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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

## 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

## 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?

## 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

## 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 equipment<sup>1</sup>
  - 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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## BACKGROUND - US CORE BANKING MARKET

- Outsourcing has existed in the US for 45 years<sup>2</sup>
  - 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 systems<sup>3</sup>
  - Small banks (under \$10B in assets) did 92% of the core banking replacements performed in 2006<sup>4</sup>
- Of small banks (under \$1B in assets) surveyed, 54% outsource their core banking system<sup>5</sup>



## CASE STUDY OVERVIEW

Conducted deep interviews with financial institutions and vendors primarily in the Washington, DC region<sup>6</sup>.

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

## 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 MFIs<sup>7</sup>

- 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

**Questions?**

**THANK YOU**

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# APPENDIX

## FOOTNOTES

<sup>1</sup>[attrition.org/dataloss/dataloss.csv](http://attrition.org/dataloss/dataloss.csv).

<sup>2</sup>[http://banktech.com/blog/archives/2008/05/outsourcing\\_is.html](http://banktech.com/blog/archives/2008/05/outsourcing_is.html).

<sup>3</sup>Ibid.

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

<sup>5</sup>Ibid.

<sup>6</sup>Case study highlights reflect the views of the interviewees and not those of the researchers.

<sup>7</sup>The 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.



## 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



## 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



## 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 Credit 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



## 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