

# Managing the Risks in Information Technology Outsourcing

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**B**efore the evolution of the new economy, many in banking did not view information technology (IT) as providing a strategic advantage over competitors. The community banks outsourced their information technology functions to keep their operations up to date in a cost-effective way and to avoid losing customers to larger competitors. This was a viable community bank strategy.

In the early 1990s, however, larger banks began to see the strategic benefits of outsourcing. In a 1993 *Harvard Business Review* article, Dick Huber, former vice chairman of Continental Bank, commented that certain banks had begun to view IT as strategic: "Two elements of the banking business far outweigh the importance of technology: intimate knowledge of customer needs and relationships with customers." He continued, "At Continental these are our core competencies, not the ability to run an IT department."<sup>1</sup>

Continental was one of the first major banks to outsource a significant portion of its IT functions. As the decade progressed, many other major banks would do the same—some to reduce costs, some to remain competitive, some to survive.

Technology is an important enabler of the new economy. The rapid developments in technology require a phenomenal range of skills to successfully leverage that technology. Investment in hard technology assets is no

longer the most difficult issue. The demand for individuals who can implement and operate the new business models is great, and the supply cannot meet the demand. The needs of the IT industry in general have surpassed most enterprises' ability to individually recruit, develop, and maintain the human assets required to use IT in promoting business strategies.

Only the rare bank has developed and maintained an Internet banking solution by itself. Most banks, large and small, outsource or join alliances to provide critical services to customers. Even banks with no history of outsourcing now rely on new-economy third-party service providers and trading exchanges to compete successfully and survive.

The opportunities to leverage third-party IT resources to enter new markets and serve existing ones have never been greater. For many banks, these opportunities have enhanced stakeholder value—no matter how value is defined in the new economy.

With every opportunity comes risk. This article will help bankers identify and consider the more critical outsourcing risks that require management. As noted below, the Federal banking regulators, while comfortable with the opportunities presented by outsourcing IT, are very concerned that banks understand that they remain responsible for all activities of the bank—those that are performed in house and those that are outsourced. Banks must effectively manage the risks related to outsourcing

in order to leverage the opportunities presented by the new economy and to increase value for all stakeholders.

## THE FUNDAMENTALS OF OUTSOURCING

Outsourcing is a strategic decision to use an outside supplier to perform work that is typically performed within a company. A strict definition of the term covers only activities that were once internal to the company and includes only the process of moving the activity to the outside. Most people involved in outsourcing, however, use a much broader definition. In this sense, the term can be applied to using a third party to service a financial service product for the first time or using a technology provider to move into new delivery channels and markets. Outsourcing also encompasses the enterprise's continued management of the relationship with its provider, or outsourcer, because nothing is more likely to lead to an unsuccessful venture than neglecting a partner.

In many ways, the outsourcing process for the new economy reflects the traditional selection process. It includes all the steps that fall within planning, selection, and management of providers. It differs from purchasing or contracting out, however, in the strategy that drives it. For enterprises that are successful at outsourcing, it is a strategy that allows them to focus talent and resources on improving and expanding activities that generate revenue, minimizing the effort spent on maintaining the infrastructure that supports the core of the business.

In the new economy, the pendulum of corporate identity has swung away from vertically integrated mega-financial services corporations to agile, heavily outsourced entrepreneurial organizations. Many well-known financial service entities have organized dot.com units to leverage the new economy's entrepreneurial spirit. As with any business strategy, however, what works for one bank does not necessarily work for another. A decision to outsource more of a company's business processes should reflect the long-term goals of the bank, not the latest trends in the business community.

The general idea behind outsourcing is for a financial institution to do what it does best and let the experts do the rest. Few banks take this radical approach, choosing instead to outsource only essential processes. Essential noncore processes stay in-house, unless outsourcing offers a strategic advantage.

In general, reducing costs is not reason enough to begin outsourcing IT. Sound reasons should include one or more of the following:

- a change or expected change in market conditions that increases the need to concentrate management efforts and resources on core competencies;
- a well-developed outsourcer market that offers advanced technology, specialized professional expertise, significant capital investments, or innovative solutions and techniques that the company cannot match;
- the opportunity to shorten cycle times for such things as product development, market delivery, or customer response.

Banks have already begun IT outsourcing in areas such as Internet banking, server administration, help desk management, and application service provider services. In the new economy, outsourcing is generally appealing. It is not unusual to hear an executive say, "Tell me why I shouldn't outsource." Most important, these executives must realize that outsourcing is a competitive necessity today.

## ORGANIZATIONAL IMPERATIVES IN THE NEW ECONOMY

To compete in the new economy, banks must be constantly innovating and redefining themselves. They must be among the first to market with new ideas and products. Banks must be able to provide total solutions for their customers, not just individual products. Competition can come from any direction, sometimes without warning. And, the competition may be based on business models that are less than a year old.

The conflict between existing sales channels for retail customers and the Internet is driving change for many banks. A recent *Banking Strategies* article called this internal conflict one of the most formidable challenges facing e-commerce executives: "Most czars lack an independent power base. Many depend on the cooperation and resources of other departments. They have to coax and cajole, and the process of re-directing human and financial resources creates lots of friction."<sup>2</sup>

To support these strategic objectives, both existing and newly forming enterprises need to restructure themselves around five organizational imperatives: focus, speed, flexibility, efficiency, and access to instant information. Outsourcing enables banks to accomplish all five imperatives quickly.

- **Focus.** Management must be focused on the bank's key strategies and supporting areas of competitive

advantage. With the rapid changes in the competitive landscape, management cannot afford to be distracted by internal issues with noncore operations. With such a low cost of entry to many businesses, any competitive advantage of established companies will be short-lived. Keeping up to date with rapid changes becomes the responsibility of the outsourcer.

- **Speed.** The speed of change in the business environment is increasing, so banks need to be able to make and implement decisions quickly. The larger the infrastructure, the slower this ship will turn. Depending on the solution selected, an outsourcing solution can be up and running in a very short time.
- **Flexibility.** Banks need to be flexible to be able to adjust to new competition. Banks may need to adjust to a rapid contraction in some businesses and even more rapid growth in others. This year's strategy may not be optimally supported by last year's organizational structure. Outsourced solutions may provide the flexibility needed.
- **Efficiency.** With the low structural cost of new competition and the price transparency that the Internet offers to consumers, banks cannot ignore inefficient operations. Geography no longer protects against cheaper interest rates, because consumers can use the Internet to shop nationally. Therefore, banks must minimize costs, especially for processes that do not touch the customer and that banks consider to be noncore. If properly managed, outsourced solutions may be more efficient.
- **Access to instant information.** To react quickly, management needs high-quality but instant information to drive decisions; old information is virtually worthless. For example, the old financial reporting process that delivers information a month or more after the event may not be sufficient to compete where product offerings can and need to be refined constantly. The Internet provides no cushion for slow decision making. Outsourcing enables management to keep up technologically with its competitors.

## WHAT RISKS NEED TO BE MANAGED?

Most banks are involved with some element of outsourcing. To achieve the benefits of outsourcing, financial institutions must ask the following questions:

### ***Are performance metrics being actively monitored to ensure the bank is getting the service it deserves?***

This not only helps the bank in receiving the services specified in the contract but also helps to resolve problems with the service provider early before they escalate into much larger problems.

### ***Is the bank actively reevaluating and updating its list of performance metrics on its IT outsourcing contract?***

Some of the bank's initial metric requirements may no longer need to be as tight or may no longer even be needed. Identifying both unnecessary measures and any new metrics that are needed will reduce unnecessary costs and keep the outsourced area aligned with evolving business needs. This will also cut down on the common syndrome where users feel that they are not being provided with what they contracted for, even though their current needs had never been specified in the contract.

### ***Does the bank link compensation to performance in its contract agreements?***

Compensation can be tied with specific performance metrics; it can also be linked with the profits gained or saved based on the bank's previous service experiences. There are many ways of imposing both rewards and penalties based on the service provider's performance. As with the performance metrics, compensation and penalties should be actively reevaluated to get the most out of the outsourcing partnership.

### ***Does the bank have processes in place to document the service provider's understanding and adherence to the bank's internal standards, policies, and regulatory requirements?***

Banks that outsource work cannot outsource their legal or customer obligations. As discussed below, recent regulatory guidance reinforces a bank's obligation to properly manage its service providers. Consider whether your outsourcer shares your bank's respect for and compliance with FDIC Improvement Act (FDICIA) and regulatory requirements. This is especially relevant to a number of the new Internet Service Providers that currently serve the financial services community.

### ***Does the bank view the outsourcing as a business partnership or as a quick fix or low-cost solution?***

Terminating one outsourcer and entering into a new arrangement with another can be very costly, both monetarily and in terms of service disruptions during the transition to the new outsourcer. The more the two entities

work together and adapt to each other as business strategies and technologies change, the further ahead both will be. Therefore, many businesses now consider their service providers to be outsourcing or alliance partners.

***Does the bank's contract take into consideration evolving technologies or the potential regulatory requirements that may develop?***

In the new economy, technology is developing at a rapid pace. The current services, skills, and technologies provided by the bank's best-fit provider of today will probably not keep the bank at the head of the pack two years from now—or even one year from now. As the bank's business plans mold to the evolving market and as new technologies appear to enhance its ability, the bank's outsourcing provider also must adapt. If the appropriate contractual plans don't exist already, ensure they are included during the bank's next contract negotiation. If not, the service provider will continue to provide what the bank initially contracted for and at a very nominal rate to the provider. The cost to your bank in missed opportunities, however, will not be so nominal. In addition, as regulatory expectations change to reflect new issues in the economy and in technology, the bank's outsourcer needs to demonstrate its ability and willingness to adapt accordingly.

## **REGULATORY GUIDANCE**

The various regulatory agencies have long had an active interest in how banks manage their outsourcing. For example, chapter 22 of the Federal Financial Institutions Examination Council (FFIEC) IS Examination Handbook provides an excellent overview of the key risks involved with using an outside service provider. To reflect the increasing reliance on services provided by other entities in support of a large range of banking operations, the Board of Governors of the Federal Reserve System (Fed) issued Supervision and Regulation letter SR 00-4 on February 29, 2000.

SR 00-4 reiterates and provides further clarification of the Fed's expectations about the management of risks that may arise from the outsourcing of critical information and transaction processing activities by banking organizations. These guidelines currently apply only to a bank's outsourced services and do not apply to outsourced products purchased or licensed from technology vendors (that is, computer systems and application software).

The letter describes the Fed's expectations that the same risk-management strategies that a bank would use

for in-house services will be used when the service is outsourced. Because banks may not maintain direct control of key processes when outsourced, reliance is then placed on the service provider to adhere to the various regulatory and control procedures.

For U.S. operations, the Fed identified eight general risk categories that banks should address as part of their outsourcing oversight program: risk assessment; selection of service provider; contracts, policies, procedures, and controls (PP&C); ongoing monitoring; information access; audit; and contingency plans. Specific issues pertaining to service providers located outside the United States were also identified.

SR 00-4 provides a good reference for managing a bank's outsourced services. Of particular note is an excellent paper by the Federal Reserve Bank of New York (FRBNY), "Outsourcing Financial Services Activities: Industry Practices to Mitigate Risks" (October 1999). This white paper discusses prudent business practices developed by financial service institutions to mitigate outsourcing risk. Exhibit 1, which details risk-mitigation strategies, is an excerpt from the white paper's appendix.

## **BEST PRACTICES FOR MITIGATING OUTSOURCING RISK**

We have found that banks with solid outsourcing track records begin with a clear sense of the competencies that make them unique and give them strength in the market; these are their core competencies. Outsourcing these core competencies would bring excessive risk—a loss of the expertise and skills that characterize the bank and that shape its products and services. The following are critical best practices.

*Develop an IT outsourcing strategy that reflects the bank's strengths and its vision.* Deciding to outsource an IT-related process or service usually results in considerable change: Employees will be affected, overhead costs will change, management focus will shift, and cycle times will shrink. Without a cohesive strategy that recognizes the potential for change, fragmented IT outsourcing activities can lead to problems that snowball into customer dissatisfaction. In developing strategy, banks should consider their sensitivity to this risk.

Developing a strategy with realistic financial goals is crucial. Outsourcing may reduce costs, including wages, salaries, and benefits, but these savings are generally short term at best. The real financial advantages lie with allowing IT management to focus time and resources on what

## EXHIBIT 1

### Industry Practices for Mitigating Outsourcing Risk

#### *Managing and monitoring the outsourcing arrangements*

1. The board of directors and senior management must retain accountability for any outsourced activity. They determine the strategic role and objectives for the outsourcing arrangement and provide necessary approvals.
2. Create a management structure to establish, manage, and monitor the outsourcing arrangement.
3. Create cross-functional teams, including internal audit, information security, human resources, legal, and the business units, to ensure a broad representation of viewpoints and to enhance institutionwide support.
4. Retain key individuals from the outsourced function to manage and monitor the outsourcing arrangement and to provide future strategic direction.
5. Monitor the relationship actively, respond to problems and issues aggressively, employ escalation procedures promptly, and engage in conflict resolution.
6. Identify objective and quantifiable performance measures that are well specified, relevant for the supported business units, mutually agreed to, and are readily comparable with established criteria.
7. Periodically review, renegotiate, and renew the contract. Reset target service levels annually.

#### *Selecting a qualified vendor*

8. Perform due diligence on the service provider to ensure technical capabilities, managerial skills, financial viability, familiarity with the financial services industry, and a demonstrated capacity to keep pace with innovation in the marketplace.

#### *Structuring the outsourcing arrangement*

9. Negotiate a written contract that is operationally flexible and that clearly articulates the expectations and responsibilities of both sides.

#### *Managing human resources*

10. Involve the human resources department early in the process when staff is to be released or transferred to the service provider. Incorporate these issues into the contract and proactively communicate with the staff.
11. Clearly define expected security controls in the outsourcing contract and develop appropriate performance measures to monitor consistent application of those controls.

#### *Establishing controls and ensuring independent validation*

12. Involve internal and/or external audit in the entire outsourcing process.

#### *Establishing a viable contingency*

13. Ensure that contingency plans are formulated and viable in the event of nonperformance by the service provider.

Source: Federal Reserve Bank of New York, "Outsourcing Financial Services Activities: Industry Practices to Mitigate Risks" (October 1999): page Appendix B.

the bank does best and where it earns most. The need to invest in new capital equipment also often leads a bank to consider outsourcing.

*Outsource IT processes in which the bank lacks expertise or where it is difficult to achieve efficiency.* Processes and services that do not make the bank unique and are not necessary to the continued success of the bank are candidates for outsourcing. The bank is apt to be less than competent in many of these areas. The first and most obvious candidates for outsourcing are generally functions such as network management and help desk administration.

*Work with trusted outsourcers, yet clearly communicate expectations in the contract.* The success of outsourcing depends a great deal on the outsourcer selection process. For some activities, one or two people may be able to select the outsourcer and transfer the process. This is typical of commodity services with a deep, experienced outsourcer market, such as photocopy services or garbage removal. For other activities, people from several areas of the company may need to shape the overall expectations for an outsourcer, identify the best outsourcer available, and transfer the process to the outsourcer.

Best-practices companies put together an outsourcer selection team that includes representation by all potential users. Members of this team will help write the request for proposal (RFP), review proposals from candidates, and interview final candidates. The RFP should be thorough enough to allow all candidates to develop a realistic solution with accurate prices. Withholding information needed to determine the level and scope of work will lead to outsourcer failure, frustration, and lack of incentives to perform.

Visits to the outsourcer's place of business help verify proposal informa-

tion, confirm the outsourcer's ability to handle the proposed volume of work, and provide a preliminary check of the outsourcer's ability to perform as expected. In addition, reference checks can provide invaluable insights into an outsourcer's loyalty, integrity, and willingness to satisfy its customers or trading partners.

Many outsourcers offer a standard contract to expedite the approval process. Outsourcing contracts can be full of loopholes; with a standard contract, the outsourcing company is apt to be the victim. Even a bank that outsources a number of processes will not have the experience of an outsourcer. An experienced lawyer should help with negotiations and contract preparation.

In addition, companies should create a replacement plan in case they have to switch outsourcers. Most companies do not have the expertise or staff needed to bring a process quickly and smoothly in-house; a well-thought-out transition plan can minimize the potential for costly delays and customer dissatisfaction.

*Create an integrated team of company and outsourcer staff to manage the transition or start-up process and oversee ongoing performance.* Many companies fail in their attempts at outsourcing because they neglect the one group that has the greatest power to make it successful: employees. Transition planning should begin when the bank first considers outsourcing. Ideally, both the bank and the outsourcer should involve their human resource experts early in this planning process. The plan should describe the business process transfer activities, bank and outsourcer roles and responsibilities, and any changes in employee salary, wages, and benefits.

Best-practices companies choose an outsourcer that is prepared to address human resource issues before the contract is awarded. A potential outsourcer who does not explore these issues early in the bidding process will fail to consider not only cultural issues that will affect employee performance but also factors that could lead to costly legal disputes.

Banks must also minimize the impact of the outsourcing decision-making process on employee productivity and morale. The uncertainty that employees face during the transition will directly affect work output. Keeping the transition process short and communicating openly and often will help minimize doubts. The more information a bank can provide to its employees once they know their work will be outsourced, the less acute their uncertainty.

Banks should closely monitor the transition process, including progress, service levels, employee morale, and cost savings. The interfaces between internal processes and outsourced processes should also be monitored.

#### *Link outsourcer compensation to outsourcer performance.*

The first step in tying outsourcer compensation to performance is to identify performance measures. The next step involves collecting baseline measures before the outsourcer takes over.

Outsourcer performance requirements should specify 100% of the outcomes. If an outsourcer must meet 90% of all service requests within three days, the other 10% may never be met. Holding the outsourcer fully accountable would mean specifying performance levels for this 10%. In this case, full accountability might mean meeting 90% of all service requests within three days and the balance within five days.

Best-practices companies provide incentives that encourage peak performance from outsourcers and include penalties for substandard performance. Cash penalties may fall short of compensating a company for the full extent of its losses in the case of extreme nonperformance. But by including a cash penalty in the contract, the company will be able to get the full attention of the outsourcer's top management if performance starts to slip.

The contract should distinguish between critical measures that the outsourcer will be penalized for failing to meet and noncritical measures. For noncritical measures, the outsourcer may face significantly smaller penalties or the thresholds for nonperformance may be lower.

In addition, financial measures should be adjusted for inflation. Without this, faltering performance may appear to be consistent performance, and average performance may actually be superior performance.

## CONCLUSION

A recent Arthur Andersen survey, "Thriving in the New Economy: Perception vs. Reality," found that a significant number of respondents expect total (21%) or partial (51%) outsourcing to support e-business. This might reflect survey participants' expressed concern about making the wrong decision with regard to the e-business approach. It may also signal the trend to use third-party providers as a proactive strategy, recognizing that to compete in a market that is growing exponentially, only the larger providers will be able to deal with scalability and process transactions cost-efficiently.<sup>3</sup>

In the new economy, outsourcing plays a significant and financially beneficial role. But ignoring its risks can have a negative financial impact. By understanding the risks and regulatory requirements, your bank can apply outsourcing best practices to succeed in the new economy.

## ENDNOTES

<sup>1</sup>Richard L Huber. "How Continental Bank Outsourced its 'Crown Jewels.'" *Harvard Business Review* 71, 1 (January/February 1993): p. 114.

<sup>2</sup>Elizabeth Judd. "Leap of Faith." *Banking Strategies* (May/June 2000): pp. 37–44.

<sup>3</sup>"Thriving in the New Economy: Perception vs. Reality." p. 14. For a complete copy of this Arthur Andersen survey, e-mail Joel Lanz, joel.lanz@us.arthuranderson.com.