OUTSOURCING PRACTICES OF THE KENYAN BANKING SECTOR

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ABSTRACT
This paper presents contemporary evidence of outsourcing practices of the Kenyan banking sector. A questionnaire was sent to forty commercial banks operating in Kenya. Descriptive analysis results indicate that Automated Teller Machine (ATM) services are the most outsourced function in the sector, while customer account processing is the least outsourced function. Banks associate outsourcing activities with high reputational, operational, strategic and contractual risks. Outsourcing benefits highlighted are: freeing of resources, cost reduction, access to specialised vendors, focus on core competence, flexibility and improved services.
Results of logistic regression indicate that bank size measured as total asset is significantly associated with outsourcing decisions. Bank performance measured as Return on Assets and ratio of Non-Performing Loan (NPL) is not statistically associated with outsourcing decisions. Similarly, banks' wage bill and total operational expenses are not significant determinants of outsourcing decisions. The findings have regulatory policy implications, and in particular the urgent need for formulating a guideline to regulate the apparent proliferation of outsourcing practices in the Kenyan banking sector.

Key words: Banks, Kenyan Banks, Outsourcing, benefits, risks

JEL Classification: M2, N27

I. INTRODUCTION AND MOTIVATION

In recent years, advances in information technology has revolutionised the way companies conduct business. Outsourcing of business processes is one of the key outcomes of the technological advancement. Due to its IT-intensive business processes the potential for outsourcing appears to be particularly high in the banking industry. This is further enhanced by the fact that most of the data in the banking sector are in digital from coupled with increased use of internet Gewald and Dibbern (2005).

Outsourcing is increasingly being used as a means of both reducing costs and achieving strategic goals Basle Committee (2005). Globally, regulators concern is how banks manage risks associated with a third party offering certain key services Basle Committee (2005). Outsourcing risk is manifested in loss of control on some key functions and likelihood of opportunistic expropriation by vendor [Ang and Cummings (1997); Lacity and Wilcocks (1998)]. While IT outsourcing has profound benefits, it equally expose firms to serious risks. Beasley, Bradford and Pagach (2004) summarise severity of outsourcing risks as follows: "the mere occurrence of one incident, such as an IT shutdown, can exponentially increase the enterprise's risks…" (p.26). Beasley et al., (2004) suggests that outsourcing poses multitudes of risks to a numbers of firm's functions such as finance, human capital, IT and operations. In Kenya, there is significant rise in outsourcing activities in the banking sector. Surprisingly, in a survey conducted by the Central Bank of Kenya, a number of financial institutions have no risk management frameworks, Central Bank of Kenya (2005). In addition, there is currently, no regulatory guideline on outsourcing.

It is against this background that we explore two fundamentally important questions:

(1) What are the perceived benefits and risks of outsourcing?
(2) What factors determine banks' decision to outsource?

This study makes important contribution to financial services research. To the best knowledge of the authors, to date, there is no study that has examined outsourcing practices of the Kenyan banking sector, and within the wider Africa context. Thus, this study, provide an exploratory finding in this field in the Kenyan context, and presents opportunities for further research. In addition, the findings of the study have important regulatory policy contributions.

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

While there a number of empirical research studies on outsourcing practices [Loh and Venkatraman (1992); Teng, Cheon and Grover (1995)], there is no published research in Kenya. This section documents findings of relevant research papers, summarise the theoretical framework, and specifies the hypotheses.

2.1 Literature Review and theoretical framework

In 1999, Federal Reserve Bank of New York conducted survey on banking industry practices for outsourcing arrangements. Findings suggest that banks outsource financial services for a number of reasons, such as, enhanced performance; costs reduction; access to superior expertise; and strategic reasons. In addition, the study indicates that although there are many benefits derived from outsourcing of financial services, the arrangement give rise to potential risks. The risks identified are: strategic, reputation, credit, compliance, transaction and country risk.

Similarly, in 2004 Federal Reserve Bank of San Francisco, conducted survey on outsourcing by financial services firms, and notes a number of motives for outsourcing, namely, operational efficiency; efficient use of resources; and quick and reliable service delivery.

Similarly, a survey conducted by European Central Bank in 2004 reveals that although the benefits of outsourcing are evident, in practice, many banks believe that outsourcing introduces new challenges and risks. The study highlights the benefits of outsourcing, suggesting; cost reduction; access to better technology and infrastructure and strategy of focusing on core activities; economies of scale which leads to improvement in synergies achieve diversification benefits or streamline services; focusing on core activities; free scarce resources; quality services; and flexibility. As with US studies, the European study also reveals several risks associated with outsourcing, namely, operational, legal, strategic risk, country risk reputational risk, loss of flexibility, loss of control and cultural/social problems.

Pujals, G. (2004) conducted a study on offshore outsourcing in the European Union financial services industry. Results of the study indicate that banking institutions may choose to outsource certain activities for various motives. Some of the motives cited are: cost reduction, access to new technology, focus on core activities, improvement of quality of services and greater flexibility. In addition, the study identified the following risks associated with outsourcing of financial services: loss of control over service, operational risks, loss of internal skills, loss of flexibility, cultural and social problems, technical constraints, decline in quality and competitive advantages.

An important feature of all the prior research studies documented in the preceding section is the exclusive focus on the Western developed economies. Thus, this study, with its primary focus on outsourcing practices in a developing country (Kenya) is an important extension of the outsourcing research and valuable addition to literature.

2.2 Theoretical Framework Hypothesis Development

The risk-benefit analysis in decision theory compares the risks associated with and the benefits expected of a decision that is made, in order to achieve an optimal result. This concept has been discussed by Jurison (1995). When the concept is applied to outsourcing, it means that the manager or decision maker has to assess all the potential risks and benefits that may arise from outsourcing process.

Perceived risk theory analyses the risk a person subjectively associates with the consequences of a decision and its impact on the intention to close a transaction (Bauer 1967). This theory is grounded on the fact that as long as the perceived benefits outweigh the perceived risks, the person in charge will have a positive attitude towards a particular decision. In information system research, perceived risk inherent in a transaction plays a critical role especially in adoption of technology. For example, Feartherman (2001) found that the overall potential risk may reduce the usefulness of an activity. Also, Pavlou (2001) noted that potential risk reduces individual intentions to conclude a deal.

It is apparent that the individual perception towards outsourcing could either be positive or negative. Negative perceptions of outsourcing are often equated with risks of outsourcing, that is, the possibility of outsourcing failure [Aubert, et al., (1998); Earl, M.J (1996)]. Similarly, there are a number of outsourcing advantages, which may be summarized as outsourcing benefits [Dibbern, et al., (2004); ECB (2004)]. In this research, therefore the risk-benefit framework is applied to examine outsourcing decisions. The framework is in line with decision theory regarding decisions that involve risk or uncertainty [Friendmann and savage (1948); Machina (1987); Tamura (2005)]. In outsourcing research, the analytical framework of trade off between costs versus risks is well documented [see for example Jurison [1995); (1998); (2002)]. This suggests that in making outsourcing decisions firm managers assess all the perceived risks and benefits. These factors are aggregated in arriving at the final decision to outsource a function or not. Consistent with this theory framework, it is plausible to argue that the decision to outsource is positively influenced by perceived benefits of outsourcing and negatively influenced by perceived risks of outsourcing.

In this research, three hypotheses, namely, size, cost reduction and profitability are tested as possible predictors of banks' decision to outsource certain functional activities. The hypotheses tested are based on literature review of pertinent studies.

Size

Size of a company portends a number of attributes such as business complexities and geographical dispersions. Larger firms may benefits from outsourcing decision taking into account the economies of scale that favour such practices [Love and Ropers (2001); Ono (2003)] as cited in Hong, Chin and Liu)]. Large companies may be better placed to manage risks associated with information technological advances [Palvia and Chervany (1995)]. Thus, this research posits that size may be associated with outsourcing decision. The following hypothesis is therefore examined:

HI: Bank size is positively associated with outsourcing decision.

Cost reduction

One of the key motivations for outsourcing certain aspects of business activities is to save on cost reduction associated with this practice. In this regard, Kakumanu and Portanova (2006) note; "the main driver in outsourcing is often cost reduction"(p.2). In an empirical study of outsourcing by UK firms, Girma and Gorg (2006) concluded that; "high wages are positively related to outsourcing, suggesting that the cost-saving motive is important" (p.817). Thus, consistent with prior findings the following hypotheses is tested:

H2: Bank wage ratio is positively associated with outsourcing decision.

Profitability

Banks outsource certain activities to concentrate on the core function of the banking business. This will enhance an institution's competitiveness in the industry and improve earnings. Hence, the following hypothesis is tested:

H3: Bank profitability is positively associated with outsourcing decision.

III. RESEARCH METHODS

3.1 Data Collection

The study used primary data which was collected from a sample of all commercial banks operating in Kenya in December 2005.

A structured questionnaire consisting of closed ended questions was developed. Questionnaires were sent to staff members of 40 commercial banks who were in charge of finance and strategy functions. A bank, which was under Central Bank statutory management, was excluded from the survey.

To refine and validate questions asked, prior to banks' survey, the questionnaire was discussed independently with staff of supervision, Research and External payment Departments of Central Bank of Kenya. Based on comments of the participants, the questionnaire was modified and finalized.

Each construct is represented by a set of indicators which form the question in the survey. The attitude/opinion of the respondents was captured on a positive- to- negative 5 point Likert scale. Questions regarding the perceived risk- state a risk and how the respondent rates the risk on the following scale; very high, high, rather high, neutral, rather low, and very low. Questions on the perceived benefits- give a statement and ask for the level of agreement on the following scale: strongly agree, predominantly agree, rather agree, neutral, rather disagree, predominantly disagree, and strongly disagree.

The time period for returning the questionnaires was four weeks from 1st December 2006 to 31st December 2006. However, due to poor response, the period was extended to 31st January 2007. Overall, 19 questionnaires out of 40 which had been sent out were returned. This represented a response rate of 48%.

The aim of the study was to identify factors that motivate banks to outsource some of the functions and the perceived risks**.** On the question of perceived benefits, respondents answering one 1 or 2 are regarded as positive on the benefits outlined in the questioned. Any respondent answering 3 can be regarded as neutral and respondents answering 4 or 5 can be regarded not in support of the benefits.

In case of perceived benefits, respondents answering 1 or 2 can be said to perceive outsourcing as risky business, respondents answering 3 can be said to be neutral or undecided, while respondents answering 4 and 5 can be said to perceive outsourcing as not risky.

3.2 Data analysis technique

To analyse the survey data basic statistical tools such as proportions and means are utilized. This is particularly useful in evaluating banks' motivation to outsource as captured on the 5-point Likert scale.

In addition, to further examine determinants of outsourcing practices, logistic regression analysis is applied in this study. Given the dichotomous attribute of the dependent variable, logistic regression is suitable over other regressions techniques such as the Ordinary Least Square (OLS) and the Probit regression (Madalla, 2001). The logistic regression model can be defined as:

$$OUTS\ (0, 1) = \beta 0 + \beta 1SIZE + \beta 2COST + \beta 3PROFITABILITY + ei$$

Where:

OUTS (0, 1)	Is the dependent variable, 1 is for outsourcing bank and 0 otherwise.
β_0	Is the constant
Size	Is measured as total assets of a bank as at 31st December 2005
Cost	Is measured as ratio of wage to total operating costs
Profitability	Is measured as Return on Assets
ei	The residual error

IV. RESULTS

4.1 Descriptive analysis

Table 1, presents information relating to personal attributes of the respondents. The respondents are well educated with 89% holding at least a first degree and all the respondents occupying management positions. This suggests that all the respondents were well versed with the policies and operations of the bank, and involve in outsourcing decisions. Thus, the survey response can be relied upon to the extent that all respondent are bank managers with majority (78%) in senior management positions. Only 28% of the respondents were female, an indication of low female representation in the banking sector.

Table 1.
Respondents' background information

Background	**Proportion of the respondents %**
Gender	
Male	72
Female	28
Total	**100**
Age(Years)	
Under 25	0
26-35	39
36-45	33
46-55	22
Over 55	6
Total	**100**
Level of Education	
Secondary School	6
Degree	6
Postgraduate	50
Total	**39**
Position in the organization	
Executive Management/Head of Department	78
Middle level Management	22
Junior Management	0
Total	**100**

Table 2 shows the level of outsourcing for each function. The level of outsourcing was captured using for constructs, dependent uopn whether the bank; already outsource the function, is under consideration, has decided against or reintegrate a particular function with others.

Analysis of the section on the level of outsourcing indicates that ATM function is the most outsourced in the banking sector in Kenya with 67% of the respondents indicating that their banks have already outsourced the function. The high rate of outsourcing of the function may be explained by high costs of maintaining ATMs and also, the emergence of private companies offering the services on sharing basis. Card processing is the second highly outsourced function with 58% of the respondents confirming that their banks have already outsourced the function. Customer account processing is the least outsourced function with none of the respondents indicating that their banks are outsourcing the function. This is probably explained by the seriousness the banks attach to the principle of confidentiality and is consistent with global concerns about money laundering where 'know your customer' is the starting point to combat this vice.

Internal audit was cited by 16% of the respondents as one of the function that banks have at one point considered to integrate with other core functions. This may be explained by critical role the internal audit function plays in the whole business process. It also indicates concerns about service quality of third party in effectively undertaking such an important internal governance responsibility.

Table 2.
Level of outsourcing (in percentages)

	Already outsourced	Under consideration	Decided against	Reintegrate function
ATM	79	0	0	11
Card processing	58	11	11	5
Internal Audit	11	0	16	21
Human Resources	26	11	0	11
Sales/ Marketing	21	16	0	0
Information Technology	32	11	5	11
Debt Collection	32	5	5	16
account processing	5	5	5	11

(Source: Survey data).

The results of the questionnaire responses on perceived benefits of outsourcing are shown in on Table 3. The respondents are generally in agreement that outsourcing process brings benefits to a bank. Focus on the core business was cited by all the respondents as one of the benefits derived from outsourcing arrangement. Freeing of resources to other functions of the bank, was rated lowest with only 45% of the respondents citing it as one of the benefits that is derived from outsourcing function. Access to specialized vendors was also positively identified as the benefit that accrues to a bank. This is especially true in IT field where the banks would prefer to outsource due to rapid changes in technology.

Table 3.
Perceived benefits of outsourcing (in percentages)

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
	1	2	3	4	5
Cost reduction	67	23	10	0	0
Focus on core competence	61	39	0	0	0
Access to specialized vendor	45	50	5	0	0
Improved services	53	36	11	0	0
Free resources	18	27	32	0	23
Provide flexibility	26	48	26	0	0
Others	50	50	0	0	0

Source: Survey data

Table 4 presents findings on risks associated with outsourcing. Banks cite reputational risk, strategic risk, operational risk and contractual risk as the most likely risks in outsourcing, with 79%, 53%, 58% and 53% respectively of the respondents ranking the risks as very high or high. Reputational risk is perceived as high or very high given the fact the quality of service being offered by the contracted third party may not meet banks' expectations, thereby damaging the reputation of the bank. Country risk is not considered as a high risk in outsourcing with 89% of the respondents ranking the risk neutral and below and only 11% of the respondents perceive the risk as high.

Table 4.
Perceived risks of outsourcing

Risks	Very high	High	Neutral	Low	Very low
	1	2	3	4	5
Strategic risks	21	32	22	26	0
Reputational risk	32	47	5	11	5
Compliance risk	16	26	32	21	5
Operational risk	5	53	16	21	5
Country risk	0	11	42	32	16
Counterparty risk	0	47	37	5	11
Contractual risk	16	37	21	16	12
Access risk	0	37	26	32	5
Concentration	5	21	37	32	5
Systemic risk	5	37	32	16	11
Exit	0	32	37	21	11

This can be explained by the fact that, all the outsourcing business taking place is done within the country. The results of the survey shows that both the risks under the control of the banks (such as strategic and compliance risks) and the service provider (such as, reputational, operational and counterparty risks) are equally important. This is inconsistent with prior findings, for instance Gewald and Dibbern (2005), suggest that risks in the area of responsibility controlled by bank are high and more important than those risks controlled by the service provider.

Correlation Matrix

Table 5 presents correlations among the dependent variables: Size, Cost and Profitability. The result suggests that multicollinearity is not of concern as to affect further multivariate test. It is generally accepted that a correlation coefficient not greater than 0.80 is not considered harmful in a regression analysis (see for example Olusegun, Naser and Mora 1994). Thus, multicollinearity is not a serious issue that may affect results of logistic regression.

Table 5.
Pearson correlation matrix

Dependent Variables	Size	Cost	Profitabilty
Size	1.000	-0.074	0.308
Cost		1.000	-0.560*
Profitability			1.000

* $p < 0.01$, two-tailed

Logistic Regression analysis

Table 6 presents results of the Logistic regression analysis. Findings indicate size[1] of bank is strongly and positively associated with outsourcing practices. Thus, hypothesis H1 is supported. This suggests that, the larger the bank, the higher the likelihood of a financial institution to outsource some of its functional activities.

Surprisingly, other predictor variables, namely, cost and profitability are not statistically significantly associated with outsourcing decisions. Thus, hypothesis H2 and H3 are not supported.

Table 6.
Results of logistic regression

Independent variables	Predicted sign	Coefficient	Wald Statistics	p-value
Constant		-7.601	5.178	0.023
Size	+	0.927*	6.041	0.010
Cost	+	-1.539	0.144	0.705
Profitability	+	-0.164	0.324	0.569
-2 log likelihood		46.591		
Nagelkerke R^2		0.197		
Chi^2 statistics		0.262		

*Denotes significance at 1%.

[1] Other measures of size: employee number and branch network yield similar results.

V. SUMMARY AND POLICY IMPLICATIONS

The primary purpose of this study is to explore outsourcing practices in the Kenyan banking sector. In particular, the study examines the perceived benefits and risks associated with outsourcing activities in the Kenyan banking sector.

One interesting and disturbing finding is the large number of financial institutions (nearly 50%) involved in outsourcing of certain banking functions, in an environment without a regulatory framework. This therefore calls for urgent measures to institute a regulatory framework in place in the form of an outsourcing guideline to the banking sector.

ATM and card processing are the major activities currently outsourced in the banking industry. Customer account processing is least outsourced activity. This is consistent with global concerns about money laundering where 'know your customer' is the starting point to combat this vice. However, as shown in Table 2 some banks are considering outsourcing of customer account processing and this may pose significant challenge in the regulatory environment, and especially with respect to fighting money laundering when a third party is involved.

Banks cite, cost reduction, focus on core competencies and improved services as the main benefits of outsourcing. Reputational, operational, contractual and strategic risks are the main risks associated with outsourcing practices. While this study may not have covered this aspect, its of interest to the regulatory authorities to examine how banks achieve a balance in risks and benefits associated with outsourcing taking into consideration interests of other stakeholders such as depositors.

Results of the logistic regression analysis indicate that bank size is positively associated with outsourcing decisions. Whereas cost saving and profitability are not significant predictors of outsourcing practices in the Kenyan banking sector. That size is a significant determinant of outsourcing decisions has regulatory implication. From a regulation vantage point it is imperative to note that larger financial institutions are likely to outsource, and therefore on aggregate scale, the industry could be highly exposed to outsourcing risks and the contagion effect in the event of third party default is difficult to predict given the interrelationship and interdependences in the sector.

The findings of this study should be viewed in light of a few limitations. The use of questionnaire to gather relevant information on the perceived benefits and risks on outsourcing must be noted. The richness and depth of this research can be enhanced by use of interviews and observations. In addition, a pragmatic review and analysis could have benefited more by use of internal bank documents like board minutes, policies and procedures which could have provided more insight into the operations and strategic thinking of the management. The study is limited to the extent that its focus is on a specific country and industry, Kenya and banking sector respectively.

An important extension of this study is to replicate this research to other countries, and more importantly conduct comparative country studies. In additions, given the changes that are taking place globally and enactment of rules and laws, on corporate governance, it would be necessary to carry out research on the role of board members in outsourcing. As it has been the tradition, the board is the key internal governance mechanism, and it would of interest to understand the board-room dynamics in making decisions to outsource of certain banking services. Interviewing board members on this vital and emerging practice will provide a rich textual and thematic understanding of boards' evaluation of risks and benefits as well as prioritisation of services to be outsourced. The findings are useful to further refine the already existing Corporate Guidelines with respect to the role of the board in considering outsourcing of certain banking services from a third party.

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