CONJONCTURE

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THINKING OUT OF THE BOX !

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"Tout l'art de la politique est de se servir des conjonctures."
Louis XIV

Outsourcing in the Mauritian banking sector

By Boopen Seetanah and Sawkut Rojid

Financial firms have entered into outsourcing arrangements for many years, albeit not to the extent seen in the recent past. For example, in the securities industry, since the 1970s, firms have outsourced quasi-clerical activity, such as the printing and storage of records. This was undertaken because of the comparative cost savings. As technology has evolved, outsourcing of information services has become more common. In fact the growing practice of BPO is closely linked to the digitalisation of the enterprise and one industry where digitalisation has dramatically altered the way in which business processes are carried out is the banking industry where the potential for BPO appears to be particularly high.

Almost the entire portfolio of banking products is available in digital form and many services are now provided through the internet. Checking the balance in current account, effecting an international payment, or the purchase of mutual funds is nowadays merely an electronic transaction which takes place in bits and bytes on a storage system within a corporate data center. In fact we have already come to the time that office functions in particular, such as processing payments, securities or consumer credit transactions have been taken over by specialised vendors that create significant economies of scale in transaction processing.

Around the world, the banking services industry remains among the largest sectoral user of outsourcing services after manufacturing. Industry reports and regulatory surveys of industry practice indicate that financial firms are entering into arrangements in which other firms, related firms within a corporate group and third-party service providers, conduct significant parts of the enterprise's regulated and unregulated activities related to both banking and non banking services.

A body of evidence points to the rapid growth of outsourcing activity in recent years. For example, Deloitte has estimated that US$356 billion of the US financial services industry will be outsourced to offshore locations in the five years from 2004. This represents 15% of the industry's current cost base.

The Mauritian case

At the second International Conference on Business Process Outsourcing organised by the University of Technology Mauritius in June 2006, we presented a study of the BPO practices in the Mauritian domestic banking sector. The methodology used was an interview/survey based technique. Eleven out of the twelve banks contacted participated in the study.

The results show that 80% of the banks surveyed started some form of business process outsourcing in the early 1990's, and the remaining 20% started in the year 2000.

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How Mauritius can cope with globalisation

By Bertrand Rassool

While the benefits of international trade had been well documented and evidenced for centuries, it was in the post World War II era that the stage was set for trade liberalisation initially under the auspices of UNCTAD and of the General Agreement on Tariff and Trade (GATT) and subsequently under the World Trade Organisation (WTO).

There have been several GATT Rounds of trade talks or negotiations which gained momentum since the early 1980s when they were held in Punta Del Este.

More recently, these have been led by the WTO including the failed negotiations in Seattle, with perhaps the most significant progress made in the Fourth Ministerial Conference in Doha in 2001. This became known as the Doha Development Agenda with clear targets set for international trade liberalisation in key goods and services.

The Doha Development Agenda was refined in subsequent Ministerial Conferences in Cancun (September 2003), the General Council in Geneva (July 2004 Package), Hong Kong (December 2005) and Geneva (June 2006).

While these main Ministerial gatherings represent important milestones in globalisation, it can be argued that negotiations, which are continual in Geneva at the level of Plenary Meetings of Ambassadors and Ad Hoc Committees, are equally significant. Indeed, developing countries, including Mauritius, are at a disadvantage in that they are not only poorly represented at such meetings, but also lack the capacity within their respective administrations to handle such negotiations.

Yet, the future of developing countries depends crucially on such WTO negotiations. In the case of Mauritius, the implications for the sugar and textile industries, which are now becoming effective, were negotiated and spelt out many years ago.

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Outsourcing in the Mauritian banking sector

By Boopen Seetanah and Sawkut Rojid (Cont., from Pg 1)

The most important factor pushing banks to outsource is that they just followed their competitors.

Surprisingly, 67% of the respondents did not carry out any research to determine the extent to which BPO could be beneficial to them. 56% acknowledge to have followed what their competitors are doing and 11% started to outsource after having attended an international seminar on BPO.

The activities that are outsourced have been divided into four main groups, namely IT related activities, core banking activities, finance and accounting activities and other activities. IT related activities and other banking activities are outsourced by all the firms. 56% of firms are engaged in outsourcing their core banking activities and 33% outsource their finance and accounting activities.

Each of these four main groups is further divided into different sub-groups. The firms were then asked about the proportion of each activity that they outsource within the main group. There are activities that are outsourced 100% by some firms while the same activity may be partially outsourced or not outsourced by other firms. We divide the share of each activity outsourced into four different ranges, namely 0% to 25%, 26% to 50%, 51% to 75% and 76% to 100%.

There exists no such activity which is outsourced by all firms. 88.9% is the highest percentage of firms engaged in an activity and there are three such activities: two in the IT-related group, namely Hardware maintenance and application development, and one in the other activities group, namely legal services.

Within the IT-related activities, 88.9% are engaged in outsourcing application development and annual hardware maintenance activities. However, outsourcing as a proportion of the total activity differs among firms. For example, within the 88.9% of firms involved in outsourcing application development activity, 55.6% of them outsource 76% to 100% of the activity. 60% of the 55.6% of firms outsource 100% of that activity. 66.7% of firms are engaged in networking and security while 44% of firms are engaged in disaster recovery. The proportion of firms engaged in outsourcing finance and accounting activities as a whole is the lowest. Firms are engaged in only two types of activities within this group: tax accounting and financial reconciliation.

Why banks outsource activities

Banks outsource four different categories of core banking activities, namely screening for loans, recovery of debts, ATM management and credit bureau. A very low proportion of firms are engaged in outsourcing core banking activities. The highest proportion of firms is 33.3%. Under the group of other activities outsourced, firms have reported to outsource five different types of activities, namely customer analysis, human resource, legal services, payroll and cash in transit.

Legal services are outsourced by the highest number of firms (88.9%). While 12.5% of them outsource 100% of legal services, all of them outsource more than 75% of that activity. 66.7% of firms are engaged in outsourcing human resource activities, but none of them outsource more than 25% of that activity.

Overall, improving efficiency appears to be the main reason for outsourcing activities. For the IT related activities, cost reduction is the main reason for outsourcing these activities. For finance and accounting activities, transfer of technology risk appears to be the main reason for outsourcing these activities. The only reason that firms outsource core banking activities is to improve efficiency.

How banks choose their outsourcing partners

For the IT related activities, pricing, flexibility and business function speciality are the main characteristics in the choice of outsourcing partners for Mauritian banks. For the finance and accounting activities, the main reasons are: pricing and business ethics and corporate culture. For core banking activities, pricing and flexibility are the most important characteristics Mauritian firms look for. For other activities, pricing, business ethics and financial status are the main reasons.

Overall, pricing is the most important factor that determines the whole outsourcing business of the banks in Mauritius. 56% of the firms outsource their IT related activities to India, 22.2 % to France, and the rest outsource their IT related activities locally. However, all other activities are outsourced locally. Because of better deal, lower price and hidden costs, 33.3% of the firms have changed outsourcing partners at least once since they started outsourcing activities.

33.3% of the firms report that, due to unavailability of proper legal framework, they are not able to outsource debt recovery activities. 22.2 % of the firms report that they cannot outsource the same activity because of lack of experienced resource persons. However, 22.2% of the firms are already engaged in such activities.

There are some mixed feelings about the perceived future of BPO in the whole Mauritian banking sector. 33.3% of the firms say their outsourced activities will continue to increase while 11.1% believe that they will not outsource more business in the near future. Those firms believe that there is a need for culture change, and that the issue of confidentiality of personal data must be sorted out before engaging into BPO to a larger extent.

Overall, 22.2% of the firms report that big firms may increase their outsourced activities. 44.4% of the firms see no change in this sector. According to some firms, the legal aspects related to the confidentiality of information on customers are not clear. Finally, the authorities must encourage seminars on the benefits of outsourcing.

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How Mauritius can cope with globalisation

By Bertrand Rassool (cont., from Pg 1)

Similarly, the implications for the foreign travel and tourism industry have already been set in train: the Mauritian tourism industry will be influenced by the Open Skies approach advocated by the WTO. But, along with other small island states dependent on tourism, Mauritius may not be contributing sufficiently towards these negotiations in order to defend a more selective Open Skies approach by taking into account the vulnerability of its environment and its social fabric.

Eliminating non-tariff barriers

As a member of the WTO and regional organisations such as the Southern African Development Community and the Common Market for Eastern and Southern Africa, Mauritius is committed to removing both tariff and non-tariff barriers on trade in most goods and services, and within the prescribed time limits set by these institutions.

The recent tariff measures announced in the 2006/2007 Mauritius Budget represent a further step in this direction. A Harmonised External Tariff regime will be allowed with a maximum of 30% customs tariff payable on an ad valorem basis on the CIF value of imports. Excise Duties and VAT will also be allowed as government revenue, provided these are applied equally to locally produced goods and to imported goods.

Also, Mauritius must eventually dismantle all preferential tariff arrangements with other countries or trading blocs.

As regards non-tariff barriers, it appears that there is not a significant number of such barriers in Mauritius, given the relatively liberal and transparent business and economic regime that prevails in the country, and given the smooth customs administration in place. Nevertheless, any remaining non-tariff barriers, such as quantitative or qualitative restrictions on imported goods or services, should be eliminated.

Exploiting economic linkages

Hand in hand with trade liberalisation, Mauritius would also need to facilitate investment into and out of its jurisdiction. It may be argued, however, that as far as foreign direct investment into its tourism industry is concerned, Mauritius should be allowed to exercise caution. In the same way that Mauritius must be defending a selective Open Skies approach – it should not necessarily allow inbound charter flights with low budget visitors –, it must avoid investment in cheap accommodation.

While globalisation clearly brings both benefits and disadvantages to Mauritius, the latter may outweigh the former in the short term, especially as the export price of sugar will plummet by 36% and as the textile industry is adjusting to the dismantle of the MultiFibre Agreement and to increased competition from China. Fortunately, both the sugar and textile industries have already begun to adapt and respond to such challenges.

The contraction of the Mauritian textile industry has stemmed mostly from closure of foreign owned factories rather than of locally owned ones. This underlines the importance of policies that promote investment by local enterprises at least as much as foreign direct investment. It is well known that locally owned enterprises are more likely than their foreign counterparts to get out of the trough of a business cycle.

In both the sugar and textile industries, Mauritius will need to continue exploiting backward and forward economic linkages in order to allow them to remain competitive. Already such linkages are being tapped in the sugar industry by way of new bagasse/coal electricity plants and through production of ethanol from melasse. In the textile sector, a forward linkage with the fashion industry is gradually emerging and may give Mauritius a new edge in this highly competitive industry.

Serving as a regional hub

While Mauritius has the ambition of further diversifying its economy through the development of the Seafood Hub, it has to take up the challenge of having lost its privileged access as an ACP state for the exports of its processed tuna to the European Union. Already the EU import duty on such tuna from non-ACP states, such as Thailand, has fallen from 24% to 12% and will be reduced to 0% within the next two years.

But that should not deter Mauritius from having such ambitions. Its port and airport infrastructure should be further developed to serve Mauritius as a regional hub, not only for the seafood sector but also more generally for the growing commercial trade between China, India and Africa. Mauritius can take advantage of its strategic location, its technology, its know-how and its conducive entrepreneurial environment.

The Double Taxation Avoidance Agreements between Mauritius and a number of trading partners, especially in Africa and Asia, have been instrumental in attracting investment within both the onshore and offshore sectors. It should be ensured that the benefits from such agreements are be eroded as has been partly the case with Indonesia. In particular, the one with India, which is currently under review, will hopefully be consolidated. New DTA Agreements should be forged with other relevant trading partners.

Mauritius should further exploit business opportunities brought by globalisation both regionally and internationally. As the domestic market offers limited growth possibilities, Mauritian enterprises should increasingly look beyond the island's shores for new investment with higher returns. In the longer term, globalisation augurs well for the country, provided both the public and private sectors remain vigilant and outward looking.

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Global Economy

As geopolitical risks have raised its ugly head with the deadly bombing in Mumbai and further unrest in the Middle East with Israel's military action in Lebanon, crude oil prices surged past the US$75 per barrel mark on reports of a larger-than-expected decline in US gasoline stockpiles and concerns that the impasse over Iran's nuclear programme may disrupt Middle East supplies. Hopes of a peaceful resolution of the Iranian nuclear standoff have receded in the past week as Iran has failed to respond to a five-week-old offer of trade and economic incentives to halt its research. Expect oil prices to remain high for the foreseeable future in light of these supply issues.

Economic data coming out of the United States continues to reinforce the fact that growth is certainly slowing. The latest US non-farm payroll figures came in below expectations yet again with 121,000 new jobs created in June (versus the consensus of 174,000). Meanwhile, inflation expectations remain a dark cloud on the horizon as average hourly earnings jumped 0.5% in June. Hourly earnings are now up 3.9% year-on-year, the largest annual increase in five years.

The June ISM reports also continue to weaken with the non-manufacturing index falling to 57.0 and the manufacturing index dropping to 53.8. The figures, however, still suggest that economic activity is increasing (readings above 50 indicate growth), albeit at a slower pace. The US housing market continues to slow, as homeowners are unable to afford both the higher property prices as well as higher mortgage rates. Despite all these difficulties, the US economy is still on track to achieve 2.5 to 3% growth this year.

Japan raised its growth forecast to 2.1% for the fiscal year and stated that deflation is no longer a threat. The closely-watched Tanken survey, a barometer of business confidence, released on 3rd July was also positive, indicating that companies expected to increase investment by the fastest pace in 16 years (11.6%). Meanwhile, consumer confidence remains robust with the May leading indicator index rising strongly to 75.0 from the revised figure of 54.5 the previous month. A number at or above 50 signals expectations that the economy will grow in the next three to six months. With corporate and consumer spending both looking good, the Japanese economy remains on a firm footing and should continue to perform well.

Business sentiment in the Euro Zone is also robust, with the manufacturing purchasing managers' index climbing to 57.7, the fastest rate for almost six years. Growth in exports is the main catalyst, fuelling both corporate investment as well as consumer spending. The unemployment situation is also looking good with unemployment falling to 7.9% in May, the lowest level in five years. Expect the Euro Zone to grow 2.1 to 2.5% this year.

MARKET OUTLOOK

By Daryl Liew

Interest Rate

The Fed raised interest rates by 25 basis points for the 17th consecutive time on June 29th, bringing short-term rates to 5.25%. Analysts are now divided as to whether the Fed will continue to hike rates at their next meeting on August 8th or whether the interest rate cycle has peaked. While growth in the US is definitely slowing down, the Fed has to deal with inflation data that continues to remain stubbornly high.

Following the strong Tanken survey, the Bank of Japan raised the benchmark overnight rate from near zero to 0.25% on July 14th. The BOJ faces rising inflationary pressures with consumer prices going up by 0.5 percent in each of the first four months of the year. Now we believe that the central bank will maintain the status quo to avoid destabilising the Japanese recovery.

The European Central Bank will probably raise interest rates by 25 bps, taking rates to 3%, when they next meet on August 3rd. ECB President Trichet continues to deliver hawkish statements indicating that policy makers are serious about keeping inflation at bay. Analysts still believe that European rates will hit 3.25% by year-end.

Technicals

After recovering in the last two weeks, the short-term technical indicators for US equities have started to turn downwards in the last few days as support levels have been breached.

We believe that the fundamental and technical considerations are now pointing towards a more difficult environment for equities, while bonds are starting to look a lot more interesting.

Valuation

Global equity valuations are still looking fair in light of the recent correction. The key concern going forward is one of earnings. The new quarterly earnings reporting season has thus far started disappointingly with several US technology companies suffering earnings downgrades. Overall earnings growth, however, is still good, averaging in the low double-digits.

Ten-year US treasuries are trading just above the 5 percent level, below the short-term rates of 5.25%. While inflation is a concern, it does appear that the interest rate cycle has probably peaked as growth slows. Bonds are starting to look a lot more appealing.

Scenarios

Base Case: Equity markets rebound as inflationary pressures cool. Central banks indicate that they are approaching an end of their rate hike cycle. The global economy grows at a sustainable pace as oil prices stabilise and the geo-political climate calms. Global liquidity flows back into the equity markets, reigniting the rise in commodities and emerging markets.

Worst Case: Inflationary pressures work their way through the system forcing central banks to raise rates faster than previously expected, adversely affecting both equity and bond markets. Further disruptions to oil supplies cause oil prices to shoot through the roof, fuelling spiralling inflation. Tensions in the Middle East escalate.

Risk

The major change in the global investment environment over the past few months has been the gradual reduction in liquidity. We started the year with global interest rates at relatively low levels and the world awash with excess capital. This speculative capital found its way to emerging market equities and commodities in search of higher returns, thus driving up prices even further. The market correction in May and June, however, is evidence that this situation is starting to reverse.

The market is now starting to feel the effects of the US Fed's series of 17 consecutive rate hikes. Other central banks like the European Central Bank and even the Bank of Japan are already in the middle or about to start pursuing a tighter monetary policy. All these rate hikes have withdrawn excess money from the market and made capital a lot more expensive.

To further compound matters, volatility is also on the rise. After a period of steady rising returns over the past three years, uncertainty is starting to re-enter equity markets. This has forced investors to factor in a higher risk premium, particularly when evaluating higher risk assets. This higher risk premium coupled with a higher cost of capital has then led to a repricing of all investment assets and resulted in money flowing out of risky assets.

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