



Banking - The future of sourcing

A survey by Ernst & Young

Editorial

Selecting the right sourcing strategy for a bank is not a new topic and has challenged the financial services industry for years. Why has Ernst & Young selected this topic to perform a survey and discuss conclusions now?

The current economic crisis puts pressure on banks to further reduce costs and make the cost basis more flexible to adapt to changes. It also heightens expectations from third-party providers.

At a time when the natural tendency may be to shut off contact with the outside world to focus on core competencies, banks may feel trapped in long-term outsourcing arrangements negotiated under market conditions far away from today's economic reality.

Call for action

Answers to the following questions may indeed lead to an urgent call for action:

- ▶ Are the current outsourcing agreements still adapted to the changed environment and strategy?
- ▶ What action can be taken to select the right sourcing options?
- ▶ Which elements of the existing outsourcing relationship should be closely monitored?
- ▶ Is it all bad news, or does the current economic environment, in fact, present an opportunity to review today's sourcing approach?

Objectives

With our survey, we wanted to achieve 3 objectives:

- ▶ Identify key experiences of current outsourcing agreements as well as drivers, objectives and challenges for future developments.
- ▶ Understand the underlying reasons through personal discussions with key decision makers rather than ticking off questionnaires.
- ▶ Develop conclusions and action points to initiate and support the implementation of effective sourcing measures by banks and service providers.

Survey design

The survey included 27 banks/service providers located in Switzerland. The participating banks were divided into 3 groups: large private banks, small and medium-sized private banks, and large retail banks. We also included Swiss based service providers for banks offering business process outsourcing (BPO) and information technology outsourcing (ITO) for banks.

Purpose of this brochure

- ▶ *Survey results:* Summarize the information obtained by the survey respondents focusing on areas that are typically subject to change.
- ▶ *Issues to consider:* Highlight key messages, considerations and challenges we derive from the survey results and our sourcing experience.
- ▶ *Call for actions:* Suggest measures to facilitate sourcing considerations and support implementation of changes. Initiate a discussion about enablers and disablers in the current sourcing market.

Authors

We are at your disposal for any follow-up discussions and support.



A handwritten signature in black ink, appearing to read 'B. Böttinger'.

Bernhard Böttinger
Partner



A handwritten signature in black ink, appearing to read 'J. Brun'.

Jürg Brun
Partner

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Key messages

We derive the following key messages from the discussions with our respondents:

Aware and open for change

Ongoing assessment of current and future sourcing options and changes is critical and strategic. Even banks that traditionally have not outsourced or centralized services are now considering new sourcing options.

Limited choice

The service offering and the service provider market is considered to be limited or leading to unwanted dependencies on specific service providers who in addition must guarantee solid financial structures.

Focus on business case

Cost reduction is the main driver for outsourcing and the business for outsourcing has never been more compelling. However, group-internal shared service center solutions are considered less costly than different local outsourcing solutions. Qualitative measures (compare the comparable) and unclear cost factors create business case uncertainties.

Short vs. long term

Short-term needs risk to override long-term strategies, and barriers may hide the potential for cost reduction, specialization and standardization.

Lack of standards

Lacking standards for business and IT processes raise barriers for centralization and/or outsourcing of all or parts of them, like unclear accountability, complexity or extended customization.

More precise regulations

There is a need for further regulatory guidance since the current expectations of the regulator are often unclear or not specific for companies providing insourcing services.

Manage and monitor

Insufficient experience with managing outsourcing changes and processes combined with a lack of trust in service providers may increase senior management's hesitation to take advantage of new sourcing options.

Losing control

Outsourcing slices of the value chain or complex systems may lead to unwanted dependencies on third parties. The lack of exit and fallback options may reinforce this perception.

Powerful infrastructures

A general call for strong BPO and ITO infrastructures is voiced loudly and clearly but is unheard at the same time. The lack of a first moving leader is a probable cause, systemic dependency risk considerations might also contribute.

Catching up

Service providers face the challenge of delivering reliable services and at the same time keeping systems up to date, introducing new user organizations and renewing technologies and service architectures. Well established third party service providers have a good potential for increasing their service offering.

Ernst & Young conclusions

- ▶ Current service providers significantly expand their service offering and increasingly work independently.
- ▶ Limited choice leads to no outsourcing.
- ▶ BPO for large bank operations is currently difficult to make work - only a step-by-step approach seems feasible.
- ▶ The financial services marketplace in Switzerland needs to develop a vision for sourcing opportunities.



Goals and risks of outsourcing

The respondents highlighted the following points:

- ▶ **Specialization:** The most commonly stated objective banks want to achieve with their outsourcing initiatives is specialization (focus on core client business, streamline organization, optimize headcount).
- ▶ **Cost reduction:** The underlying primary driver for the outsourcing business case is cost reduction or at least maintaining the current cost level in the future. However, respondents agreed that it is difficult to benchmark and measure the impact on cost reliably.
- ▶ **Complexity and risk:** Reducing complexity and risk as well as change management capabilities are considered prerequisites for successful outsourcing.
- ▶ **Operational goals:** Improving process quality and performance is the most cited operational objective to be achieved by outsourcing.
- ▶ **Regulations and risk:** Some banks suggest more transparent regulations for service providers. While service providers perceive increased shared responsibility for performance risks as becoming part of their service offering, such sharing was not high on the banks' priority list.

Selected citations

- ▶ The bank is open to any sourcing options as long as they are supported by a convincing business case.
- ▶ Appropriate segregation of back office and front office functions requires appropriate bonus incentives in line with roles and responsibilities.
- ▶ Switzerland needs infrastructure to outsource; and the regulator needs to implement specific rules for service providers.

Ernst & Young conclusions

- ▶ **Strategy:** We see an accelerated trend by banks to focus their business model even more on the client advisory activities and to seriously evaluate high-quality solutions for their non-core processes.
- ▶ **Management:** Beside a sound business case, top management support is key to successful implementation of different sourcing solutions.
- ▶ **Business case:** Although cost and efficiency mainly drive outsourcing decisions, preparation of appropriate business cases and their communication to senior management remain important challenges which may lead to substantial non-achievement of strategic long-term goals.
- ▶ **Unclear service offering:** The following service provider selling points are insufficiently recognized by the market:
 - ▶ Growth potential and scalability options.
 - ▶ Service evolution over time (market needs, efficiency increase, cost reduction, compliance).
 - ▶ Shorter time to market is seen almost adversely by providers and banks.
 - ▶ Improved customer service leads to different perspectives between providers and banks.
- ▶ **Lack of metrics:** Further progress is required for standardized outsourcing metrics, including qualitative factors, to achieve "comparing the comparable" with new sourcing solutions.
- ▶ **Incentives:** Adapted incentive solutions are important enablers of successful outsourcing.

Actions to consider

- ▶ **Prepare strategy:** Prepare a sourcing strategy that addresses short-term needs without jeopardizing long-term goals.
- ▶ **Obtain commitment:** Involve senior management early and regularly in sourcing decisions and projects and decide with maximum awareness.
- ▶ **Implement metrics:** Define a small but consistent set of metrics for monitoring existing and justifying planned sourcing solutions and aligning incentives.
- ▶ **Clarify service offering:** Ensure transparent service offering addressing the areas of controversial expectations between banks and service providers.

Perception of the importance of outsourcing risks



Business process centralization and outsourcing

The respondents highlighted the following points:

- ▶ **Plans for the near future:** Most respondents plan to (further) outsource and/or centralize business processes in several areas of the banking value chain.
- ▶ **Potential:** Execution and settlement is currently the major BPO area and is considered to have the highest outsourcing potential in the future, together with payments and product development. Little interest is shown in further outsourcing support processes, except IT. The priority in credit administration is primarily seen in increased automation rather than in outsourcing. Most processes in sales and advice are too closely linked to client service to be considered for outsourcing.
- ▶ **BPO service infrastructure:** Many respondents indicated their preference for larger regional/national BPO infrastructure offerings, including the related IT.
- ▶ **Offshoring:** Offshoring of business processes was not considered a priority by the responding banks. Some banks are evaluating increased offshoring of selected IT related services (e.g., development).

Selected citations

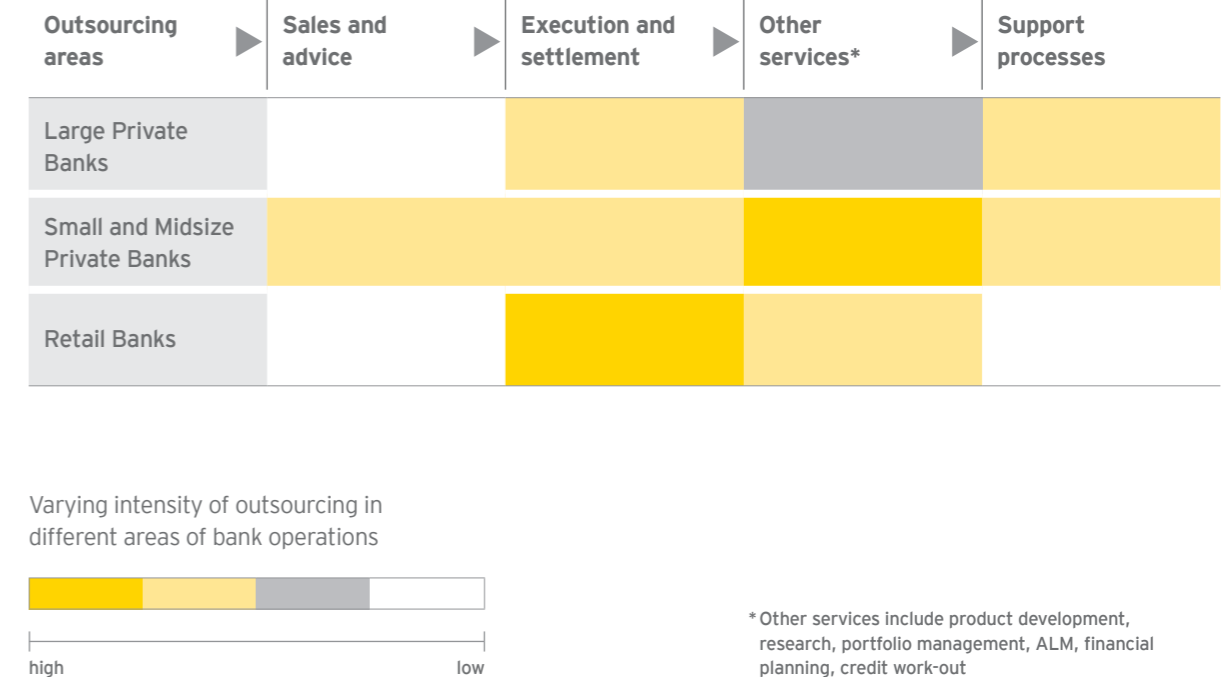
- ▶ Setting up a transaction bank by SIX Group would be interesting.
- ▶ How would a risk management service provider ever dispose of the required historic data that only exists in the bank's own information system?
- ▶ There is no easy route back should outsourcing not work.
- ▶ Sharing "mini-CFO, -CRO and -CIO functions" with service providers would allow banks to focus on the COO function.

Ernst & Young conclusions

- ▶ **Mergers, acquisitions and divestitures:** Increased structural changes are a consequence of the market development and heighten the emphasis on the flexibility, scalability and specialized know-how that might lead to considering new sourcing solutions.
- ▶ **Market offering:** First movers in providing larger BPO infrastructure would be welcomed by several respondents but no leadership role is established in the Swiss market.
- ▶ **BPO barriers:** Despite the perceived potential, many banks still consider the barriers for implementing centralized/out-sourced business processes as too high.
- ▶ **Risk management:** A general interest is shown for exploring partial risk management process outsourcing focusing on methodology improvement and access to specialized know-how.
- ▶ **Product outsourcing:** Although generally a well accepted outsourcing area, the more complex and risky a product is the more in-house knowledge is required.
- ▶ **Outsourcing exit options:** The lack of predefined and agreed upon outsourcing exit and fallback options is considered an important barrier, in particular in times where some selected reinsource movements can be observed.

Actions to consider

- ▶ **Assess BPO options:** Critically assess current business process structures and consider simplification, centralization and outsourcing options.
- ▶ **Promote service infrastructure:** Promote opportunities and roles for creating larger BPO and ITO service infrastructure offerings by involving large service organizations.
- ▶ **Assess barriers:** Obtain an independent and objective assessment of barriers and measures related to sourcing options.
- ▶ **Weigh risk management sourcing options:** Carefully consider the pros and cons of risk management outsourcing before decomposing these processes.
- ▶ **Provide exit options:** Include exit and fallback options in existing or new service level agreements and outsourcing contracts.



* Other services include product development, research, portfolio management, ALM, financial planning, credit work-out

Information technology outsourcing

The respondents highlighted the following points:

- ▶ **Extent of outsourcing:** The majority of banks surveyed currently use ITO to varying degrees and plan to extend the scope in the future, in particular in the area of IT operations.
- ▶ **Uncertainties:** Although most outsourcing experience stems from ITO, there are still uncertainties in the banks about defining a consistent and long-term IT sourcing strategy, e.g., with regard to platform life cycle, regulatory compliance, ownership and going-concern of providers, international competition.
- ▶ **On-demand services:** On demand services are generally seen as a potential future outsourcing area, although few service providers currently offer service-oriented architecture solutions.
- ▶ **IT platforms:** More and more banks are implementing standard banking systems and lay the ground for (further) information technology outsourcing. However, the operating models used as a basis for such systems still require considerable customization and lead to complex systems, thereby driving down financial attractiveness for the provider.

Selected citations

- ▶ The challenge for IT application systems is: how much does it cost not to invest?
- ▶ Service-oriented architecture remains a theoretical concept due to different data models, development tools or technology standards.
- ▶ We only select an ITO service provider who is responsible for the complete system environment, including satellite systems developed or run by other third parties.
- ▶ A barrier to outsourcing exists if a service provider offers core banking applications that are based on old technologies.

Ernst & Young conclusions

- ▶ **Standardization:** Since ITO models are still highly customized, the know-how for one-time and ongoing parameterization requires considerable efforts by the banks and the service providers.
- ▶ **Different IT platform providers:** Reducing the number of different IT platform providers remains an important objective. While striving for all-in-one service providers, many sourcing solutions still require different providers and increase the interface management complexity.
- ▶ **Release capability:** The different systems needed to support a bank's operations require internal know-how, discipline and effort to keep up with costly and complex platform releases developed by the vendors.
- ▶ **Platform lifecycle:** The challenge with IT application systems is to evaluate their position in the technological and functional lifecycle.
- ▶ **On-demand services:** Although perceived as a convincing concept, experience with practical implementations still needs to be gained.
- ▶ **Independent attestation:** IT outsourcing service providers face increasing demand to provide independent attestations related to service delivery processes and contract compliance. This becomes particularly important where service providers subcontract some of the services from other organizations.

Actions to consider

- ▶ **Reduce complexity:** Streamline process integration and reduce the number of service providers and interfaces.
- ▶ **Balance know-how:** Maintain a balanced team structure of internal know-how and external specialist support.
- ▶ **Increase standardization:** Request and promote standardized process and business models for IT platforms, including application interfaces and service architectures and develop standards to reduce release compatibility issues.
- ▶ **Consider platform lifecycle:** Take into consideration all short- and mid-term investments to create a reliable basis for full-cost sourcing evaluations.
- ▶ **Request attestations:** Request and promote the use of independent attestations to reduce duplication and cost.



Preferred service providers

The respondents highlighted the following points:

- ▶ **Limited market:** Many of the respondents complained about the perceived oligopoly structure of the restricted service provider market in Switzerland.
- ▶ **Roles and responsibilities:** Banks require clear definition and separation of roles and responsibilities with service providers allowing for appropriate accountability and performance metrics.
- ▶ **Service provider independence:** For ITO, the service provider ownership is considered less critical, with independent service providers being the preferred solution. For BPO, bank-owned service providers are suggested mainly to ensure access to specialist knowledge.
- ▶ **Regulated service providers:** Banks expressed the need for a better regulated service provider market offering in Switzerland.

Selected citations

- ▶ Independence is a strategic MUST for service providers; banks do not want to outsource to other banks.
- ▶ A government-owned service provider would have little chance since banks prefer independent service providers.
- ▶ International competition will increase in all outsourcing areas due to regulatory changes (e.g., bank secrecy).

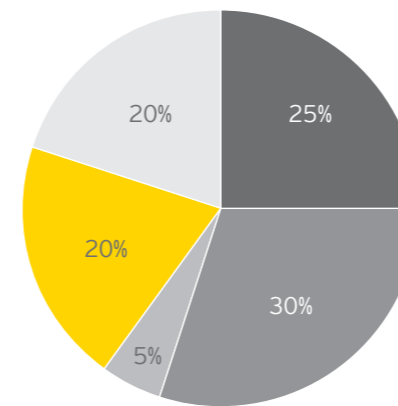
Ernst & Young conclusions

- ▶ **Service provider responsibilities:** Clear allocation of responsibilities between bank and service provider is essential since the bank continues to own execution and performance risks.
- ▶ **Service provider ownership and location:** While there is openness to the ownership structure of ITO service providers, no doubt exists with regard to the mandatory Swiss (respectively Liechtenstein) location of BPO and ITO service providers due to jurisdiction concerns.
- ▶ **Service provider regulations:** While the current outsourcing regulations are well accepted, more specific benchmarks and guidance, in particular for BPO, are required.
- ▶ **Changes of service providers:** We expect convincing and more transparent service offerings for BPO and ITO to increase the willingness to change the service provider. Although the appetite for change is low, IT platforms still drive changes of ITO providers.

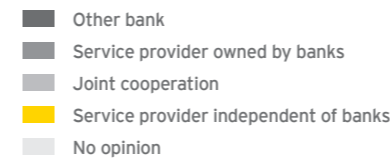
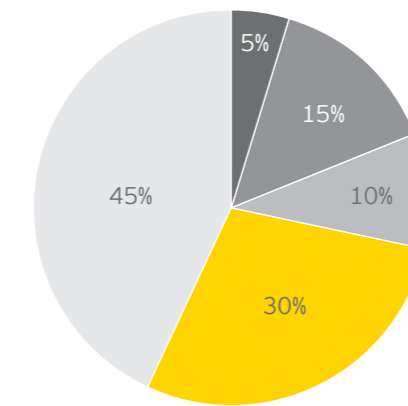
Actions to consider

- ▶ **Increase offering transparency:** Service providers should consider increasing the transparency and pro-active communication of their market offerings and promote more standardized service contracts/service level agreements.
- ▶ **Specify regulations:** All parties involved should promote further regulatory clarification and more concrete guidelines for BPO and ITO constellations.
- ▶ **Include appropriate selection criteria:** The service provider selection should, among others, include criteria like business model, size and volumes, type of banking platform as well as financial and operational stability of the service provider.

BPO-preferred providers



ITO-preferred providers



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Contacts

Bernhard Böttinger, Partner, Advisory

Financial Services

Phone +41 58 286 46 92

Email bernhard.boettinger@ch.ey.com

Jürg Brun, Partner, Advisory

Financial Services

Phone +41 58 286 32 03

Email juerg.brun@ch.ey.com

Thomas Schneider, Partner, Assurance

Financial Services

Phone +41 58 286 33 18

Email thomas.schneider@ch.ey.com