

International Conference on Leadership, Technology and Innovation Management

## Advantages and disadvantages of outsourcing: analysis of outsourcing practices of Kazakhstan banks

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### Abstract

In contemporary life, where competition among businesses intensifies rapidly, one of the instruments that will give possibility to open access to nearly every resource that offered in market is outsourcing. Drawing from Resource-Based View, Core Competency Theory, and Transaction Cost Approach, this study analyzes outsourcing practices of Kazakhstan banks. Sample of this research consists of three banks operating in Kazakhstan: HSBC Bank Kazakhstan, BTA Bank and Halyk Bank. Results of face-to-face interview with managers of these banks reveal that, advantages and disadvantages of outsourcing vary according to its type and size. In spite of the fact that outsourcing became very popular topic among scientific works all over the world, there is no research done on outsourcing activities in Kazakhstan particularly, and especially in banking industry of the republic.

Keywords: outsourcing; advantages and disadvantages; resource-based view; core competence

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### 1. Introduction

Outsourcing is one of the most effective activities in contemporary business, because many companies try to use all innovations of science, techniques and technologies to issue qualified and competitive product which will satisfy consumer. This situation is very usable for both parts, because each of them can concentrate its resources on development of core competencies and prospective directions of activity [1]. This leads to essential reduction of expenses on production of the end product because each part works on that it can do best without applying additional effort and without investing for learning new activity types.

This study focuses on advantages and disadvantages of outsourcing experienced by Kazakhstani banks. The study begins with a literature review of outsourcing including the theories and types of

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outsourcing, its advantages and disadvantages. Then, research methodology, analyses and results of this study will be presented. The last part discusses conclusion and recommendations for further research.

## **2. Literature Review**

### *2.1. Definition and Types of Outsourcing*

According Power et al. outsourcing is made up of two words – “out” and “sourcing”; sourcing refers to “the act of transferring work, responsibilities and decision rights to someone else”. Companies must source out work because there are others who can do it cheaper, faster, and better [4]. Ashley gave the definition of outsourcing as “the allocation of risk and responsibility for performing a function or service to another entity” [5]. In brief, outsourcing can be defined as the process of delegation of operations or jobs to the third party, who can do it better, cheaper and faster. Depending on level of control over performance of outsourced function, outsourcing can be separated into internal and external types. Internal outsourcing is “reallocation of functions in business system for saving control over its performance” and external outsourcing is “delegation of performance of separate or mutually related functions to external outsourcer” [6]. For example, divisions of joint activities of external outsourcing include centers concept, cooperation, joint servicing, and participation in capital, whereas divisions of joint activities of internal outsourcing include long-term partnership, short-term partnership, and single partnerships. Depending on effective use of resources and reallocation of risk and responsibility outsourcing is divided into partial and full outsourcing types. Partial or selective outsourcing is “the delegation of certain functions or business processes to outsourcer, while set of mutually related functions are performed by company itself” and full outsourcing refers to “the delegation of separate function to outsourcing company with entrusting it with full responsibility for function’s performance” [7].

### *2.2. Theories Related to Outsourcing*

Outsourcing consists of different activities and each phenomenon can be described by several frameworks that are embedded in various theoretical approaches. Much of the studies on outsourcing have been affected by three approaches: Resource-Based View, Core Competency Approach, and Transaction Cost Theory. The resource-based view in outsourcing builds from a proposition that an organization that lacks valuable, rare, inimitable and organized resources and capabilities, shall seek for an external provider in order to overcome that weakness [8], [9]. According to Perunović and Pedersen, the most prominent use of the resource-based theory in outsourcing process is the preparation phase for defining the decision making framework and in the vendor selection phase for selecting an appropriate vendor [10]. Organizations will plug gaps in resources and capabilities in the most cost-effective manner to maintain a distinctive product and its competitive advantage [11]. The essence of the core competency theory is that it should be kept in-house, but that other activities that the organization deals with, which are not counted to be core or critical to its function, should be considered for outsourcing [12], [13]. According to Henry “a core competence can be thought of as a cluster of attributes that an organization possesses which in turn allows it to achieve competitive advantage” [14]. If the organization is to focus on its core competencies as the basis of its sustainable competitive advantage, then activities which do not constitute a core competence for the firm can be given to outside firms who can provide these at lower cost. Additionally, transaction cost theory has been developed to facilitate an analysis of the comparative costs of planning, adapting, and monitoring task completion under alternative governance structures [15]. The unit of analysis in transaction cost theory is a transaction, which by the words of Williamson “occurs when a good or service is transferred across a technologically separate interface” [16]. Decision-makers must weigh up the production and transaction costs associated with executing a transaction within their firms – insourcing, versus the production and transaction costs associated with executing the transaction

in the market – outsourcing. Organizations can choose whether to buy from the market or to develop in-house, the decision is based on the relative cost, which is combined from the costs of production and costs of the transaction.

### *2.3. Advantages and Disadvantages of Outsourcing*

**Advantages of Outsourcing:** The most significant advantages of outsourcing are focus on core activities, cost savings, access to experience, improving performance, and flexibility. First, many researchers agree on the fact that by handing over noncore activities to a trusted third party, a company can concentrate on activities central to its value proposition and increase its competitive positioning [17], [18]. Second, outsourcing in general is held toward one of the main goals as cost savings [19], [20], [21]. The special necessity arises when a certain resource, either human or equipment resources, is not needed full time, or the efforts to obtain the resource cannot be justified. For example, for a medium-size business keeping technical expertise and maintenance is needed occasionally. Since the cost of hiring and training an engineer who is competent in computer support is too high, it will be beneficial for the organization to outsource this task. Third, by outsourcing companies have the possibility to access to highly qualified personnel, who may not be available to the client organization [22] and fully exploit the suppliers' investments, innovations, and specialist capabilities [23]. Fourth, an important reason for outsourcing consideration is achievement of an improvement in performance that the outsourcer company might offer due to economies of scale. Large scale can provide a variety of functions and opportunities which will help to save the best available worker, who might not want to work in a less stimulating consumer environment. Additionally, with service providers the level of operational experience is expected to be higher, because of the greater concentration of staff on tasks as compared to internal operations [24]. Fifth, flexibility is the key reason for outsourcing for many companies. Outsourcers' contracts and the jobs of their employees depend on the degree of flexibility to reflect changing business environments.

**Disadvantages of Outsourcing:** Main disadvantages of outsourcing are loss of managerial control over outsourced operations, threat to security and confidentiality, quality problems, hidden costs and reallocation of existing teams. First, disadvantage related to the lost of control over the outsourced operations stems from the reason that managing external resources requires special skills which is a combination of the skills of people and process management, contract management, and power negotiation. Second, almost every outsourcing contract has terms of security and confidentiality spelled out, but the execution and audit are always difficult. In financial services, requirements keep information known to investment bankers away from traders, brokers, and other individuals who might attempt to use such insider information improperly [25]. Third, one reason to outsource is the expectation of receiving better service from the outsourcer than from internal staff. Outsourcer has to be chosen in that particular way to ensure that there is no bad influence on the quality of goods and services produced. Otherwise, company may lose its position on the market [26]. Fourth, company will sign a contract with the outsourcing company that will cover the details of the service that they will be providing. Anything not covered in the contract will be the basis for the company to pay additional charges. For example, an analyst may intentionally exclude costs to favor one decision, such as selecting one provider versus another, choosing in-sourcing over outsourcing, or staying in a particular business or not [27]. Fifth, the outsourcing is often related to the firing in employees' minds. It is also a problem for the organization's top management team to decide how to reallocate the existing employees. Often after outsourcing a part of the original team moves from outsourcing party to the outsourced one [28], which in turn causes major changes. According to Bragg, sponsoring such a major change and seeing it fail can lead to termination of one or more of a company's management staff [29].

### **3. Methodology**

#### *3.1. Significance and Objectives of Research*

Significance of this research is in analyzing current state of outsourcing practices in Kazakhstan banks. In spite of the fact that outsourcing became very popular topic among scientific works all over the world, there is no research done on outsourcing activities in Kazakhstan particularly, and especially in banking industry of the republic. As well as outsourcing became a systematical study for many of researchers, it started to bear many positive and negative characteristics from theoretical view, while the reality for organizations can be different. Certainly, outsourcing is a wide-spread activity which is practiced nearly by every business sphere, so, it has to be taken into account that all features presented by scientists, who analyze outsourcing phenomena, are applicable. Therefore, the objective of this research is to identify real advantages and disadvantages of outsourcing by focusing on benefits gained and risks faced particularly by Kazakhstan banks.

#### *3.2. Sample, Data Collection, Measures and Limitations of Research*

Increasing outsourcing experience by banking industry makes banks to be a good candidate for this study. Sample of this research consists of three banks operating in Kazakhstan: HSBC Bank Kazakhstan, BTA Bank and Halyk Bank. For performing proper research it is necessary to choose correct research method that will provide with wide information related to a subject that is being discussed. Face-to-face interview with top managers of companies was chosen as the method of current research. The main advantage of face-to-face interview is that the researcher can adapt the questions as necessary and ensure that the responses are properly understood by repeating or rephrasing the questions [30]. For this reason, Assistant of Bank Chairman of HSBC Bank Kazakhstan, Head of Payment Cards Department of BTA Bank, and Head of Processing Division of Card Center of Halyk Bank Kazakhstan were interviewed in February-March 2009. Respondents were guided by a list of interview topics about key factors of this study. There was no bias problem from leading respondents to focus only items on the list because the list was used as an outline of the interview. Respondents were free to discuss at all time. The interview was conducted in Russian language and interview time was varying in length from 30 minutes to one hour. According to Patton's suggestion, in face-to-face interview it is better to start conversation in neutral way [31]. Therefore, first five questions have been asked to gather general information concerning the company and its outsourcing practices. Questions from 1 to 5 identify respondent's position in the bank, functions that are outsourced by the bank, duration, size, types, and satisfaction with the results of outsourcing. Additionally, to measure advantages and disadvantages of outsourcing, questions were taken from Johansson and Reischl [32], Schniederjans and Cao [33], Gul and Zaib [34]. Overall 10 items with 5-point ordinal scale were used to analyze advantages and disadvantages of outsourcing. Concerning the limitations, the subject of this work itself implies to some limitations. These limitations refer to the difficulty in gathering primary data due to the security and confidentiality reasons. The other important restriction faced while conducting this research relates to no interest in helping from the side of top managers that were planned to be interviewed.

### **4. Analyses and Results**

HSBC Bank Kazakhstan is one of the branches of international HSBC Group which successfully operates in broad network all over the world. Kazakhstan representative of HSBC Group is counted to be small in comparison to other local banks. Therefore, its outsourcing practices mainly flow out from limited resources. BTA Bank is a merger of two banks – Turanbank and AlemBank. This merger forced newly formed bank to outsource processing center AlemCard LLP, because developing and maintaining

processing system by its own forces is very expensive for BTA Bank. And, Halyk Bank mostly operates with governmental institutions and the number of its clients is incomparably higher. Therefore, Halyk Bank is forced to seek outsourcing of third-party service providers to guarantee continuous improvement in performance for its clients.

According to analyses of outsourcing size and types, outsourcing practices in BTA Bank and Halyk Bank have similarities. Both banks are experiencing an outsourcing function of “payment cards processing” which is actually one of the most expensive functions among the banking operations, and therefore it requires long-term (8-12 years) and stable relationship between bank and outsourcer. Both BTA Bank and Halyk Bank are outsourcing “most processes” and “mostly satisfied” which can be proved by the specification of outsourced function and with the fact that payment cards processing cannot be delegated partly. Further, analyses reveal that both BTA Bank and Halyk Bank are practicing “internal outsourcing”. The reason for this is the fact that the level of control over performance of processing centers directly influences performance of the bank in whole. On the other hand, the level of control over outsourced party by HSBC Bank is “low” and type of outsourcing can be counted as “external”. The reason for this is that duration of outsourcing relationships has short-term character (1-3 years) and only “several finance and banking processes outsourced”. And the reason why HSBC Bank is using “partial outsourcing” seems rational due to the size of outsourced functions. In case when only “several processes outsourced” and they do not need high level of control over performance, full outsourcing with separating whole business process with reallocation of risks and responsibilities is not possible. But it does not mean that the type defined by reallocation of risks and responsibilities depends on the level of control over performance. For example, both BTA Bank and Halyk Bank experience “internal outsourcing” whereas the types of outsourcing by reallocation of risks and responsibilities were different (partial or full).

Table 1 shows advantages of outsourcing. Main advantages of outsourcing as were discussed previously are the possibility to focus on core activities, cost savings, access to experience, performance improvement, and flexibility.

Table 1 Advantages of Outsourcing

Bank name	HSBC Bank	BTA Bank	Halyk Bank
Advantages of Outsourcing			
Focus on core activities	Partially achieved	Mostly achieved	Moderately achieved
Cost savings	Partially achieved	Mostly achieved	Fully achieved
Access to experience	Moderately achieved	Partially achieved	Not achieved
Performance improvement	Moderately achieved	Mostly achieved	Partially achieved
Flexibility	Mostly achieved	Mostly achieved	Partially achieved

Results show that HSBC Bank Kazakhstan focus on core activities “achieved partially”. This result can flow out from the point that outsourcing practices give more possibility to focus on core activities, when function delegated to the outsourcer on long-term partnership characteristic, which makes relationship trusted, while short-term partnership requires more coordination from client and gives less possibility to concentrate resources on those activities that are more valuable for organization. On the other side, there is difference in answers of BTA Bank and Halyk Bank, in spite of the fact that both of them outsourcing in long-term bases. This can be caused by differences in types of outsourcing by reallocation of risks and responsibilities. As a result of full delegation of risks and responsibilities to the outsourced processing center, BTA Bank has an opportunity to focus more on its other core activities, while for Halyk Bank this advantage achieves less. Concerning the advantage with cost savings, the

highest level of achievement belongs to Halyk Bank. This can be caused by the size of bank, as such big organization like Halyk Bank reduces costs by outsourcing more, and expenses related to outsourcing activity are negligible for it. On the other side, for smaller banks like BTA Bank and HSBC Bank cost savings cannot be fully achieved or only partially achieved, because other costs can become significant. Achievement of access to experience of outsourced party is directly depends on the character of partnership between client and outsourcer. Halyk Bank does not achieve this advantage due to the character of relationship between bank and its outsourcer. Access to experience of outsourced party was not of high priority goal for Halyk Bank, whereas, outsourcing gives the opportunity to have an access to experience of outsourcer and to perform separate functions outsourced before on its own in future to HSBC Bank. Further, for BTA Bank outsourcing gives the possibility to continuously “improve performance”. This depends on policy of bank that tries to make financial transactions faster by improving processing systems, where performance of outsourced company plays the key role. Lower level of achievement of performance improvement is shown by HSBC Bank, whereas Halyk Bank “partially achieves”, because from the words of respondent outsourcing activity of bank does not significantly influence its performance level due to size of bank. Additionally, outsourcing can give the opportunity to company to be flexible in operations performed. While for in-house departments it is difficult to adapt to frequently changing environment, it is easier for outsourcing company due to its specialization and expertise. As seen from the table, this advantage has been achieved by BTA Bank and HSBC Bank. For these banks, operation flexibility gained by quick reaction of outsourced processing center on changes in rules set by government and other external factors. However, for big company like Halyk Bank outsourcing activities cannot give high level of flexibility, because there are many levels in managerial structure of company due to its size which in turn is an obstacle for being flexible.

Table 2 shows results concerning disadvantages of outsourcing stated as loss of managerial control, threat to security and confidentiality, quality problems, hidden costs, and reallocation of existing teams.

Table 2 Disadvantages of outsourcing

	Bank name	HSBC Bank	BTA Bank	Halyk Bank
<b>Disadvantages of Outsourcing</b>				
Loss of managerial control		Sometimes	Sometimes	Never
Threat to security and confidentiality		Sometimes	Sometimes	Never
Quality problems		Often	Sometimes	Often
Hidden costs		Often	Often	Sometimes
Reallocation of existing teams		Often	Never	Never

As seen from the table, loss of managerial control takes place at HSBC Bank and BTA Bank. Disadvantage for HSBC Bank is related to the activities outsourced, particularly sales team of other banks. Bank can produce good product, for example credit which will have commission for credit organization lower than on the market, or even if commission is high, it is attractive because terms are longer or rates are lower. But when this good product comes to outsourced sales team, as a result of bad expertise of certain employee, potential client can be lost, so this kind of situations cannot be properly managed. From the other side, Halyk Bank fully avoids this disadvantage because of external and partial characteristics of outsourcing project. Character of work of financial organizations, especially banks that operate with significant amount of confidential information every day, forces to keep information security on the high level. But sometimes outsourcing activity of such organizations can cause problems related to the threat to security and confidentiality. This disadvantage is sometimes faced by HSBC Bank and BTA Bank. According to the respondents, it can appear in every organization, but its possibility raises when

functions with corresponding information delegated to external service provider. Further, it was discussed that companies in many cases decide to outsource certain functions in order to achieve improvement in performance. However, sometimes outsourcing can lead to quality problems. Accordingly, BTA Bank is more satisfied with work of its outsourcer in comparing with other banks. But for HSBC Bank, dishonest work of outsourcer often causes quality problems. For example, notary without seeing original document can notarize its copies. If a problem arises and bank addresses to the court, it will be realized that documents were falsified. This will be counted as a fault of bank. The same situation can appear with appraisals. In some cases, bank's potential or current client can give bribe and appraisal evaluates his or her property at a higher price. Such issues can cause problems related to quality, and is the main threat for the reputation of a company. Additionally, hidden costs are faced often by HSBC Bank Kazakhstan. For those activities which cannot be operated by its own according to legislation, bank hires in-house employees that coordinates and controls the activity of outsourced companies. From the point of BTA Bank, hidden costs appear due to the continuous improvement characteristic of processing. Expenses increase because of the flexibility of outsourced functions. When company decides to outsource activity that previously was in-house, it should also decide what to do with its existing teams. This issue can affect negatively current employees of a company. Due to the long-term partnership of BTA Bank and Halyk Bank with their outsourcers, there are no such problems faced by these banks. On the other hand HSBC Bank often experiences such disadvantage and need to find optimal decision for avoiding it.

## **5. Conclusion**

Outsourcing became one of the most widely used contemporary business practices. However, it has both advantages and disadvantages. While character of work in which company operates and aims that it sets changes, outsourcing can also change and bring benefits or risks to client company. From our analyses, it is obvious that outsourcing practices are not similar for all companies, as this particular activity was considered in financial industry. Several results can be taken from this work. If a company is small and has limited resources, then it needs to outsource. However, outsourcing practices cannot always ensure such common advantage as cost reduction as it was observed in HSBC Bank Kazakhstan. On the other hand, Halyk Bank claims that it fully reached cost savings and mostly achieved focus on core activities advantage of outsourcing. Additionally, Halyk Bank keeps outsourcing with high level of control over its performance and does not fully reallocate risks and responsibilities. This issue was particularly considered by resource-based theory, which states that internal resources of company plays key role in creating successful competitive advantage. And, disadvantage related to hidden costs can also find its theoretical background in transaction costs theory. In fact, while company makes its main activity by outsourcing, there will be many hidden costs that can negatively influence company's performance. Moreover, BTA Bank underlined achievement of focus on core activities and reached to this advantage due to the internal and full type of outsourcing. Here, we can see the consistence of outsourcing practice with core competency theory. Additionally, recommendation for businesses can be done on the bases of banks that were analyzed in this work. For example, banks with long-term and trusted relationships like BTA Bank and Halyk Bank are advantageous in comparison with HSBC Bank Kazakhstan. On the other hand, sizes of these banks are incomparable too. Also, it should be mentioned that for outsourcing with short-term characteristic like in HSBC Bank Kazakhstan, advantage like flexibility is easier to be achieved. Anyway, outsourcing as in any other business practices should be applied carefully in order to achieve its advantages and avoid disadvantages. There is a gap in outsourcing practices of banks and generally all other organizations in Kazakhstan. Although study and practice of outsourcing are very popular among today's businesses, because of the lack of knowledge about outsourcing, particularly in Kazakhstan, this issue has not been analyzed broadly yet. Therefore, it can be developed further in order to provide with new and deeper results.

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