the service provider.

Operational risks may arise when there is technology failure, fraud or error, or inadequate financial capacity of the service provider to fulfill obligations. There is the risk of conflict of interest if vendor provides similar services to other banks.
Casper Rose\textsuperscript{91} had undertaken a case study in which he has dealt elaborately on the nature of operational risk. According to him, operational risks can be managed efficiently when services are outsourced and by tailoring the risk management framework. Top management must be aware of the increased operational risks that are associated with outsourcing. The management of operational risks has always been a fundamental element of banks’ risk management programs.

The paper presented by Akomode\textsuperscript{92} proposed a model based on analytical hierarchy process for risk management in IT outsourcing. The risk factors in IT outsourcing are identified as performance, technical expertise, commitment, adequate time to volume, quality and adequate forecasting of total cost. The computer simulation presented in the model seeks to help managers in the provision and prediction of useful outsourcing risks information.

In a study conducted by Heiko Gewald and Jochnen Franke\textsuperscript{93}, it is proposed that the risk structure of information technology outsourcing is different from risks in business process outsourcing. Their assessment has been conducted via structured interviews with senior business and risk managers of BPO service providers and BPO customers. Their findings indicate that, although the individual risk types are generally the same, they differ significantly in tendency. Fifteen individual risks were analyzed. Outsourcing has become a growing aspect of international trade and business. When employment is threatened on the domestic front, the concern of losing jobs as a result of outsourcing becomes more intense (Nicole Cubides)\textsuperscript{94}. 
Perceived risks associated with outsourcing strongly influence managers’ intention to outsource operations. Based on an empirical survey of banking and finance industry, they have concluded that perceived risk does indeed have a significant impact on manages’ attitudes towards outsourcing and that these attitudes strongly influence the outsourcing decision. According to their study, financial risks turn out to be a major risk factor for banks which outsource solely to save costs. In addition, the high importance of performance risk requires banks to invest in sophisticated vendor management. The cost of outsourcing has to be borne in the short run in the form of unemployment of certain skilled and unskilled workers. (Arora et al.)

By charting the various items that contribute to risk exposure and by specifically applying the appropriate mechanisms that can target the elements with the higher levels of risk exposure, outsourcing risk can be adequately managed. (Aubert et al) Captain Raghu Raman in his article has said that security is critical when outsourcing banking operations. According to him, the moment a bank outsources, it exposes itself. The degree of safety in outsourcing is in inverse proportion to the cost. In recent times, many banks have been forced to outsource due to the pressures of expansion, competition and widespread cost-cutting initiatives. It is not unheard of for the banking CTOs and process heads to be asked to implement up to 15% cost cutting measures every year. His conclusion was that everything comes at a price.
To ensure safety of data when outsourcing, clients should intelligently assess points of risk and structure the outsourcing agreement to mitigate them (R. Bagby). Critics of outsourcing argue that advantages are not without a price and often times, quality is secondary to cost (Brian Thoms). There will be resistance to outsourcing from the internal IT staff as they give up control. The affected IS professionals should be treated in a fair manner as a smooth outsourcing evaluation and transition period is not possible without their cooperation (Khosrow-Pour et al.).

BoozAllen Hamilton, presents a framework focused on strategic outsourcing decisions. The report identifies six flaws in the traditional outsourcing and classifies them under two heads, decision making flaws and implementation flaws. Under the decision making flaws, the report states that non-core activities are outsourced too automatically, there is insufficient consideration given to full economic impact of outsourcing and that firms generally ignore the cost base. In the implementation flaws, the report states that insufficient attention is paid to the supplier selection, ongoing relationships with suppliers are poorly managed and that firms are unable to transform to manage the new processes and relationships.

According to a survey conducted by European Central Bank in 2004, many banks are of the opinion that outsourcing introduces new challenges and risks. The study also reveals several risks associated with outsourcing namely, operational, legal, strategic risk, reputation risk, loss of flexibility, and loss of control. One of the main risks is that an organisation may become too dependent on the service provider. There could be instances where the provider does not know the business or
company’s practices leading to problems. If the provider does not take the essential strategic perspective, the client may not be able to generate significant improvement over the long run. The service provider’s human resources specialists should be involved before the initiation of the contract (Kralovetz). The biggest risk analysis, done by the firms before outsourcing, concerns the security issues (data confidentiality). The study also suggests that there are differences between the two sectors in their motivation and risk factors evaluation behind the adoption of an IS/IT outsourcing.

Although organizations may outsource for cost related reasons, there are no guarantees that expected savings will be realized. There is increasing evidence that cost savings have been overestimated and costs are sometimes higher after outsourcing (Cole-Gomolski, 1998).

A big problem with outsourcing comes from the workers themselves as they fear loss of jobs (Malhorta 1997). Employees in any organization that outsources, especially, in banks, resist this outsourcing, due to fear of loss of jobs.

2.6 SERVICE PROVIDERS

A service provider may be defined as a business organization that provides outsourcing services. A banker enters into an agreement with the service provider for performance of certain activities of the bank that is not done in-house. Contracts are entered into by bank and service provider that should define the duties, responsibilities and liabilities of both the bank and the service provider. Every bank should ensure that outsourcing agreement addresses the risks and risk mitigation
strategies. Banks should opt for either going in for another provider or supplementing the service provider’s commitments with additional controls to mitigate risk. Effective outsourcing relationships can drive adoption of new technologies and techniques that save the customer money and improve delivery performance.

A poorly or inadequately drafted agreement can increase the risk to both the serviced bank and the service provider. The agreements should be appropriate for the nature and materiality of the arrangement and all items agreed upon during negotiations should be included in the final signed contract.

The key to the right service provider is to choose one with integrity, honesty, efficiency and great communication skills. Although this seems like a formidable challenge, it’s pretty easy to ask the right questions. They should have professional expertise to deal with the assignment of banking operations as per the specific requirements of the client banks.

In choosing an outsourcing vendor a bank should take into account the reliability, reputation, cost, references, experience, quality of service, upgrading potential, commitment, communication, creativity and contract terms and restrictions of the vendor. They insist that the client should ask for a “trial period” to monitor how things are going before signing a regular contract (Jae K. Shin and Joel G. Sieget)\textsuperscript{109}. While beginning an outsourcing relationship, banks need to keep long-term considerations in mind such as whether a current outsourcing vendor will continue to be able to meet the banks strategic needs five to ten years down the road (Dennis Jones et al.)\textsuperscript{110}.
A tight contract is a prerequisite to an effective outsourcing arrangement. Co-operation between the customer and service provider is essential. The most fruitful outsourcing arrangement may be a partnership where the client and the service provider together co-operate in improving business processes and share the resulting benefits (Beaumont). According to the traditional view: cultivate many suppliers, foster competition between suppliers and contracts should be on the basis of combination of quality, price and time of delivery (Klepper).

The factors which need to be evaluated sequentially for making the outsourcing decision are: customer view of function, capabilities and physical assets required to perform function, technological requirements, world class abilities, performance and delivery capabilities versus competitive alternatives, time and cost required to close performance gaps and long term commitment. The most important characteristic is financial solvency of the vendor (Blumberg).

Burnett, in his book, has given opinion about designing and managing contracts for outsourcing. He has dealt with factors involving legal agreements. The chapters in the book deal with aspects of contracts like structure and format of the contracts, selecting vendors, service level agreements and give a useful contract structure. The important chapters in the book are those dealing with charges for outsourcing services, service level agreements, software licensing and how enforceability should be incorporated in the contract.

An article by Everest Group provides a framework for outsourcing contracts. Some of the suggestions for IT contracts are: Start all contracts with the companies’
business objectives; Determine and align clear business objectives with the supplier’s capabilities; Employ internal and external benchmarking to determine current capabilities and costs to help the company set a baseline and refine business objectives; Develop performance and cost targets to develop initiative; Review performance regularly; And decide whether to expand or shrink the relationship with the outsourcer.

The research paper presented by FDIC\textsuperscript{116} suggests techniques that can help the financial institutions to address the challenges of technical outsourcing. According to the paper, selection of a competent and qualified service provider is the most critical part of the outsourcing process. The criteria for selection should be determined in advance to facilitate the evaluation process. The major techniques in the selection process are: To clarify the objectives of the selection process, to identify the qualified providers, evaluation and selection of the providers and negotiating a contract. While evaluating and selecting the service provider, some criteria are suggested like compatibility of the service provider’s vision/value preposition with that of the bank, financial stability of the vendor etc. Some practices have also been suggested to facilitate the evaluation process.

Jayatilka et al,\textsuperscript{117} describe a framework for outsourcing the IS operations. According to them factors other than cost could be important of outsourcing. Their research conclusion states that an organization should consider the knowledge needed for a specific application including availability and location of qualified and knowledgeable IT professionals; the size and complexity of the application and the
compatibility of the application with existing infrastructure; and the risks associated with it.

The article by Mah et al., discusses four potential warning signs in relationship management in outsourcing and the strategies to overcome these issues. Getting into a contract in a rush, without analyzing all aspects is the first warning sign. If this has already happened, both parties need to discuss service levels and other issues that reflect the reality; they should also solve the problem of scope very early to manage the expectations. Having a poor or inadequate metrics framework is another warning about potential problems. To mitigate this, the client and the supplier need to jointly develop a reliable, agreeable measurement framework with the help of metrics subject matter experts. If outsourcing is treated strictly as a transaction, it could also lead to problems. To avoid these joint teams that develop shared identity should be formed. Finally, the contractual dispute resolution clause emphasizing conflict escalation may be a warning too. The parties need to gain a clear understanding of what causes conflict, what kinds of communication tend to sustain and deepen conflict, and what methods can manage conflict most effectively.

A good contract is often the key to a successful IT outsourcing relationship. The contract defines the rights, liability, and expectations of both the outsourcing vendor and the outsourcing customer concerned, and is often the only solid mechanism for regulating the relationship of the parties. Outsourcing contracts are often of high value and last a relatively long time. It is therefore of particular importance to get them right first time. Issues such as service level, transfer of assets, staffing, pricing and payment, warranty and liability, dispute resolution mechanism, termination,
intellectual property matters, and information security are to be discussed with the service providers.\textsuperscript{119}

According to Zaw Zaw Aung\textsuperscript{120} any form of failed outsourcing arrangements put the firm on substantial losses. Not only the financial loss, but there are many forms of losses including losses in – capability, process knowledge, human resource, reputation – which will, at worst, can never be recovered. Companies that outsource should continue to monitor the service providers’ activities and establish constant communication (Guterl 1996).\textsuperscript{121}

Bailey (1997), when investigating collaborative technology development found a significant link between how vendors were selected and the eventual success of the collaborative venture. He discovered that the factors most closely associated with success were technical management, management ability, development speed and compatible aims of the contending company. He also found that giving cost of bid a high weighting in the selection procedure was negatively correlated with having a successful partnership.

A study has shown that service providers often value long-term relationships. Over time, trust and mutually created capabilities means a long term focus is created. The relationship changes from a cost focus to a trust-based relationship as trust is gained on both sides. When this happens the provider gains more control over the processes being outsourced. Capabilities which contribute to mutual benefits are identified (Vivek et al., 2009).\textsuperscript{123} Outsourcing benefits can increase productivity
and/or efficiency so that both the service vendor and outsourcing organisation mutually benefit.

A detailed flowchart of the main focus of this study is presented below:

![Flow Chart of this Study](image)

**Figure 2.1**
Flow Chart of this Study

2.7 CONCLUSION

Ever since the early 1990s when Business Process Outsourcing (BPO) was just beginning to become popular, the main theme has been to “concentrate on what one
can do best and outsource the rest.” Outsourcing is made up of two words – ‘out’ and ‘sourcing’. Sourcing refers to the act of transferring work responsibility to a third party who is capable and competent of delivering the work cheaper and faster. This is to tap into specialized expertise, knowledge, processes and capabilities found outside the organization.

Technologies such as cloud computing, big data analytics and social media, will continue to redefine how banks and their outsourcing providers manage their resources and communication channels to deliver good services to customers. The move towards effectiveness and efficiencies with the help of technology will change the relationship between vendors and bankers from a service provider to a partner who shares risks and rewards. The banks can also rely on their vendor to help ensure compliance with the latest codes of practice from the industry and its regulators. In other words, they can focus on banking, while the vendor focuses on technology.

Outsourcing business activities is not without risks and organizations have to take steps to be careful about the result of the outsourced work. Banks have to be more careful about outsourcing because they have not only to satisfy their customers but also, the customers’ accounts and transactions with them have to be kept secret.

The current study has focused on selected aspects of outsourcing such as risk involved, the quality of outsourced work, and the satisfaction achieved due to outsourcing the bank operations, which have been taken up for analysis based on review of literature on outsourcing. Not much research work has been undertaken on
the perceptions of bank executives regarding the risks and satisfaction of the outsourced work. Hence, to fill up this gap, this study has been undertaken on outsourcing by banks in India.

In the next Chapter an analysis has been undertaken in detail about some of the demographic attributes of the respondents and the different aspects of outsourcing based on the questionnaire adopted for the study.
CHAPTER II - END NOTES


34. Capgemini Ernst & Young -- Survey in 2004.


55. Bernardo Batiz-Lazo, Douglas Wood: Corporate Strategy, Centralisation and Outsourcing in banking: Case studies on paper payment processing.”


90. Krass, P. op.cit.65.

91. Casper Rose; op.cit.76.


