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## OUTSOURCING – A TOOL FOR INCREASING THE COMPETITIVENESS OF CZECH BANKS<sup>1</sup>

*About the competitiveness of the Czech banking system can we talk from the first decade of the 21 century. The decisive factor may be considered the entry of foreign strategic investors in Czech banks and consolidation of banking regulation and supervision. It also created space for greater use of outsourcing increases competition in the banking system. Relatively tight control of outsourcing external use and the formation of banking groups have contributed to the fact that banks have begun to focus primarily on the so-called internal outsourcing, also called on sourcing. This not only gives the opportunity to avoid regulation and supervision, but also brings high synergy effects, which remain within the group. On the other hand, a high proportion of foreign capital raises questions about the readiness of banks to help the growth and competitiveness of the Czech economy. The low level of the promoting competitiveness index demonstrates it. At the same time as the result of calculating the Herfindahl-Hirschman index of competition (HHIK) by banking groups shows that even the level of competition within the banking system rather promotes oligopolistic nature of its operation.*

*Key words: competitiveness, outsourcing, on sourcing, synergistic effect, promoting competitiveness index, the index of competition.*

**Analysis of the competitiveness of Czech banks.** The modern Czech banking system exists for twenty years. From the standpoint of the process of creation of banks' competitiveness there can be distinguished two basic periods – till the year 2000 and after the year 2000.

**1a) First phase** (1989 – end of millennium) is a period of formation and consolidation of the Czech banking system. It featured these attributes:

- transition from administratively controlled flat (one-level) bank system based on administrative principles to a two level system, founded on emerging financial markets and market principles;
- transformation of the hitherto existing state owned specialized banks to universal commercial banks. Their main tasks were to contribute to the privatization of the economy, to the reorientation of the international economic relations and to the transition of the state economy to market principles;

- birth of new small and middle sized banks with Czech capital. These new banks had been founded by groups of newly emerging entrepreneurs and privateers. In their beginnings they were of mostly just regional character, and aimed at the loan support of the enterprises of their shareholders. They had only minimal experience with bank entrepreneurship;
- foreign capital was entering the banking industry mostly through the means of the foundation of new banks or establishing branch offices. Problems with imperfect knowledge of the internal underdeveloped market and law framework of the entrepreneurship;
- the banking regulatory principles and supervision only just started to take shapes, the prudential measures were of rather administrative character. Big benevolence towards the founding of new banks;
- starting with the year 1995 the establishing of the credit unions was allowed, their regulation had been minimal, the experience with the banking cooperative was even smaller.

From the viewpoint of the competitiveness development of the Czech banking system it is possible to characterize the outcomes roughly in the following way. Large state owned banks, aimed mostly

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at the support of the privatization projects, began to get into financial difficulties, due to the problematic economic takeoff of the privatized enterprises. For the sake of preserving these banks, the Consolidation program I. was elaborated and realized, aiming at purging their assets from bad loans, allocated until 1989 in the volume of 100 billions CZK. Soon after it the so called Consolidation program II. followed, aiming now at purging the assets of these banks from bad privatization loans. The Consolidation program II also included the project of adjusting the banks for privatization. The realization costs of the Consolidation program II, with the adjustment costs included were assessed at 225 billions CZK.<sup>2</sup>

The Czech private commercial banks were gradually, one after another, falling into liquidity problems. They were, in some cases, the result of excessive speculation, undervaluing the market risks, or, more precisely, inadequate skills of the market risks management. Last but not least, the credit exposure towards one entity or towards related entities. Not unfrequented was also the collision of interests. The speculative motives manifested themselves an unresolved problem especially with the middle sized banks, the high credit exposure was a problem mostly for small banks. The collision of interests was, in general, connected with the composition of shareholders, who let the banks credit the enterprises with their own capital participation.

The result was among other things a massive revoking of banking licenses (till the year 2001 there were 25 licenses revoked, totaling in 29). The regulator, the Czech National Bank, established for 13 small banks a "Program of Stabilization" (in the year of the Program startup, 1997, there were 6 small banks included in it, i.e. almost a half of all the existing small banks).<sup>3</sup> In the viewpoint of the banking system competitiveness, the Credit unions played almost no role. They amassed primary deposits of 10,7 billion CZK in only 4 years, but this sum had almost no economic power in comparison with the primary deposits of 992,1 billion CZK (out of it 699,2 billions were households deposits) of the commercial banks. With its 1,07 % share against the primary deposits total and 1,53 % against the households deposits, it presented indeed only a minuscule part of the whole of this sector of financial market. The only role the Credit unions played out was the minor fluctuation of primary deposits mar-

ket due the Credit unions' subsequent and massive going bankrupt. It can be thus concluded that the general situation of the Czech banking sector in the past decade did not create any positive conditions for strengthening the role of banks, may it be in the view of increasing the competitiveness of the banking sector itself, or improving the competitive environment of the Czech economy as a whole. The regulator had too much to do while coping with the transition from the administrative regulation methods to the economic methods and trying to uphold (if not even to save) the stability of the branch of undertaking on financial and monetary markets. In this context it is quite logical that the role of outsourcing in improving the competitiveness could not be elsewhere than in infancy. (The role of foreign commercial bank will be examined in the analysis of the following period). Certain level of understanding the structure of Czech commercial banking can be provided by the Table 1, Czech Banking System in the years 1989 – 2010.

**1b) Second phase** (ca. from the year 2000 up till now) is a phase of the classical, functional banking and financial market formation.

The most important attributes of this phase are the strong penetration of the foreign capital into the Czech banking and Czech capital being virtually displaced from the Czech banking market, notwithstanding the emergence of new Czech commercial banks in the last few years of the first decade of the 21st century. While in the years 1994/1995 was the share of Czech banks 60 % of the total of licensed banks, it was only 33 % on the verge of the millennium and in the years 2009/2010 mere 19 % of the total count of the active banks. In this are however included also two banks with state share ("Českomoravská záruční a rozvojová" and "Česká exportní" banks), designated for supporting the small and middle sized entrepreneurship and exportation. The development of the capital ownership structure confirms this tendency. From the year 2002 the foreign capital owner's ratio consistently exceeds 80 %. There is certain tendency towards decreasing this ratio, (from the year 2004 in which the foreign share of capital reached its maximum of 85.8 % the ratio decreased to 80.3 % in the year 2009), but the power held by this foreign capital has not diminished in any way.<sup>4</sup>

<sup>2</sup> Řežábek Pavel: Konsolidační instituce a jejich historie v České republice z 27.02.2008 (Consolidation's institutions and their history in the Czech republic)

<sup>3</sup> Vencovský, a kol.: Dějiny bankovníctví v českých zemích, Bankovní institut Praha 1999, ISBN 80-7265-030-0, str. 499 (Banking history in the Czech countries)

<sup>4</sup> This decrease can be more likely attributed to the changes related to the accession of Czech Republic to the EU than to the entry of the Czech capital. For example some controlling companies started to transform their owned banks into branch offices due to the unified license framework, thus retracting their capital engaged in Czech Republic back abroad.

Czech Banking System in the years 1989–2010

Year	Commercial banks total (1)	Of it the Czech banks	Of it the private banks	Foreign capital (2)	Credit unions total (3)
1989	5	5	0	0	0
1990	9	9	4	0	0
1991	24	20	15	4	0
1992	37	26	21	11	0
1993	52	34	28	18	0
1994	55	34	28	21	0
1995	55	32	27	23	0
1996	53	30	25	23	45
1997	50	26	21	24	66
1998	45	20	15	25	76
1999	42	14	10	27	127
2000	40	14	10	26	77
2001	38	12	8	26	55
2002	37	11	9	26	46
2003	35	9	7	26	42
2004	35	9	7	26	33
2005	37	9	7	28	20
2006	37	9	7	29	20
2007	37	8	6	29	19
2008	37	7	5	30	17
2009	39	7	5	32	17
2010	41	8	6	33	14

(1) With valid license. Source: Česká národní banka, author's calculation

(2) Banks and branches of foreign banks

(3) Only active unions. Source: Jiří Dymeš, Vývoj družstevního bankovníctví v letech 1995 – 2006, Bakalářská práce, Duben 2011, Bankovní institut vysoká škola, Praha.

After the accession of the Czech Republic to EU, new phenomena emerged in the banking competitive environment along with the application of the unified banking license. Firstly, there is certain tendency of the controlling companies towards transforming their previously founded banks into mere branch offices and towards founding only branch offices instead of banks.<sup>5</sup> Furthermore, the interest in providing trans boundary credit services on the side of foreign banking and credit institutions increased (in the year 2005 there were 108 interested parties, 2006 already 145 interested parties, 2007 as many as 198 banks declared their interest, 2008 252 banks and in the year 2009 there were 276 EU

members' banks declaring their interest in the trans boundary services).

With the completion of the consecutive privatization of big commercial banks, realized on the principle of foreign strategic partner entry (Austrian, Belgian, French and Italian capital) and with the small and middle sized banks consolidated, a new possibility for the inter banking competition formed. This competition had however, and up till now has, several specific attributes:

- On minimal scale it takes place in the form of **pricing competition**, i.e. by the means of the interest and fees war. Except for the limited period during which Česká spořitelna steeply and almost in a dumping way decreased its interest rates in an attempt to get to the leading position on the mortgage market, the price competition takes place only seldom, e.g. in the scope of seasonal proceedings proclaimed by the individual banks. This fact can be attributed to the fortuitous de-

<sup>5</sup> For example the Citibank transformed into a branch of the Irish bank City Europe plc and a branch of the foreign bank „Straumur-Burdaras Investment Bank hf – organisation unit“ entered Czech banking market in the year 2008.

velopment on the financial markets in this time period, during which the interest rates gradually and generally decreased so much that there was only little space for the price competition. Along with that the price of resources decreased as well, often to zero, insomuch that the banks got satisfactory revenues and their capital appreciated even while keeping the active interest rates low. In comparison with the rest of the EU, the capital appreciation was above average.<sup>6</sup>

- The banks compete mostly in the **quality of their services**. As an example can be used the individual character of services (personal bankers), the offer complexity (offer packages with certain bonuses), originality (“inside-out mortgage”), innovativeness (banking insurance) etc.
- The competition diversifies according to **segments and sectors**. During the first decade it took place mostly in the scope of retail banking (consumer credits, mortgage loans, building savings, current accounts, credit cards, direct and electronic banking etc.), while mostly the small and middle sized banks attempt to penetrate into the banking market by the means of specializing in one or a few products and offering advantageous conditions. (For example the eBank tried to gain control of the electronic direct banking market, eventually winding up in the arms of Raiffeisenbank.) In the present time of the retail market exhaustion the competition slowly moves to the realm of the small- and middle scale entrepreneurship, where a certain level of state endorsement starts to be felt as well
- Czech banking, despite the Czech accession to the EU, concentrates predominantly and decisively on the **inner market**. This notion is supported by the fact, that up till the end of the year 2009 only four banks announced their interest in offering trans boundary banking services and only one Czech bank has a branch office abroad.

In regard to the credit union banking, it plays only marginal role even after its consolidation. Even the possibility of enabling them to transform to general banks has been taken into consideration.

Regarding the banks’ competitiveness, the Herfindahl-Hirschman index bears witness of its positive development.

<sup>6</sup> Capital appreciation on the level Tier 1 examples:

Year	2007	2008	2009	2010
Profitability in %	28,36	23,98	31,53	24,94

Source: Česká národní banka, Shares of bank groups in selected indicators of the banking sector as of 31.12. the year, link: [www.cnb/dohled nad finančním trhem/Souhrnné informace o finančním sektoru/Základní ukazatel/banky](http://www.cnb/dohled_nad_finančním_trhem/Souhrnné_informace_o_finančním_sektoru/Základní_ukazatel/banky), Tab. č. 7

Year	HHIC debts	HHIC deposits
2007	0,100	0,127
2008	0,101	0,116
2009	0,103	0,118

Source: CNB, Financial Markets Banking Supervision Report, years 2007, 2008, 2009

Index value close to 0,1 reflects the relatively small concentration level. If calculated not for single banks, but for bank groups (large, middle sized and small banks and credit unions), the situation is quite different:

Year	HHIC
2007	0,421154
2008	0,379863
2009	0,381364
Author’s calculation, actives total	

This Herfindahl-Hirschman index value reflects rather oligopoly structure of the Czech banking system and to a certain level proves author’s conclusions about Czech banking sector’s characteristics of competitiveness in the first decade of the 21<sup>st</sup> century. Based on the analysis of the developments of the first decade of the 21st century it is possible to state, that the competitive environment of the Czech banking system changed so much, that the conditions for outsourcing usage as a tool for improving the banks’ competitiveness got considerably better. On the other hand, how much did this development contribute to the interest of Czech banks on the improving of the Czech economy competitiveness is still a question. Foreign capital has control over nearly 99 % of the largest Czech banks, which have almost 60 % of all of the assets of the Czech banking sector at their disposal. Along with the branch offices of the foreign banks they have 69.37 % of the assets under their control. The ratio of the foreign capital in most of the other banks (small, middle sized) is at least at the blocation level. (See table 2.). From this viewpoint a question can be asked: To what extent is, or could be, the foreign capital interested in strengthening the role of “Czech” banks in improving the competitiveness of Czech economy, especially while the Czech economy is a very open one and strongly dependent on export.

The validity of this thought is supported by the above mentioned knowledge of the banking operations being (with the exception of the system of payments) unequivocally limited and aimed only at the Czech territory.

Foreign capital share of total bank capital, %

Year	Large banks		Mid-size banks		Small banks		Build. and loan association		Total <sup>7</sup>	
	Czech	foreign	Czech	foreign	Czech	foreign	Czech	foreign	Czech	foreign
1995	x	x	x	x	x	x	x	x	77,2	22,8
1996	x	x	x	x	x	x	x	x	75,9	24,1
1997	x	x	x	x	x	x	x	x	70,5	20,5
1998	x	x	x	x	x	x	x	x	61,3	38,7
1999	x	x	x	x	x	x	x	x	51,7	47,3
2000	x	x	x	x	x	x	x	x	45,5	54,4
2001	x	x	x	x	x	x	x	x	30,0	70,0
2002	x	x	x	x	x	x	x	x	18,1	81,9
2003	4,5	95,5	36,9	63,1	34,8	65,2	50,4	49,6	15,1	84,9
2004	3,0	97,0	40,5	59,5	33,9	66,1	51,4	48,6	14,2	85,8
2005	3,3	96,7	40,4	59,6	49,9	50,1	50,3	49,7	17,9	82,1
2006	3,3	96,7	39,5	60,5	35,1	64,9	55,8	44,2	17,4	82,6
2007	1,7	98,3	44,2	55,8	36,9	63,1	55,0	45,0	17,4	82,6
2008	1,7	98,3	50,5	49,5	39,2	60,8	49,9	50,1	19,0	81,0
2009	1,6	98,4	50,5	49,5	42,2	57,8	47,2	52,8	19,7	80,3

Source: Česká národní banka, Zprávy o výkonu dohledu nad finančním trhem v jednotlivých letech, link: www.cnb/dohled nad finančním trhem/zprávy o dohledu nad finančním trhem

This is a fundamental difference in comparison with the openness of the real Czech economy towards the abroad, with the goods and capital moving to and from abroad almost in equal volumes. Czech banking in general is thus in the situation of foreign capital influx and the net profit out flux.

The progress of foreign bank capital's will for supporting the Czech economy competitiveness can be best described with **index of support**. For the needs of this research paper, the index is defined as

a ratio of Czech to foreign capital share on total bank capital.

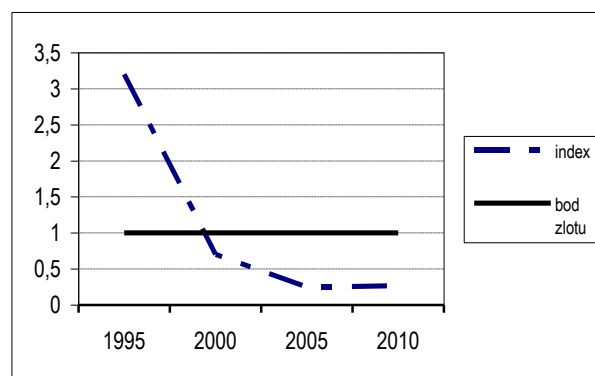


Chart no. 1. Support index development – Czech banking system as a whole

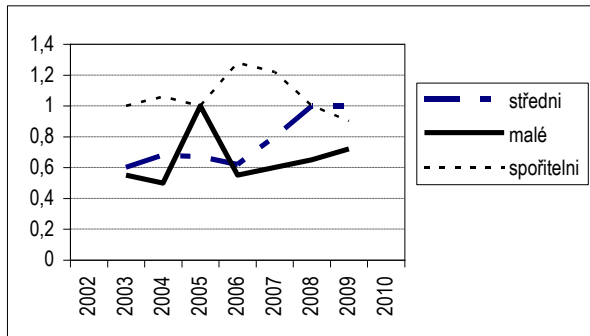
The big picture is more optimistic, if we calculate the support index for middle sized and small banks and building and loan associations.

<sup>7</sup>Large banks: Česká spořitelna, a. s., Československá obchodní banka, a. s., Komerční banka, a. s., UniCredit Bank Czech Republic, a. s. ,

Mid-sized banks: Českomoravská záruční a rozvojová banka, a. s. GE Money Bank, a. s., Hypoteční banka, a. s. ,Raiffeisenbank a. s..

Small banks: Banco Popolare Česká republika, a. s. Česká exportní banka, a. s. , Evropsko-ruská banka, a. s. , J&T BANKA, a.s. ,LBBW Bank CZ a.s., PPF banka a. s. , Volksbank CZ, a. s.,Wüstenrot hypoteční banka a. s..

Build and loan associations: Českomoravská stavební spořitelna, a. s, Modrá pyramida stavební spořitelna, a. s, Raiffeisen stavební spořitelna a. s., Stavební spořitelna České spořitelny, a. s.. Wüstenrot stavební spořitelna, a.s. (dle stavu z roku 2008)



**Chart no. 2. Support index – Czech middle sized and small banks, and building and loan associations**

## 2. Outsourcing – a tool for enhancing the competitiveness of Czech banks

“The question is ... how do we use outsourcing to enhance competitiveness in what is, and forever will be, a global market place.”<sup>8</sup> Outsourcing in its most basic form can be understood as a „act of getting services from external source“ (Brown, 2008, str. 18). The outsourcing is being usually structured in three levels, i.e. tactical, strategic and transformatory outsourcing (Dvořáček, 2010, Brown, 2008).

**Tactical outsourcing** encompasses mainly the simplest forms of outsourcing aimed at quick reaching the goals, especially in the form of reducing the costs or increasing the effectiveness of the employees. It aims preferentially at tasks generating utility above all for the company itself and generating the value for the clients only in indirect way or not at all. Among the most usual aims of such outsourcing are reducing the costs as fast as possible, decreasing the staff workload, evading future investments, obtaining additional financial resources by selling or renting company’s property etc. It is based on outsourcing the marginal, unimportant tasks as are for example housecleaning, building administration etc. to the non-banking companies.

**Strategic outsourcing** concentrates on the longer-term solutions of internal functioning issues of the company. It addresses the issues standing in the way of employees’ freeing from routine administrative, mechanical and noncreative tasks, thus enabling them higher level of concentration on the core tasks bringing the effect by the means of higher level of customer satisfaction. Strategic outsourcing should free for example the IT workers from the routine tasks of data gathering and storage and empower them to concentrate on addressing the needs

<sup>8</sup> Brown Douglas, Wilson Scott: The black book of the outsourcing, how to manage the changes, challenges and opportunities, Wiley, USA 2008, ISBN 978-0-471-71889-5, 366 pages

of the clients, or free the managing staff from mostly administrative tasks, blocking their creativity etc. The ideal situation is when the outsourcing is generating added value to the outsourcee as well as to the outsourcer. The limitation of the strategic outsourcing lies in the fact, that even this kind of outsourcing does not cross the frame of solving the internal problems of the company.

**Transformatory outsourcing** represents a third generation of outsourcing of its kind. With certain level of simplification it can be stated that tactical outsourcing (as a first generation) brings the expected effects while keeping the current rules and custom practices. Strategic outsourcing can be considered a second generation, demanding appropriate changes in the company practices. Transformatory outsourcing, as the name implies, demands substantial changes and in some cases a new system and entrepreneurship practices definition. It is based on innovations yielding added value to everyone, from the employees, to the stakeholders, to the shareholders (Brown 2008, p.23). In regard of Czech banking, it is quite easy to unambiguously document that in the beginning of its emergence and formation, in the field of outsourcing usage there prevailed with:<sup>9</sup>

- **the large state owned banks** – self reliance. That is, system known as “go”. That is relying on oneself, safeguarding most of the tasks by their own employees, even of the simplest supportive and non-essential tasks;
- **the private commercial banks** owned by Czech capital – a typical Czech form of outsourcing – contracting the support and non-essential tasks to the companies founded by the bank shareholders or their related entities specifically for this purpose;
- **the private banks owned by foreign capital and the branch offices** – it was possible to identify certain forms of strategic outsourcing. The main reason for it was the transfer of know-how from their controlling companies. As well as that, the controlling companies secured their subsidiaries often with many service tasks, especially

<sup>9</sup> These mentioned pieces of knowledge, applicable to the last decade of the 20th century, stem from the author’s personal experience, who was working during said period –from 1989 till 2006- at the Federal Ministry of Finance (FMF) and after it’s being abolished due to the cessation of the Republic of Czechoslovakia he relocated to the banking sector, where he undertook various positions. While working at the FMF he participated on elaborating the legal documents ensuring the transition of Czech banking to the two-level system, by virtue of his banking positions he participated on founding at least two banks, helping with privatization of small and mid-sized Czech enterprises, participated on creating and forming of two bank holdings, as well as the birth and development of the Czech mortgage banking. He had also the opportunity to know many banks from inside.

in the field of IT. Here the first elements of offshoring manifested, i.e. over boundary outsourcing “over large distances” (Dvořáček, p. 5).

During the second development period, especially after the privatization of the large state owned banks was concluded and small and mid-sized banks segment consolidated, a rather fast transition to the higher stages of outsourcing took place, both to the strategic and transformatory outsourcing. Even the hints of the fourth stage of outsourcing emerged, the globally integrated enterprises. The forms of outsourcing yet in the Czech banking unused emerge as well, in the form of franchising. While putting aforementioned factors aside, to this relatively quick qualitative development in the outsourcing usage contributed especially:

- a) birth of large banking holdings or, in general, financial conglomerates (financial groups)
- b) Czech National Bank outsourcing regulation.

Large, as well as the mid-sized and small banks in Czech republic tend form groups, in which a good many entities are proprietarily and often even organizationally related, not only in the scope of the banking sector, but in the scope of insurance and stocks, bonds and securities trading segments. Many of the banks are stocks,

- As an example of large banks can serve the Československá obchodní banka, a.s., encompassing the companies Poštovní spořitelna (Post savings bank), Českomoravská stavební spořitelna (Building society), a.s., Hypoteční banka, a.s. (Mortgage bank), ČSOB pojišťovna (insurance company), ČSOB Leasing, ČSOB Factoring (and four more) in its group.
- As an example of the mid-sized banks we can use the Raiffeisenbank, a.s., which fused with the eBank recently and encompasses Raiffeisen leasing, s.r.o., Raiffeisen stavební spořitelnu (Building society) and Uniqua pojišťovna (Insurance company) in its group.
- As an example of small banks we can use a group active under a unitary name Wüstenrot. The group comprises Wüstenrot stavební spořitelna (Building company), Wüstenrot hypoteční banka (Mortgage bank), Wüstenrot životní pojišťovna (Live insurance) and Wüstenrot neživotní pojišťovna (General insurance).

It is more than logical that within these groups, sooner or later, a tendency towards integration, concentration of tasks and rearrangement of division of labour emerges. This applies especially to the tasks common for all group members, which can be carried out from one place, by a single group member.

Last but not least, the relatively quick qualitative development in the outsourcing usage is supported by the specificity of banking as a form of financial

market entrepreneurship. This highly specific attribute is the fact, that all their entrepreneurial activities have one common and unifying aspect – they trade money, especially the money belonging to someone else. That applies to all of them, regardless all the variety of products and services offered.

Another momentum having an effect from the vector of inner integration and concentration of support services of bank groups is the fact that the outsourcing usage is subjected to regulatory rules. The conditions of the classical outsourcing are defined by the regulator and are subject to rather strict rules. Severity of these rules applies not only to the bank, but to the outsourced services supplier as well, as if he was a bank itself. One of the effects stemming from this is that some banks choose not to utilize the forms of outsourcing subject to regulation at all. On the other hand, this strict regulation contributed to modifying the forms of outsourcing, the art of transferring the services, which we can name *inner outsourcing*, or more precisely **onsourcing**.

**3. Outsourcing usage regulation principles.** In respect of the effort for the most comprehensive risk management, the “Joint Forum” (hereinafter JF) at the Bank Committee for Banking Supervision at BIS created a group addressing the operative risks. In preparation of regulations for the operative risks management, JF addressed also questions risen from the risk management related to the commercial banks’ outsourcing usage. In February 2005, JF published a benchmark named “*Outsourcing in financial services.*”<sup>10</sup> This work became, along with others,<sup>11</sup> a standard of the banks’ outsourcing usage. The main problem of the outsourcing, as considered by the regulators, is the question of potential risk transfer from a regulated entity (bank) to another entity, which is not subject to the regulation.<sup>12</sup> On the level of European Union the “Outsourcing is defined as a regulated entity’s use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that

<sup>10</sup> Outsourcing in Financial Services, Joint Forum, únor 2005, Link: [www.bis.org/bcbs/jointforum.htm](http://www.bis.org/bcbs/jointforum.htm)

<sup>11</sup> e.g. Guidelines on Outsourcing, from December 2006, European Committee of Banking Supervision (now EBA) or Sound Practices for the Management and Supervision of Operational Risk from Feb. 2003, BCBS.

<sup>12</sup> “Outsourcing has the potential to transfer risk, management and compliance to third parties who may not be regulated, and who may operate offshore.

In these situations, how can financial service businesses remain confident that they remain in charge of their own business and in control of their business risks? How do they know they are complying with their regulatory responsibilities? How can these businesses demonstrate that they are doing so when regulators ask?” (Outsourcing in Financial Services, Joint Forum, February 2005)

would normally be undertaken by the regulated entity, now or in the future“ (JF, march 2005). This definition is based on the emphasis underlining the regulated entity’s act consisting in usage of a third party’s services. This definition’s scope is very wide, since it aims at all the regulated intermediaries operating on financial markets. Czech regulator, the Czech National Bank, approaches the definition from a slightly different angle. The main emphasis is being put on a definition of an entity ensuring on a contract basis an operation, which would otherwise have to be carried out by the bank or credit union itself.<sup>13</sup> The founding motive of the outsourcing regulation is the protection of the consumers’ interests (bank clients). In particular, it must not occur:

- harm to their interests
- client’s personal data security breach
- client’s information security breach.

The last point concerns especially the information about client’s transactions, which are subject to the banking secrecy.

Out of this stem also the rather strict requirements put on the selection of the outsourcing provider. In case of so called “chain outsourcing”, the requirements apply for the subcontractor as well. The examined aspects are: reliability, adequate financial, economic and technological capacity, quality of the outsourced service’s performance, etc. A bank outsourcing any activities is not deprived of responsibility for the outsourced tasks’ quality of performance. For the case of the outsourcee’s failure to provide adequate services, the bank is obliged to have a backup solution. The outsourcing regulations are based on assessing the risks connected, or the risks that could be connected, to the outsourcing usage. The most important risks are considered:

- operative risks, or risks of a third party (external service provider failure);
- reputational risks (loss of reputation due to the service provider failure);
- legal risks (adherence to legal regulations – compliance, law enforceability, observing contracts, withdrawal from contract);
- concentration (hereby is understood the excessive concentration of the whole branch – e.g. banking – on outsourcing of one similar task, important for banks – e.g. IT providers).

Considering Czech experience, the Czech regulator highlights also the risk of conflict of interests. JF formulated also 9 principles of a bank outsourcing

guide. Seven of them aim directly at the regulated entities, two at the regulator’s approaches. The regulation principles can be stated in short as: prudence, system of risk management, provider reliability screening, tenders, and transparent relations with the provider based on written contract, backup plan including the backup verification, confidential data protection. The regulator is supposed to include into the system of regulated entities evaluation the continuous evaluation of outsourcing usage, and supervise possible systemic risks, stemming from the said risk of excessive concentration.

#### 4. Basic forms of outsourcing usage in Czech Banking System.

4a) Short overview of outsourcing throughout Europe and worldwide. On global scale, the outsourcing presents big business. It is assessed, that the volume of the global outsourcing market is somewhere around one trillion USD, of which almost 57 % is being realized in United States of America (Brown 2008, p. 4). As for the outsourcing in the financial services, Deloitte estimated in his report of March 2004 to the Board of Governors of FED that during previous four years there were traded about 356 billion USD by the means of outsourcing. That was around 15 % of operating costs.<sup>14</sup> According to the research performed by the<sup>15</sup>, outsourcing is mostly being used in the realm of IT, around 55 %. Administration is on the second place (47 %). Other activities, such as transportation, building administration, call centers, human resources, etc., are being outsourced in the scale of 10 to 22 %. There is an estimation from the year 2003 stating, that out of 340 billion USD spent on IT, around 1/3 of tasks were provided by third parties. According to the research carried out by the European Central Bank in 2004, European banks indicate as their main motives for the outsourcing usage:

<b>Cost reduction</b>	<b>89 %</b>
Access new technology/better mgt	69 %
Focus on core	58 %
Scale economies	29 %
Free resources	24 %
Quality service	24 %
Generate change	16 %

Source: European Central Bank 2004

<sup>13</sup> Official communication of the Czech National Bank from 18 July 2007: Outsourcing. Citation: “An **entity providing** ... (outsourcing) ... may be a physical or legal entity ... entity within a consolidators group ... entity providing some activities related to offering or selling services ... **Provider is not** ... a supplier of wares or services.”

<sup>14</sup> Deloitte presentation to Board of Governors of the Federal Reserve System, Offshoring and Cross-Border Outsourcing by Banks, March 30 2004., JF, February 2005

<sup>15</sup> Outsourcing Institute, link [www.outsourcing.com](http://www.outsourcing.com), international organization mediating relations between the demand and supply of outsourcing, including the research. (Cited as written by JF, February 2005, 5th Annual Outsourcing Index)



**4b) Outsourcing's Application in Czech banking system**<sup>16</sup>. Ve využívání outsourcingu v bankovníctví v České republice lze pozorovat dva relativně rozdílné proudy. První, klasický, kdy outsourcing podléhá regulatorním pravidlům České národní banky. Druhý, kdy banky se soustřeďují na využití možností dělby práce uvnitř finanční či jí podobné skupiny a kdy se outsourcing mění v insourcing, respektive jeho vrchol – onsourcing. The use of outsourcing in the banking sector in the Czech Republic can be seen two relatively different currents. The first, classic, where outsourcing is subject to regulatory rules of the Czech National Bank. Second, when banks are focused on realizing the division of labor within a financial or similar group and when the outsourcing changes in insourcing, or its peak - onsourcing.

**Classical external outsourcing** usually occurs at the tactical or strategic outsourcing. According to a survey classical outsourcing is used namely in the management of car operation, scanning and storing documents, mailroom operations, security services, as well as that of IT outsourcing in the field of automation to inform the regulator. In regards of the management processes used in the standard outsourcing, according to the replies of banks approached, the processes comply to the regulatory rules (however, all of the banks approached refused the author to inspect any contracts) and pay respect to the more modern systems of their outsourcing management. As for several banks, the author stumbled upon their applying systems known under the abbreviation SLA (Service Level Agreement). The SLA abbreviation covers the system of standardized terms of contract of making outsourcing contracts. The conditions include the service description, rights and obligations of contracting parties, guarantees etc. The accessibility, reliability, productivity, the trigger reaction time limits, opening hours etc. are specified. As a complement, especially with the outsourcing of IT, the technical conditions are specified as well. (Dvořáček, 2010, p. 41). Most of the banks approached have stated that the outsourcing usage is based on project approaches. Authorized group or committee elaborates firstly a rough project, then in-depth analysis, and should the outsourcing utility for the firm be positive, the project would be approved. Then a provider is chosen, mostly in a tender. The contracts are usually time-limited. The contract's implementation is being supervised in accordance with the regulatory measures, it is being evaluated on regular basis.

<sup>16</sup> Source: results of an interview and banks' annual reports

Table 3 lists the costs of various banks in the Czech Republic on outsourcing at the end of 2010. It is the outsourcing activities subject to regulation.

Table 3

**Cost of classical (subject to regulation) Outsourcing  
In thousands CZK, end of year 2010**

Banks	Outsourcing costs	Other administrative expenses in total	Share of costs for outsourcing %
Large	7 456	15 326 280	37,61
Medium	527	4 164 239	12,36
Small	35	1 037 502	2,25
Building societies	92	1 513 139	6,09
Banks Total	8 110	22 041 160	29,02

Source: Statement of the information required on quarterly pursuant to Decree No. 123/2007 Coll. prudential rules for banks, credit unions and securities dealers

The table shows clearly how the activity in traditional outsourcing decrease parallel with the decreasing size of banks their activity. As seen, the greatest activities in the classical field of outsourcing are major banks. The average is about 37 % of the other administrative costs. In doing so, but it is within each of the large banks is a relatively large dispersion, from 15 % to almost 61 %. For medium-sized banks, the average share of the cost of outsourcing to other administrative costs only around 12 %, taking dispersion is much smaller than the large banks. And small banks are no longer just two and a half percent, a relatively small variance. The total cost of the banking system to the classical outsourcing were in 2010 about 8 billion.

**Onsourcing as a way of optimizing the internal outsourcing.** It is definitely possible to state, that banks active on the Czech financial market focus especially on an internal outsourcing, a so called **onsourcing**. That means, that if they transfer some of the tasks they could manage on their own, they choose to transfer their provision to some of their group's members. Sometimes they also found new companies controlled by them for these purposes. All it is about is in fact the third generation of outsourcing (transformatory outsourcing) of its art. This concerns mostly the mid-sized or large banks, who are either the organizer or a member of their financial group. Incorporated in it use to be also the non-banking entities, from intermediaries active on financial markets, to the organizations not dealing with financial services. A kind of exception presents

a agglomeration of small financial institutions working as a group under the header Wüstenrot. The main motive for onshoring is to acquire the synergy effects by the means of procedure unification in the field of utilizing and improving the information systems, multi-branding<sup>17</sup>, multichannel product and services distribution, and centralization and concentration of typically operational activities. A typical example of this approach is the organizing of banking products and services distribution. For example the Česká spořitelna recently founded a subsidiary company, named „Partner of Česká spořitelna”, aimed at external sales management and their realization by the means of external partners of physical entities. In the field of banking products distribution the cross-selling plays also an important role. Within the ČSOB group, the pension funds’ products sale in the year 2009 was provided by the subsidiary “ČSOB penzijní fond” (pension fund) only at the level of 22 %, subsidiary “Českomoravská stavební spořitelna” (building society) at the level of 61 % and the controlling company itself around 17 %. The sales of life insurance is provided by the “ČSOB životní pojišťovna” (life insurance) at the level of 58 %, the controlling company at 42 %. The cross-selling is herewith substantially improving their supply effectiveness, as well as their competitiveness on financial market (in the said example the average increase in performance of the ČSOB group’s selling said six products can be estimated as almost 60 %). Other groups or standalone banks do not even create their own distribution channels. They are using their own independent retail networks right away (e.g. already mentioned group Wüstenrot). They also use specialized retail networks, who offer their services to several banks or large number intermediaries active on Czech banking market. UniCredit bank even attempts to switch to “external onshoring”, which is at least “third-and-a-half generation” of the outsourcing, if not even a fourth, the so called franchising. Outsourcing tendencies however concern even many other activities. In the first place stand the IT services. There was almost no bank not putting outsourcing or onshoring in this field on the forefront. With the IT services, the significant factor of outsourcing development is motivating the synergic effects stemming from the unification of information systems. This applies namely to the large banking groups, but to the other banks with significant foreign capital participation as well. In many

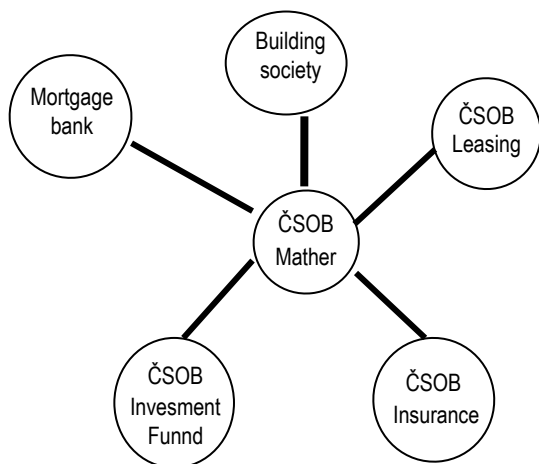
cases it is a modification of offshoring, where a group practices something of a kind of cross-border onshoring. The supplier and administrator of the IT systems supporting the core activities is in such cases the foreign member of the group. Synergic effects of the outsourcing transfer and tasks reorganization within the group are however expected the side of services with operationa<sup>18</sup> character, including the supportive activities, as are the document scanning, accounting and payroll agenda administration and processing, filing room operations, statements of accounts printing, documents custody, providing security services and safeguarding the credit cards services, cash dispensers, payment terminals etc. One of the new tendencies in utilizing the onshoring synergy is the integration of activities of various banking groups. We will demonstrate this again on the example of the „Československá obchodní banka” (ČSOB). In the year 1999 the owner of ČSOB became the Belgian bank KBC. Herewith, the ČSOB and gradually the whole of its group started to be pulled by the means of ownership and economic relations into the KBC group. That marked a start of gradual integration of both groups, enabling the utilization of the business synergy, e.g. customer distribution channels, systemic integration, expert experience transfer and new product implementation. This integration also includes ČSOB switching to the Financial Reporting according to the IFRS, implementing the KBC policies regarding the Management Reporting, risks management and internal audit. One of the most important aspects of integration became the providing of ICT services through a common, centrally driven ICT system to the KBC group as a whole, which was implemented in the year 2009.<sup>18</sup> It is possible to speak about using the fourth generation of outsourcing and the globally integrated enterprise. A similar trend can be seen in such group of Czech Savings Bank, owned by Austrian bank Erste Bank Group. From 1 February 2008, Erste Group Bank introduced a new “holding” business model of trading on financial markets, “Capital Markets Group”. Risks from the restricted client operations are transferred to the same portfolio of transactions, Erste Group Bank holding company, also listed on the bond markets, derivatives and foreign exchange market and interbank transactions were transferred to the Holding Company. Erste Group Bank on an annual basis by redistributing income share of the holding of such trading in

<sup>17</sup> For example, the “Československá obchodní banka” is active on the Czech Banking Market under four brands: “ČSOB”, “Poštovní spořitelna”, “Českomoravská stavební spořitelna” and “Hypoteční banka”.

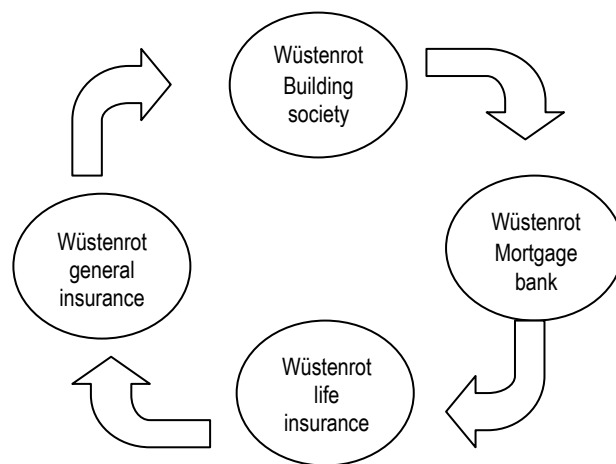
<sup>18</sup> Source: Annual report 2009 by ČSOB. The author of this article experienced beginnings of this integration himself, as an employee, Office Director and Supervisory Board member of one of the subsidiaries.

accordance with the approved model. Closing new business and listing on the money market and stock market were left in the Czech Savings Bank. Aside from this, in the „globally integrated enterprise“ Erste Group, it can be observed a tendency towards the integration of IT systems and their centralization (abroad, in Vienna), or vice versa towards the integration and centralization of foreign payments and

foreign checks processing of Erste group in Hodonín (i.e. Czech Republic). Previous knowledge of outsourcing optimization through outsourcing also allows reach a preliminary conclusion about the origin and the existence of two outsourcing models. Outsourcing centralized (eg. type of ČSOB) and decentralized type outsourcing (type of Wüstenrot):



**Centralized model (ČSOB)**



**Decentralized model: (Wüstenrot)**

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### Анотація

У статті наголошується на застосуванні аутсорсингу конкуренції з метою зростання банківської системи, що не тільки дасть можливість уникнути регулювання та нагляду, а й принесе високий ефект синергії. При цьому висока частка іноземного капіталу викликає питання про готовність банків допомогти зростанню конкурентоспроможності чеської економіки.

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