

**BUSINESS PROCESS OUTSOURCING STRATEGY AND PERFORMANCE OF
COMMERCIAL BANKS IN KENYA**

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**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF
REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS
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DECLARATION

I declare that this project is my original work and has never been submitted for a degree in any other university or college for examination/academic purposes.

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Supervisor’s Declaration

The research project has been submitted for examination with my approval as the University Supervisor.

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DEDICATION

I dedicate this project to my loving parents Mr. Ernest Peter Mukuna and Mrs. TruphosaAndeyoAmbe and to my beloved twins Neo and Neora.

ACKNOWLEDGMENTS

This far the Lord has brought me. To Him be thanks, glory and honor always. I would like to express my profound gratitude and appreciation to my supervisor DrJ.M.Munyoki for his tremendous support, guidance and encouragement from the time I submitted my proposal to date. I have immensely benefited from his deep and extensive knowledge, experience and insight. May God bless you abundantly Doctor. I would also like to thank all my family, colleagues and friends for their encouragement, without which this project would not have come to fruition.

ABBREVIATIONS AND ACRONYMS

BAT: BritishAmericanTobacco

BFI: Banking and Financial Industry

BPO: Business Process Outsourcing

CBK: Central Bank of Kenya

IT: Information Technology

KBA: Kenya Bankers Association

NSE: Nairobi Stock Exchange

RBV: Resource Based View

ROA: Return on Assets

ROE: Return on Equity

ROS: Return On Sales

ROVA:Return On Value Added

ABSTRACT

This study sought to determine the extent of application of BPO strategy among commercial banks in Kenya and to establish the challenges/risks facing Banks in Kenya in implementing the adopted BPO strategies. The study was a descriptive cross sectional survey and a census of commercial banks in Kenya was done. The researcher used primary data sources. A questionnaire was sent to all forty three commercial banks operating in Kenya. Descriptive statistical tools were used to analyze the data. From the study findings, 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 indicate that bank size measured by the number of permanent employees and branch network is significantly associated with outsourcing decisions. The findings imply commercial banks in Kenya can improve their business performance through implementation of outsourcing on its non-core activities. 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. The study recommends that for commercial banks to succeed in their outsourcing strategy clear communication is a must to all stake holders, job quality should be a priority, there should be realistic achievable service level agreements so that the work is done professionally and in good time.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In today's dynamic environment, characterized by growing business and technological uncertainties, corporations are faced with various new challenges. The organization of market places has shifted from pure hierarchy and market-based modes to hybrid arrangements involving significant vendor participation. Triggered by these emerging new market structures Business Process Outsourcing (BPO) is gaining importance among new forms of business to business exchanges. Outsourcing is an arrangement in which one company provides services for another company that could also be or usually have been provided in house. Outsourcing is a management approach that allows delegating to an external agent operational responsibility for processes or services previously delivered by an enterprise. It can be defined as the purchase of a good or service that was previously provided internally Elmuti and Kathawala (2000).

In general outsourcing can be related to make or buy decisions on intermediate goods, to the hiring of temporary labour, and to the use of external services. By Leveraging the core capabilities of both the outsourcer and the vendor, BPO can be a source of competitive advantage. It helps the organization to achieve higher levels of value creation for the final customer. Drivers of outsourcing emanate from organizational initiatives, improvement focus, financial and cost objectives, or growth objectives. A wide range of core and non core critical business processes are increasingly being outsourced covering a large spectrum of sectors and

operations, enabling host organizations to gain access to world class capabilities. BPO offers unique potentials that are accompanied by distinctive risks and benefits.

Managers or decision makers apply several theories in making organizational outsourcing decisions. According to the resource based view (RBV) theory, the accumulation and use of resources and capabilities that builds unique, inimitable and non substitutable competencies provides competitive advantage. Such resources owned by an organization will affect on outsourcing decisions of an organization. The risk benefit analysis theory requires the manager or decision maker to assess all the potential risks and benefits that may arise from outsourcing process. In perceived risk theory the decision to outsource is positively influenced by perceived benefits of outsourcing and negatively influenced by perceived risks of outsourcing. The point in contingency theory is to design an organizational structure that can handle uncertainties in the environment effectively and efficiently. Agency theory suggests that the firm can be viewed as a nexus of contracts between resource holders. The theory attempts to deal with two specific problems: first, agency problem and second, that the principal and agent reconcile different tolerances for risk. This theory might be applicable in making outsourcing decisions given that outsourcing entails incorporation of other parties in handling organizational processes.

Business competition in the banking industry in Kenya has increased substantially over the last decade. On the one hand, margins have become smaller due to cut throat competition in some segments; on the other hand customers demand better and faster services. In the era of internet and mobile commerce, customers expect orders to be performed much more rapidly than in the past. In addition, the number of policies and rules imposed by national and international regulatory bodies has risen, which contrasts to the customer-oriented expectations for faster

services delivery. In this situation process performance of financial institutions has become a key element. To increase the competitiveness, various organizational and technical options must be evaluated. One approach could be to outsource selected processes to a leading firm. Another approach is to keep these processes internal and to improve them through a combination of organizational and IT-related measures. Banks associate outsourcing activities with high risks and possible high benefits. The benefits of BPO to banks depend heavily on leveraging capabilities by aligning structures and resources between exchange parties. Intensive cooperation is necessary to ensure that such benefits are attained.

1.1.1 The concept of Strategy

The concept of strategy has been much used and often abused. It is a multi-dimensional concept and has found application in all fields of study and life. It has been defined variously by different scholars; Thompson and Strickland defined it as the game plan management has for positioning the company in its chosen market arena, competing successfully, pleasing customers and achieving good business performance targets. Johnson, Scholes and Whittington (2005) defined Strategy as “the direction and scope of an organization over the long term, which achieves advantage in a changing environment through its configuration of resources and competences with the aim of fulfilling stakeholder expectations”. Mintzberg (1998) introduced the 5Ps of strategy; Strategy as a Plan, ploy, pattern, position and perspective.

There are various Levels of Strategy in organizations namely; corporate strategy whose key focus is on the effectiveness of the firm (Overall purpose and scope of the organization, Overall business domain, corporate resource allocation and Value addition to the different parts of the organization). Business Strategy’s Principal focus is on effectiveness (Competition with other businesses in the market to ensure Achievement of competitive advantage by focusing on the

Strategic Business Units – SBU). Functional (Operational) Strategy focuses on efficiency of the firm.(How the various functional areas contribute to achieving business and corporate strategy- Organizational processes).

1.1.2 Business Process Outsourcing Strategy

Business process outsourcing refers to an Organization that contract with another company to provide services that might otherwise be performed by in-house employees Clott (2004). Many large Organizations outsource jobs such as call center services, cleaning, Security, e-mail services, and payroll. These jobs are handled by separate companies that specialize in each service. One of the most familiar forms of outsourcing is business process outsourcing (BPO), like transferring the operational ownership of one or more of the firm's business processes to an external supplier that, in turn, administers the processes according to some predefined metrics.

Business Process Outsourcing refers to the rearrangement of entire business functions to some other service providers, primarily in low cost locations. The service provider may be either self owned or a third party,Lankford and Parsa (1999). This relocation or transferring of business processes to an external provider is essentially to accomplish increased shareholder value. BPO involves business process management and outsourcing. Business process management utilizes technology aimed at revamping the process, trimming own unnecessary steps, and eliminating redundancies. On the other hand outsourcing uses proficiency and resources of dedicated external service providers to execute many of these fundamental yet non-core activities McIvor and Humphreys (2000).

1.1.3 Organizational Performance

Organizational performance comprises the actual output or results of an organization as measured against its intended outputs (or goals and objectives). The performance of financial institutions in Kenya are measured using both financial indicators and non financial indicators such as capital structure, sales growth, profitability, cost efficiency, total assets, return on investment, sales volume, turnover, market share (value), earnings per share and liquidity. Organizational performance encompasses three specific areas of firm outcomes: (a) financial performance (profits, return on assets, return on investment); (b) product market performance (sales, market share); and (c) shareholder return (total shareholder return, economic value added). Specialists in many fields are concerned with organizational performance including strategic planners, operations, finance, legal, and organizational development. Performance Measurement provides feedback to the manager on all aspects of the operations - resources, processes and consequences. It is the meeting point of strategy, decision making and organizational learning. The goal of organizational performance measurement is to help optimize the interaction of these elements. Performance Measurement tools are a means to that end.

The Balanced Scorecard is a tool that provides a method of linking organizational strategies to activities and results. The Balanced Scorecard consists of a Strategy Map and linked measures and indicators. A Strategy Map is essentially a special kind of Logic Model depicting the organization from four distinct perspectives – the financial perspective, the customer perspective, the internal process perspective, and the growth perspective. Performance is tracked and measured in multiple dimensions. A Logic Model is a Performance Measurement tool used to map the relationship between organizational activities and impacts (results). Costing provides the

link between resources and processes. By mapping resources consumed to activities conducted (which have been mapped to results achieved by way of Logic Modeling) organizations are able to establish resources to results linkages. The Performance Dashboard is a tool for organizing and providing ready access to performance information. The Dashboard is often used in Business Intelligence or Executive Information systems to allow easy monitoring of key performance indicators.

1.1.4 The Banking Industry in Kenya

The Banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalized in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. As at December 2013 there were forty three banking institutions, fifteen micro finance institutions and one hundred and nine foreign exchange bureaus. Thirty-five of the banks, most of which are small to medium sized, are locally owned. The industry is dominated by a few large banks most of which are foreign-owned, though some are partially locally owned. Ten of the major banks are listed on the Nairobi Stock Exchange (NSE).

The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banking sector's interests. The KBA serves a forum to address issues affecting members. The commercial banks and non-banking financial institutions offer corporate and retail banking services but a small number, mainly comprising the larger banks, offer other services

including investment banking. The banking industry is operating in a highly competitive business environment, exemplary customer service is one of the distinguishing characteristics that banks can exploit to establish a competitive edge. Since most banks offer comparable products and services, they continually search for strategies that will give them a competitive advantage and enable them attract new customers while at the same time retaining existing ones. Banks therefore, must endeavor to develop innovative programs and initiatives to maintain superior customer service levels while remaining profitable Mullei and Masai (2006). Over the last few years, the Banking sector in Kenya has continued to grow in assets, deposits, profitability and products offering. The growth has been mainly underpinned by; an industry wide branch network expansion strategy both in Kenya and in the East African community region and automation of a large number of services and a move towards emphasis on the complex customer needs rather than traditional 'off-the-shelf' banking products. Players in this sector have experienced increased competition over the last few years resulting from increased innovations among the players and new entrants into the market.

The key issues affecting the banking industry in Kenya are: changes in the regulatory framework, where liberalization exists but the market still continues to be restrictive, declining interest margins due to customer pressure, leading to mergers and reorganizations increased demand for nontraditional services including the automation of a large number of services and a move towards emphasis on the customer rather than the product; and introduction of non-traditional players, who now offer financial services products. The banking sector is poised for significant product and market development that should result in further consolidation of the banking sector (CBK, 2010). It's for these reasons that the banks in Kenya are seeking strategic

management tools like outsourcing to enable them maximize profits at minimal cost without compromising on the quality of service being offered to customers.

1.2 Research problem

In recent years, globalization and advances in information technology has revolutionized the way companies conduct business. Outsourcing of business processes is one of the key outcomes of the technological advancement. Outsourcing is a fast-growing aspect of the world economy with a worldwide spending of about US\$ 3.7 trillion in 2001 Clott (2004). Business Process Outsourcing (BPO) has been suggested as one of the biggest area of growth in the outsourcing market and has been a rising trend in outsourcing since the end of 1970s. Even so, many organizations are still reluctant to outsource business processes that are part of their core business Kakabadse and Kakabadse, (2002). Most common type of business process outsourcing, information technology outsourcing, started to become more popular in the 1980s. In the same time information and computer systems became more complex and new possibilities for companies to seek competitive advantage were found.

Technological advancement especially in the use of mobile cell phones and constant use of internet facilities by consumers has affected the way commercial banks in Kenya conduct business. Customers and partners demand new and uninterrupted services, 24/7 either via E-banking options or mobile banking options. Stiff competition among banks and pressures to offer world class goods and services to the customers at minimal costs; deliver improved transparency and risk management and successfully navigate an ever changing and consolidated financial ecosystem is adding to the complexity. Efficiency and effectiveness is key to gaining a competitive advantage in the various market segments in the banking industry. As resources in

the financial services industry continue to become even more strapped, institutions are turning to outsourcing. Outsourcing is increasingly being used as a means of both reducing costs, achieving strategic goals, reducing turnaround time and accessing highly skilled professionals. 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 form coupled with increased use of internet. Although there are good reasons to outsource, a number of potential obstacles and risks associated with outsourcing are also recognized. Such risks may be financial risks, strategic risks, performance risks and social risks.

In 1999, Federal Reserve Bank of New York conducted survey on banking industry practices for outsourcing arrangements and found out that although there are many benefits derived from outsourcing of financial services, the arrangement give rise to potential risks. 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. Pujals (2004) conducted a study on offshore outsourcing in the European Union financial services industry. The study identified various risks and benefits associated with outsourcing of financial services. In 2004 Federal Reserve Bank of San Francisco, conducted survey on outsourcing by financial services firms, and notes a number of motives for outsourcing. Kirui (2001) carried out a case study on BAT (British American Tobacco) and focused on how competitive advantage through outsourcing of non-core logistics activities within the supply chain of BAT could be beneficial. Nyarandi (2001) did a survey study on implementation of outsourcing in a private hospital and found out that most outsourcing initiatives are formed with clear objectives, however if implementation is not carried out well it might account for the

dissatisfaction in outsourcing. In a survey conducted by the Central Bank of Kenya (2005) on risk management among the various financial institutions in Kenya, it was established that a number of financial institutions have no risk management frameworks and that there is currently, no regulatory guideline on outsourcing. Kinyua (2010) conducted a study based on the impact of business process outsourcing at Kenya Power and Lighting Company Limited. Kamau (2012) did a study on the use of outsourcing among pharmaceutical manufacturing firms in Kenya in which the studies done found a significant relationship between outsourcing and profitability.

The prior research studies on BPO in the banking industry documented in the preceding section focus on developed economies (Europe and USA) whose applicability may not be practical in developing economies such as in Kenya. The other studies on BPO done in Kenya have focused on other service industries. There has been no study that has examined outsourcing practices of the Kenyan banking industry. It is against this background that we explore the fundamental question: Does business process outsourcing strategy affect performance of commercial banks in Kenya?

1.3 Research objectives

The objectives of this study are:-

- i. To determine the extent of application of BPO strategy among commercial banks in Kenya.
- ii. To establish the challenges/risks facing Banks in Kenya in implementing the adopted BPO strategies.

1.4 Value of the study

The study shall make theoretical, practical and methodological contributions. Academic scholars and researchers would be able to borrow from the findings of this research to support literary citations as well as develop themes for further research. The findings would contribute to professional extension of existing knowledge in business processing outsourcing by helping to understand the current challenges for adopting these strategies and their effects on environmental response in various financial institutions in general.

This study shall assist in addressing issues relating to the body of strategies adopted for business processes outsourcing in which firms operate in, particularly in the following areas: Government and policy makers at various levels of management would gain value added information on adapting business processing outsourcing in response to changing competitive environment. For instance, the managers responsible for strategies may use the findings to formulate effective monitoring and control systems to mitigate against the challenges while formulating and adopting strategies for business processing outsourcing.

Stakeholders shall benefit from this research as it would be an important blueprint for the other players in the banking and financial industry (BFI). The findings of this study would act as a reference source for other commercial banks especially when planning on which services to outsource. The banks will put contingency plans to deal with the perceived risks associated with outsourcing of financial services.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter documents finding of relevant research papers, summarize the theoretical framework, and specifies the hypotheses. Secondary material such as books, journals, and articles which carry previous research work on the study topic are analyzed. The material is of importance to this study as it forms a basis for observations which will be made during the study in line with the study aims and objectives.

2.2 Theoretical Foundation of the Study

This study is anchored on the resource based view theory. The Resource Based View (RBV) theory focuses on the internal resources of organizations. According to the RBV, market success of organizations is not primarily a function of the external environment it works in, but the specific tangible and intangible resources and capabilities that organizations control. The RBV explores the role of key resources viz. tangible and intangible assets and capabilities, in creating competitive advantage and superior performance. These assets and capabilities determine, how efficiently and effectively organizations perform its activities. A firm will be positioned to succeed if it has the most appropriate stocks of resources for its business and strategy. According to RBV, the accumulation and use of resources and capabilities that builds unique, inimitable and non-substitutable competencies provides competitive advantage. Therefore, a firm has a reason to internalize when an equivalent resource is available in the environment. If the resource can create greater value in combination with the firms other resources than if it was outsourced, the resource should be internalized.

There are other theories that decision makers/managers may use in making outsourcing decisions for their organizations. 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. 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 (1998) and Earl(1996).

Similarly, there are a number of outsourcing advantages, which may be summarized as outsourcing benefit. 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. In outsourcing research, the analytical framework of trade off between costs versus risks is well documented. 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.

Contingency theory is a behavioral theory that claims that there is no single best way to design organizational structures. The best way of organizing for example a company, is, however, contingent upon the internal and external situation of the company. The contingency approach to organizational design tailors the design of the company to the sources of environmental uncertainties faced by the organization. The point is to design an organizational structure that can handle uncertainties in the environment effectively and efficiently.

When making an analysis of the contingencies in the environment, a PESTEL analysis could be very helpful. An organization has selected, acquired and combined a set of resources that were available in the environment. However, these resources may not be sufficient for it to meet its goals. This causes the organization to perceive a gap between its present capabilities and its intended capabilities. This gap may be also caused by the dynamics of the external environment. The changing environment may expose new opportunities and threats to the firm. This again causes the perception of a gap between the present resources of a firm and those needed to exploit opportunities and counter threats. The organization seeks to achieve a fit between the resources of the firm and the competitive environment by acquiring the resources in the gap either through outsourcing or internalizing. Contingency theory would predict the decision to be a result of the fit between environmental and firm-level factors. If the environment is uncertain, the firm cannot predict whether the resource would be needed in the future Koberg and Ungson (1987).

The resource may lose value and would no longer be able to generate rents, or imitations or substitutes of the resource may be available that may have higher value. In such a situation, the firm may decide that greater flexibility may be achieved through acquiring the resource through short-term outsourcing rather than by internalizing through heavy investments. Therefore, from

the perspective of contingency theory environmental uncertainty or dynamism is an antecedent to outsourcing. We speculate that greater environmental uncertainty will lead to an increase in outsourcing. As a consequence of outsourcing, the contingency theory implies greater organization-environment fit.

Agency theory suggests that the firm can be viewed as a nexus of contracts (loosely defined) between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents. The primary agency relationships in business are those between stockholders and managers and between debt holders and stockholders. These relationships are not necessarily harmonious; The theory attempts to deal with two specific problems: first, that the goals of the principal and agent are not in conflict (agency problem), and second, that the principal and agent reconcile different tolerances for risk. This has implications for, among other things, corporate governance and business ethics. When agency occurs it also tends to give rise to agency costs, which are expenses incurred in order to sustain an effective agency relationship (for example offering management performance bonuses to encourage managers to act in the shareholders' interests). The agency theory is likely to predict the outcomes of outsourcing.

2.3 Business Process Outsourcing Strategy and Organizational Performance

The financial performance of a firm can be measured in various ways including capital structure, sales growth, profitability, cost efficiency, total assets, return on investment., sales volume, turnover, market share (value), earning per share and liquidity. Different studies on outsourcing and BPO have used different measures. For example, Narayanan

(2010) use three financial measures: profit level, market share and cost reduction. Kotabe (2008) analyze the effect of IT outsourcing using Return on Value Added (ROVA) which is total profitability divided by the firm's value added where value added is calculated as sales minus external sourcing. Gwebu(2010) use ROA (calculated as net income/total assets) and ROS (calculated as net income/sales) to measure firm performance.

In this study focus will be on the profitability and cost efficiency of the outsourcing banks, as these two instruments are commonly used to define financial targets in banking industry. From an accounting point of view, an increase in profitability, for example, can either stem from a reduction in costs, an increase in revenue, or both; hence use of other different financial metrics to try to decompose the effects of outsourcing on profitability and cost efficiency will be applied in the study. The change in overall costs and labor productivity will be analyzed. As an important objective for outsourcing has been found to be workforce reduction we also analyze whether BPO has an impact on the size of the banks' workforce. An increase in cost efficiency or cost reduction is still one of the major objectives of outsourcing.

In a nutshell, the decision to outsource can be regarded a special form of the make-or-buy decision where firms would prefer to buy as opposed to making certain services as long as the cost of outsourcing is lower than in-house production. As outsourcing vendors typically provide services to many clients they can achieve cost advantages over single firms' productions costs as they benefit from economies of scale and centralization of expertise. Additional cost savings can stem from lower wage levels of the service provider (Abraham and Taylor, 1996). If vendors pass on their production advantages via lower costs to their clients, the outsourcing

firms will benefit from this transaction in terms of higher cost efficiency by producing the same output at lower costs. As we analyze the BPO of highly standardized back office processes which are provided by a small number of service providers to a large number of banks, we can assume that these theoretical considerations can be applied to our research settings.

2.4 Challenges of Implementing Outsourcing Strategies

Although there are good reasons to outsource, a number of potential obstacles are also recognized. There is evidence that outsourcing does not reduce costs as expected in some cases. These include loss of control, loss of critical skills, inadequate capabilities of service providers, loss of flexibility, failure to realize the hidden costs generated by the contract, difficulty in obtaining organizational support, indecisiveness on which activities to outsource, inadequacy of cost and benefit analysis systems, are among the commonly cited inhibitors to outsourcing (McIvor and Humphreys, 2000).

Despite the dramatic rise in outsourcing in recent years, few empirical investigations of the subject have been conducted. Previous work on outsourcing has been primarily theoretical in nature and has relied mostly on anecdotal evidence to support assertions. Furthermore the conclusions of these works are inconsistent. Many intuitively appealing arguments have been offered both for and against outsourcing as a means of achieving sustainable competitive advantage Gilley and Rasheed (2000). Inadequate capabilities of service provider results in loss of competitive advantage and loss of market share Jennings(2002). Service providers who form the major backbone of business process sourcing are faced with key challenges, ranging from; organizing and designing the work, facilitating employee transitions, managing performance, managing turnover and legal obligations Lankford and

Parsa (1999). They argue that Lack of capable service providers is a major problem of outsourcing which includes inability to provide effective transportation networks, poor transportation tools, old -designed warehousing facilities, lack of qualified staff, and lack of IT capability.

Fear of job loss results in increased resistance to change and lower staff morale Razzaque and Sheng (1998); Emblemton and Wright (1998). Pre and post outsourcing costs in areas like administration, and office expenses have no clear post-outsourcing measurements. Managing performance has the obstacles such as employee discretion in performance (customer service), assessment of employees working on the work, and career verses task-oriented training (managing turnover such as maintaining service continuity to meet contract obligations, and transition of former client employees to service provider and identified as obstacles of business process outsourcing Quinn and Hilmer (1994).

Loss of control is one of the potential obstacles and problem associated with outsourcing, the impacts comprises of loss of core competence and risks of alienating customers . Loss of control over the outsourced activity is also considered one of the most commonly cited inhibitors to outsourcing. Aligning employee behaviors with the organization's objectives often is facilitated by a performance –management process. In the outsourcing environment, it is impractical to apply the traditional performance management process Beaumont and Sohal(2004). Several researchers have discussed a wide range of risks in outsourcing scenarios, resulting in undesirable outcomes such as unexpected escalated costs, disputes and litigations, lock-ins, and loss of organizational competencies, and loss of control over outsourced functions. When outsourcing is carried out with an offshore vendor it poses additional

risks such as cultural differences, language barriers, and geographical and time zone related barriers Beaumont and Sohal(2004).

Although there are a good number of reasons to outsource, a number of potential obstacles are also realized. According to Beaumont and Sohal (2004), outsourcing does not reduce costs as expected in some cases. Failure to realize hidden costs of contract, results in increase operating cost. The pre and post –outsourcing costs are usually experienced in the areas of administration, operation and office expenses. After over a decade of economic boom times, the recent global economic turndown has significantly accelerated and intensified market competition pressures, causing many corporations to seek innovative ways to deal with the changed economic landscape. In the process, an increasing number of organizations worldwide have turned to BPO, which has significantly lower overhead costs without sacrificing quality and productivity levels. Today, BPO is considered not only as a simple cost-cutting mechanism but also a strategic initiative, which is expected to shape and prepare the organization for future business dynamics Quinn and Hilmer, (1994).

Difficulty in obtaining organizational support and indecisiveness on which activities to outsource, results in increased chances of failure. However, the positive implications of BPO services for a company's performance also depend on the managerial ability of the BPO client company Kakabadse and Kakabadse(2000). Conflicts in outsourcing are a result of difference of interests between the client and their vendors. One of the major risks in outsourcing is contractual conflicts, which arise because of: differences in objectives of the client and vendor. If conflicts are not resolved amicably, the hostility and bitterness resulting from them can lead to negative consequences including employee resistance and employee turnover Quinn and Hilmer (1994). Loss of Critical skills, mostly results in loss of

competitive advantage, and increased number of competitors. By strategically outsourcing and emphasizing a company's core competencies, managers can leverage their firm's skills and resources for increased competitiveness Quinn and Hilmer. Executives need to look beyond the company's products to the intellectual skills or management systems that actually create a maintainable competitive edge. Products, even those with valuable legal protection, can be too easily back-engineered, duplicated, or replaced by substitutes. Instead competencies tend to be sets of skills that cut across traditional functions. This interaction allows the organization to consistently perform an activity better than functional competitors and to continually improve on the activity as markets, technology, and competition evolve Maloney (1992). The interactions among skilled people in different functional activities often develop unexpected new insights or solutions. Companies fear outsourcing will make such cross- functional serendipity less likely.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The chapter outlines the research design, the research method, the population under study, and the method that was used to collect and analyze data. The reliability and validity of the research instrument was addressed.

3.2 Research design

This section gives the blueprint for the study, highlighting on which questions were studied, which data was relevant, what data was collected, and how the results were analyzed. Research Design is a logical and systematic plan for directing a research study. It specifies the objectives of the study, the methodology and techniques to be adopted for achieving the objective(s) Mugenda and Mugenda, (2003).

This study was a descriptive cross sectional survey. A cross-sectional survey collects data to make inferences about a population of interest (universe) at one point in time. Descriptive research is devoted to the gathering of information about prevailing conditions or situations for the purpose of description and interpretation. This type of research method is not simply amassing and tabulating facts but includes proper analyses, interpretation, comparisons, identification of trends and relationships. In a cross-sectional study design, either the entire population or a subset thereof is selected, and from these individuals, data are collected to help answer research questions of interest.

3.3 Population of the Study

Cooper and Emory (1995) define population as the total collection of elements about which the researcher wishes to make some inferences. An element is the subject on which the measurement is being taken and is the unit of study. It is generally a large collection of individuals or objects that is the main focus of a scientific query. All individuals or objects within a certain population usually have a similar common, binding characteristic or trait. One strategy to research the population is to conduct a census. In a census we examine each and every member of the population in our study. In this study the population was all the 43 commercial banks in Kenya as listed by the central bank of Kenya. It was a census, not a survey. The list of the banks is attached under appendix 11.

3.4 Data collection

The study used primary data which was collected from a census of all commercial banks operating in Kenya as at December 2013. A structured questionnaire consisting of closed ended questions was used. Questionnaires were sent to staff members of the 43 commercial banks who are in charge of sourcing or an equivalent role. For validity and reliability of questions asked, prior to banks' census, the questionnaire was issued to senior staff of supervision and strategic planning managers of the various banks.

Each construct was represented by a set of indicators which formed the question in the study. 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. The time period for returning the questionnaires was four weeks.

3.5 Data analysis

Analysis of data is a process of inspecting, cleaning, transforming, and modeling data with the goal of discovering useful information, suggesting conclusions, and supporting decision making. The data collected was quantitative in nature. To analyse the census data in this study basic descriptive statistical tools were utilized. These included measures of central tendency (value or score that represents the entire distribution) like mean scores and Measures of variability (describes the spread of the scores) like standard deviation and range. This was particularly useful in evaluating banks' motivation to outsource and the extent of its use as captured on the 5-point Likert scale. In addition, to further examine the inter relationships among the variables, regression and correlation analysis was applied in this study. Regression analysis is a statistical process for estimating the relationships among variables. It includes many techniques for modeling and analyzing several variables, when the focus is on the relationship between a dependent variable and one or more independent variables. Dependence is any statistical relationship between two random variables or two sets of data. Correlation refers to any of a broad class of statistical relationships involving dependence.

CHAPTER FOUR

DATA ANALYSIS AND DISCUSSION OF RESULTS

4.1 Introduction

This chapter presents the analysis and interpretations of the data from the field. The data was gathered exclusively from the questionnaire as the research instrument. The questionnaire was designed in line with the objectives of the study. From the study 37 out of the 43 respondents targeted responded to the questionnaire making a response rate of 86%. This response rate was accentuated after the researcher made personal calls and visits to request the respondent to respond to the questionnaire as well as insisting on the importance of participating in the study.

4.2 Background Information of the Bank and the Respondent

Table 4.1 below presents information relating to general background information of the bank and the respondents.

Table 4.1: Respondents' background information

Background	Number of respondents	Proportion of the respondents (%)
Number of Years of service/worked in the bank		
0-20 years	4	10.81081081
21-40 years	3	8.108108108
41-60 years	9	24.32432432
over 61years	21	56.75675676
Number of years of bank's existence in Kenya		
0-5 years	6	16.21621622
6-10 years	16	43.24324324
11-15 years	10	27.02702703
over 16 years	5	13.51351351
Position in the organization		Proportion of the respondents (%)
strategy manager	5	13.51351351
sourcing manager	28	75.67567568
senior manager/head of department	3	8.108108108
Other	1	2.702702703

(Source:Surveydata).

The study sought to establish the size/age of the bank and the personal attributes of respondents. 7 out of the 37 banks indicated that their banks had been in existence for less than 40 years, implying that 81% of the banks have been in existence in the country for over 40 years. The number of permanent employees in the banks was to a large extent directly related to the age/number of years the bank had existed in the country. This suggests that the banks that have existed for a longer period in the country seem stable and had more permanent employees than the relatively younger banks with a wider branch network across the country. Such banks seem to have embraced the use and application of BPO strategy as compared to their relatively new counterparts. 83% of the respondents have worked for the individual banks for at least 5 years and all the respondents occupy management positions. This suggests that all the respondents were well versed with the policies and operations of the bank, and are involved in outsourcing decisions. Thus, the survey response can be relied upon to the extent that all respondents are bank managers with majority (77%) as sourcing managers.

4.3 Extent of Application of BPO Strategy in Commercial Banks in Kenya

Table 4.2 shows the extent of application of outsourcing for each function. The extent of outsourcing was captured using five constructs, dependent upon whether the bank; always outsource the function, most of the time, under consideration, rarely and does not outsource at all.

Table 4.2 :Level of outsourcing (in percentages)

	All the time	Most of the time	Under consideration	Rarely	Not at all
ATM	43	36	0	0	11
Card processing	31	27	11	11	5
Internal Audit	7	4	0	16	21
Human Resources	10	16	11	0	11
Sales/ Marketing	10	11	16	0	0
Information technology	20	12	11	5	11
Debt Collection	14	18	5	5	16
account processing	0	3	7	5	11

(Source:Surveydata).

As shown in Table 4.2 above, Analysis of this section on the extent of outsourcing indicates that ATM function is the most outsourced in the banking sector in Kenya with 79% of the respondents indicating that their banks always or most of the time outsource the function. Card processing is the second highly outsourced function with 58% of the respondents confirming that their banks always or most of the time outsource the function. Customer account processing is the least outsourced function with none of the respondents indicating that their banks are outsourcing the function. Internal audit was cited by 16% of the respondents as one of the functions that banks have at one point considered to integrate with other core functions.

4.4 Challenges of BPO Strategy Application by Commercial Banks in Kenya.

Table 4.3 below presents findings on risks/challenges associated with outsourcing.

Table 4.3: Perceived risks/challenges of outsourcing (in percentages)

Risks	Very	High	Neutral	Low	Very
	5	4	3	2	1
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

(Source: Survey data).

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. 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.

4.5 Discussions of the Findings

The findings in this study indicate that ATM function is the most outsourced function in the banking sector in Kenya. 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. Customer account processing is the least outsourced. 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 as one of the functions that banks have at one point considered to integrate with other core functions. This may be explained by the critical role the internal audit function plays in the whole business process. It also indicates concerns about service quality of third party ineffectively undertaking such an important internal governance responsibility. These conform to the findings of Nag (2004) who argued that outsourcing had become a critical strategic decision that could allow organizations to develop and leverage the capabilities required to compete in today's global business environment. Outsourcing is increasingly being employed to achieve performance improvements across the entire business.

The outsourcing posed challenges to the Bank exposing it to various risks. 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 bank's expectations, thereby damaging the reputation of the bank. Country risk is not considered as a high risk in outsourcing. 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.

The findings in the study indicate that outsourcing a business process brings benefits to a bank. Some of the benefits cited include 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 and access to specialized vendors. This is especially true in IT field where the banks would prefer to outsource due to rapid changes in technology.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of key data findings, conclusion drawn from the findings highlighted and recommendation made there-to. The primary purpose of this study is to determine the extent of application of BPO strategy among commercial banks in Kenya and to establish the challenges/risks facing Banks in Kenya in implementing the adopted BPO strategies.

5.2 Summary

The study found that majority of commercial banks in Kenya outsource various business processes including ATM, Card processing, Internal Audit, Human Resources, Sales/Marketing, Information technology, Debt Collection and account processing. The researcher also found that the major challenges/risks experienced as a result of outsourcing include Strategic risks, Reputational risk, Compliance risk, Operational risk, Country risk, Counterparty risk, Contractual risk, Access risk, Concentration and Systemic risk. Others include failure to adhere to quality systems poor structures to manage the outsourcing function well, dilution of control, increase in cost of administering the outsourcing function, providing unclear specifications and poor planning.

The study established that 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 on the extent of application of BPO in commercial banks; 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. Reputational, operational, contractual and strategic risks are the main risks associated with outsourcing practices. While this study may not have covered this aspect, it’s 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.

The study also established that banks outsource in order to realize cost efficiency; for technical considerations, increase productivity/performance and the need to focus on core activities. The banks are motivated to outsource for quality improvement, gaining access to new talent and technology, the easy availability of vendors with expertise and economies of scale. Thus the banks aimed at meeting changing customer needs, making better use of time and energy costs, redirecting or conserving energy directed at the competencies of the business, or to make more efficient use of labor, capital, (information) technology and human resources.

5.3 Conclusion

This paper tries to answer two research questions; what is the extent of application of BPO strategy among commercial banks in Kenya and what are the challenges/risks facing Banks in Kenya in implementing the adopted BPO strategies? Based on an analysis of 37 commercial banks in Kenya we find that the most commonly outsourced business operations include the ATM, card processing, debt collection and the IT systems. Customer account processing is least

outsourced activity. Reputational, operational, contractual and strategic risks are the main risks associated with outsourcing practices. Further the study found out that the outsourcer's financial performance in terms of profitability and cost efficiency was increased significantly compared to industry peers without BPO. It was deduced that the propensity of a bank to outsource some of its processes is determined by the bank size (in terms of number of permanent employees and branch network) and age (number of years of its existence). 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. Banks that outsource some of their business processes perform better financially more so in terms of cost reduction, focusing on core competencies and improved services as well as better resource allocation and capacity utilization.

5.4 Limitations of the Study

There were various challenges and obstacles faced in carrying out the study. Financial constraints were experienced given that the study was self sponsored with no external financial aid. Due to limited finances the study could not be carried out on the other bank officials and stakeholders whose input is important in making the outsourcing decisions of the banks. The duration that the study was to be conducted was limited hence exhaustive and extremely comprehensive research could not be carried on implementation of the business process outsourcing strategy. The researcher had no insight into the firms' strategies. Given that this was a descriptive cross sectional study on all commercial banks the data gathered might have differed from bank to bank. This is because different banks adopt different strategies that

differentiate them from their competitors. The study however, constructed an effective research instrument that sought to elicit general and specific information on the extent of application of BPO strategy and the challenges of implementation/adoption of the business process outsourcing strategy.

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.

5.5 Suggestions for Further Research

The researcher recommends a replication of 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.

The researcher further recommends that a similar study be done on other institutions for the purposes of benchmarking. This will help in the establishment of how outsourcing has influenced the business operations of firms in general in Kenya and the wider African continent.

5.6 Implication of the Study on Policy and Practice

The findings imply commercial banks in Kenya can improve their business performance through implementation of outsourcing on its non-core activities. In order to improve on the same, the banks' management/decision makers should put more effort to overcome the challenges/risks mostly associated with BPO decisions. In practice, the findings of this study can be used by other organizations in planning their strategies for maximum utilization of their resources. This will help in the development of optimum strategies to facilitate better resource utilization as well as capacity utilization.

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APPENDICES

Appendix I: Questionnaire Guide

Part A: General Background information of the bank and the respondent

- 1) What is the name of your bank?.....
- 2) What is the number of permanent employees/staff does the bank have?.....

(Please mark the appropriate response with a tick on each of the following questions)

- 3) For how many years has the bank existed in Kenya?

0-20 years 21-40 years 41-60years over 61years

- 4) For how long have you worked in this bank?

0-5 years 6-10 years 11-15years over 16years

- 5) What is your position in this organization?

- Strategy manager (or equivalent)
- Sourcing Manager (or equivalent)
- Senior Manager/head of a department

Part B: Extent of application of BPO strategy in commercial banks in Kenya

6) To what extent does your department outsource any of the following business processes?

(Please mark the appropriate response with a tick alongside each process)

Business process	All the time	Most of the time	Under consideration	rarely	Not at all
	5	4	3	2	1
ATM					
Card processing					
Internal Audit					
Human resource					
Sales and Marketing					
Information technology					
Debt collection					
Accounts opening					

Part C: Challenges of BPO strategy application by commercial banks in Kenya

7) Please respond to all the below listed perceived risks/challenges of outsourcing in accordance to your personal opinion for each statement. To what degree do you relate the below risks/challenges of BPO to your organization?

risks/challenges of outsourcing	Very high	High	Neutral	low	Very low
	5	4	3	2	1
Strategic risks					
Reputational risks					
Compliance risks					
Operational risks					
Country risk					
Counter party risks					
Contractual risks					
Access risk					
concentration					
Systemic risk					
exit					

8) Any comment regarding business process outsourcing?

.....

.....

.....

Thank you.

Appendix1I: List of commercial banks in Kenya

1. ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank (Kenya)
6. CfCStanbic Holdings
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Ecobank

17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. First Community Bank
22. Giro Commercial Bank
23. Guaranty Trust Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib Bank
27. Habib Bank AG Zurich
28. Housing Finance Company of Kenya
29. I&M Bank
30. Imperial Bank Kenya
31. Jamii Bora Bank
32. Kenya Commercial Bank
33. K-Rep Bank

34. Middle East Bank Kenya

35. National Bank of Kenya

36. NIC Bank

37. Oriental Commercial Bank

38. Paramount Universal Bank

39. Prime Bank (Kenya)

40. Standard Chartered Kenya

41. Trans National Bank Kenya

42. United Bank for Africa

43. Victoria Commercial Bank

Source: Central bank of Kenya Website: <http://www.centralbank.go.ke>