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A sourcing strategy for the middle offices in financial institutions

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ABSTRACT

This article examines the strategies of sourcing the middle office functions in financial institutions. While some functions, in particular the back office functions in financial institutions are popularly and successfully outsourced or co-sourced, it may not be appropriate to do so for sourcing the functions of middle offices. Outsourcing or co-sourcing of the middle offices implies contracting out the risk management function of a financial institution partially or completely. This may reduce the effectiveness of risk management implementation and may potentially expose the institution to great risk. This article compares different strategies, namely outsourcing, co-sourcing, and shared services; and shows that shared services has many advantages over the other two strategies.

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1.0 Introduction

Financial institutions often classify their operational departments and divisions into three categories, namely the front office, middle office and back office. The front office comprises departments and divisions that are in contact with clients to generate profits for the financial institution. The back office contains departments and divisions that provide administrative functions or support services, such as human resources and IT services. The middle office consists of departments and divisions that deliver the services that directly support the front office, including internal controls, profit and loss calculation, risk management, regulatory compliance and so on. These services do not directly generate profits, but are essential and critical for profit generation and loss control.

In general, outsourcing and co-sourcing have been widely used by organizations to contract out non-core business operations to external third-party service providers (Kakabadse & Kakabadse, 2000; King, 2006; Krempel, 2000; Rison, 2005). The main motivations of outsourcing and co-sourcing are: reduce the overall capital and operational costs; increase focus on the core business functions.

For outsourcing, King (2006) notes that the third-party service provider and the outsourced organization enter into a bilateral contract involving an exchange of services and payments. For co-sourcing, business operations are performed by both in-house staff and external third-party service providers (Kakabadse & Kakabadse, 2000).

Typically, the external third-party service provider provides expertise or support to the in-house staff during co-sourcing.

Since the early 21st century, many financial institutions have already adopted outsourcing or co-sourcing (Brandau & Hoffjan, 2010; Williams, 2006). In particular, many financial institutions have outsourced or co-sourced various business operations of their back offices with great success (Krempel, 2000; Williams, 2006; Maitner, 2011). However, in contrast to the back office, which generally delivers non-core business services, the middle office provides essential support to the front office. The middle office deals with the business data and knowledge that are critical for profit generation and risk management. For both outsourcing and co-sourcing the middle office functions, there are potential risks of partially or completely losing control of the core business data and knowledge of the middle office (Maitner, 2011; Wang & Wang, 2014).

In regard to outsourcing, it has been widely recognized that products or services can be outsourced, but risks cannot. Outsourcing or co-sourcing the middle office functions implies contracting out the risk management function of a financial institution partially or completely, which will expose the institution to a great risk.

Learning from the lessons of a number of great financial disasters, mainly caused by misusing financial derivative securities in the 1990's, it has been recognized that to ensure effective risk management in financial institutions, the middle office must have appropriate authorization to access any necessary information independently and to integrate risk management functions in the daily operation of a financial institution (Chance & Brooks, 2015). This implies that the middle office can access some important information with a high degree of sensitivity and confidentiality. Clearly, it is inappropriate to allow an external service provider to have access to that kind of information. Similarly, it is also inappropriate, and difficult, to allow an external party to be involved in the daily operations of the institution, such as risk management. Thus, while the risk management functions of a middle office is outsourced or co-sourced, it may reduce the effectiveness of the risk management function.

To overcome these problems, we propose a sourcing strategy, shared services, for sourcing the middle offices of financial institutions. For shared services, the common business operations and processes of the middle office are standardized and consolidated across multiple partner financial institutions to reduce operational costs and to increase data and knowledge sharing (Kakabadse & Kakabadse, 2000; Wang & Wang, 2007), without losing the effectiveness of risk management function.

The remainder of this paper is organized as follows： Section 2.0 describes the shared services for sourcing the middle offices. Section 3.0 compares the shared services with outsourcing and co-sourcing for sourcing the middle offices. Section 4.0 illustrates the organizational design processes for shared services for the middle office. Finally, Section 5.0 presents the conclusions and policy implications.

2.0 Shared services for sourcing the middle offices

Many government and healthcare organizations have successfully adopted shared services as an alternative solution to outsourcing and co-sourcing (Amiruddin, 2013; Ask *et al.,* 2008; Borman, 2010; Janssen & Joha, 2006; Kamal, 2012; Lindvall & Iveroth, 2011; McDowell, 2011; Minnaar, 2013; Niehaves & Krause, 2010; Ulbrich, 2010). The idea is to consolidate and standardize common business processes across multiple partner organizations using one or more shared service centers. These shared service centers are capable of reducing operational cost and increasing information and knowledge sharing among the partner organizations (Kakabadse & Kakabadse, 2000; Wang & Wang, 2014). Back office operations such as IT services and human resource management are particularly suitable for shared services. Many success stories have been reported in the literature (Amiruddin, 2013; Borman, 2010; Lindvall & Iveroth, 2011; McDowell, 2011; Minnaar, 2013; Niehaves & Krause, 2010; Tsai & Yen, 2008; Ulbrich, 2010).

For sourcing the middle office with shared services, multiple partner financial institutions must first form a long-term strategic alliance. This long-term strategic alliance will enable the partner financial institutions to share the governance, cost and risks of the shared services, as well as the data and business knowledge. The data and knowledge sharing aspect of shared services allows the partner institutions to gain extra competitive advantages over other competitors in addition to cost reduction.

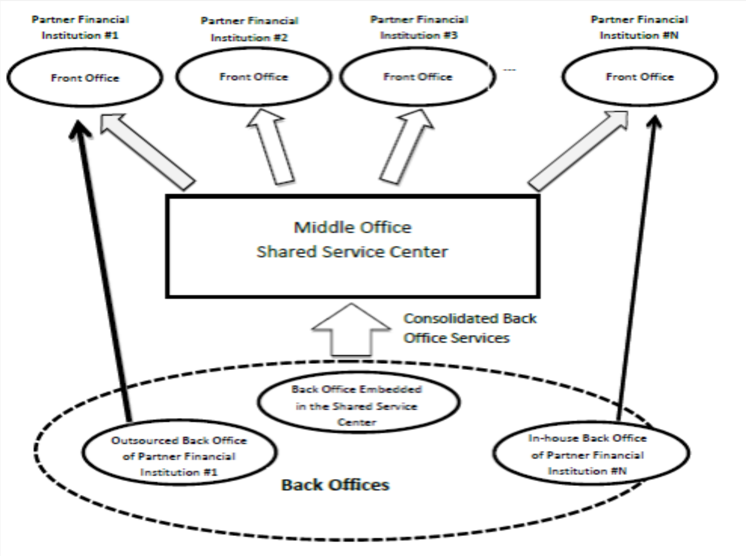
As shared services create a special environment for partner financial institutions, the following set of policies must be created:

a. Governance of the shared service center
b. Rights and responsibilities of each partner institution
c. Cost distribution of the shared service center

d. Authority for service access of each partner institution
e. Authority for data sharing among the partner institution
f. Authority for business knowledge sharing among the partner institution
g. Ethical code of conduct

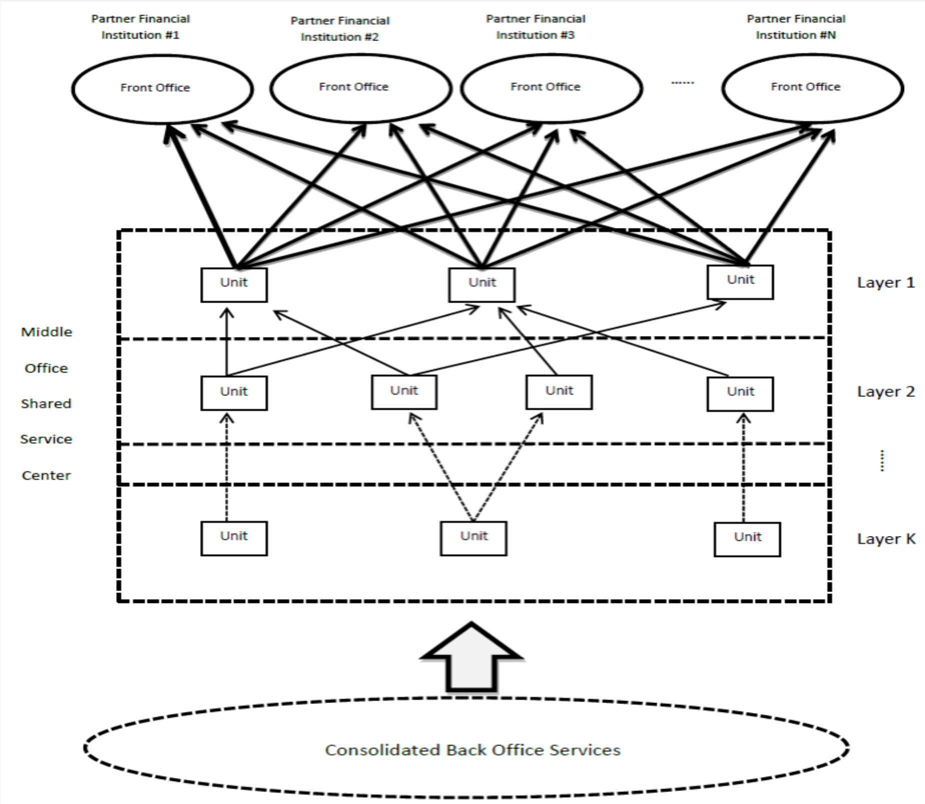
These policies must be fair to each partner institution and represent the common interest of all partner institutions.

Figure 01: Organizational structure of the middle office shared service center



Moreover, organizational structure changes are required for each partner financial institution. As shown in Figure 01, the partner financial institutions will form a network with the nucleus of a shared service center for the middle office.

Figure 02: A layered network structure for the middle office shared service center



The shared service center for the middle office provides support to the front offices of the partner institutions. The back office services that the shared service center receives are consolidated from various sources. The shared service center has its own back office for its administrative support and may receive further support from various back offices of the partner institutions. The forms of the back offices from which the shared service center receives the services are not important and may vary from outsourcing to in-house.

To implement the organization structure changes for each partner financial institution, business process reengineering (BPR) is generally used to re-examine the existing business processes and the relationships between involved operational units within the financial institution. Business process reengineering often results in a set of refined business processes and a new organizational structure (Minnaar, 2013; Wang & Wang, 2007). Figure 02 shows an example of a layered network organizational structure of a shared service center for the middle office. In this example, operational units of the original middle office are re-organized into a layered network. The top layer units are in contact with the front offices of the partner institutions and deliver the final products/services to the front offices. The rest of layers participate in the various business processes and support the top layer units. Each operational unit may also receive support services directly from the back office.

The goals of the shared service centers for the middle office are to:

a. Lower the operational costs of the business processes of the middle office.
b. Improve the quality of the services provided by the middle office through business process reengineering.
c. Enhance the services of the middle office through data and business knowledge sharing among the partner institutions.
d. Increase the performance of the partner institutions through a focus on their front offices.

3.0 Comparison of shared services, outsourcing and co-sourcing

Shared services are different from outsourcing and co-sourcing. For outsourcing and co-sourcing, the middle office contracts out services to external third-party service providers. For shared services, the shared service center for the middle office is formed and governed by the partner financial institutions. The main objectives of shared services are as follows:

a. Long-term stable cost saving through reducing the overall capital and operational costs.
b. Increase focus on the core business functions of the front office.
c. Establish a long-term strategic partnership with other financial institutions to share data and business knowledge.

For outsourcing, the relationship between the external third-party service provider and the financial institution that outsources the operations is defined by a short-term bilateral contract. Outsourcing provides the outsourced organization great budget flexibility and control. It allows the outsourced financial institution to pay for only the services it needs, at the time when it needs them. The outsourced financial institution does not need to hire and/or train specialized employees for the middle office but simply mitigates skill and expertise shortages through outsourcing. However, outsourcing may be associate with potential risks, such as:

a. Lack of transparency of the middle office operations,
b. Loss of quality control over results,
c. Failure to deliver the results as expected,
d. Loss of control over the data and business knowledge of the middle office,
e. Failure to maintain the standard of conduct

For co-sourcing, the external third-party service provider provides expertise or support to the in-house staff in the middle office. As with outsourcing, the relationship between the external third-party service provider and the financial institution of co-sourcing is also defined by a short-term bilateral contract. Co-sourcing attempts to alleviate the potential risks associated with outsourcing. However, co-sourcing often incurs extra cost. First, co-sourcing increases the governance scope as external personnel work together with in-house staff. Second, co-sourcing increases chances of business process fragmentation and variation. Existing business processes of the middle office must be modified to accommodate the new external personnel. Third, co-sourcing requires increased communication between the in-house staff and the external third-party service provider, which may mean the loss of productivity for both. Finally, like outsourcing, co-sourcing is also associated with the potential risk of losing control of core business data and knowledge of the middle office as third-party service providers are involved.

As both outsourcing and co-sourcing are associated with the risks of partially or completely losing control of core business data and knowledge of the middle office, shared services allows a financial institution to use policies to control the loss of data and knowledge. Major advantages of shared services over outsourcing and co-sourcing include:

a. Long-term stable cost savings for each partner institution,
b. Data and business knowledge sharing among the partner institutions to gain additional competitive advantage over other competitors,
c. High degree of control over the data and business knowledge to be shared among the partner institutions.

Table 01 summarizes the comparison of shared services, outsourcing and co-sourcing.

4.0 Organizational design processes of shared services

The following six organizational design processes may be served as a blueprint for sourcing the middle office using shared services. They are continuous processes and should be continuously refined and improved.

Table 01： Comparison of shared services, outsourcing and co-sourcing

Managerial Aspects	Shared Services	Outsourcing	Co-sourcing
Cost savings	Long-term	Short-term	Short-term
Organizational structural changes	Medium	Minimal	Complex
Reduction of business process duplication	Yes	No	No
Refining/enhancing business processes	Yes	No	No
Data and knowledge sharing among partners	Yes	No	No
Risks of losing the control of data and knowledge	Minimal	High	Medium

Process 1: Initiation and planning of the shared services for the middle office

As top management involvement is an essential requirement for effective risk management (Chance & Brooks, 2015), sourcing the middle office using shared service centers should be initiated by the top management of financial institutions. A feasibility study should be conducted to evaluate the level of interest of the potential partners, organizational capacity and the scope of the shared service centers.

Process 2: Establishment of the long-term strategic alliance

When multiple financial institutions establish a long-term strategic alliance for the shared services, they should

- Create a governance board of the shared service center,
- Identify liaisons from the partner financial institutions to the shared service center, and
- Specify the operational structure of the shared service center.

Process 3: Business process re-engineering of the middle office services

During this process, common business operations and processes of the middle offices of the partner financial institutions are standardized and consolidated. The existing business processes should be refined and improved.

Process 4: Creation of the policies for the shared services

The governance board of the shared service center should create a set of policies, such as:

- Rights and responsibilities of each partner institution
- Cost distribution of the shared service center
- Authority for service access of each partner institution
- Authority for data sharing among the partner institution
- Authority for business knowledge sharing among the partner institution
- Ethical code of conduct

Process 5: Implementation of the shared services

The key component of this process is change management (Minnaar, 2013; Wang, 2007). Management teams at the partner financial institutions should ensure all changes are smoothly and successfully implemented to achieving the expected benefits.

Process 6: Evaluation of the shared services

The purpose of a formal and systematic evaluation is to ensure the success of the shared services and to initiate similar projects in future.

5.0 Conclusion and future research directions

This article has presented a strategy for sourcing the middle office using shared services, and has illustrated six organizational design processes. Compared to outsourcing and co-sourcing, shared services allow partner financial institutions to achieve long-term stable cost savings and a high degree of control over the data and business knowledge to be shared among the partners. Data and business knowledge sharing enable the partner financial institutions to gain additional competitive advantages over other competitors.

Though there are many advantages of employing shared services over outsourcing and co-sourcing, one limitation of this strategy is that only financial institutions that have no informational competitive advantage would use shared services, as all companies with competitive advantage would have incentive to hoard information[1].

While this article is focused on presenting the strategic framework of shared services, with a comparison of other two sourcing approaches, it will need further research to be done for the implementation of the model, in particular when the model is applied under different regulatory environments. This will be a topic for our future research.

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