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OUTSOURCING OPTIONS FOR MICROFINANCE

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AGENDA

- **Project Overview**
- Summary of Results
- Case Study Highlights
- Outsourcing Tradeoffs
- Recommendations
- Appendix



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PROJECT OVERVIEW

- Research conducted as part of the USAID-funded AMAP Financial Services Knowledge Generation project
- Approach was to explore the experiences and lessons of US small banks who have outsourced or not outsourced their core banking systems
- Goal was to provide guidance on outsourcing options and identify lessons and insights applicable to MFIs in developing countries



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SPECIFIC RESEARCH QUESTIONS

- Can outsourced core banking solutions resolve the MIS, IT capacity, and infrastructure challenges of MFIs
- Would outsourcing enable MFIs to perform more effectively and focus on business goals?
- What would the MFIs gain and what would the tradeoffs be?
- Would MFIs still be able to provide additional services if they outsource?



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SUMMARY OF RESULTS

- Reasons US small banks choose to outsource:
 - To reduce IT staff, infrastructure, and maintenance costs
 - They lack sufficient IT staff and resources
- Technology helps level the playing field against larger banks
- Core banking systems allow them to offer new products more quickly and scale for their planned growth



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SUMMARY OF RESULTS (continued)

- Data security concerns are misplaced
 - Statistics indicate the greatest percentage of data breaches (36% - 43%) were due to stolen computer-related equipment¹
 - It's not a matter of "if", but "when", and being prepared to handle the security breach
- In-house may be more cost-effective for very small institutions (less than 1000-2000 loans) that have low transaction volumes or slow growth



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Case Study Highlights

BACKGROUND - US CORE BANKING MARKET

- Outsourcing has existed in the US for 45 years²
 - Called “service bureau” or “third party processing”
- Sales trends:
 - 70% of core banking system sales for all financial institutions (FIs) in 2007 was for outsourced systems³
 - Small banks (under \$10B in assets) did 92% of the core banking replacements performed in 2006⁴
- Of small banks (under \$1B in assets) surveyed, 54% outsource their core banking system⁵



CASE STUDY OVERVIEW

Conducted deep interviews with financial institutions and vendors primarily in the Washington, DC region⁶.

Institution	HQ Location	Description
Chain Bridge Bank	Virginia	De novo bank; \$25M+ in assets; outsourced
Eagle Bank	Maryland	\$900M in assets; migrating from in-house to outsourced
Latino Economic Development Corporation (LEDC)	DC	A community development financial institution (CDFI); \$750,000 loan portfolio; In-house system
Catalyst Consulting Group	Arizona	Consultants to financial institutions
Large core bank processing vendor	US	Top 10 vendor, offers both in-house and outsourced implementations
IBM	New York	Developing “processing hubs” for MFIs in Africa and Latin America



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OUTSOURCING TRADEOFFS

- Vendor management is critical to success
 - Use service level agreements (SLAs) to set service expectations and accountability
- It may be easier or less costly to adapt some business processes to the vendor's product
 - Rather than adapting the product to the MFI's process.
- The vendor's product release schedule may not match the MFI's plans, however:
 - One way to have a voice and raise the priority is if the vendor has a process for collecting customer requests and feedback.
 - Same dependency as using the vendor's product in-house



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OUTSOURCING TRADEOFFS (continued)

- The vendor's technology may not be state-of-the-art
 - The tradeoff is that it is proven to work, assuming the vendor has a history and base of satisfied clients.
 - Core banking software in developing countries may be based on more recent technology if the software is more recently developed.



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ADVICE FOR MFIs⁷

- Manage the vendor, do not let the vendor manage you
- Never outsource the management of the system or the bank's institutional knowledge
- If an MFI is considering outsourcing, try to select a system that can be brought in-house later, to give yourself more options
- Select a system that will establish a foundation for future products and services

SPECIFIC TIPS ABOUT MANAGING THE VENDOR

- “Show me” test:
 - Get demos, case studies
 - Do site visits, talk to the staff, call references
- Control the vendor’s pitch:
 - Only X hours for their presentation, only 10 minutes for corporate background
 - Give vendor explicit instructions; “yes” means function exists now, “no” means it does not exist, “maybe” means they may provide it if paid to do it
- Evaluate vendor’s viability – financial position, significant wins and losses over last year



CORE SYSTEM SELECTION AND IMPLEMENTATION

- Involve IT staff in product selection and maintenance
- Pick a system with a track record
- Select a vendor who will act as a trusted advisor
- Ask for tiered pricing
- Ask for security audit report (SAS70 in the US)
- Allow time to learn the system; no system is “turnkey”; do not cut training to save costs
- Have enough staff for the setup; setup is a lot of work
- Analyze the “total cost of ownership” of both in-house and outsourced system



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Questions?

THANK YOU

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APPENDIX



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FOOTNOTES

¹attrition.org/dataloss/dataloss.csv.

²http://banktech.com/blog/archives/2008/05/outsourcing_.html.

³ibid.

⁴<http://www.aitegroup.com/reports/200701291.php>.

⁵ibid.

⁶Case study highlights reflect the views of the interviewees and not those of the researchers.

⁷The first two recommendation slides are primarily based on comments from Catalyst Consulting Group. The third slide is a compilation of recommendations from all the interviewees and the researchers.



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Case Study Highlights

OUTSOURCING REASONS AND BENEFITS FOR CHAIN BRIDGE BANK

- Faster implementation: system must be ready for regulator pre-opening exam
- Made no sense to spend \$100K on hardware, staff, disaster recovery, etc.
- Ability to offer a lot of different services; systems are very customizable



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Case Study Highlights

OUTSOURCING BENEFITS FOR EAGLE BANK

- Outsourcing model is more affordable
 - Reduced IT staffing requirements
 - Vendor does the hardest, labor-intensive work
 - Several servers can be put to other uses in-house
- Estimated 25% annual cost savings
 - partly due to consolidation of two platforms into one
 - Received heavily discounted introductory price



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Case Study Highlights

LATINO ECONOMIC DEVELOPMENT CORPORATION (LEDC)

- Growth of loan program was primary driver to replace spreadsheet system
- Initially planned to outsource, decided to buy in-house package
 - Wanted more control
 - Didn't want to lose contact with clients
- Package cost was \$5000
 - Select Edition and 5 modules, 4-5 PCs, targeted at CDFIs
 - One module reports to the credit bureaus through the C Builder's Alliance



BENEFITS FOR LEDC

- Critical to ability to scale cost-effectively
- Operate more professionally
- Improved forecasting for risk and fundraising
- Tasks are much easier, more efficient to execute:

Task	Before	After
Billing	“Crazy” process took 2 days	Processes 7 times the number of loans in < 1 hour
View Portfolio at Risk	2 days to run through spreadsheets	Run a report in seconds



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Case Study Highlights

COMMENTS FROM TOP 10 VENDOR

- The idea that in-house systems and staff means more control is a bit of a fallacy
- Data security risks are “people-based”, not inherent to the outsourcing model
- Core systems offer audit reports, most offer transaction-level security, fraud controls
- One of their products, targeted at FIs with \$50K-400K in assets, only available in-house; outsourced version would not be cost-effective for FIs
- Product development is driven from regulations