Offshore outsourcing in the EU financial services industry

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Introduction

Offshore outsourcing of services has received an enormous amount of attention in the media and political circles in recent times. In just five months, between January and May 2004, there were 2634 reports in US newspaper on service offshoring, mostly focusing on the fear of job losses. Firms have been accused of "exporting jobs" to developing countries. These concerns are not limited to the United States. The debate is equally vigorous in Europe where the threat of competition from Eastern Europe and China is raising intense anxieties. For example, 380 reports on offshoring appeared in UK newspapers during the same period[2].

All this media hype would lead one to believe that offshore outsourcing is some new phenomenon that has exploded. What is new about offshoring today is that it is increasingly in services. The growing offshoring of services in industrial countries is a reflection of the benefits from greater division of labour and trade that have been described for manufactured goods since the time of Adam Smith and David Ricardo. In the past, the service sector was largely considered impervious to international competition. With improvements in communication technologies, such as the Internet, services can now cross national borders. Although service offshore outsourcing still remains a small fraction of individual countries' GDP[3], it is without a doubt the newest chapter in the globalisation debate.

But outsourcing, let alone its consequences, does not appear to be widely understood. Some people interpret it to mean outside the firm, and others outside the country. Media and political attention seems firmly focused on offshore outsourcing, even though domestic outsourcing is also common. So, the nations still has much to learn about offshoring, and existing data is not adequate to the task. Besides management consultant reports[4], there is indeed very little empirical economic research on service offshoring. Therefore, we thought it would be useful to examine this phenomenon to distinguish facts about offshore outsourcing from exaggerated claims.

Drawing on the experiences of the United States, we can say that, in the aggregate, job losses in one industry often are offset by jobs created in other growing industries[5]. Moreover, Americans' economists[6] argued that offshoring contributes to lower inflation and higher productivity, meaning that the overall economy will grow faster. Catherine Mann (Institute for International Economics) has estimated that US GDP growth would have been lower by 0.3 percent a year between 1995 and 2002[7] without offshore outsourcing of jobs in information technology[8].

Concerning Europe, the European Monitoring Centre on Change (EMCC) has published data[9] for major European company restructuring since the beginning of 2002. Results from January 2002 to June 2004 are presented in *Table 1*. As in the case in the US economy, offshore outsourcing is directly

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2 According to a report by Roland Berger Strategy Consultants and UNCTAD (2004), UK companies represent more than 60 percent of all service jobs offshored (in terms of total volume). It's the first comprehensive survey on the offshoring strategies of leading European companies (polled a representative sample covering more than 20 percent of total revenues of Europe's top 500 companies).

3 Amiti M. and S.J. Wei (2004) « Demystifying outsourcing: The numbers do not support the hype over job losses », Finance & Development, December.

4 Looking forward, perhaps the best-know projection is by Forrester, an information technology consulting firm, which expects the number of US jobs outsourced to grow from about 400.000 in 2004 to 3.3 million by 2015. If this estimate turns out to be accurate, then offshoring could result in roughly 250.000 layoffs a year. Goldman Sachs has estimated that offshoring has accounted for roughly half a million layoffs in the past three years. According to the McKinsey Institute, for every dollar of US services activity offshored, a net gain of 12 to 14 cents is generated.

5 Amiti M. and S.J. Wei (2004), "Fear of service outsourcing: Is it justified?", IMF Working paper, n°186, October; L. Brainard and R. Litan (2004), "Offshoring service jobs: Bane or boon and what to do ?", Policy brief, Brookings institution, n°132; C. Schultz (2004), "Offshoring, import competition and jobless recovery", Brookings brief.

6 Mann Catherine (2004), "Global sourcing and high-tech jobs: Productivity gains and policy challenges", presentation at the Institute for international economics, March 11; Council of economic advisors (2004), "Economic report of the President".

7 Indeed, lower inflation and higher productivity have allowed the Federal Reserve to run a more accommodative monetary policy.

8 Mann Catherine (2003), "Globalization of IT services and white collar jobs: The next wave of productivity growth", International economics policy brief, n°11, December.

9 These data include restructuring that affect at least one EU country and entail an announced or actual reduction of at least 100 jobs. Cases are identified through a press review of daily newspapers and business press in the 15 old EU Member States. Almost 80 percent of the total volume of services jobs offshored is involving less than 300 jobs per project (Roland Berger and UNCTAD, 2004).

responsible for only a very minor part of large-scale job losses in European countries, although like in the US, offshoring may be included in other categories such as "Internal restructuring" or "Relocation". Considering the extent of political tension regarding offshore outsourcing, it is remarkable that these data – with their significant caveats and limitations – indicate that the phenomenon has a relatively small effect on both US and European labour markets, relative to other sources of job losses. Although the significance and implications of this finding may be restricted, the finding demonstrates that the political storm from offshore outsourcing has little to do with the sheer number of job losses.

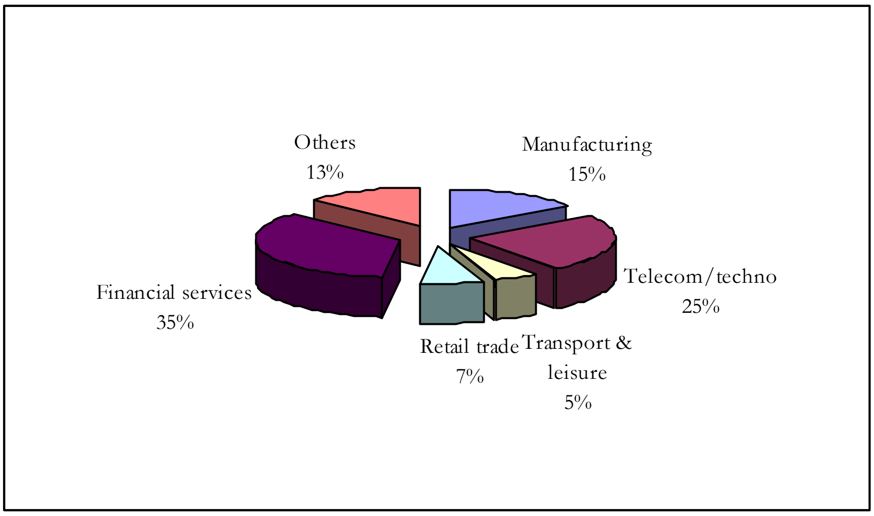
Table 1. Job losses associated with major European firm restructuring

Type of restructuring	*Planned job reductions*	*% planned job reductions*	*Number of cases*	*% of cases*
Internal restructuring	560.557	75.8	860	64.5
Bankruptcy / Closure	100.666	13.6	296	22.2
Relocation	36.513	4.9	91	6.8
M & A	22.884	3.1	48	3.6
Offshore outsourcing[10]	18.335	2.5	13	1.0
Other	820	0.1	26	2.0
Total	**739.775**	**100**	**1334**	**100**

Source: European Restructuring Monitor (2004).

The current offshoring debate is highly charged, both emotionally and politically. Yet the discrepancy between the public perception and actual magnitude of this issue is quite considerable, calling for a more objective approach to the subject. While service offshoring has become established practice and has already been addressed by various studies for the US, it has only recently attracted public attention in Europe. Given the attractiveness of the phenomenon[11] and the potential implications for competitiveness at all levels of development in Europe, there is a need for more analysis on the corporate strategies underlying this trend. In that way, our study will describe the offshoring phenomenon from the European financial services industry point of view. Why this sector? Although offshoring is a trend across all sectors, several consulting studies have shown that the offshore outsourcing scene is currently dominated by banks and other financial services firms (*see Chart 1*).

Chart 1. Offshore market distribution by sector



Source: Deloitte Research (2004).

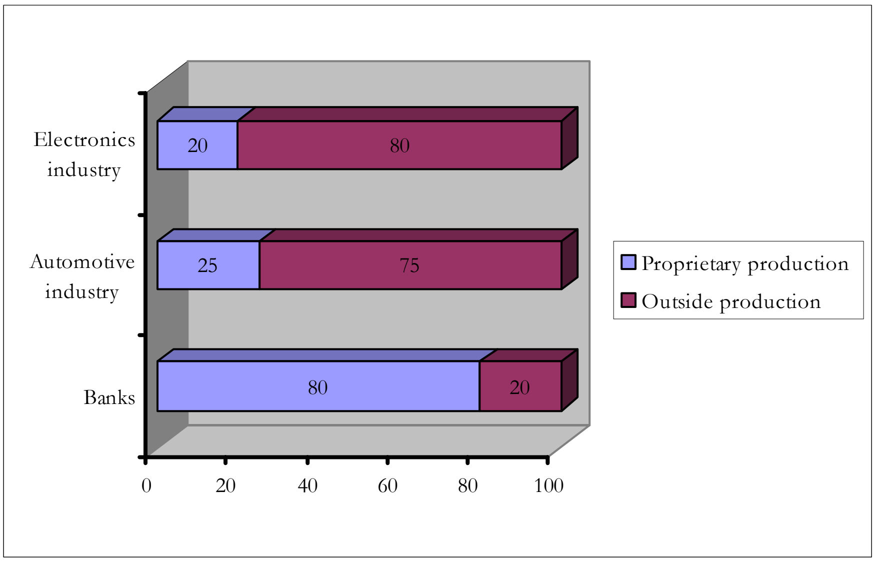
In the financial services industry, outsourcing has been in use for quite some time. For example, since the 1970s, financial institutions have used outside firms for such clerical activities as printing customer financial statements and storing records. As Information Technologies (IT) evolved during the 1980s and 1990s, financial services firms began to outsource a great variety of IT activities as means of

[10] European Restructuring Monitor (ERM) does not distinguish between outsourcing and offshore outsourcing.
[11] According to Roland Berger and UNCTAD report (2004), more than 40 percent of companies polled have relocated services in the past. Regarding future activities, almost half of all companies are planning to offshore (further) services within the next years. Companies that have offshored in the past are generally the ones that are also planning to offshore in the future.

lowering their costs and gaining faster access to up-to-date technology. Currently, more strategic areas are also becoming subject to outsourcing. As attention turned increasingly to efficiency and the need to focus on core businesses and as transaction costs started to drop (i.e., outsourcing service providers were able to reduce costs), financial institutions started to outsource a growing share of their activities[12].

The financial services firms have several common features that might predispose them toward using a large degree of outsourcing. Specifically, in the course of their businesses, they handle large volumes of information, in both paper and electronic form, and they typically provide customers with a wide variety of related services. The sheer volume and breadth of these activities present compelling reasons for outsourcing particularly to technology service providers that have developed expertise in specific business applications. Moreover, the high potential to "industrialize" is one of the main reasons for outsourcing in financial services. Banks tend to be much stronger vertically integrated than the manufacturing sector. German banks, for example, create 80 percent of their products and services themselves, compared with 25 percent in the automotive sector (*see Chart 2*). Concentrating on core competencies not only helps to cut costs but also to gain strategic advantages.

Chart 2. Vertical integration of different sectors in Germany



Source: Deutsche Bank Research (2004).

Financial institutions around the world are under constant pressure to cut cost while simultaneously increasing revenue. In response, many are shifting more and more business processes to countries like India and China with dramatically lower wage rates. This practice, know as "offshore outsourcing or offshoring", is fundamentally changing the way financial institutions do business. In 2003, Deloitte Research estimates the number of offshore jobs in financial services has increased by a factor of five. More important, offshoring has created a truly global operating model for financial services, unleashing a new and potent competitive dynamic that is changing the rules of the game for the entire industry.

The main objective of this paper is to investigate and to establish what are the facts and implications about offshore outsourcing in the EU financial services industry. Section 1 defines briefly the various aspects and concepts of outsourcing. Section 2 describes a set of recent stylised facts in the financial services industry. Section 3 first depicts business models used and activities subject to outsourcing, and then proposes the corresponding motives cited by the European banking sector. Finally, section 4 expresses EU banks' opinions on the risks of outsourcing and what regulators do to mitigate these risks. These two sections are mainly founded on a March-April 2004 survey of 82 individual banks[13] from nineteen EU countries and the aggregated answers from 24 European supervisory authorities.

[12] See "Banking behind the scenes", the McKinsey Quaterly (2002), for a review of the outsourcing behaviour of over 30 institutions in Western Europe for 11 specific ICT-related. The study find the market for outsourcing in European banking is large and rapidly expanding.

[13] This survey untitled *Outsourcing in the EU Banking sector* was conducted by the authorities represented in the BSC (European Central Bank). Each Member State was asked to survey a maximum of five banks. Banks were selected to reflect both large and small banks, without prejudice to the importance and role of outsourcing in their organisation.

Section 1. Definition: What's in a name?

Before we explore the magnitude of the offshoring trend in the EU financial services industry, it is useful to distinguish between two different terms frequently used interchangeably in the debate: Outsourcing *vs* offshoring. A common misperception exists (*see Table 2*).

Outsourcing refers to firms purchasing services from outside specialist providers. Conversely, the word "Insourcing" refers to the production of something inside a company. Outsourcing can be domestic or abroad. Abroad outsourcing is part of a country's imports (good and services). A specific feature of outsourcing is that the direct control over these operations is shifted to the external service provider, which can be an intra-group company or an independent third party. This type of activity is as old as at least the industrial revolution, and basically refers to firms specialising in what they do best and leaving the rest to others. It is a crucial process in which firms engage to remain cost-competitive and raise productivity.

Offshoring – named also "Offshore outsourcing" – refers to purchase by firms of services from foreign providers[14]. Offshoring is in vogue, i.e. the relocation of business processes to lower-cost locations abroad. Often these activities are carried out by external providers (offshore outsourcing), but this organisational distinction need not necessarily be the case. They can also be provided from within the company itself (in-house or "captive" offshoring), for instance by subsidiaries or company units abroad, or by joint ventures and strategic alliances. The growth of services offshoring is linked to the availability of reliable and affordable communication infrastructures.

Table 2. Service provision typology

	Domestic	*Abroad*
Internal	Insourcing	In-house (or "Captive") offshoring
External	Outsourcing	Offshore outsourcing (or "Offshoring")

While outsourcing has occurred for many years, offshoring is a relatively recent phenomenon. At least four factors have driven the recent rapid rise in offshore outsourcing: Technological innovation, free trade, possible cost savings and access to a large pool of skilled English speaking labour outside the home country.

We found it useful to differentiate the potential benefits of outsourcing and offshoring. Each of these models, which can be applied independently or combined, has distinct advantages in specific situations and provides different sets of benefits. For example, "captive" offshoring is likely to be more attractive where the issues of control and confidentiality matter. But, firms more focused on general cost-cutting are likely to make more widespread use of external agents (outsourcing or offshoring strategies).

Section 2. General trends in the financial services industry

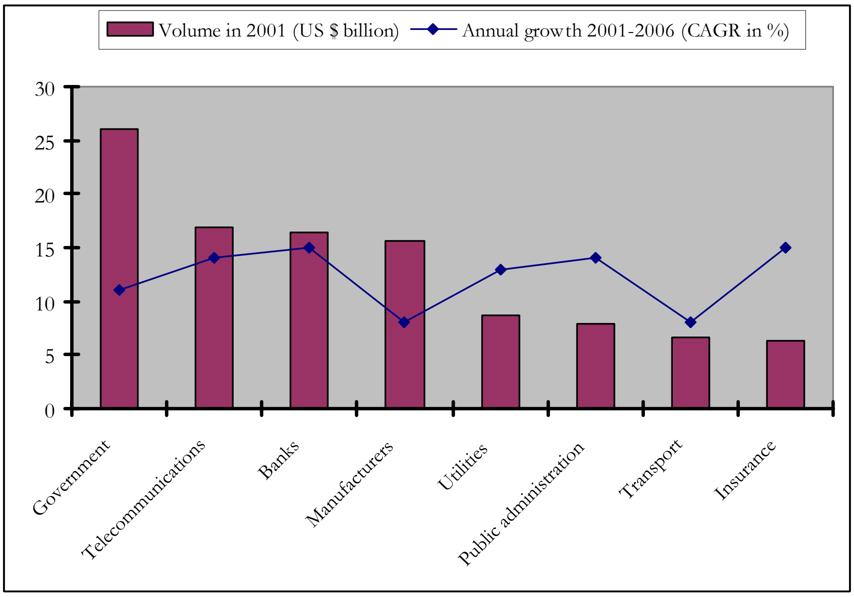
2.1. Outsourcing

The financial industry has a long tradition of outsourcing but public interest has developed only in the last few years. The number of outsourcing contracts in the financial services industry rose from 2 in 1991 to an estimated 52 in 2003. Banks were pioneers in this field and still account for the lion's share. However, insurance companies have been catching up, particularly since the turn of the millennium.

Outsourcing continues to play a major role in the financial services industry. Compared with other sectors, banks and insurance companies show the strongest dynamic in outsourcing (*see Chart 3*). According to Roland Berger (2004), outsourcing in Western Europe's financial industry will grow by 15% per year up to 2006. More and more IT are outsourced by the financial sector. As technology has evolved, outsourcing of information services has become more common. IT infrastructure made up two-thirds of the global outsourcing deals between 1990 and 2003 (measured by value of the deal).

[14] Cooperation between partners on the same continent is termed "Nearshoring".

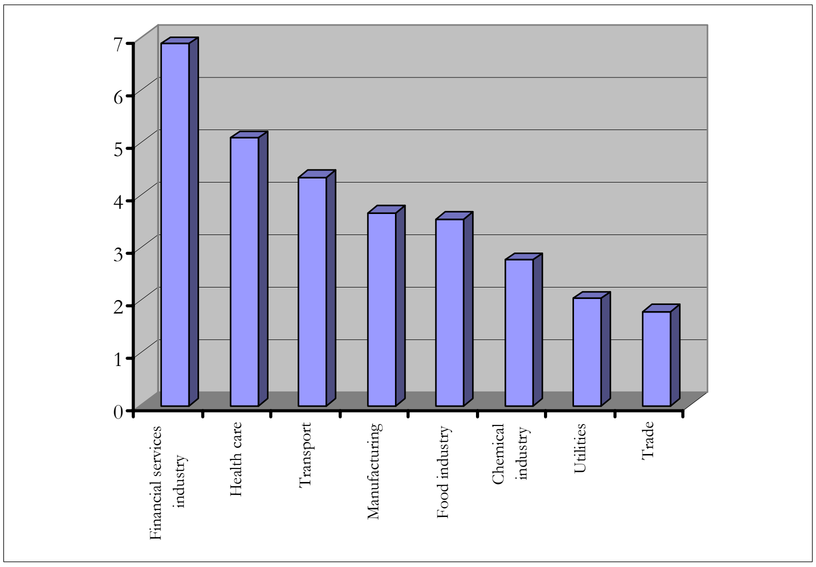
Chart 3. Outsourcing in different sectors / Western Europe



Source: Roland Berger (2004).

Relatively speaking, the financial services industry has the largest IT budgets (*see Chart 4*) and IT spending for the Western European banking sector will have an average compound annual growth rate of 5.6 percent between now and 2008 according to Celent Institute (2004). IT plays a major role in banking industry and it will even gain in importance in the future as the number of electronic cash transactions is still growing. The IT-driven transformation of banks has not yet come to an end. Financial services firms give priority to their IT organisation's potential to reduce the company's overall operating costs and improve the productivity of the workforce.

Chart 4. Relative IT spending in different industry (% of revenue)



Source: Metagroup (2004).

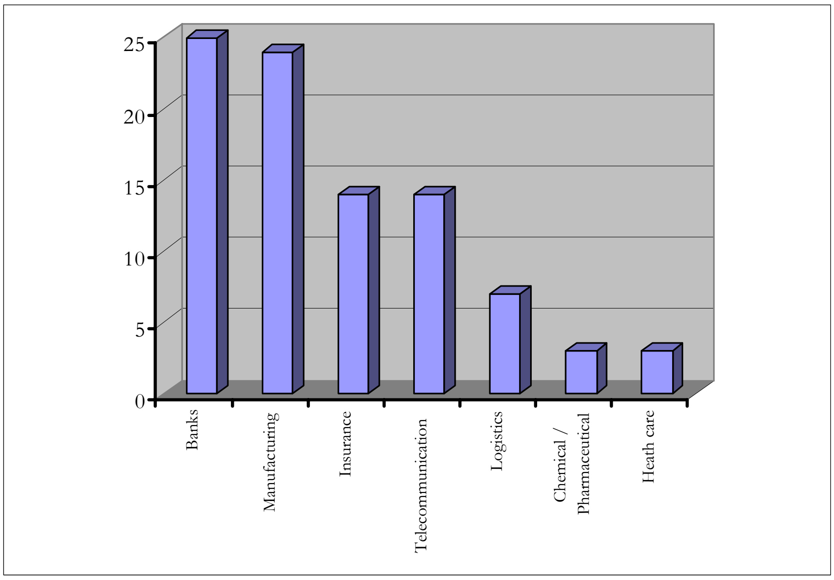
Recently, we also have seen a growth of outsourcing in more strategic areas such as human resources, accounting/finance and "business processing outsourcing" (BPO), i.e. outsourcing of a business line or process in its entirety. BPOs also mean that the relationship between the outsourcer and the third party changes somewhat as the latter becomes more a strategic partner than a traditional supplier.

Such growth could be seen as part of a trend away from outsourcing of specific tasks towards more strategic operations.

2.2. Offshoring

While offshoring is a trend across all sectors, the financial services industry in particular is keen to relocate processes and job to low-cost destinations (*see Chart 5*) and it can achieve the greatest savings from offshoring operations. Since insurers first and banks second typically have a plethora of IT-based processes and corresponding costs, they harbour the biggest cost-savings potential to be tapped *via* offshore outsourcing. Banks can save 8-12% of their overall costs, and insurers as much as 10-15%.

Chart 5. Sectors that tend to go offshore (% of industry)



Source: Metagroup (2004).

Offshoring is not suitable for all tasks in the financial sector. But as offshoring gains momentum, financial institutions will likely move a broader range functions to lower-cost locations. Within few years, all types of business processes will be offshored and not just IT operations (applications development, coding and programming). Indeed, most kinds of services are potential candidates for future offshoring (transaction processing, accounting/finance, human resources, administration and call centres notably). There are less and less "sacred cows".

India attracts the most financial services companies. Several studies show around 80 percent of all financial service offshoring takes place in India. India's scale, skills, culture and governance are the primary factors for its success in attracting financial services operations. Large internationally operating banks like HSBC, Citigroup and General Electric Capital employ approximately 22.000 people in India alone (*see Table 3* where approximate staff numbers are indicated in parentheses).

Anecdotal evidence suggests that China, Malaysia and the Philippines are also seen as desirable outsourcing locations. In the future, we expect that offshore activity will extend around the Indian Ocean Rim, encompassing markets in South Africa, Malaysia, Australia, China and Singapore. Nonetheless, the "hub" market will be India, potentially accounting for as many as one million new positions from offshored financial services.

Table 3. Financial services companies in India (2003)

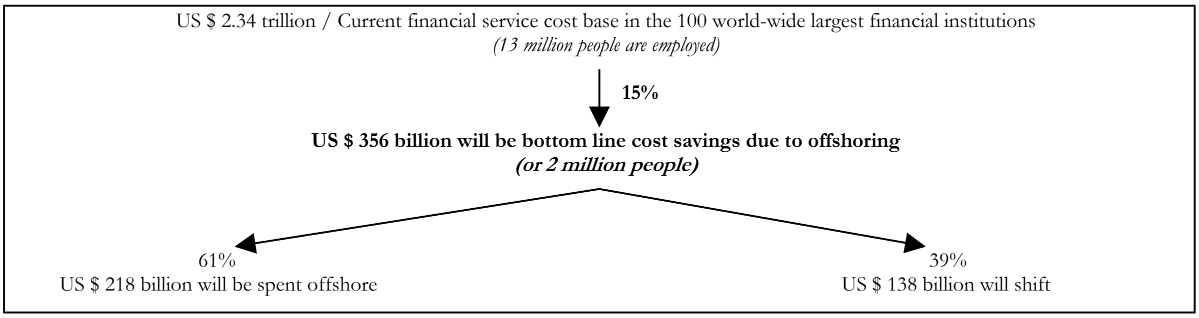
ABN Amro (+ 300)	American Express (+ 1.000)
Axa (380)	Citigroup (3.000)
Deutsche Bank (500)	General Electric Capital (11.000)
HSBC (2.000)	JP Morgan Chase (480)
Mellon Financial (240)	Merrill Lynch (350)
Standard Chartered (3.000)	

Source: Deloitte Research (2004).

According to a report[15] by Deloitte Research (2004), offshoring will continue to grow throughout this decade. The report estimates the percentage of global financial services companies with offshore facilities grew to 67 percent in 2003 compared with 29 percent in 2002, along with an estimated 500 percent increase in offshore jobs. By the year 2010, more than one-fifth of the financial services industry's global cost base will have shifted offshore according to the survey. In that time, the 100 largest financial institutions in the world – those with market capitalization exceeding $10 billion – will have moved nearly US $ 400 billion of their cost base offshore, reducing costs by 37 percent for each process relocated and saving each firm on average a little below US $ 1.5 billion annually. By the end of 2005, it anticipate around US $ 210 billion of the cost base will be offshore with average cost savings to be over US $ 700 million for the largest 100. The report notes that the percentage for large firms is significantly higher than for small firms[16] and also indicates that increasingly firms are setting up their own operations offshore ("captive" offshoring), distinguishing this trend from the growth of outsourcing.

Deloitte Research (2003) also estimates that US $ 356 billion of operating expenses (or 2 million people) will be relocated offshore in the global financial services industry within the next five years[17].

Chart 6. The global impact of offshoring over the next five years



Source: Deloitte Research (2003).

US banks, brokerage firms, insurance companies, mutual funds and other financial services firms are planning to relocate more than 500.000 jobs offshore[18] – representing 8 percent of their workforce – over the next five years, according to a study[19] conducted by the global management consulting firm A.T. Kearney (2003). The relocations will involve a wider range of internal functions than have typically been slated for overseas transfers, including financial analysis, research, regulatory reporting, accounting and human resources. "Any function that does not require face-to-face contact is now perceived as a candidate for offshore relocation", said Andrea Bierce, the A.T. Kearney managing director who oversaw the study. The relocations are expected to reduce annual operating costs by more than US $ 30 billion.

Offshoring is changing the structure of the financial services industry, providing a truly global operating model that is significantly more cost-efficient and launching a powerful new competitive dynamic that is forcing financial institutions to rethink the way they do business. Offshoring is also creating a global division of labour that demands new operating models, new business structures and new management skills. The manufacturing industry experienced a similar transformation. This trend has taken twenty to twenty-five years in manufacturing. Witness the case of Levi's, which started relocating production activities in the late 1970s and closed its final four factories in the US in 2003. We anticipate that financial services institutions are likely to see a similar transition, however, the industry is unlikely to fully replicate the trend in manufacturing due to the need to have greater customer contact.

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[15] Deloitte's second annual offshore survey *The Titans Take Hold*, 2004. The survey is based on responses from 43 financial institutions based in seven countries and included 13 of the 25 financial institutions in the world by market capitalization.

[16] 80 percent of the world's largest financial institutions (i.e., those with market capitalization exceeding US $ 10 billion) are already working offshore, with less than 20 percent keeping everything at home. For smaller companies, the number are split 50:50 between those offshore and those staying home. That disparity creates a significant cost advantage for the larger institutions and the gap is likely to get wider.

[17] Deloitte Research (2003), « The cusp of a revolution: How offshoring will transform the financial services industry».

[18] In a recent report "Offshoring in financial services: A detour along automation highway" (July 2004), Celent Institute estimates that the US financial services industry will relocated potentially 2.3 million jobs within the next six years.

[19] The study was conducted with approximately 100 financial services firms in the banking, brokerage and insurance sectors, and reflects the opinions of the industry executives.

Offshoring was initially driven by economic pressure and the need to cut cost. But lately offshoring has begun to undergo an important metamorphosis, transitioning from "something to consider" to "something that must be done". In the early days, mots companies opted for outsourcing. It was the fastest and easiest way to get started, and it required the least investment and limiting risk. However, now that offshore outsourcing is a standard business practice and increasingly becoming a fundamental components of the financial services business model, more and more firms are choosing a "captive approach" (retaining ownership and direct control through a wholly owned offshore subsidiary). There was a huge increase in "captive" offshoring over the last year and it looks to be the model of choice for the future. That's a clear sign offshoring has been accepted as a core element of the global business model for financial services.

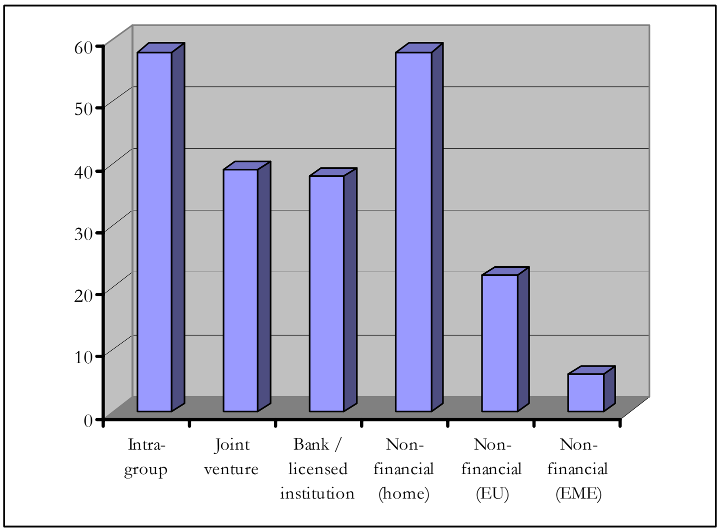
Section 3. Business models, activities outsourced and motives for the European banks

3.1. Business models

The *Chart 7* reports the scope of business models used in outsourcing. It shows that nearly two-thirds of the respondent banks apply "captive models" (intra-group, joint venture or strategic alliance). Purely intra-group solutions and local non financial companies are equally preferred. Moreover, banks often use different types of business models simultaneously, depending on the type of the outsourced activities. On average, two business models for outsourcing are used within a bank.

In contrast to the results of previous studies, the respondent EU banks do not seem to have outsourcing projects with providers in emerging market economies (EME) as offshore centres. In addition, only 25 percent of the respondent banks said they are considering future outsourcing to offshore locations. Around 60 percent of the banks surveyed said they definitely would not offshore activities.

Chart 7. Scope of business models (in %)



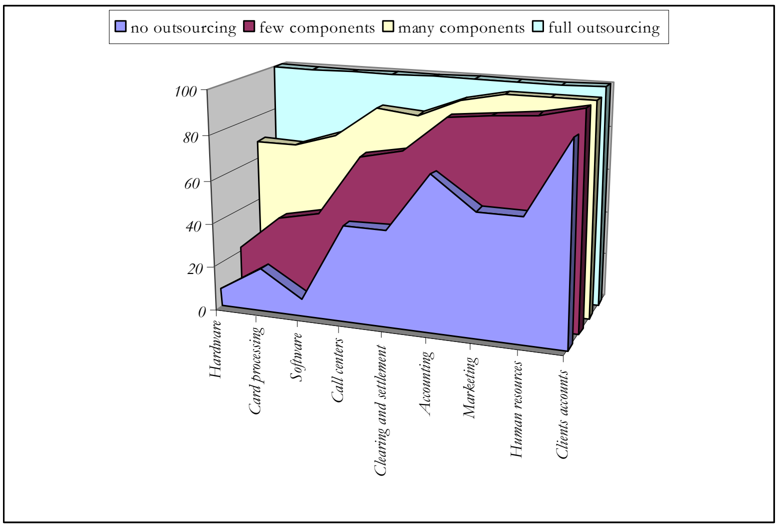
Source: European Central Bank / ECB (2004).

3.2. Activities and services outsourced

A look at the types of activities that are reportedly outsourced indicates that most are support activities, which in nearly 40 percent of the cases are significantly or completely outsourced. On the other hand, outsourcing of core activities such as treasury activities, risk management or asset management is very limited or non-existent at 80 percent of the banks. The identification of core competencies and which functions banking institutions need to retain in-house is becoming less clear-cut as firms extend the range of functions they outsource.

Banks are increasingly outsourcing activities that could potentially be considered core functions. But when banking institutions belong to larger group structures, core activities are often outsourced within the group. Concerning the support activities (*see Chart 8*), those most often outsourced include IT functions (hardware installation, maintenance, software development) and card processing. Nearly one-third of the surveyed banks had outsourced its telephone services to a call centres.

Chart 8. Relative importance of EU banks' support activities outsourcing (in %)

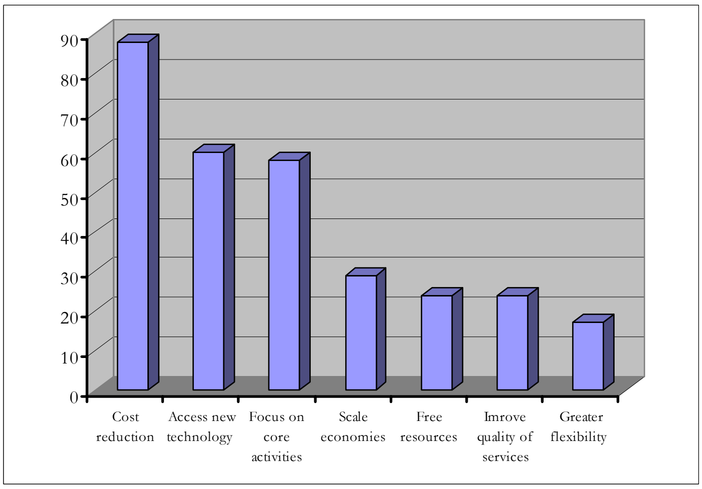


Source: ECB (2004).

3.3. Motives for outsourcing

Banking institutions may choose to outsource certain activities for various motives. According to the *Chart 9*, the first motive for outsourcing is cost reduction, cited by almost 90 percent of respondent banks. In second instance, around 60 percent of the banks' cited access to better technology/infrastructure and the strategy of focusing on core competencies.

Chart 9. EU bank's motives for undertaking outsourcing (in %)



Source: ECB (2004).

Almost 20 percent of the surveyed banks also said that outsourcing allows them to relieve resource constraints (i.e., when there is lack of internal staff or know-how), and improve quality of services. Indeed, outsourcing might be used to develop and provide new customer services more quickly and reliably than is possible with only internal resources. Finally, in one out of six banks, generating a momentum for change or seeking to achieve greater flexibility throughout the organisation is seen as a valid motive for outsourcing.

Section 4. Risks associated with outsourcing and regulatory perspective

4.1. Risks of outsourcing for European banks

Although the benefits of outsourcing strategies are evident, in practice, many banks also consider that outsourcing introduces new challenges and risks. For example, failure to choose a qualified and compatible service provider, and to structure an appropriate outsourcing relationship, may lead to ongoing operational problems or even a severe business disruption. Most banks cite two to three different risks related to outsourcing.

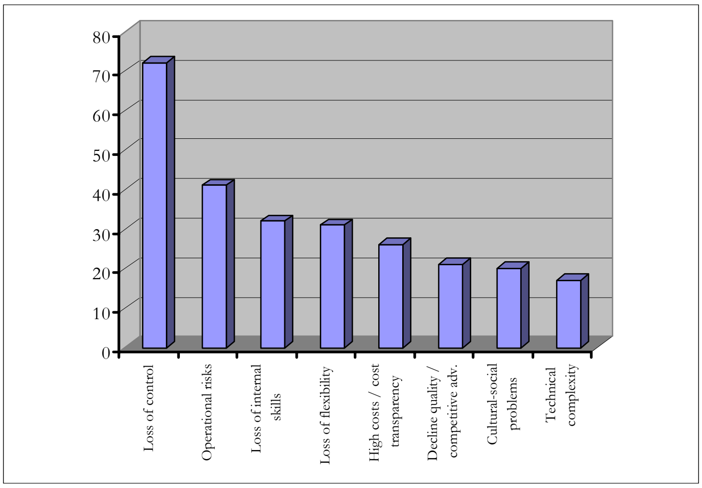
More specifically, almost 75 percent of the banks involved in the survey see a potential risk arising from the loss of control over the activities or services being outsourced, or from an undesirable dependency on the service provider (*see Chart 10*). The transfer of customer financial information to a service provider introduces the risk of potential violations of confidentiality, either due to security issues during the transfer itself or due to a provider's imperfect control environment. While the legal responsibility for such a violation may clearly reside with the service provider, the banking institution would not easily be able to avoid damage to its reputation (reputational risk).

About 40 percent see operational risks. Operational risk has been defined as the risk of monetary losses resulting from inadequate or failed internal processes, people, and systems or external events. While operational risk exists whether or not a firm outsources certain business activities, the transfer of managerial responsibility, but not accountability, *via* an outsourcing agreement to a third-party service provider introduces new concerns.

Around one-third of the banks fear that they might lose certain institutional skills/know-how or lose the flexibility to react to changes in customer behaviour or to changes in the economic environment, which can be seen as strategic risks. Furthermore, 20 to 25 percent of the respondent banks see outsourcing risks stemming from high costs and a potential decline in the quality level of service combined with a reduction of its competitive advantage (entailing a loss of customers). Cultural and social problem (i.e., resistance by current staff, differences between the bank and the service provider in understanding and approaching the customer, etc.) and technical constraints (i.e., due to technical complexity) are also quoted as relevant by several banks.

All those categories of risk apply to any outsourcing arrangements. But when outsourcing agreements are made abroad – a practice commonly referred to as "offshoring" – concerns regarding country risk factors are also introduced. Changes in foreign government policies as well as political, social, economic, and legal conditions in the country where the service provider is based or where the contractual relationship has been established could materially affect the outsourcing agreement.

Chart 10. EU bank's assessment of risks to outsourcing (in %)



Source: ECB (2004).

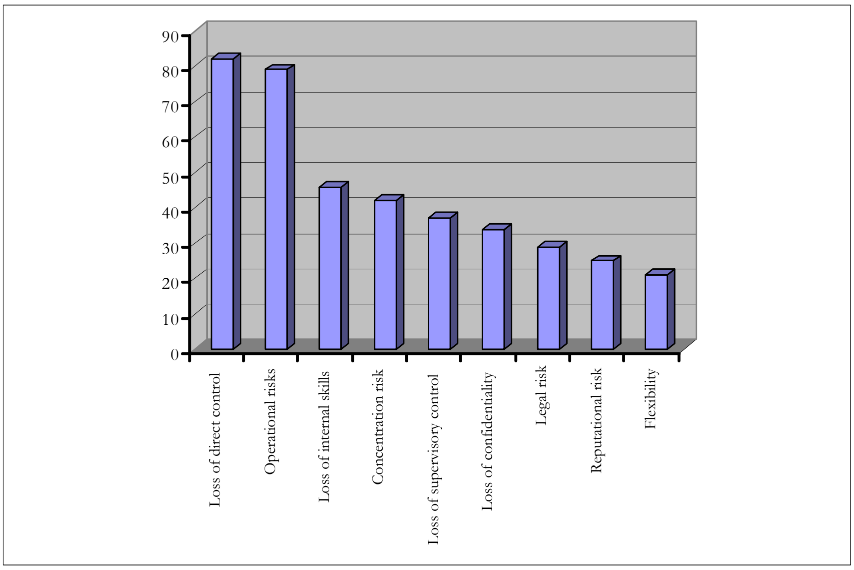
Banks use different techniques to manage the above-mentioned risks. Notably, banking institutions apply a careful screening of service providers and limit the time duration contracts. Mutual shareholding as in a joint venture business model also can be seen as a natural risk mitigation technique, as it involves a closer cooperation on a larger commitment by both partners. Despite all possible risks attached to outsourcing, and consistent with earlier studies[20], most EU banks seem to be satisfied with the experiences they had so far with outsourcing[21]. The current survey shows that outsourcing arrangements achieved the expected results in around 75 percent of the banks. The remaining 25 percent indicated it was too early to tell whether outsourcing had created the expected value.

4.2. The regulatory perspective

This section analyses briefly supervisory authorities' responses[22] to what they saw as the most important risks related to outsourcing by banks in their country and how these risks have been mitigated through prudential regulation. The most important risks related to outsourcing as perceived by supervisors are indicated in *Chart 11*. It appears that 20 out of 24 supervisors are concerned about the fact that banks lose direct control over outsourced activities, and 19 out of 24 see potentially high operational risks (i.e., business continuity threat or operational failures).

In second instance, about half of the supervisors appear to share concerns that banks may lose certain internal skills and that they become too dependent on a small number of outsourcing companies. Indeed, a high concentration in the market for outsourcing with only a few service providers may lead to an excessive dependence[23] and high switching costs. Nearly one-third of the supervisors were concerned about confidentiality risks and the potential for their supervisory control to be hampered. Other concerns, such as legal risks[24], reputational risks and reduced flexibility, seem to be more country-specific.

Chart 11. Supervisors' concerns over outsourcing in banking (in %)



Source: ECB (2004).

Bank supervisors have already taken active approaches to deal with outsourcing in banking. In 16 countries, some form of regulation on outsourcing is in place. Most commonly, this takes the form of supervisory surveillance (the granting of inspection rights at the service provider), laws on internal control and adequate organisation to monitor and review the quality of activities at the service provider. In 6 countries, it is explicitly forbidden for banks to outsource (parts of) core banking activities such as the management of risks to external service providers. Some supervisors also require banks' to inform them

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[20] Kakabadse (2002), "Trends in outsourcing: Contrasting USA and Europe", European Management Journal, April.

[21] Some banks nevertheless pointed out some negative experiences, mainly involving a deterioration in the quality of the service (15 percent of the banks surveyed) and high costs or market power of the provider (12 percent of the banks surveyed).

[22] The survey was answered by the authorities of 24 out of the 25 EU countries that are represented in the BSC. The results show that the supervisory authorities have expressed various concerns over banks' outsourcing strategies.

[23] This is especially true for specialised activities, but much less so for IT and basic functions.

[24] Legal risk can take several forms, since outsourcing arrangements are based on binding contractual relationships. For example, the outsourcing contract might have a long duration during which the firm's business needs and environment could change in important, but unexpected, ways. Consequently, firms might get locked into agreements that reflect outdated business realities.

about their intention to outsource – either in advance or ex-post – and their implementation of outsourcing.

The regulatory environment is becoming stricter in response to the growing risks faced by the financial services sector. Outsourcing risk is increasing in the financial industry, especially as greater use is made of offshoring. The most important regulatory principle is that the outsourcing of an activity does not mean the outsourcing of responsibility. A financial services company that outsource a function must be accountable for that function. Not surprisingly, financial services companies (and their regulators) are extremely concerned about losing control over their businesses during the outsourcing process, given that this could have a serious impact on their reputation and competitive position. That's why regulators have increased their focus on making financial services companies mitigate outsourcing risks properly. High level principles are currently under discussion in the Committee of European Banking Supervisors (CEBS) and the Joint Forum.

European banking supervisors began work in 2002 on developing high level principles that could be used to help the convergence of supervisory approaches and practices in relation to outsourcing. They are based on a range of current practices and the common elements of policy that have been to date in various Member States. CEBS is proposing a three-tier classification[25] of activities: 1) Strategic or "core activities" which cannot be outsourced; 2) Non-strategic but "material activities"[26], which should be pre-notified to the supervisory authority and 3) Non-strategic and "non-material activities", which do not have to be pre-notified but for which the institution must remain responsible for ensuring any supervisory guidelines are still met.

In February 2005, the Joint Forum[27] releases outsourcing guidance for financial services firms. This report untitled *Outsourcing in Financial Services* develops a set of principles that give guidance to companies (banking, securities and insurance) and regulators to help them better mitigate risks without hindering the efficiency and effectiveness of firms. It focuses on establishing coherent policy and risk management programmes for outsourcing activities. The nine principles suggested can be grouped broadly into three categories. The first category refers to the policies that regulated financial services firms should have in place even before entering an outsourcing agreement. The second category addresses concerns surrounding specific outsourcing arrangements. Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities, and expectations of all parties. The third category addresses concerns specific to supervisors. Supervisors should take into account outsourcing activities as an integral part of their monitoring responsibilities. Supervisors should also assure themselves that outsourcing arrangements do not hamper the ability of the firm to meet its supervisory requirements (i.e., supervisors should be able to obtain promptly any relevant materials regarding outsourcing activities).

Outsourcing by financial services firms raises important concerns for both the firms and their supervisors. Specific supervisory efforts are currently in place and more are in development. However, such efforts will need to be flexible and will most probably be modified over time as the nature of these outsourcing arrangements evolves. The principles on outsourcing should therefore interfere to the lowest possible degree in the entrepreneurial freedom of financial services firms. Limitations need to be justified by increased risk and should be restricted to the minimum necessary to achieve the regulatory aim. We also suggest that the problem of outsourcing abroad should be studied further. Indeed, managing compliance risk is particularly difficult when offshoring is used. In order to avoid a duplication of inspection and control of outsourced services, supervisors should conclude cooperation arrangements according to which the authority, which has best access the provider, will become active. A duplication of supervision by different authorities has absolutely to be avoided.

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[25] *High level principles on outsourcing*, CEBS Consultation Paper, April 2004.

[26] It is hard to make a clear distinction between "core activities" and "material activities". A more pragmatic approach would be to consider that a firm may outsource any of its activities, on condition that it is capable of controlling the attendant risks.

[27] A financial services policy group established by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors.

Concluding remarks

As described in this document, outsourcing/offshoring is a very important issue for European financial services industry and it will continue to increase in the next years. The rapidly changing markets, increasing competition, imperative to cut cost, pressure of market consolidation and technological progress require that financial firms more and more focus on their specific field of competence. Tasks and activities, which are not in the focus of business policy or which can be provided at considerably lower cost by foreign entity, are more and more delegated.

Then, offshore outsourcing is having an effect on the industry and is contributing to the rise of new business models. Offshoring has involved a new and potent competitive dynamic that is likely to reshape the world-wide financial services industry for the rest of this decade and beyond. Offshoring is also creating a global division of labour that demands new operating models and new business structures that is forcing financial institutions to rethink the way they do business. Nevertheless, financial services institutions must move cautiously.

Indeed, while outsourcing presents all firms with important challenges, financial services firms face two interrelated challenges which are being heightened as they push outsourcing further into their business: firstly, the need to resolve the increasingly large regulatory requirements governing outsourcing and responsibility for compliance; secondly, the need to manage the risks associated with increasingly complex outsourcing arrangements. The latter issue has recently led to important developments in the supervision of financial services firms, particularly banking institutions.

Generally speaking, the offshoring debate will continue to rage for some time to come in the industrial countries. The challenge for policymakers is to make sure European people have the skills they need to compete successfully in the global economy.