



# OUTSOURCING

Claudia Ružičková, National Bank of Slovakia

*With the growing complexity of banking and financial services and technologies new risks are appearing in the banking sector. These include also a bank's operational risk, a part of which is the risk from outsourcing. The term outsourcing itself can be interpreted in several different ways: in semantic, functional as well as legal terms. In the semantic interpretation we can break the word "outsourcing" down into its two component parts "out" and "source". A functional interpretation would differentiate a service from a purchased service - a purchased service is not included among basic services nor is it the subject of business, therefore companies are getting rid of auxiliary activities that are not economical for them. The legal interpretation does not, however, have any special footing in the Slovak legal code; therefore the legal interpretation of this term is created in the respective contract with the service provider.*

## What is outsourcing?

Examples of definitions of outsourcing in individual countries are contained, for example, in the regulations of Holland and the Czech Republic. According to the regulation in Holland<sup>1</sup> outsourcing is defined as the causing of the supply of services, goods or facilities that form a part of the banking or auxiliary business processes on a structural basis by other group entities or by independent third parties, except in so far as this relates to purchasing. The Czech National Bank defines<sup>2</sup> outsourcing as the supplying of banking activities or activities supporting banking activities by another entity for the bank on a contractual basis.

Most countries in the European Economic Area (EEA), for example Austria, Belgium, Denmark, Finland, France, Greece, Iceland, Ireland, Luxembourg, Norway, Portugal, Spain and Sweden do not have a formal definition of outsourcing, although they have clearly working definitions. It is not, however, completely clear whether all countries have the same understanding of the term "outsourcing". A negative definition of outsourcing would be deemed to mean the situation where activities that are regulated by the banking act or which require a banking licence may not be outsourced. A positive definition of outsourcing would be deemed to mean the situation where banks are permitted to outsource activities. Austria and Ireland have an implicit – negative definition of outsourcing. Five countries have in principle a formal generally positive

definition of outsourcing, covering core banking activities. Some countries in their definition explicitly or implicitly exclude non-core banking activities. Germany has a positive regulatory definition, which is applied as a supplement to banking act requirements. Similarly, UK has a positive definition, covering all services provided to a bank, with a separate definition of material outsourcing of core activities. Italy has the secondary legislation that defines outsourcing very generally, but indicates specific activities that credit institutions are allowed to outsource. Some countries have both positive and negative definitions of outsourcing.

## What leads banks and other institutions to use the outsourcing services of various companies?

First and foremost the reasons are economic – for the same or even lower costs an institution can get a higher-quality service. Secondly, there are professional reasons, since an institution can only with some difficulty keep experts, if it is not able to provide them with sufficient professional work, thereby limiting their professional growth. An example of this situation can be seen in information technology and experts in this field.

On the basis of findings by Deloitte Research<sup>3</sup> it was found that financial institutions around the world, mostly for reasons of cutting overheads (e.g. that a bank cannot afford to pay experts in this field, since development is progressing at such a fast pace), outsource information technologies to countries with lower over-

<sup>1</sup> 4201 Regulation on Organisation and Control, De Nederlandsche Bank N.V., October 2002.

<sup>2</sup> Official Information of the Czech National Bank of 1 October 2001 on the use of outsourcing by banks.

<sup>3</sup> Beth Ellyn Rosenthal: Deloitte Study Discovers 75 Percent of Global Financial Institutions Plan to Outsource Offshore, June 2003.



heads, such as India, Sri Lanka, China, South Africa, the Philippines, Singapore and Malaysia. 33% of respondents replied that they are already outsourcing IT and up to 75% of respondents replied that they will outsource IT over the course of the coming 24 months. In this way financial institutions save around 39% of their overheads. Similarly, as with the outsourcing of IT, the outsourcing of business processes, such as call centres, general processing for human resources, finance and accounting, back office services and life insurance are also being prepared. In the future a hybrid model may arise, where banks will, together with their service providers, create joint ventures, i.e. partnerships of two or more business units, creating an independent unit with the aim of conducting economic activity. In the final result, however, the outsourcing of services (i.e. their provision by means of outsourcing, or with the help of external suppliers) means a reduction in expenses.

Outsourcing for banks on the one hand means certain advantages, though on the other hand is accompanied by certain risks. An advantage for banks is in particular that they can get closer to experts in a certain field and gain a quality of service that they are not able to ensure from their own resources. Risks include, for example, technological disclosure to service providers, as well as deficiencies in outsourcing services that a bank has not secured by a contractual relationship. The main risk to which a bank is exposed in using outsourcing is connected primarily with the protection of banking secrecy (the respective provisions of the Act on Banks concerning banking secrecy may be breached). The bank is therefore obliged to ensure that data on its clients is protected, and it bears full liability for this. Although a bank will ensure data protection through a contract concluded with a service provider, primary liability for data protection remains with the bank itself.

The basis of an outsourcing relationship is the contract concluded between the bank and the outsourcing service provider. No model contract exists; rather, a contract is always drawn up for the specific binding relationship. The contract is always in writing so that there is no doubt as to its content. The contracts used may have a specific name (for example work contract, lease contract, mandate contract) or not (not being explicitly governed in the legal code). The content of the contract should cover the subject of the outsourcing, obligations of the contracting parties, the price for the services provided, contractual treatment of risks ensuing from the outsourcing (protection of the bank against non-fulfilment on the part of the service provider and its failure, the protection of the bank in case of the termination of the contractual relationship, protecti-

on of data and information, liability for damages arisen), the life and termination of the contract (notice of termination, withdrawal from the contract, consequences of these) and the resolution of disputes.

**Most countries have the fundamental principles concerning the use of outsourcing governed directly in an act on banks.** More detailed issues, such as the procedure of a bank in deciding on activities, which it wants to outsource are governed in norms with lesser legal force, such as directives, regulations and decrees. We differentiate two basic types of outsourcing - internal outsourcing, where the outsourcing is performed by a member of the banking group, and external outsourcing, where the outsourcing is not performed by a member of the banking group, but by an external company. In legislative terms, however, the rules do not differentiate between the two. Formal consent of the regulator (the institute overseeing banking activity, whether this is banking supervision or a more or less integrated financial market supervisory authority) to the use of outsourcing is, as a rule, not required. Most regulators, however, are in agreement in their opinion as to the need for outsourcing to be overseen by a regulator, regardless of whether the service provider is a part of the bank's economic group. Some regulators state that activities for a bank that are significant and risky, subject to banking supervision, or those that are subject to banking secrecy may be outsourced only with the national regulator's consent. In the case that the use of outsourcing does not proceed in accordance with legislation and rules stipulated by the regulator, the regulator can prohibit a bank from the further use of outsourcing or impose sanctions.

The basic condition for using outsourcing in individual countries is the prudential management of all activities, including those outsourced. This obligation is stipulated in individual legal regulations. The degree of a bank's prudence in managing outsourced activities must be at least equal to that were the outsourced activities to be performed by the bank itself. Moreover, the bank should have clearly defined principles of managing risks ensuing from outsourcing, where these risks should be also evaluated and quantified.

In general outsourcing is permitted in all EEA countries. The range of activities that may be outsourced is wide. Some regulators state cases where the use of outsourcing is explicitly not permitted. This concerns, for example, the outsourcing of internal audit, where the service provider is not a component of the financial group (external outsourcing) and the keeping of accounts and the preparation of the closing of accounts for the bank's external auditor or the firm with which the external auditor co-operates. Those countries that do have a definition of outsourcing intend also



to have legal limitations on its scope. Most regulators are of the same opinion that the outsourcing of core activities for which an institution holds a licence should be regulated or prohibited and the liability for their management should never be outsourced.

As regards European Union legislation, a legal regulation concerning outsourcing as yet does not exist; currently only a document<sup>4</sup> is prepared, containing a draft of 11 outsourcing principles. The first eight principles concern the policies and procedures of banks, while the last three principles are intended for national regulators. The principles intended for banks include, for example: management responsibility cannot be outsourced; the ultimate responsibility for proper management of the risks associated with outsourcing lies with a bank's senior management; banks should have a policy on their approach to outsourcing, including contingency plans and exit strategies; all outsourcing arrangements should be subject to a formal contract. Activities that may not be outsourced cover fields of corporate planning, organisation, management and control, since these are primary management functions. Important fields that can be outsourced may, for example, include back-office and administrative activities connected with the provision of mortgage loans. As regards peripheral fields of banking activities (for example consultancy services used by a bank such as legal and tax consultancy), there are no restrictions intended for their outsourcing, provided that these do not concern internal control or key banking functions. The principles concerning regulators relate to the possibility to conduct on-site inspections in a provider's premises, the concentration of risks (where a service provider provides outsourcing services to several banks) and to risks connected with "chain" outsourcing, where the service provider uses sub-contractors. The mentioned EU principles are, however, only guidelines for both regulators and banks; they are not legally binding upon them.

**The document of the Basel Committee on Banking Supervision, Sound Practices for the Management and Supervision of Operational Risk<sup>5</sup>** gives a set of ten principles that provide a framework for the effective management and regulation of operational risk. This document is intended for both banks and regulators for evaluating principles and procedures of operational risk management. Since risks connected with outsourcing are to a large extent a part of what is

generally understood to be operational risk, this document focuses also on the issue of outsourcing. According to it, banks should also establish policies for managing the risks associated with outsourcing activities. The outsourcing of activities can, through transferring activities to other entities with greater expertise and scale to manage the risks associated with specialised business activities, reduce an institution's risk profile. The use of third parties by a bank, however, does not diminish the responsibility of the board of directors and management to ensure that an activity of a third party is conducted in a safe and sound manner and in compliance with applicable laws.

**The legal code of the Slovak Republic** does not as yet expressly govern outsourcing, nor contain a legal definition of it. Banks are governed in their business by applicable legislation, mainly the valid Act on Banks and decrees of the National Bank of Slovakia. The National Bank of Slovakia is currently preparing methodological instruction for banks and branches of foreign banks for the performance of activities by outsourcing. This regulation has been based on research in the Slovak banking sector conducted among banks and branches of foreign banks over the course of July and August 2003. The research showed that although outsourcing is not yet regulated in the Slovak Republic it is used to a greater or lesser extent by all banks. The service providers used are mainly Slovak corporate entities, as well as members of the bank's own group (parent, subsidiary and fellow subsidiaries) and building societies, as well as persons – sole traders. Banks use outsourcing in particular for legal, tax and personnel consultancy, information systems and information technology, debt recovery, intermediary activity, and the operation of cash dispensers and ancillary services (property administration, document administration, cleaning services, security services, etc.), activities connected with payment cards and marketing activities.

In conclusion it is necessary to mention that as regards the risks ensuing from the use of outsourcing services, it is necessary to approach them in a similar fashion as regards other risks, meaning that these risks also need to be identified, measured (estimated), monitored and controlled/mitigated. Nevertheless, outsourcing needs to be regulated so that the security of the banking sector is not threatened. In the conditions of the Slovak banking sector, regulation of outsourcing is possible directly in the Act on Banks, in decree of the National Bank of Slovakia or in methodological instruction, which, however, are not binding for banks but merely express the regulator's opinion on a given issue.

<sup>4</sup> High Level Principles on Outsourcing, Groupe de Contact, October 2002.

<sup>5</sup> Sound Practices for the Management and Supervision of Operational Risk, Basel Committee on Banking Supervision, February 2003.