Offshoring / Outsourcing Banks' Trade Services

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Executive Summary

Ever since offshoring and outsourcing in the services sector began to evolve, the banking industry has been in the fore-front to take advantage of this trend. While it started with non-core activities in the periphery, as capabilities and confidence grew, it has progressed to business enablers such as IT and then to critical back-office processes and pre-sales/post-sales support activities.

Trade Services, such as letters of credit, offered by Banks is a critical business activity that has been considered for offshoring/outsourcing by major banks in recent times. Interestingly, as we shall show, the need here is not just because of cost, but due to other multiple inter-linked business factors.

As banks are regulated entities, the offshoring of banking services has received the attention of central banks. The Basel Committee on Banking Supervision (which is a global central banks organisation) through a Joint Forum has identified key risks in outsourcing and offshoring of the banking services and has provided recommendations on how central banks and banks should address these risks. We will go through the highlights of this consultative document in this paper.

For case study purposes, we will share in this paper, ABN AMRO's approach to the restructuring of the trade delivery model and some of the experiences associated with offshoring back-office processes to India. In conclusion, this paper will also touch upon how ABN AMRO has been able to leverage the offshoring capabilities to providing outsourcing (third party) services to other banks.

1. Market Scenario for Trade Services Banks

Introduction

International trade grew by 6.5% during 2005. The corresponding growth for world GDP and world production (aggregation of the world's output in the agricultural, mining and manufacturing sector) are 3.3% and 2.6%.[1] This trend is not new. For several years now, the growth of world trade has outpaced the growth of world production. This reflects the nature of many goods and services that are transhipped for value addition in several countries before they reach the ultimate consumer. In turn, this raises the need for supporting commercial services.

A significant part of this comes from the banking industry in the form of Trade Services, which is formally defined~~s~~ as any banking activity that supports an enterprise in completing a global trade. It includes letters of credit, collection services, trade finance and payment services. The products under Trade Services are traditionally products that facilitate exchange of documents for payment or payment commitment by the buyer's bank and the seller's bank acting on behalf of their respective clients. As banks are regulated entities they act as trusted intermediaries between the buyer and the seller, who may be in different geographies and time-zones.

Payment Services are provided when a bank executes a payment on behalf of its client to the seller's bank, to pay the seller for the goods received or to be received.

Banks provide pre-shipment and post-shipment finances to help produce goods and to sell or buy the produced goods.

The Paradox

The trade landscape is changing rapidly today. Large manufacturers have realised that as critical parts of the manufacturing processes are being procured from sources across the globe and inventory management is a key driver, they no longer can adopt a transaction based, buyer-vendor approach, even if the vendor or the supplier could be an SME in an emerging market. Hence the emergence of the relationship based Supply Chain approach with shared goals and objectives between the partners in the chain.

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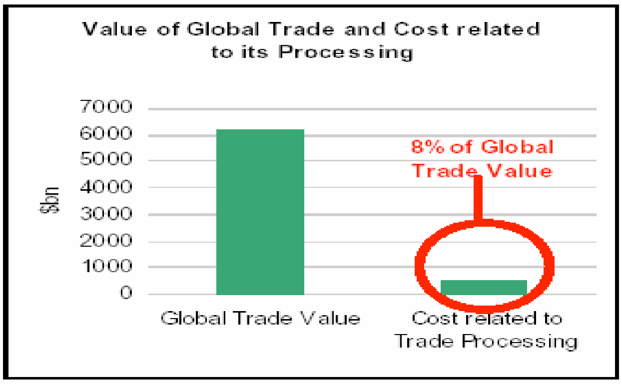
[1] Reference: World Trade Organisation (WTO), International Trade Statistics 2006

While a strong buyer-seller relationship approach is good for banks providing finances to trade, it has reduced the usage of the traditional intermediary services products. Many buyers and sellers prefer to deal directly on an “Open Account” basis whereby they agree on schedules for shipment and payment and exchange commercial documents (including title to goods) directly. This has resulted in a significant loss of fee income for banks that are providing trade services.

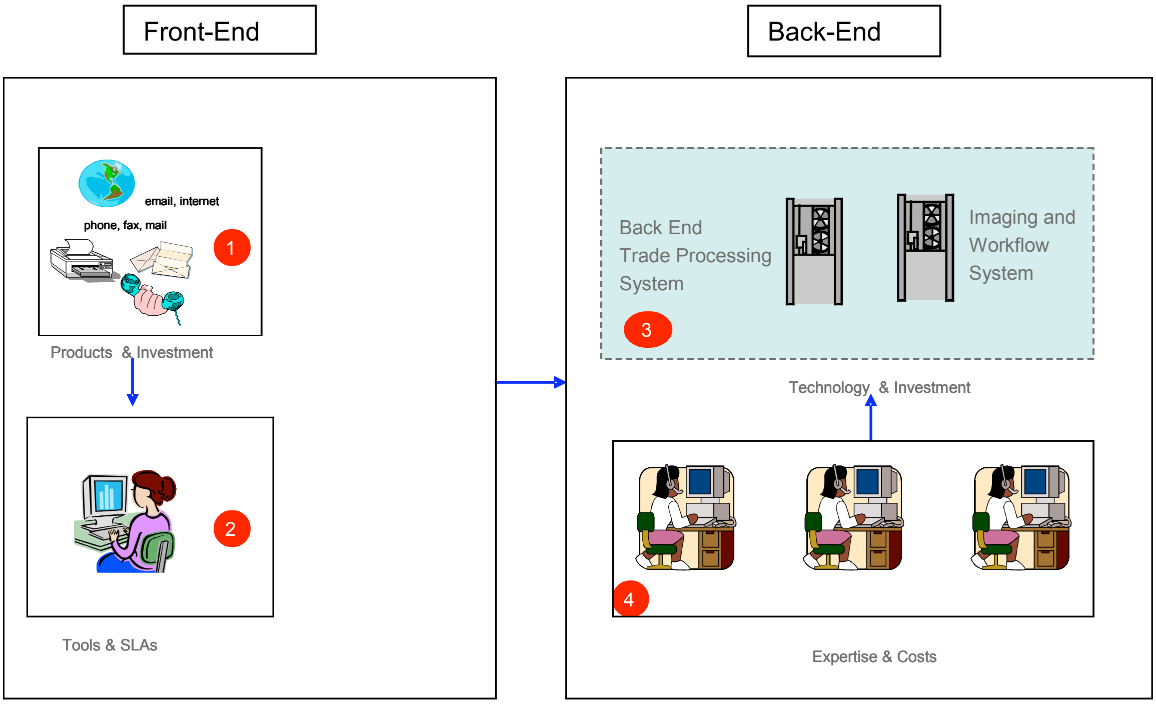


Source: Celent Communications

Trade Banks are hence changing their strategic pursuits in one of the three ways.

Growth: Make step- change. Offer new products & services. Considering market dynamics, time to market and low investments are important drivers. Goal – Long term revenue growth. Harvest: Margins are under pressure. Hence, there is a need to either lower the price and the costs correspondingly or hold on to the price levels by creating consumer surplus. Maintain: Trade is only a support product for other business lines. There is a need to reduce costs, without impacting other business lines.

Capabilities required to delivering trade services



1. Front-end Electronic Channel

A corporate customer conducting trade business with the banks requires an internet based front-end system so that it and its suppliers can stay connected with the bank, from various locations (offices), to send, and query on, their transactions. This is a relatively new product for a bank which calls for additional resources in product development and technology

2. Local Customer Service Staff

Even though the commercial process has become easier today than in the past, compliance to various countries' regulations and optimizing the opportunities necessitate corporates to seek advisory services from banks from time to time and in many cases in their own local language. Appropriate and adequate staff, to be able to leverage on a positive customer experience for business benefits, is an important need.

3. Back-end Processing Platform

A back-end system is required to process trade transactions and generate accounting entries to the bank's book-keeping system and also pass credits and debits to the customer accounts. This system has to be capable of handling multi-locational, multi-entity situations to drive down the investment in hardware and implementation time-frames and also be flexible enough to be accessed from various locations. As new technologies emerge on the front-end side, the back-end system also has to be compatible with them.

4. Back-end Technical Operations Staff
Trade technical expertise is a key requirement to process transactions in line with international and local regulatory requirements, International Chamber of Commerce guidelines and bank's own internal policies and procedures. With the banks' overall trade business shrinking, it has put a serious limitation on availability of new talent to backfill the retiring staff in developed markets.

As can be seen from the above, the banks are facing a "comprehensive business" problem as opposed to just a cost and/or service problem. It can be ~~, as~~ summarised as below.~~below.~~

(a) Value Proposition
(b) Technology Investment
(c) Operating Cost
(d) Technical Expertise

Hence, only "extending the key-board" to a low-cost location does not provide a sustainable, optimum solution to their problem.

2. Offshoring/Outsourcing from a Compliance Perspective

The Joint Forum of the Basel Committee on Banking Supervision established a working group to develop high-level principles about outsourcing. The key issues and risks and the principles are contained in the Joint Forum Publication, February 2005 [2.]

The following are the extracts of the key risks identified in this publication:

Risks	Major Concerns
Strategic Risk	The third party may conduct activities on its own behalf which are inconsistent with the overall strategic goals of the regulated entity. Failure to implement appropriate oversight of the outsource provider. Inadequate expertise to oversee the service provider.
Reputation Risk	Poor service from the third party. Customer interaction is not consistent with overall standards of the regulated entity. Third party practices not in line with stated practices (ethical or otherwise) of regulated entity.
Compliance Risk	Privacy laws are not complied with. Consumer and prudential laws not adequately complied with. Outsource provider has inadequate compliance systems and controls.
Operational Risk	Technology failure. Inadequate financial capacity to fulfil obligations and/or provide remedies. Fraud or error. Risk that firms find it difficult/costly to undertake inspections.
Exit Strategy Risk	The risk that appropriate exist strategies are not in place. This could arise from over-reliance on one firm, the loss of relevant skills in the institution itself preventing it bringing the activity back in-house, and contracts which make a speedy exit prohibitively expensive. Limited ability to return services due to lack of staff or loss of intellectual history.

Counterparty Risk	Inappropriate underwriting or credit assessments. Quality of receivables may diminish.
Country Risk	Political, social and legal climate may create added risk. Business continuity planning is more complex.
Contractual Risk	Ability to enforce contract. For offshoring, choice of law is important.
Access Risk	Outsourcing arrangement hinders ability of regulated entity to provide timely data and other information to regulators. Additional layer of difficulty in regulator understanding activities of the outsource provider.
Concentration and Systemic Risk	Overall industry has significant exposure to outsource provider. This concentration risk has a number of facets, including: • Lack of control of individual firms over provider; and • Systemic risk to industry as a whole.

The Joint Forum developed the following high-level principles for a bank (a regulated entity), which is considering outsourcing, and their regulators to bear in mind:

1. A Comprehensive Policy to guide the assessment of whether and how those activities can be outsourced. The Board of Directors or equivalent body retains responsibility for the outsourcing policy and related overall responsibility for activities undertaken under that policy.
2. A Comprehensive Outsourcing Risk Management Programme to address the outsourced activities and the relationship with the service provider.
3. The Outsourcing arrangements should neither diminish its ability to fulfil its obligations to customers and regulators, nor impede effective supervision by regulators.
4. Appropriate Due Diligence in selecting third-party service providers should be conducted.
5. 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.
6. Both the regulated entity (the bank) and its service providers should establish and maintain contingency plans, including a plan for disaster recovery and periodic testing of backup facilities.

7. Appropriate steps should be taken to ensure that the service providers protect confidential information of both the regulated entity and its clients from intentional or inadvertent disclosure to unauthorised persons.

8. Regulators should take into account outsourcing activities as an integral part of their ongoing assessment of the regulated entity (bank). Regulators should assure themselves by appropriate means that any outsourcing arrangements do not hamper the ability of the regulated entity to meet its regulatory requirements.

9. Regulators should be aware of the potential risks posed where the outsourced activities of multiple regulated entities are concentrated within a limited number of service providers.

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[2] Reference & Further Reading: Basel Committee on Banking Supervision, The Joint forum, Outsourcing in Financial Services, February 2005 publication of Bank for International Settlements.

3. Case Study : ABN AMRO's Offshoring/Third Party Experience

ABN AMRO responded to the market situation by taking the following steps:

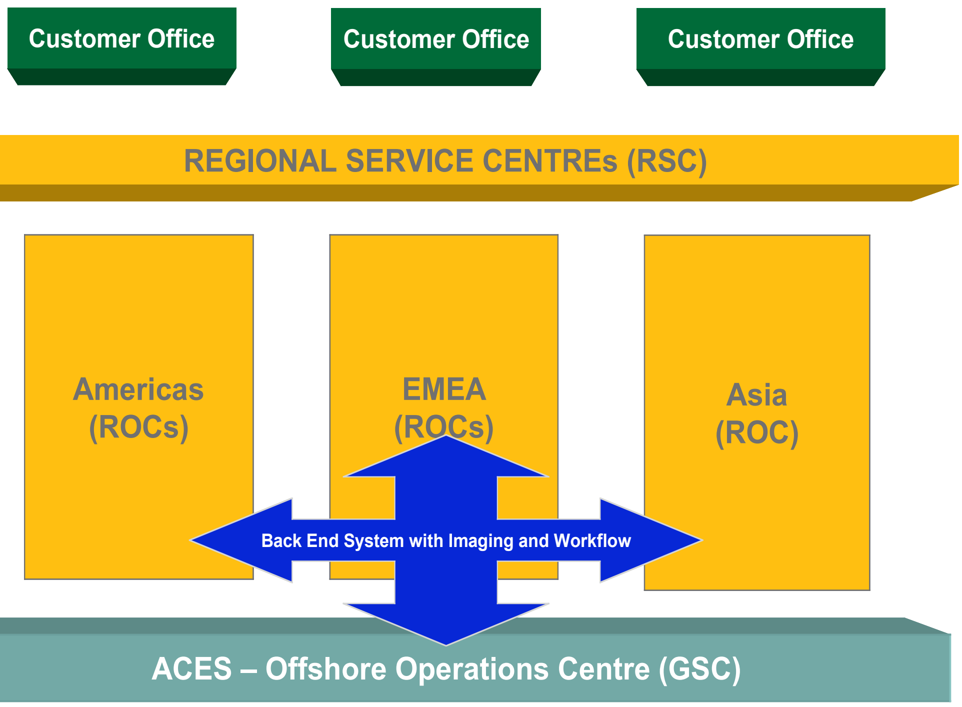
1. Invest in Technology
2. Create an Offsore Low Cost Knowledge Centre
3. Restructure and Consolidate captive business
4. Create White-labelling capabilities
5. Provide Insource business from other banks (third-party services)

Taking into account the need to maintain local touch points and at the same time to reduce cost and create a pool of expertise, ABN AMRO converted the trade business into a globally integrated business but with a local and regional content.

The trade operations jobs were split into three components: Front Office, Client Services and Back Office Operations.

The trade offices in the countries were re-designated as Customer Offices to provide the Front-Office (advisory services) to the clients.   The routine (linear) client service requirements were moved to a Regional Service Centre which was staffed with multi-lingual people with abilities to serve more than one country in the region.

In order to link-up the various offices, the in-country/regional backoffice systems were migrated to a global platform with a view of the work across the globe. A new web-based front-end system was created with additional supply chain products.



The Back-office operations were Offshored to a bank's subsidiary (ACES – ABN AMRO Central Enterprise Services Pvt Ltd) created in India with the ability to operate on a 24 x 7 basis and to become a centre of trade expertise.

<u>Initial Challenges – Send Side:</u>

As is the case with many such projects, the pilot phase was a crucial and challenging one. For strategic reasons, migration of five countries processes into India within the first year (on a lift and drop approach) was required to be achieved in the first year. With no prior offshoring experience and only centralisation experience, this was not going to be easy. Added to this, is the fact that in many countries offshoring of banking services required conformance to specific guidelines from the central banks, which in some case had the potential to extend the pilot phase beyond the first year.

The offshoring of services was also linked to headcount rationalisation in these countries which included discussions with various trade union bodies.

Trade Services has a strong linkage to Credit and Cash processes and systems. It was hence essential to ensure that all the stake-holders buy-in was received before the process from a country could be migrated.

As the work required images to be transferred to the offshored location, the bandwidth of the telecommunication network had to be augmented to ensure smooth transfer.

<u>Initial Challenges - Receive Side:</u>

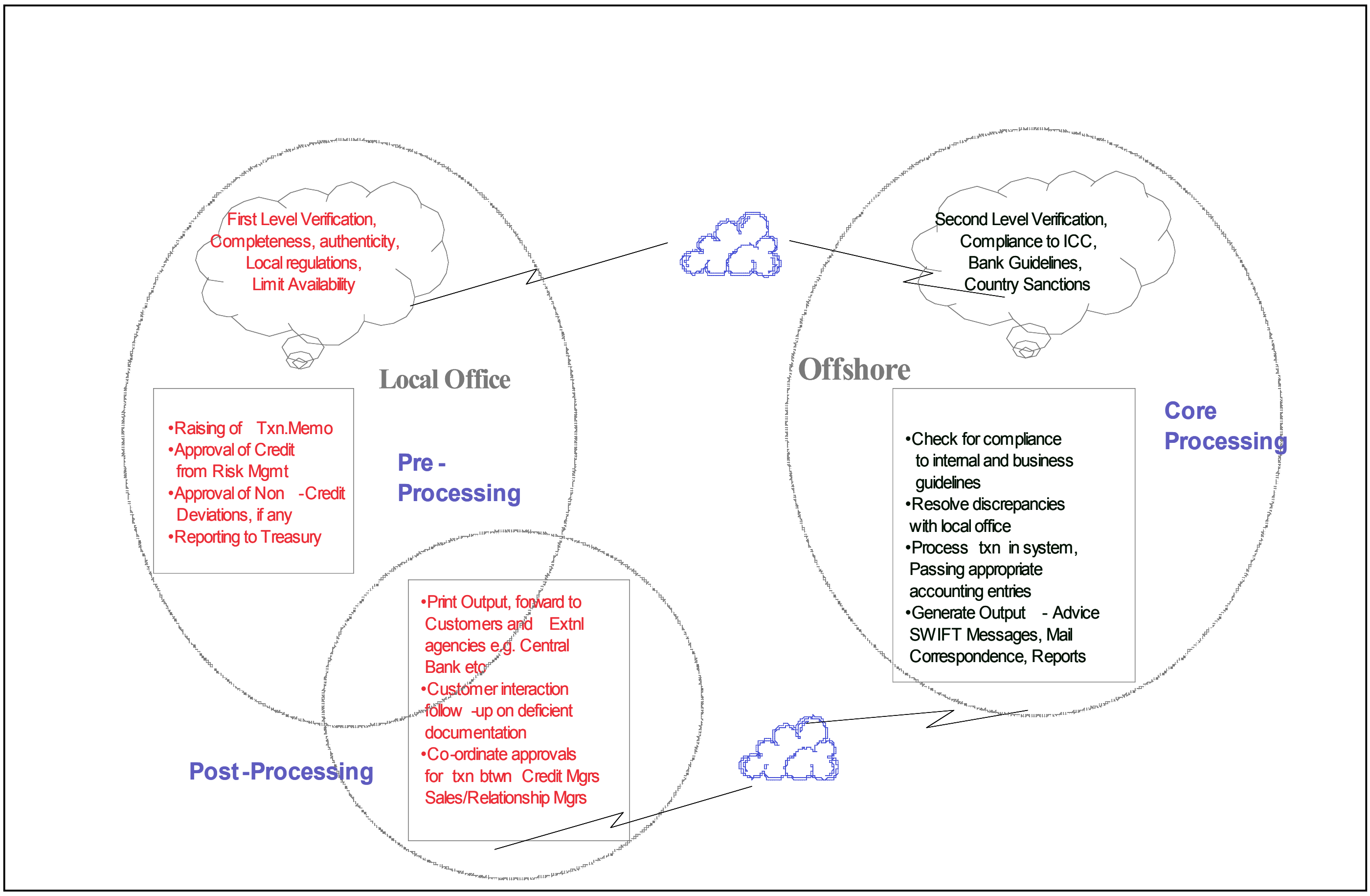
Offshoring and providing banking services at 3 am in the morning was something that was not widely heard of in the year 2000. Hence, to find appropriate and adequate staff willing to work at odd shifts, with the buy-in of their families, was an important task.

Training new staff on a significantly complex process (example Checking Commercial Documents against Letters of Credit in line with International Chamber of Commerce regulations) was a daunting task. As certain customer/physical documentary process steps were left behind in the countries (see sample model), offshoring presented with new risks which had to be identified and addressed suitably.

As ABN AMRO in Chennai did not have adequate space to accommodate this expanded service, a new office facility of floor space of about 20,000 sqft had to be built-up in just 45 days. As these activities qualified for a Software Technology Park of India (STPI) special status, the documentation and process required were different from what the Bank was used hitherto.

As the Transfer Pricing regulations had just been introduced in India, finding the right cost allocation method and implementing it in quick time was a challenge on the Finance side.

Sample Model for Offshoring of Trade Processing:



Thanks to a commitment across the whole organisation, the challenges were overcome and the five countries were migrated in time and successfully. This success gave the Bank the confidence to offshore many more of its processes to India.

Today, ACES has operations in 3 cities (Chennai, Mumbai and New Delhi) and handles a whole range range of services. An example of this is given below.

Processes	Tier-1 (Least Complex)	Tier 2	Tier 3	Tier 4
Treasury	Transaction Processing	Loan Administration, Agency Services	Trade Support & Settlements, Cash Management & Brokerage	FX Asset Servicing, Derivative Confirmation
Transaction Banking	Reporting, Message Processing & Indexing	Global Incident Management, Electronic Payment Repairs	Account Facilitation, Documentary Collections, Cash Pooling, Training	Documentary Checking & Preparation, Trade Financing, Reconciliation & Investigations
Consumer & Commercial	Cheque Processing, ATM Maintenance, Consumer Lending Index, Pin Generation	Loan Maintenance, Account Opening and Maintenance	Mutual Funds, NRI Processing, Loans against Securities	Risk Management, Real Estate Capital Market, Financial Statement Spreading
Shared Services	Data Entry	Cost Allocation Analysis, Off market price testing, System Testing, IT Help Desk	Reporting & Decision Support, Revenue Analysis, P&L Analysis, Application Regression, IT Project Mgt. Vendor Mgt.	Basel 2 Data Warehouse Product Delivery, User Training
Business Support Services		Equity Research Production	Equity Research Analysis	Global Clients Analysis

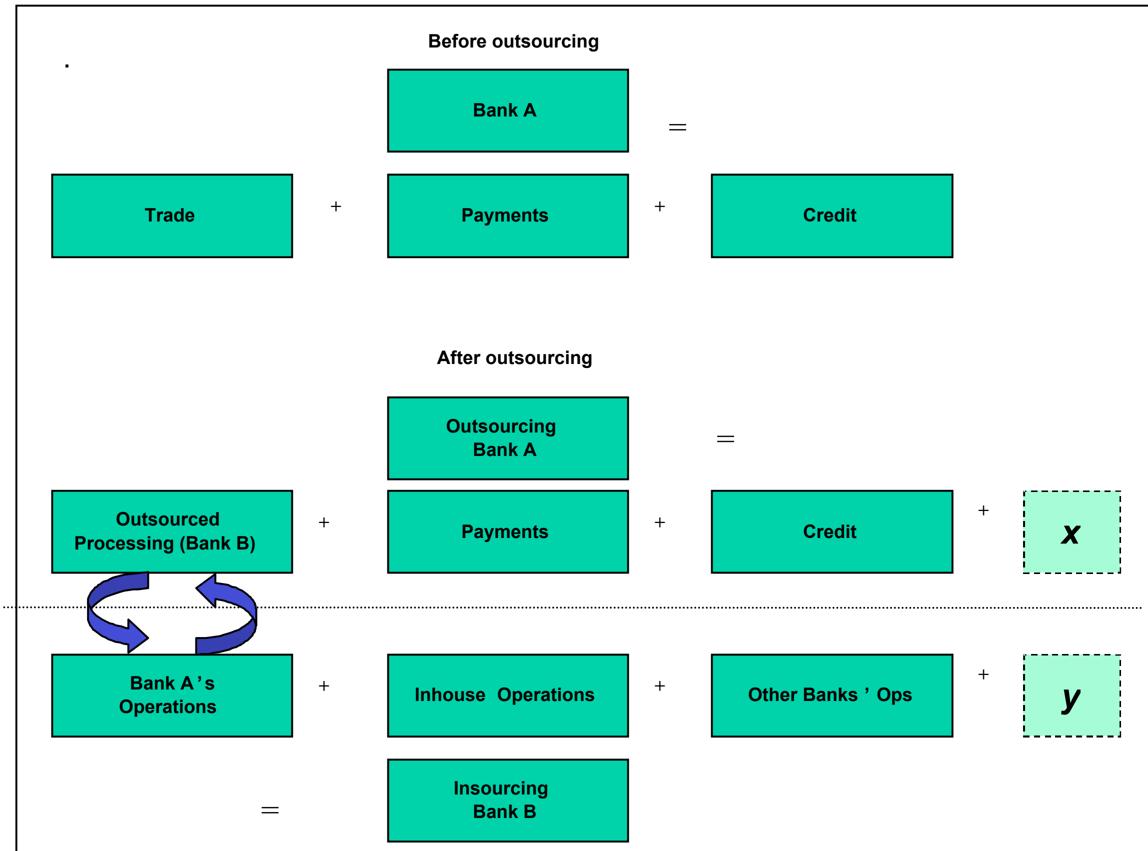
ACES now has over 3750 staff with about 875 staff working only on the Trade Services product. This makes this shop, one of the largest concentrations of trade staff in the world. A significant number of the staff has a professional degree (MBA, Chartered Accountancy, Cost Accountancy and Engineering).

Challenges in Outsourcing Banking Services

A thorough understanding the inter-dependency of the processes being outsourced with the other business units' processes and the buy-in of all stake-holders who touch the outsourced processes is a key success factor.

To understand this let us try to express two banks, the outsourcing bank (Bank A) and the insourcing bank (Bank B) through a simple first order algebraic equation, only with two other business processes/units, as variables).

As we introduce a new variable in any mathematical equation the result changes, the structure of the organisation, however small it may be, changes. It is also generally presumed that outsourcing affects only the organisation that is outsourcing and not the organisation that is insourcing. This is not true as can be seen from the emphasis that has been placed by the Basel Committee paper discussed earlier.

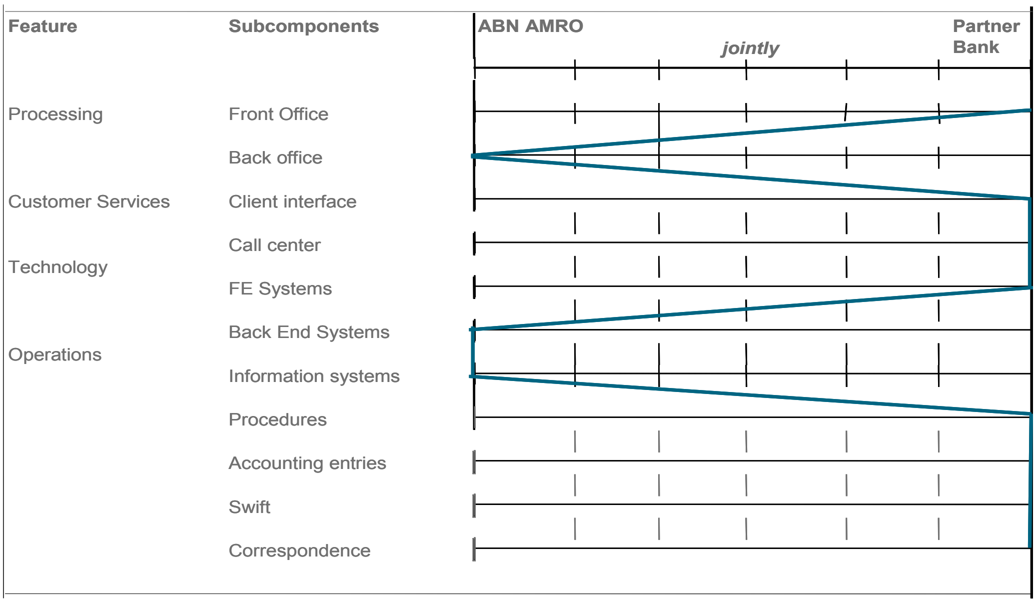


It is not possible to replace or add a business process without impacting, in some way, the existing set-up. x and y are "synergy" or "disturbance" variables that may arise from internal relationships, unwritten customers/practices, cultures/values, inter-related processes etc. Not recognizing that the equation changes and allowing for these variables is a cause of failure of many outsourcing initiatives

ABN AMRO's Insourcing Experience (Third Party Services)

The market was now, for reasons mentioned above, looking for opportunities to offshore their processing and lower their cost base. After migrating a large percentage (around 60%) of the bank's business offshore, ABN AMRO was in a position to create white-labelled capabilities on the technology side and offer offshore backoffice capabilities to other banks who did not either have scale or had a strategic objective to offshore.

To enable clients of ABN AMRO's trade services outsourcing business to choose their most efficient portfolio, ABN AMRO broke the trade services process into sub-components to be able to customize the needs of a bank and their immediate and long term goals. Based on this approach, the outsourcing bank could choose the components and the degree of outsourcing that they were comfortable with. This is illustrated below



What do Outsourcing Banks look for?

Feedback from clients suggests the following:

Drivers for Outsourcing: Operating Model, Cost Reduction, Service Improvement and Partnership Opportunities.

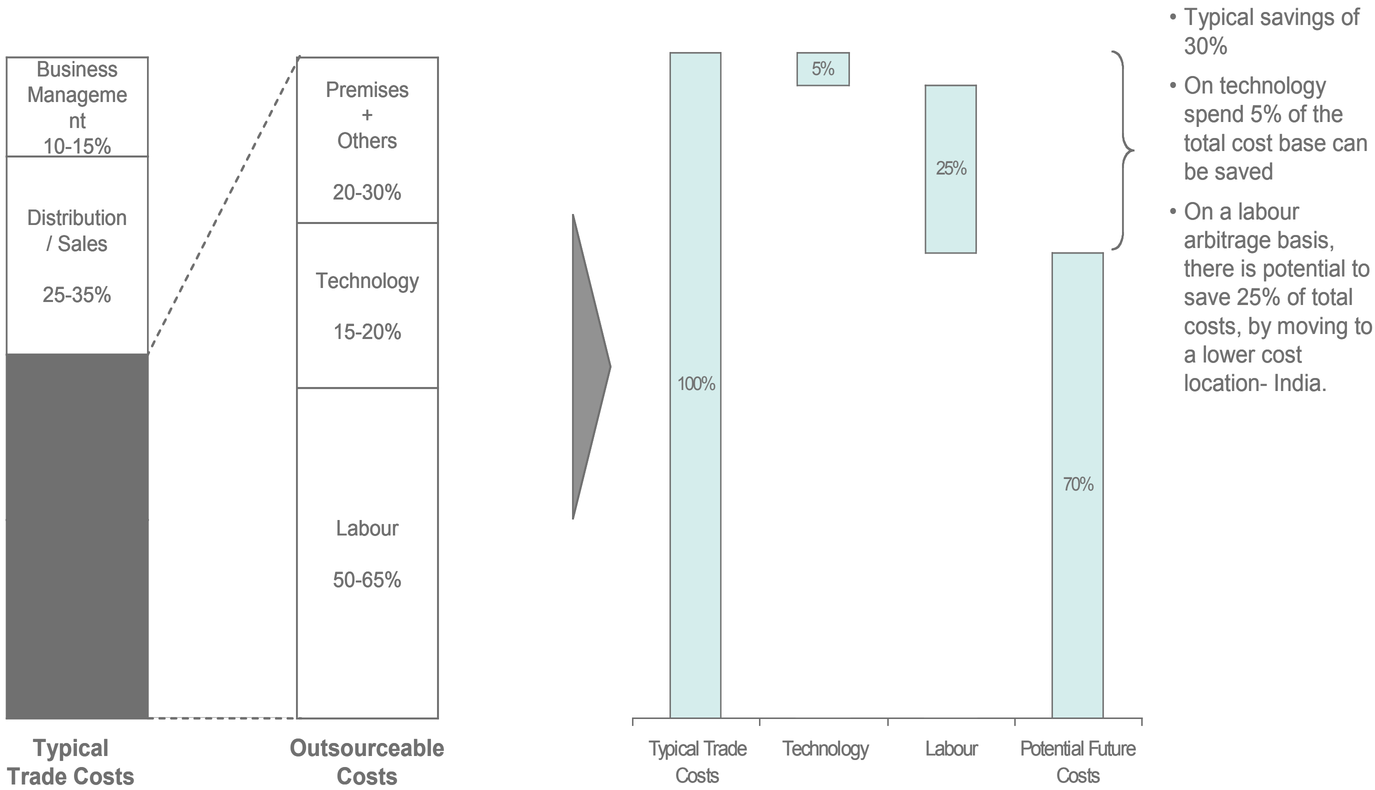
Selection Criteria Used: Country Risk, Supplier Risk, Knowledge of the business, Service Standards, Price, Quality of Staff, Relationship, Migration Approach and fit with the Target Operating Model.

Migration Path

ABN AMRO has tailor-made solutions for its partner banks. But the preferred and time-tested model is when jobs are migrated in a phased manner rather than through a big-bang approach. A typical migration plan for trade products of a large bank that ABN AMRO migrated was as below:

Phase	**Product**	**Activity**	**Complexity**	**Risk**	**Migration Date (Example)**
Phase-1	Export LC Advising	Straight Through Process Image Enabled – Manual	Low Medium	Low Low	January April 1st half
Phase-2	Import Collections	Standard Non-Standard Payment	Low Medium Medium	Low Low Medium	April 1st half End April End April
	Import LCs	Issue / Amend Document Examination Payments	High High Medium	Medium High High	End May End May Mid June Mid June
Phase-3	Export Collections	Initiation & Payments	Low Medium	Low Medium	End June
	Export LCs	Document Examination Payments	High Medium	High High	Aug 1st half Aug 1st half
	Reimbursements	Settlements	Low	Medium	End Aug

Estimated Quantifiable Benefits Achieved by Outsourcing Trade Services



Realising the full potential

When offshoring takes place to a country in a different time-zone, the time difference between the two centres needs to be exploited to the advantage of the ultimate customer, with a longer time-window and revised priorities. Cost advantage can be derived by not only leveraging the labour cost arbitrage, but also by intelligently stretching the business day, utilising the infrastructure multiple times and by servicing the customers and their counter-parts differently.

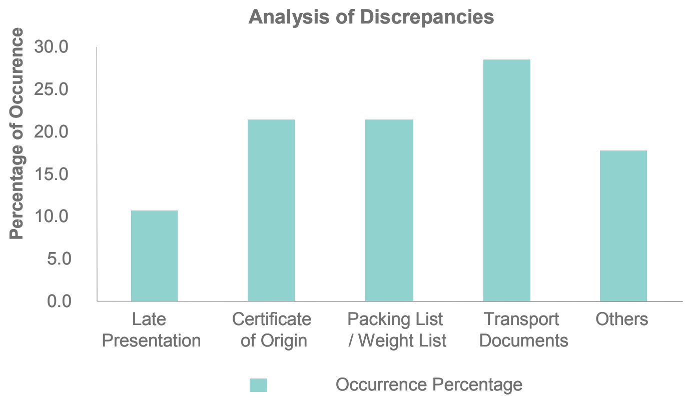
Example: Our clients based in Western Europe have quite a number of LCs to be issued on behalf of their importer clients to exporters in Asia. As ABN AMRO's offshore centre was in India and working on a 24 x 7 basis, they could have people start processing the transaction earlier in the day and have the LC sent across to Asia during Asia's working hours (which is 7-8 hours ahead in terms of time-zone). Also, where the LC on the exporters side was going via ABN AMRO's branch say in Hong Kong, because ABN AMRO had offshored its operation to the same centre, a few process steps could be eliminated and the processing time crashed.

Value Added Partnership approach – the Key to Success

Going beyond the contract, building a partnership approach and adding extra value to the client's business is what will make an outsourcing relationship work. Two examples from ABN AMRO's experience that were appreciated by the clients were the following:

Due to a high number of staff with analytical background, ACES could provide new value-added services to the countries that had offshored their trade processing to them. One of them is analysing the discrepancies in the documents submitted by large exporters under the letters of credit and finding a pattern in them. An analysis of this nature helps the corporate clients to fix their process for clean submissions in the future. A document without any discrepancy ensures quicker payment for the exporters and lower service charges.

Example:



27th Nov 2005, Chennai, India

Due to a combination of ~~taking~~ contingency measures and staff commitment, 65% of staff was present, and a near-Business As Usual situation was achieved for the insourcing partners during a flood/cyclone situation. Examples such as this increase the reliability factor and create confidence to further outsource critical processes.