

Do Low-Cost Bundled Banking Services Solutions Cost More in the Long Run?

Best-of-breed payment services solutions may make the best business sense where the customer is involved.

By:

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Introduction: Market Trends Present Banks With New Choices in IT System Upgrades

According to a recent market study by J.P. Morgan, financial institutions spend about \$35 billion annually on bank processing technology and services.¹ These expenditures cover licenses and services for the systems that institutions use to support all their business activities and can be divided into two broad categories:

1. **Core systems and services** that focus on back-office functions handling an institution's main transactions and record-keeping activities. These systems and services include managing demand deposits, general ledger accounting, statement processing, lending, Automated Clearing House (ACH) settlement and some bank operations. Employees, not customers, are the primary users of core bank processing systems. In addition, many of the functions within core systems are processed in batch cycles at the end of a day or month, rather than in real time.
2. **Payment systems and services** are the customer-facing applications that support debit and credit card processing, bill payment and electronic funds transfer (EFT), ATMs, online banking, mobile account management and other customer interactions. Most payment systems conduct processing in real time.

Financial institutions typically go through alternating cycles to update these different systems. Updating core systems enables institutions to add back-end functionality to support new products, comply with the latest regulatory and security requirements, and replace outdated legacy systems with more stable functionality built on easier-to-maintain software.

Similarly, updating customer-facing payment systems enables institutions to keep current with regulatory, compliance and payment industry mandates and provides enhanced customer-oriented interfaces to support new products and services, evolving security features, new channel access and emerging form factors. It also provides institutions with upgraded functionality to more effectively promote and cross-sell services to their customers.

The economic slowdown of the past few years has forced financial institutions to reconsider their system upgrade and expansion plans. Many have delayed major investments in full core system replacements and are taking a more incremental approach, focusing on areas that provide the quickest return on investment, such as advanced risk management applications and analytical tools that can improve customer retention and the effectiveness of marketing programs.

Consequently, the market for core banking systems has become somewhat stagnant. According to financial industry consultant Art Gillis, in 2009 annual revenue for the top core system vendors declined by nearly 7 percent.² In comparison, the market for customer-facing bank payment

systems appears to be growing briskly. This situation is driven in part by advanced functionality required to support the new ways customers are doing their banking and also by institutions that desire better and more sophisticated marketing features in their customer-facing systems.

Weak growth in the core systems market combined with strong growth in sales of customer-facing systems has resulted in considerable market consolidation among bank system vendors. It has also resulted in an emerging trend among core service vendors to expand their product portfolios to include payment systems as well. And this development presents institutions with a new choice.

Does it make sense for institutions to consolidate their core systems and payment systems procurement with one vendor? Or are best-of-breed solutions from different vendors the best option?

Vendor Consolidation: Advantages and Trade-offs

Historically, banking system vendors have tended to be specialists, often focusing on either core bank functionality or on payment systems. Consequently, it has been common for institutions to work with multiple vendors for these banking systems and services.

As the core segment of the banking systems sector stagnates, it makes sense for those vendors to look for new growth areas. This is one reason why core system vendors are increasingly adding payment systems functionality to their product offerings in an effort to diversify their business and provide a more comprehensive solution to their customers. This trend offers certain benefits to both the vendors and their customers:

- **Advantages to core system vendors:** By adding customer-facing payment systems to their portfolio, core vendors can increase revenue by entering a higher growth area of the market. They can continue selling products to existing customers who are shifting expenditures away from core systems and investing more in functionality that strengthens customer retention. Core vendors can also offer attractively priced bundled packages that provide their customers with a complete solution for IT services.
- **Advantages to institutions:** Financial institutions are under continual pressure to reduce operating costs. By contracting with their core systems vendor to also provide payment systems, institutions can simplify their technology procurement processes, potentially saving money. They may be able to lower IT costs by negotiating favorable package deals from one vendor.

Core vendors typically promote their payment systems as a lower cost solution when bundled with core processing functionality. They often sell payment systems and services at a very low margin in order to capture new core systems business.

There is another marketing tactic employed by the core system vendors based on the need for payment systems to integrate with core systems. Typically, when an institution invests in a payment systems solution, part of the cost involves integrating with the core systems; this is part of what the institution pays the payment system vendor to do. However, some core vendors have now begun to charge extra fees to support payment processing systems supplied by "outside" vendors, creating an artificial barrier for institutions that are contemplating a business relationship with non-core providers.

What Are Institutions Giving Up When They Select One Vendor?

If the choice was simply between a higher cost, two-vendor solution and a lower cost, equivalent functionality, one-vendor solution, that would be an easy decision for institutions to make. However, significant trade-offs noted below need to be considered.

- Vendors who specialize in payment systems are specialists in these customer-facing aspects of banking services. These vendors offer best-of-breed solutions for banking services that are customers' primary points of interaction with their financial institution. These best-of-breed products should therefore have more robust functionality that enables institutions to more effectively personalize customer service, acquire customers and cross-sell other bank services to customers. When an institution selects a single-vendor solution from its core services vendor, it potentially forgoes the advantages of best-of-breed payment systems functionality.
- The primary business focus of core banking system vendors is their core systems product offering. Generally, this is the area of their product portfolio that receives the greatest business investment, and this is the area that stands to receive most of their attention when it comes to product innovation and modernization. When a financial institution selects a single core services vendor for all its banking systems and services, it may be choosing a solution with less innovation on the customer-facing payment systems side.
- The market reality today is that customer-facing payment systems are the most rapidly evolving segment of IT banking systems. There are several reasons for this:
 - Emerging technologies enabling advanced forms of Internet-based commerce and mobile commerce are also creating new ways for consumers to manage their accounts and their money, which increasingly presents opportunities for financial institutions to create new customer "touchpoints" for their banking customers.
 - Economic conditions are influencing how consumers spend and manage their money, which is creating demand for new kinds of payment products and accounts.
 - More sophisticated analytics are making it possible for institutions to personalize, in real time, the services they provide and promote to their customers.

As a result, customer-facing payment systems are changing much more rapidly, in fact, than core systems. When an institution selects a single vendor for all its banking services, it often locks itself into a monolithic system upgrade schedule, thus limiting the institution's ability to respond quickly to consumer-driven changes in the market.

The real questions for institutions are twofold: Do the possible cost advantages of a single vendor solution outweigh the value of potentially having better functionality for acquiring customers and promoting services to them? And do the cost benefits of a single-vendor solution outweigh the value of staying current with technological innovations and consumer preferences in a rapidly changing segment of the market?

To answer these questions, let's take a closer look at the true value of best-of-breed customer-facing payment systems.

The Real Business Value of Customer-Facing IT Services

When considering the importance of customer-facing payment systems and services, it is essential to look beyond the immediate operational costs and benefits these services provide.

In many ways, of all the banking technologies an institution purchases, it is the customer-facing systems that have the greatest impact on the long-term health of the institution's business. It is these systems with which customers interact every day, and they are also the systems that enable institutions to successfully market products and services to their customers.

As the recent economic downturn unfolded, the tightening of credit forced institutions to focus on growing the deposit account side of their businesses. Customer-facing technologies played a key role in this effort. Consider how these customer-facing technologies helped attract customers and build loyalty:

- **ATMs** – With the latest technology, institutions can provide their customers with state-of-the-art ATM services such as check imaging and deposit automation, transaction personalization, and one-to-one marketing and cross-selling messages.
- **Remote Deposit Capture** – Technology is available that enables consumers to deposit checks by scanning them from their homes and offices, or even by photographing them with their smartphones.
- **Internet Banking** – For consumers, Internet banking continues to evolve from basic account administration and money transfer services to consolidated account management for all types of accounts (e.g., deposit, credit and mortgage accounts), manual and automatic bill paying, and investment management. The Internet banking platform is also an ideal place to market new products and services. Promotions can be personalized to the customer, and Internet-based service offerings and campaigns can be changed frequently to accommodate new initiatives.
- **Mobile Banking** – The growth of smartphone use is resulting in increasing consumer demand for mobile banking services. This situation is likely to grow more rapidly in coming years as mobile commerce and mobile payments become a typical way for consumers to conduct business.
- **Automated Telephone and Call Center Support** – More sophisticated inbound and outbound automated answering systems provide a better customer experience, reduce the overall call center cost and create opportunities for more targeted cross-selling.
- **Merchant Acquisition and Services** – Technologies supporting merchant services are a key to remaining competitive. As merchants expand their own e-commerce offerings and increasingly globalize their sales strategies, institutions need to be able to offer innovative merchant services to support these efforts.
- **Real Time Customer Analytics** – In some cases, payment system vendors who specialize in consumer-facing services have sophisticated analytic capabilities that can provide valuable information about how consumers use the institution's customer touchpoints and how they respond to offerings and initiatives. This information can be a powerful tool for refining the marketing and sales strategy.

The commonality underlying these capabilities is the need to provide a flexible 24/7 banking experience for consumers, and the opportunity to offer better, faster, more secure and personalized services through these systems. This approach makes these consumer-facing services fundamental to an institution's ability to acquire and retain customers.

An institution that makes a cost-saving decision to select a single core banking services vendor for all their IT services—rather than choosing a best-of-breed payment services solution—could be limiting its ability to compete effectively for new customers or retain its existing customers.

The Advantages of Unbundled Best-of-Breed Services

In addition to better functionality for responding to consumer interests and demand, best-of-breed payment systems solutions offer two other significant advantages:

1. **The flexibility to take a phased approach to system upgrades.** When a core systems service provider augments its core product with payment systems functionality, its institutional customers' abilities to upgrade or update one or the other could become more complicated.

A bundled solution is more likely to contain proprietary technological dependencies that make it more difficult to "decouple" the systems. That means upgrades of one depend on upgrading the other. This linking of core and payment processes makes it more difficult to take a phased approach to system upgrades, especially at times when it makes economic sense to do exactly that.

A decoupled best-of-breed solution gives institutions the flexibility to upgrade the payment processing side of their systems more frequently to keep up with changes in the marketplace.

2. **The ability to respond more quickly to new technology and shifts in the market.** By decoupling core and customer-facing systems, institutions are able to respond rapidly to competitive pressures that impact their ability to gain and retain customers. These competitive pressures can be the result of shifting market preferences—for instance, the current trend away from credit and toward debit and prepaid among some demographics or from new industry regulations. Competitive pressures can also arise from changing technology, such as the rise of mobile commerce, the ability of competitors to engage in more precise targeted marketing, and the capacity to quickly roll out new banking products for customers.

A decoupled, best-of-breed payment solution not only enables institutions to provide the most sophisticated customer-facing interactions points possible, but it also offers the flexibility to be more responsive to changing market realities and to invest in upgrades when it makes most business sense to do so.

Summary: Things to Consider for the Best Long-Term Value

If your institution's goals are tied to deposit growth and customer satisfaction, it follows that customer-facing IT services should relate to those goals. Here are key ideas for building long-term value with IT services:

- Use a layered approach to IT investments and upgrades. Bundling core and payment systems in one solution could restrict the institution's ability to pursue this approach to IT investment; decoupled best-of-breed solutions do not.
- Consider the speed with which new technology and changing economic conditions can alter needs for customer-facing banking services. It is a reality that payment systems are changing more rapidly than core systems, and if an institution is to remain competitive, it must have the flexibility to change the "front end" of its operations as the market changes.
- To remain competitive, a financial institution needs customer-facing functionality that incorporates the latest features customers expect, and a vendor that can provide new technologies and emerging business intelligence capabilities such as real-time analytics. It is this ability to keep customer-facing services fresh and responsive to customer demands that can facilitate a successful competitive approach to gaining and retaining customers.
- Find a provider with extensive experience and a proven track record securely processing real-time transactions with 99.999 percent uptime, as well as the capability to provide the back-office and value-added services needed to service customers during and after the transaction.

When considering investments in banking systems, examine the net effect on profitability. A core-centric solution might reduce expenses in the near term but could weaken an institution's ability to serve its customers—which means lower retention rates and reduced revenue per customer. Accordingly, a best-of-breed payment system solution may be the wiser investment for long-term growth and profitability.

Sources

¹ Huang, Tien-tsin, CFA and Cohen, David E., CFA. "Bank Processing Industry Primer." J. P. Morgan. September 25, 2009.

² Gillis, Art. "Bank Tech Vendors Do Not Live By Core Alone." Bank Systems & Technology blog. www.banktech.com/blog. March 16, 2010.

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