Outsourcing Financial Services Activities: Industry Practices to Mitigate Risks

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I. MANAGEMENT OVERVIEW

Outsourcing, or the use of third-party service providers, is a business strategy that is being considered more frequently by financial institutions as they respond to an increasingly competitive marketplace. While not new, many of the activities currently being outsourced, such as information systems, business processes and internal audit,[1] are integral to the functioning of the organization, vital to supporting core businesses and create dependencies upon service providers. Given the scale and prevalence of these types of arrangements, outsourcing raises potential supervisory concerns.

Outsourcing arrangements present four key challenges, which if not addressed adequately, introduce significant risks for the financial institution. While other risks exist and are discussed in this paper, the primary concerns are:

- ***Selecting a qualified vendor and structuring the outsourcing arrangement*** – Failure to choose a qualified and compatible service provider, and to structure an appropriate outsourcing relationship may lead to on-going operational problems or even a severe business disruption. These events may result from service provider employees not having the necessary skills or familiarity with the industry, or from service providers lacking an adequate technical capacity or financial stability. The contract needs to clearly articulate the structure of the outsourcing arrangement and the expectations of both sides, otherwise excessive amounts of management time may be consumed with dispute resolutions or with managing a contentious relationship.

- ***Managing and monitoring the outsourcing arrangement*** – As management focus shifts from direct to indirect operational control over an activity, there is a risk that undue reliance may be placed upon the service provider by the financial institution. Without active management and monitoring of the relationship, sub-par service may occur or, at the extreme, loss of control over the outsourced activity. Given the customized nature of the service contracts, changing service providers in the face of unsatisfactory responsiveness may not be a viable option. Even when alternatives are available, switching service providers is likely to be a costly option that adds to operational, legal and other risks.

- ***Ensuring effective controls and independent validation*** – Given the reliance on a third party for the performance of critical activities, there is the risk that without independent validation of the control environment the institution cannot determine that the controls have been effectively implemented. A sound control environment in an outsourcing arrangement encompasses many of the same management concerns as when the activity

[1] In the past, institutions most frequently outsourced non-critical activities such as payroll processing and building maintenance.

is performed in-house. However, if not independently validated, the financial institution risks receiving performance monitoring reports that are overly optimistic. The service provider also may not always maintain the necessary capacity, employee skill set or financial capability as agreed to in the contract.

- ***Ensuring viable contingency planning*** **–** Given the dependency on a third-party service provider, financial institutions face the challenge of ensuring adequate contingency planning to avoid business disruptions. What contingency plans does the service provider have in place? What contingency plans does the financial institution have in the event of nonperformance by the service provider? Recurring performance problems coupled with the absence of comprehensive contingency plans by the service provider and the financial institution may result in unintended credit exposures, financial losses, missed business opportunities and reputational concerns.

The supervisory assessment of outsourcing risk at a financial institution will depend on several factors: The size and criticality of the outsourced activity, how well the institution manages, monitors and controls outsourcing risk, and how well the service provider manages and controls the inherent risk. In principle, outsourcing may enhance or weaken an institution's overall risk profile. For example, overall risk may be reduced when the service provider's expertise is superior to that of the financial institution and/or when prudent risk mitigating practices are utilized by the financial institution.

Given the trend towards outsourcing, the Federal Reserve Bank of New York formed a team to better understand the related issues and concerns. The team interviewed a cross-section of Second District financial services institutions, service providers, management and process consultants, lawyers and academics. From these meetings, the key risks and prudent business practices developed by financial services institutions to mitigate outsourcing risk were identified and compiled as industry practices.[2] Institutions considering outsourcing may find this paper useful as an overview of the issues and risks that need to be considered. For other institutions, industry practices may serve as a benchmark or suggest refinements to existing practices.

In Section II, the outsourcing market is briefly reviewed including a definition of outsourcing, potential benefits and risk factors. Section III presents our findings on current industry practices. Existing guidance on outsourcing is briefly reviewed in Appendix A.

[2] See a related paper, *Industry Practices to Mitigate Vendor Risk: The Year 2000 Context*, April 1998 (**www.ny.frb.org/bankinfo/announce)** for a more focused discussion of outsourcing risk pertaining to Year 2000 issues.

II. THE OUTSOURCING MARKET

Background

Outsourcing is the transfer of direct managerial responsibility, but not accountability, to an unaffiliated,[3] third-party service provider who performs services previously delivered by internal staff and management.

Outsourcing relationships take many forms. At one end of the spectrum are contractor-like relationships where the choice among capable providers is large. In this case, contracts tend to be relatively short-term, and the cost and inconvenience of switching among vendors is relatively low. At the other end of the spectrum are long-term partnerships/strategic alliances/joint ventures where both parties share in the associated risks and revenues. The intention of these arrangements is for the institution and service provider to be fully integrated in seamless delivery of customized services. Contractor-like relationships are relatively easy to set up and are best for commodity-like services such as procurement operations or mortgage servicing. The large mega deals, such as those involving full support of information technology efforts, are examples of outsourcing strategic, more complex activities that are not easily transferable. In these cases, staff, equipment and full responsibility for delivering an extensive group of services is outsourced to the service provider.

Although financial institutions have outsourced activities such as payroll processing for years, outsourced activities have recently included information technology, accounting, audit, electronic funds transfer, investment management, and human resources. According to published reports,[4] thirty-nine percent of all U.S. banks and thrifts outsourced at least some processing activities in 1998. The most frequently outsourced activity, according to a survey[5] of commercial institutions, is some aspect of information technology (e.g., desktop support). Next in importance is business process outsourcing ("BPO"), such as treasury operations, internal audit and human resources, though currently only at one-third the level of information technology expenditures. Industry experts indicate that BPO is the emerging area of growth since it facilitates financial institutions' reengineering of core business processes.

While estimates vary, the outsourcing market is reported to be large and growing (see Figure 1). A business survey indicated that, in 1997, total global expenditures on outsourcing increased 23 percent to \$180 billion, with expenditures anticipated to rise another 27 percent to \$235 billion in 1998.[6] Some sources predict outsourcing to exceed \$300 billion by the year 2001.

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[3] Outsourcing may also be defined to include the use of affiliates or, in the case of a U.S branch or agency of a foreign bank, a non-U.S. office or operation of the foreign bank. In this document the focus is on an arrangement with an independent third party, which illustrates outsourcing risk most clearly.
[4] Adrianna Senior, "40% of New Core Systems Were Outsourced Last Year," *American Banker,* Wednesday July 14, 1999, p. 14.
[5] See the Dun & Bradstreet Barometer Global Outsourcing Survey in *Fortune, Special Supplement, Outsourcing '98*, July 20, 1998. The survey tracks business-to-business outsourcing by companies with annual revenues of more than \$50 million.
[6] Ibid.

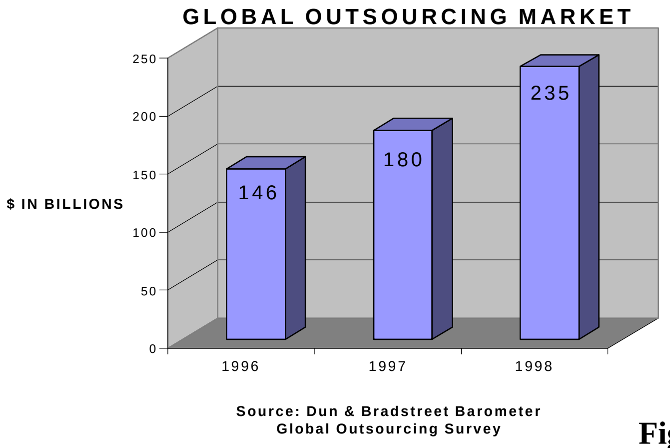

Figure 1

Potential Benefits of Outsourcing

Reasons to outsource include reduced costs, enhanced performance, an ability to access superior expertise and industry best practices, and a desire to devote scarce human resources to core businesses.[7] A third-party service provider may provide better performance at a lower cost than in-house providers because of economies of scale, specialization and tactical focus. Cost savings may be secured by converting fixed costs to a variable cost structure to accommodate fluctuations in labor and equipment needs. Additionally, outsourcing can provide immediate access to expertise and best business practices that may be too expensive to build internally or hire – particularly in areas such as technology.

The choice of which activities to outsource is often determined by the strategic value of the activity and its level of operational performance. Generally, the less strategic the activity and/or the lower the level of internal performance, the more likely to consider it for outsourcing.

Lastly, in the case of certain technology activities, such as desktop support, the cost of keeping current in a rapidly evolving environment is a precipitating factor. Centralized internal support functions, such as internal help desk operations, are other attractive areas to outsource. Such units were typically consolidated to capture internal economies of scale, and are therefore relatively self-contained and easily separable.

[7] Financial institutions may also outsource for strategic reasons or to effect organization changes. For example, they may outsource rather than build a start-up business internally. Outsourcing may be part of an exit strategy for a business that is about to be divested. Sometimes, a business acquired during a merger is outsourced as an interim step to deciding whether to integrate it into the institution. Some institutions change their technology environment by outsourcing their large (legacy) computer systems and redeploying in-house resources into newer technology initiatives. In other cases, especially information technology, a business unit may initiate outsourcing because they cannot find or retain people with the desired skills.

Outsourcing Risk Factors

Several factors innate to outsourcing give rise to potential operational, legal and reputational risks. One factor is that outsourcing arrangements are binding contractual relationships with another legal entity, typically an unaffiliated third party. The duration of contracts may be fairly lengthy, often five to ten years, during which time business needs and environments can change significantly and in unanticipated ways. Consequently, there is a risk that financial institutions may be locked into agreements that reflect outdated business realities. The contractual basis of outsourcing coupled with this intrinsic business uncertainty contributes to legal risk.

Another innate factor is that outsourcing almost inevitably results in changes in the financial institution's business practices and processes, which contributes to operational risk. These changes may be required to capture economies of scale and operational efficiencies, or simply reflect a different way of doing business by the service provider. For example, operations that were performed in-house by decentralized units may be consolidated either before or as a part of the outsourcing arrangement. Consequently, business processes that were customized for individual business units or for the financial institution may now be changed and converted to a more standardized format.

A third innate risk factor is the unique concerns that arise from giving third parties access to confidential data, strategic technology applications, or the books and records of the institution. The potential for violations of confidentiality by service provider employees contributes to operational, legal and reputational risks.

Fourth, outsourcing requires modifications to the institution's management structures and practices to mitigate operational risk. For example, managers need to be skilled in negotiating and administering outsourcing arrangements, and monitoring the inherent risks at the service provider rather than exercising direct managerial control of departments. If not, the provider may deliver sub-par service or even fail to deliver some critical business activity, possibly resulting in a business disruption. An in-house coordination and communication mechanism may also be needed to coordinate internally among business units, externally among several service providers, and between the internal and external groups. Outsourcing often makes considerable demands on in-house staff to provide relevant information.

A related issue is the outsourcing of functions that are not well managed and effectively controlled when performed in-house. While the temptation to outsource activities that are experiencing problems is considerable, such actions pose significant operational and legal risks. Management needs to understand the nature of their problems before they can define the solutions that will work and select an appropriate service provider. This understanding is also necessary to define realistic performance measures and to engage in effective monitoring of the service provider.

Fifth, outsourcing creates a potential dependency on the third-party service provider, which raises several issues. One concern is ensuring adequate responsiveness from the service provider. For example, if a financial institution needs their service modified in some way, that request may be placed in a queue of requests. Individualized and timely attention from the service provider may be uncertain and may entail significant additional costs. In the face of unsatisfactory responsiveness, changing service providers is likely to be a costly option that adds to operational, legal and other risks.

This potential dependency on the service provider may increase over time since organizational learning is based mostly on experience, and therefore the financial institution's capacity to learn may be diminished. Day-to-day responsibilities, hands-on experience, and responding to changing business needs provide a training environment for managers. As these processes are transferred outside the organization with outsourcing, managers retained at the institution will need to develop alternative channels to keep their knowledge base current and their skills sharp. Moreover, the next generation of managers – those with both technical expertise and knowledge of the business and the institution – will need to be developed.

Outsourcing also poses significant reputational risk. A problem at the service provider is potentially a problem for the client financial institutions. For example, if the service provider has a highly visible problem with one client institution, the adverse publicity of that situation may have contagion effects for other client institutions. Also, in some situations, such as customer service call centers, the service provider's employees interact directly with the financial institution's customers as if they were employees of the financial institution. This direct interaction poses reputational risk for the financial institution if the interaction is not consistent with the financial institution's policies and standards.

Lastly, a factor unique to outsourcing is managing the operational, legal and reputational risks during the transition phase. As mentioned, processes may be modified or systems changed. Internal staff may need training in the service provider's systems. Adjustments to staff size and transfer of employees to the service provider may raise morale and complex labor law issues. Inadequately handled, the transition can cause the loss of personnel who are highly skilled and familiar with the institution's practices and requirements.

III. Industry Practices for Outsourcing Arrangements

The Federal Reserve Bank of New York team's meetings with industry professionals identified six key elements to mitigate outsourcing risk:

- Managing and monitoring the outsourcing arrangements;
- Selecting a qualified vendor;
- Structuring the outsourcing arrangement;
- Managing human resources;
- Establishing controls, and ensuring independent validation; and
- Establishing a viable contingency plan.

A. Managing and Monitoring the Outsourcing Arrangements

In contrast to in-house provision of services where management attention is directed to managing both the process as well as the results, outsourcing by design separates these two functions. With outsourcing, in-house management needs to focus on managing and monitoring the outsourcing arrangement. Management oversight is directed to obtaining the desired results while relinquishing direct operational control over the activity. Process issues are left to the service provider. To achieve the desired objectives, successful outsourcing requires the financial institution to establish a management framework that reflects this shift in focus and of responsibilities.

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.**

In any outsourcing arrangement, the board of directors and senior management of the financial institution retain full accountability for the outsourced activity as if the service were being performed in-house. In no case does outsourcing permit an abdication or transference of management accountability. Only the day-to-day managerial oversight is delegated to a third-party service provider.

At the outset, the financial institution needs to identify the role of outsourcing given their overall business strategy and objectives. Management needs to develop a robust understanding of what outsourcing is capable of achieving for their organization. This analysis requires deep and honest corporate self-assessment as to core competencies, managerial strengths and relative weaknesses, and overall values and future goals of the institution. This assessment is performed at the very highest levels of management and is integral to the institution's strategic planning efforts. Based on this analysis, outsourcing objectives are set and specific outsourcing activities evaluated.

Given the underlying strategic motivation, outsourcing decisions are frequently initiated by senior management. Once made, support from the top of the organization is essential to setting the tone for a successful effort and to building internal support. Articulating the goals and objectives of the outsourcing initiative, and communicating how the effort will benefit the institution are key to building institution-wide support, and to achieving a smooth transition process and successful long-term relationship.

Institutions caution against being over-confident in the service provider and adopting a hands-off management approach, even in the case of standardized activities outsourced to reputable third parties. A hands-off approach frees management time and resources to be redirected to other objectives. However, it may also increase operational risk by leading to an eventual loss of control over the activity or, at the very least, excessive reliance on the service provider's assessment as to the quality of the service being provided.

2. Create a management structure to establish, manage and monitor the outsourcing arrangement.

The critical step to successful outsourcing is establishing an adequate management structure to oversee the process from beginning to end (See Figure 2).

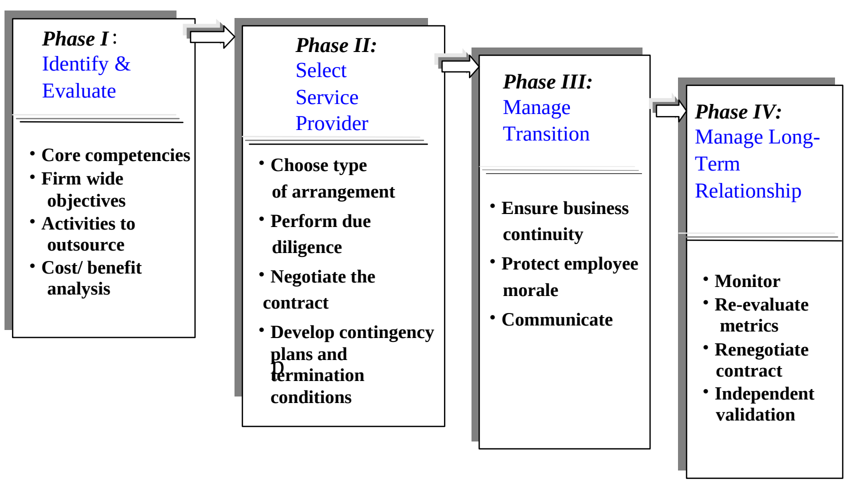

Figure 2

This structure varies across financial institutions. In some cases, a single manager may be adequate. For more complex arrangements, a committee of senior level managers may oversee teams of people responsible for different aspects of the process. The key is that sufficient resources are allocated to the management structure, both in people and time, to enable managers to adequately plan, analyze and oversee the various phases of the outsourcing effort. All of the institutions surveyed noted that underestimating the necessary resources, especially management time and attention, is a common occurrence.

Initially, the managers identify and evaluate the outsourcing options. Once the decision to outsource is approved, the outsourcing plan, including a methodology and timeframe for the effort, is established. The outsourcing plan needs to be comprehensive, detailed and specific. For each phase of the process, goals must be set and the appropriate analytical framework, deliverables, documentation, and the necessary sign-offs identified. A contingency plan and exit strategy for the outsourcing arrangement also needs to be formulated.

To signal commitment, financial institutions frequently appoint a senior officer as a sponsor who will take ownership for the outsourcing effort and provide leadership. The sponsor needs to be very highly regarded and possess excellent communication skills. These qualifications are key to building internal support for the outsourcing arrangement by communicating with the affected business units about the goals and potential benefits of outsourcing. Sometimes, internal business units are reluctant to give up dedicated resources for a more removed, albeit higher quality, service provider. Personnel in the affected units are also likely to be resistant to the change, especially at the mid-management and lower levels.

Resistance to outsourcing can arise for a variety of reasons. Decreased influence and indirect reporting lines are concerns of local management. Business units may be reluctant because direct billing may raise their costs.[8] And, many well-functioning support units genuinely believe that they can meet the needs of their institution better than any third-party service provider.

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 institution-wide support.

Evaluating an activity for outsourcing requires considerable analysis and input from the affected business lines. Plans and frameworks must be developed. Baseline costs and performance measures must be compiled.

Typically, this analysis is performed by cross-functional teams consisting of representatives from the business unit(s) to be outsourced, internal client units, as well as the audit, legal, information security, and human resources departments (see Figure 3). While team membership frequently changes as the process proceeds, it is recommended that the long-term outsourcing relationship manager – the individual who will manage the arrangement over the long term – be identified early and be a participant throughout the process.

[8] In fact, many institutions find that the transfer price for the internally provided service was too low relative to internal costs and that outsourcing often leads business units to modify their business practices. For example, because each customized service costs extra, the number of projects often drop, and requests are prioritized more tightly.

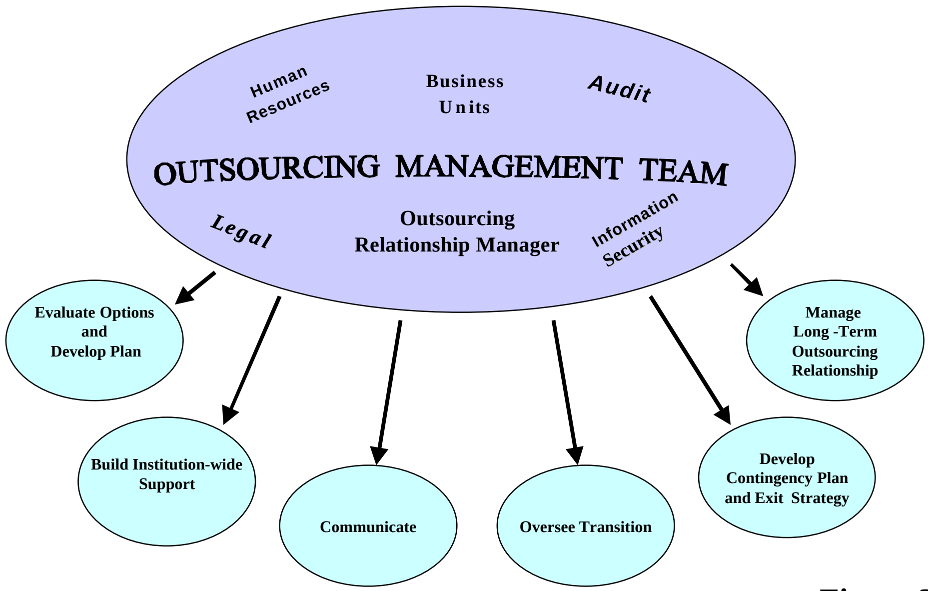

Figure 3

In practice, including the relationship managers from both the financial institution and the service provider in the process from the start yields several benefits. They can develop an early relationship, and provide continuity to the discussions and the arrangement. By being a part of the negotiations, these individuals will better appreciate the various trade-offs that determined the final outcomes, and can reflect this intent in the day-to-day decision making of the relationship. Often, the individuals who negotiated the arrangement move on to other challenges, which frequently places a strain on the outsourcing relationship.

Team members experienced in outsourcing are valuable since such individuals are able to bring a realism and perspective to evaluating and addressing issues. Institutions without such in-house talent, or even those with such talent, often use outside consultants in a variety of ways. Consultants coach internal teams and can conduct some of the actual work such as performing cost analyses and participating in the negotiations. They can provide impartial input, which is especially important for institutions where sensitivities or internal politics are an issue to the outsourcing decision.

If staff is to be transferred as part of the outsourcing arrangement, the cross-functional team devises the plan and oversees the transition from the financial institution to the service provider. The transition plan specifies timeframes for the transfer of staff and other resources, and integration with in-house processes. Financial institutions report that this is an emotionally stressful phase, with many human resource issues (see practices 9 and 10 below). Done right, the transition sets a positive foundation for a successful future relationship as employees feel that they were treated fairly. However, firms frequently underestimate the amount of management resources needed for managing the transition phase satisfactorily.

4. Retain key individuals from the outsourced function to manage and monitor the outsourcing arrangement, and to provide future strategic direction.

After the transition of activities to the service provider, a manager is needed to manage, monitor and provide strategic direction to the long-term relationship on an institution-wide basis.[9] Frequently, the manager and support staff are retained personnel from the outsourced department.

Retained managers must have excellent strategic thinking, negotiation and communication skills, rather than the people and process managerial skills needed to run operations day-to-day. Strategic thinking is needed to set the direction for the service provider, who is then responsible for implementing processes to achieve expected goals. Negotiation and communication skills are needed to create and support the web of relationships between the service provider and internal end-users, and to bridge any emerging gaps. Managers need to be able to secure the right services from the service providers and encourage sometimes-reluctant internal managers to use the service.

Functionally, the service provider's representative reports to a senior officer at the financial institution. For example, in the case of IT outsourcing it is usually the chief information officer, and for internal audit outsourcing it would be the general auditor. Depending on the size and complexity of the arrangement, there may also be interaction between counterparts at the business unit levels of the financial institution and the service provider.

At the beginning of an outsourcing arrangement, management from the financial institution and from the service provider often meet regularly (perhaps weekly) to review all major developments. Over time, this frequency may decline. Of course, daily contact at the operational levels is common, depending on the service.

5. Monitor the relationship actively, respond to problems and issues aggressively, employ escalation procedures promptly, and engage in conflict resolution.

As a practical matter, financial institutions realize that the negotiated contract is essential for clarifying and setting expectations and service levels, but that in practice, problems or differences inevitably emerge. The outsourcing relationship manager needs to identify such situations promptly and push for rapid resolution. Managers from both sides should meet and mutually solve business problems rather than try to enforce exact terms of the contract.[10]

[9] At financial institutions with multiple outsourcing arrangements, responsibility for managing the service provider may be divided. The responsibility for managing the institutional aspects of the relationship may be centralized at an office that manages all outsourcing relationships for the financial institution. However, the responsibility for managing and monitoring the service level performance of the service provider may be delegated to a local manager at the business unit choosing to use that service provider. In such cases, there are typically institution-wide lists of vetted and approved service providers from which the business units may choose.

[10] This approach is often referred to as "manage to the business relationship, not to the contract."

However, if differences persist, rapid escalation of the issues is undertaken. (The outsourcing contract specifies the process for problem solving and conflict resolution.) A mistake that many financial institutions caution against is allowing issues to linger. Such delays inevitably erode the relationship and contribute significantly to operational risk.

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.**

Objective performance measures are essential for several reasons. When clearly specified, they define the expectations and responsibilities for both sides of the relationship. This mutual understanding is the basis for monitoring on-going performance, and measuring the success of the outsourcing arrangement. Such measures are also used to motivate service provider performance, especially if penalties or incentives are attached for under- or over-performance. Performance measure reports are generated on a regular basis, and sent to both parties for review.

For commodity-like services, such as payroll processing, performance measures are usually standardized by the service provider, with the financial institution setting the service level against which to measure performance. For more customized services or for more complex arrangements, there are no standard measures. Instead, a range of measures needs to be identified and monitored by the outsourcing relationship manager.

The identification and development of performance measures starts in the early phases of the outsourcing process. When evaluating activities to outsource, baselines for internally provided service levels and costs are determined and compared with outsourcing alternatives. These baseline measures identify appropriate performance measures, which are then incorporated into service provider requirements and the final contract.

An important step in establishing performance measures is to obtain the input and support of all affected business units who are end-users of the outsourced service. This step will ensure that the measures make sense from a business perspective and not just from a technical perspective. This is especially important for IT outsourcing where there can be a gap between business and technical measures.

7. **Periodically review, renegotiate and renew the contract. Reset target service levels annually.**

Financial institutions regularly review their outsourcing arrangements. For this purpose, they may undertake internal cost-benefit analyses and benchmark performance against industry standards. Any significant internal business changes are reviewed and the implications for the outsourcing arrangement are incorporated into the contract annually.

Performance measures usually incorporate the notion of continuous improvement. In other words, annual service levels reflect an expected improvement from the service provider every year. Only performance above and beyond these expected improvements qualifies for performance incentives.

B. Selecting a Qualified Vendor

Even very reputable service providers may not be the best choice in all situations because they may not have the requisite capacity or capability. For example, they may not have enough experienced staff and/or managers with the necessary skill mix. The service provider may be over-stretched or not have familiarity with the financial services industry. Alternatively, the financial institution may be considered a small client and not have much leverage in getting its needs met in a timely way or in obtaining customized solutions. The risk is that the outsourcing arrangement may create a dependency on an unsatisfactory vendor and finding alternative suppliers and solutions could be costly because of the size of the contract, transition costs, and potential business disruptions.

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.**

As outsourcing options are evaluated, the requirements for the service provider become readily apparent. These requirements guide the selection process. Any special needs, such as servicing geographically dispersed operations, must be determined and met by specifying suppliers with similar reach or capability. Requests for information (RFI) are sent out after narrowing the number of potential suppliers to a manageable size. From this field, the final few are identified and asked to submit a proposal in response to a request for proposal (RFP) for final negotiations and selection.

In general, institutions recommend that service provider selections emphasize compatibility and performance, and only then consider costs. Turning over a key business activity to a third party requires a degree of trust and comfort that will arise only if there is a good fit between the two parties. A good match as to culture, values and ways of managing and doing business are essential to making the relationship work well in the future. Moreover, institutions that focus on costs often find that they do not necessarily receive the desired quality of service.

Important elements of due diligence include probing for information on intangibles such as the service provider's business strategies, human resources policies, service philosophies, quality initiatives, and policies for managing costs and improving efficiency. Good compatibility on such cultural dimensions is the foundation for a creative, interactive problem-solving approach from both sides.

A service provider's prior track record in providing the necessary service, especially to other institutions in the financial services industry, is another important consideration. Since familiarity with the business is an important qualifier for certain types of activities, some financial institutions prefer to outsource to other financial institutions over commercial firms. Asking the service provider for references and contact names is a recommended practice.

Conversations with past clients may uncover areas or business practices that may give rise to conflicts or problems, and provide some indication of how well the service provider handles client issues.

To assess the service provider's financial viability, information such as market share can supplement current financial statements and annual reports. A search as to pending or threatened financial or legal claims that may affect the provider's financial stability are also important areas to explore.

Institutions report that making the final selection is one of the more difficult steps in the process. Utilizing objective measurement criteria that reflect the institution's overall objectives for outsourcing are useful guides. In anticipation of this step, the RFI and RFP should be designed to capture these criteria and values, with all results normalized so as to compensate for any quality or definitional differences among the service providers.

Many institutions recommend that the final field consist of no fewer than two service providers in order to learn from them and to bring competitive pressures to the negotiations. For smaller outsourcing arrangements, however, financial institutions often engage service providers with whom they have prior experience or an on-going relationship. A few institutions recommend vetting a service provider by entering into a small contract, which can then be expanded into a wider or deeper relationship. However, this option is not always feasible because of time constraints.

C. Structuring the Outsourcing Arrangement

The most frequent cause of unsuccessful arrangements is that the service provider did not meet the financial institution management's expectations - usually because these expectations were poorly understood or articulated by both parties involved. Such a situation may arise in IT outsourcing, for example, because end-users may not be sure of their needs, the technology may be new or untested, business requirements change frequently, or implementation did not occur as expected.

In some situations, senior management may have conflicting objectives for the arrangement, or unrealistic expectations as to what problems the outsourcing can solve. For example, if outsourcing is undertaken primarily to reduce costs or to convert fixed costs to variable costs, it may result in an arrangement that compromises quality, timeliness and level of service, which may be unanticipated by management and lead to disappointment with the arrangement. In such cases, as the situation deteriorates, outsourcing risk increases.

Since every aspect of a contractual relationship is governed by the contract, the expectations of both sides should be clearly and fully documented in a formal, executed contract. The contract acts as a map to the relationship and defines its structure.

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

The contract for the relationship must articulate the mutual expectations of both parties, including performance measures and incentives. Also, the right type of outsourcing arrangement, ranging from contractor-like to partnership, must be selected. Lastly, the approvals of the board of directors and senior management need to be obtained.

Institutions emphasize that negotiating a fair and reasonable contract is in the interests of both parties. Contracts that are overly aggressive on cost may be shortsighted because they can result in contracts that are not viable for the service provider in the long run and result in deficient service in the interim.

Contracts also need to be flexible. The typical contract lasts from five to seven years, with some extending as far as ten years or further. It is very difficult for managers to foresee and contract for every possible contingency that may arise. Also, business needs change or the market may evolve in unexpected directions. For these reasons, the contract must be flexible enough to meet the challenges of a changing environment.

Key elements of the contract include:

- Scope of services – what specifically is to be outsourced;
- Terms of the agreement;
- Written procedures;
- Minimum services levels, including any ancillary services to be provided;
- Payment schedules;
- Incentives – contracts may offer bonuses for exceptional performance and penalties for poor performance. Overall, they should be used to align the interests of the service provider with that of the financial institution;
- The right to retain other third parties – to keep the service providers sensitive to competitive pressures;
- The use of subcontractors – approval by the institution should be required;
- Auditability – the right to conduct audits of the service provider and/or accept third-party reviews of their operations;
- Retained ownership and confidentiality of data shared with service provider;
- Warranties, liability and disclaimers;
- Dispute resolution mechanisms – including service levels to be provided during the dispute, escalation procedures and provisions for arbitration.
- Termination clauses and potential bankruptcy;
- Change management issues;
- Human resource issues;
- Contingency and business recovery plans; and
- Force majeure, or “Act of God” events.

An element of the contract worth emphasizing are staffing and human resource issues. For significant outsourcing arrangements, the key individuals who will be responsible at the service provider for performing and/or overseeing delivery of the service may need to be identified by name. For other important functions, the experience profiles and skills testing of staff assigned to the account may be specified. Frequently, the financial institution retains veto power over key staffing decisions. Similarly, service providers are required to inform the institution and obtain necessary approvals if a sub-contractor is to be retained for some element of the service being provided.

Preparing outsourcing contracts is highly specialized work. Accordingly, institutions frequently use legal consultants in addition to in-house legal staff for such work. Given the significance and length of these contracts, errors or poor execution can have major implications by locking an institution into a contractual relationship that does not meet their needs.

D. Managing Human Resources

An important source of operational risk, especially during the early phases of the outsourcing process, is the potential behavior of affected staff, or "people risk." Once knowledge of the outsourcing becomes public, whether through formal announcement or rumors, employees frequently start to be concerned for the security of their jobs. These concerns impact staff in both the affected and unaffected business units and are, at the very least, a distraction that may result in errors and productivity losses. More seriously, they can wound employee morale and lead to loss of desirable or key employees. In extreme cases, institutions fear misconduct or retaliatory behavior.

Financial institutions report that human resource issues are the most complex challenges. These issues may eventually account for about one third of all the time spent on the outsourcing effort. Consultants are frequently used to address situations that may lead to legal and reputational risk.

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.

Practices vary on releasing staff versus transferring jobs to the service provider. An important motivation for outsourcing is that it can offer skilled employees a better career path at the service provider than at the financial institution. In cases such as IT outsourcing where the scarcity of technologists is widespread, retaining skilled staff with knowledge of the financial institution is a high priority for both parties. In other situations, if the financial institution is seeking an infusion of new ideas or was unhappy with the performance of in-house staff, releasing personnel would be the preferred option. However, the service provider may choose to recruit from the released staff.

Whichever option is chosen, the specifics must be negotiated into the contract. For example, the contract can require the service provider to offer employment to all current staff at the financial institution for a period of time, often six months to one year. In such cases, their compensation and future bonus structures are usually specified in the contract. In other cases, the service provider may only commit to interview individuals and hire those that qualify.

In situations where the staff is to be transferred, human resource clauses need to be negotiated into the contract and the structure of the relationship. Typically, this affects the cost of the transaction. The terms of the transfer must be negotiated, including the transfer of pensions, benefits and other potential liabilities.

All institutions agree that aggressively communicating with affected staff is absolutely essential. There was less agreement on when to communicate the outsourcing decision. Communicating very early in the process risks building employee anxiety with its attendant negatives over a long period of time. However, communicating late risks incurring employee distrust and heightened turnover as the rumor mill works overtime, and may even threaten business continuity.

While practices vary with specific circumstances, some institutions tend to inform employees when they undertake a concrete and visible action such as soliciting RFPs. Other institutions may do it as early as soliciting RFIs. However, no institution recommended announcements during the internal identification and evaluation phase given the uncertainty of the eventual decision to proceed with outsourcing. Another important concern is what and how much to communicate.

E. Establishing Controls and Ensuring Independent Validation

An essential element in mitigating operational risk is the establishment and agreement of key measures to effectively control the outsourced service. Financial institution management regularly assesses the controls necessary to conduct safe and sound operations and discusses these measures with the service provider. In many situations, the service provider's approach to performing the service is equivalent to or exceeds the control environment of the institution. However, security controls over corporate information and other assets needs to be clearly defined. Once defined, the institution can establish performance measures to monitor application of the controls.

In addition to monitoring, the institution should conduct independent validation of the service provider's operation to ensure the service is being delivered in a way that is consistent with the institution's objectives. An institution's internal audit function or evaluation by a third-party reviewer can accomplish this. The right of independent validation is established in the contract.

11. Clearly define expected security controls in the outsourcing contract and develop appropriate performance measures to monitor consistent application of those controls.

Outsourcing adds to the challenge of maintaining effective information security.[11] An additional dimension is the need to not compromise the corporate approach to security, even when certain responsibilities have shifted to the service provider. For example, when an institution outsources information processing and business processes, management establishes standards for controls and measures to be followed by the service provider such as providing dual control procedures governing sensitive records of the institution (e.g., no one individual

[11] See a related paper, *Sound Practice Guidance for Information Security for Networks*, Sept. 1997 **(www.bog.frb.fed.us/boarddocs/SRLetters/1997/SR9732.htm)**.

should be able to complete a sensitive transaction alone). Such controls and measures are stated clearly in the outsourcing contract and monitored by the service provider on a regular basis. The financial institution receives exception reports on all situations that may have occurred.

In most cases, the corporate security policy is provided to the service provider to ensure a level of security consistent with that of the institution. In the event of significant anomalies in security, the institution coordinates with the service provider to limit operational, reputational, and legal risks arising from security-related situations. Such procedures are typically set in place before the activity is transferred to the service provider.

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

Depending on the specifics of the arrangement, the institution's internal and/or external auditors may be involved in all phases of the process after the decision to outsource. Audit provides the independent review necessary to ensure that the outsourcing process is being implemented in a way that is consistent with management's objectives. After implementation, audit continues to be involved with on-going independent reviews of the arrangement with the service provider. The right to conduct such audits is established in the negotiated contract.

While the right to conduct audits is established in the contract, in some cases institutions choose instead to receive a copy of the third-party audit review performed by a certified public accounting firm. In either case, the institution ensures that some type of independent review takes place in accordance with the risk assessment methodology used by the institution (e.g., high risk activities are audited at least annually, medium risk activities every two years, and low risk activities every three years).

F. Establishing a Viable Contingency Plan

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

Outsourcing creates a dependency on the third-party service provider, which raises several issues that must be addressed. Concerns stem from the potential consequence of a business disruption or other problem at the service provider. In anticipation of such a situation, the financial institution needs to verify that the service provider has a prudent business recovery plan in place. The adequacy of this plan needs to be reviewed by audit as a part of the vendor selection due diligence process and on an on-going basis.

More importantly, the financial institution needs to have contingency plans in the event of deteriorating performance by the service provider or other such event. Given the costs of alternative options, most financial institutions work with the third party to resolve difficulties. In the face of unsatisfactory responsiveness, an institution's options include changing service providers, returning the activity to the institution, or sometimes even exiting the business. All institutions emphasize that these are very costly options, which are often taken only as a last measure. Nevertheless, this eventuality and associated costs are increasingly being prespecified in the contract as a part of the negotiation process. In older contracts, such clauses are added at renewal.

G. Conclusion

Financial institutions view outsourcing as a valuable strategic tool that enables them to focus on core competencies by shifting direct operational responsibilities to the service provider and gaining industry expertise. Interviews with market participants indicate a keen appreciation of the benefits and risks associated with outsourcing. The industry has devoted significant resources to mitigating outsourcing risk by developing business practices to effectively manage and monitor outsourced activities. Market participants agree that other critical elements include selecting a capable, qualified and appropriate service provider; structuring an arrangement that meets the needs of both parties; addressing unique human resource issues effectively; and establishing controls, independent validation and viable contingency plans.

From a supervisory perspective, the outsourcing trend is a significant development. Whether outsourcing results in an increase or decrease in the overall risk profile of an institution will depend on the significance of the outsourced activity, the effectiveness of controls over outsourcing risk, and the strength of the service provider. If not properly managed, outsourcing can increase an institution’s overall operational, legal and reputational risk, and ultimately lead to unintended credit exposures and business expenses, or other types of losses.

Appendix A
Regulatory Requirements Regarding Outsourcing

Financial institutions are increasingly selecting outsourcing as a business solution to improving their banking products and services. Certain laws, policy and guidance exist that contain requirements and, safe and sound practices with regard to outsourcing any banking activities. These are described below in an abbreviated fashion along with the supervisory concerns and information to obtain the complete documents. ***Institutions should also check with their appropriate state banking agencies for particular outsourcing requirements in their state. In addition, specific regulations may have been issued by other federal regulatory agencies.***

Bank Services Company Act ***(Public Law 87-856, October 23, 1962 as amended – Title 12, U.S. Code, Sec. 1861 et seq.)***

The Act describes the conditions in which a bank service company can be established as well as permissible activities. Also, it describes the necessary approvals that are required and in Section 7 discusses regulation and examination of bank service companies. Section 7 (c) (2) states "…whenever a bank that is regularly examined by an appropriate Federal banking agency, or any subsidiary or affiliate of such a bank that is subject to examination by that agency, causes to be performed for itself, by contract or otherwise, any services authorized under this chapter, whether on or off its premises – (1) such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the bank itself on its own premises…" This section provides Federal banking agencies the authority to examine third-party service providers, in the United States, that provide significant banking services to financial institutions.

Supervisory concern focuses on the ability of a banking institution to maintain effective control over an outsourced activity as though that activity continued to be conducted by the institution internally. The specific areas of outsourcing risks are detailed in this paper.

Interagency Statement on EDP Service Contracts for Financial Institutions ***(Web site –*** www.bog.frb.fed.us ***Supervision and Regulation Letter SR 90-5)***

The January 24, 1990 interagency statement alerts financial institutions to potential risks in contracting for EDP services and/or failing to properly account for certain contract provisions.

Supervisory concern focuses on financial institutions that enter into EDP servicing contracts that contain provisions which may adversely affect the institution. Contract provisions may include areas such as substantial cancellation penalties and improper inducements (e.g., the service provider purchasing assets, such as computer equipment, at book value, which exceeds current market value). Although the statement focuses on contracting for EDP services, these same issues may exist in contracts for other vital banking services. The risk-focused examination approach will establish that the scope of internal/external audit coverage includes a thorough review of contract provisions and that a comprehensive legal review of the contract was conducted.

Outsourced Service Arrangements ***(Federal Reserve Bank of New York Supervisory Letter dated March 29, 1995 – see Appendix B)***

The purpose of the supervisory letter was to remind Second District banking institutions of the reporting requirements of the Bank Services Company Act. Specifically, the requirement to notify the appropriate Federal banking agency of the existence of the service relationship within thirty days after the making of such service contract or the performance of the service, whichever occurs first. Notification includes the provision of the name and address of the service provider; nature of each service; the contractual and financial arrangement under which the service was established; and the date the arrangement began.

Supervisory concern focuses on the existence of a clearly written contract and an evaluation of the perceived risks for each outsourced service. When the service is critical to the institution, or has significant operational or other risks, supervisory concern extends to areas such as financial viability of the service provider, insurance considerations, audit coverage, contingency plans, security and controls. Examiners will review the scope of internal/external audit coverage to establish that outsourcing risks are effectively mitigated. In addition, accurate information provided to banking agencies allows timely notification to serviced institutions of a service provider that experiences problems which may affect the safety and soundness of banking institutions.

Fedwire Third-Party Access Policy ***(Web site –*** www.bog.frb.fed.us ***Supervision and Regulation Letter SR 95-48 SPE)***

The purpose of the policy, dated November 9, 1995, is to inform to depository institutions of modifications to operating procedures and requirements when Fedwire funds transfer or book-entry securities transfer operations are outsourced to a third party. Outsourcing Fedwire activities requires a separate approval process by the Federal Reserve System. Recent modifications also outline additional requirements for institutions that choose to outsource Fedwire activities outside the United States.

Interagency Guidance on the Internal Audit Function and its Outsourcing ***(Web site – www.bog.frb.fed.us Supervision and Regulation Letter SR 97-35)***

The purpose of the December 22, 1997 interagency guidance is to describe sound practices for management of an internal audit function that is outsourced. This policy statement contains guidance on outsourcing an internal audit function and the responsibilities of the board of directors and senior management for ensuring that a banking institution's systems of internal controls, including the internal audit function, are adequate for the nature and scope of the bank's lines of business. More specifically, this statement identifies appropriate organizational structures, internal audit management staff and quality controls, audit scope and communications.

Supervisory concern focuses on the quality and effectiveness of an institution's internal audit function. Areas of specific concern with regards to outsourcing include the ability of the financial institution to direct the efforts of the service provider in providing effective audit coverage e.g., retaining a senior audit officer to manage the vendor relationship. Also, that institutions and service providers must allow examiners to access a servicer's audit reports and related workpapers. Finally, if the service provider is a CPA firm that also certifies the bank's financial statements, they should not assume a management or employee role in either fact or appearance.

Industry Practices to Mitigate Vendor Risk: The Year 2000 Context ***(Web site –*** www.ny.frb.org/bankinfo/announce ***Federal Reserve Bank of New York supervisory paper dated April 1998)***

The purpose of the supervisory paper is to share information on industry approaches that mitigate Year 2000 vendor risk. The approaches are distilled into nine practices organized within a generalized vendor relationship framework.

Although the practices are not intended as supervisory guidance or regulation, they do reflect sound and prudent behavior in addressing Year 2000 vendor risk for institutions not completed with their conversion efforts. For other institutions, the practices may serve as benchmarks and suggest refinements to internally established programs.

Appendix B
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 institution-wide 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.*
Establishing controls and ensuring independent validation	**11.** *Clearly define expected security controls in the outsourcing contract and develop appropriate performance measures to monitor consistent application of those controls.*
	12. *Involve internal and/or external audit in the entire outsourcing process.*
Establishing a viable contingency plan	**13.** *Ensure that contingency plans are formulated and viable in the event of non-performance by the service provider.*