



Western Independent Bankers

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Issue Focus: Best Practices, with an emphasis on Technology Outsourcing

Outsourcing: Five Must-Ask Due Diligence Questions

By Joel Lanz

In their never ending search to enhance service delivery and return to shareholders, many community banks choose to outsource a variety of technical services. Rather than analyze the costs and benefits of outsourcing, this article addresses five questions that bankers must consider in performing due diligence over the proposed outsourcing relationship.

Do you have a SAS 70, and if so, is it a Type II report and what type of exceptions does it contain?

Per the American Institute of Certified Public Accountants, a SAS 70 report is a report provided by a licensed CPA who reports "on a service organization's controls that may be part of a user organization's information system in the context of an audit of financial statements." Rather than having auditors from each of the service organization's review the organization's controls separately, an independent CPA performs the review annually and the results of the review are provided to each of the organization's clients. Without this review, for many banks, it would be necessary for each bank to audit the internal controls of the service organization as they might impact financial reporting.

Generally in a SAS 70 report, the service provider (e.g., outsourcer) identifies the controls that are included in the report. There are two types of SAS 70 reports – Type I and Type II. The primary difference is that in a Type II report, the CPA tests the identified controls in the report to ensure their operational effectiveness. Material exceptions are then included in the report. A better alternative is the new Trust Services Report in which the service provider is assessed against a mandatory guideline.

How does your technology offering help my bank comply with regulatory privacy expectations?

By their nature, information systems store lots of information. And in banking, lots of privacy-related information is kept. The challenge facing bankers is how to manage the information needed to identify cross selling and customer relationship management opportunities while balancing the threat of not adequately protecting client confidential information. For example, has the vendor modified its software so that social security numbers do not appear on every screen or report? Or, does the software provide alternative methods of verifying identity besides using the customer's social security number? Remember, privacy risks not mitigated by the technology will have to be mitigated through compensating manual controls. So you might as well determine how the outsourcer's products help your bank answer all those new FFIEC IT Examination Handbook questions on privacy.

Do you have an independent internal audit function and are they sufficiently staffed and qualified to identify problems at an early stage?

Despite everyone's best intentions, processes and services may not always go according to plan. The same way that the bank's internal auditors test to assure compliance with regulatory requirements and established policies and procedures – so should the outsourcer. If the outsourcer does not have a qualified function to do this – the bank's staff will have to increase their monitoring activity over the outsourcer to ensure that everything complies with requirements and expectations.

How good is your insurance coverage and how does it protect my bank?

Nearly every outsourcer has insurance. The question is what types of risk does the bank face if it engages the outsourcer and to what extent does the combination of the bank's and outsourcer's insurance coverage mitigate the identified risk. It is not unusual for coverage previously obtained to mitigate loss while the service was processed internally at the bank to no longer be covered once the service is outsourced. Involving the bank's insurance specialists in the due diligence process can result in significant dollar savings down the road.

Would my bank extend credit to your outsourcing business?

If your bank would not lend money to the outsourcer, can you trust the outsourcer with your business? Many outsourcers dismiss their poor financial condition by saying that new competitive products and software are being developed by companies that do not appear to be in the strongest financial condition, and as a result, a bank may not be obtaining the latest software that could provide the most competitive advantage. Although there is some truth to this statement, given the risk profile of the average community bank, the benefits of dealing with a financially insecure provider would seldom outweigh the cost of the risk involved.

Conclusion

Bankers can obtain many benefits from outsourcing. However, bankers cannot outsource their responsibility to their customers and stakeholders. Bankers must aggressively manage their outsourcing relationship to ensure that the relationship achieves the hoped for benefits and cost savings.

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