The Credit Union Core Data Processing Quandary: In-House or Service Bureau?

An Insightful Investigation that Goes Beyond Industry Headlines

by

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Executive Summary

In order to remain competitive, Credit Unions must continually investigate how they can operate more efficiently. This is achieved by offering products and services that maintain or exceed member expectations. Thus, the prime motivation for converting to a new solution is usually the realization of an under-performing core data processing platform, budgetary concerns or both.

So, when a Credit Union approaches the all-important task of determining whether to reach out to a service bureau or assume all related responsibilities to maintain an in-house data processing system, a number of quandaries immediately arise.

The first issue centers on the asset class, size and geographic location of the Credit Union. For many small-to-medium sized organizations, the ability to effectively oversee an information technology (IT) operation is not feasible and therefore relying on a third party is essential to success—providing vendors are accessible. And for larger Credit Unions that are properly staffed with an IT department, it may be prudent to handle all operations in-house as it provides more flexibility when selecting hardware, software and third party solutions, as well as dealing with contract negotiation of services.

The Business Performance Innovation (BPI) Network, in association with Paladin fc, released a report in May 2013 entitled, “How Core Vendor Contracts Impact Bank and Credit Union Value.” The study defined “Core and IT Services” as outsourced processing and IT services such as Account/Data Processing, Item Processing, Internet Banking, Mobile Banking, Bill Payment, ATM/EFT, Network Monitoring and other critical outsourced managed services.

The major takeaway from the study was that Credit Unions are, on average, losing money due to IT-related contracts. Thirty-nine percent of survey respondents said they are paying over fair market for core and related IT services, while 35 percent think they are being fairly charged. The balance of respondents didn’t know if they were paying too much for IT services. The report further concluded that community institutions can save an average of 24 percent, or $905,265, over the life of a contract, by bringing core service contracts in line with fair market pricing.

Further, the report found that 90 percent of respondents said they added to their core bank processing and related IT services in the past three years. Seventy-four percent expect to make additions in the next three years, compared to only nine percent that said they have no immediate plans.

The purpose of this white paper is to determine when a Credit Union should select a service bureau or whether the core processing platform can be managed in-house through relations with disparate vendors. It is important to note that a “one-size fits all approach”
to core contracts never works in this niche industry. As a result, a deeper dive will be taken in this white paper to illuminate tell-tale signs as to which direction a Credit Union should proceed, and how best to negotiate a fair market core contract.

**Controlling the Core**

In June 2013, *Credit Union Times* published an article entitled “Hosted Cores Gain Momentum Among Small CUs.” The article cited Callahan & Associates, which reported that 2, 272 credit unions currently have hosted cores. In institutions with under $20 million, 777 have hosted cores. The firm finds that there are 208 credit unions with assets over $1 billion; nine of those have hosted cores.

“For smaller Credit Unions, a hosted core is where most will wind up,” David Gibbard, an executive with Birmingham, Ala., core provider EPL told *Credit Union Times*. “The primary reason is because an in-house solution requires a team of IT professionals. The smaller credit unions have less money so they cannot afford that expenditure and, therefore, they embrace a hosted core.” He added that money can be saved. “I estimate that an in-house credit union could reduce between 25 percent to 50 percent of their IT budget with a hosted solution.”

Seeking a new technology requires thorough research, a process that identifies existing operating issues and shortfalls. As Gibbard noted, a service bureau is an attractive option to many Credit Unions because it is “one-stop shopping.” All services essential to core system operations—from remote deposit capture to core data processing—may be under one roof. This streamlined approach is attractive to many c-level executives because there is seemingly “one throat to choke” when problems are presented.

By having one point of contact, an organization is freeing itself up to accomplish the task at hand, which is achieving member satisfaction. In doing so, however, a Credit Union is also giving up control, and in many cases not fully understanding the economic variables pursuant to the service bureau contract. Since a Credit Union CEO is not witnessing first hand contract negotiations on aspects of the core, they understandably do not know if money is being left on the table or if a better deal could be reached on their behalf.

To be clear, a Credit Union that has put its faith in a service bureau often does so due to credibility and success within core and internet banking solutions. To this end, there are four vendor leaders—oligarchs—in this arena: Fiserv, Fidelity Information Services, Jack Henry & Associates and D+H, the latter came to prominence after acquiring Harland. There are also smaller providers in addition to Credit Union Service Organizations (CUSOs) that also offer service bureau options to Credit Unions.

Celent analyst, Stephen Greer, told *American Banker* in October 2013, that the leading banking vendors could be compared to large pharmaceutical companies. “They’re just massive and they wait for others to innovate. When others innovate, they acquire them.” To this end, the once booming banking technology entrepreneurs of the late 1980s and 1990s have dwindled. This is not to say that the sophistication of technological
advancements have suffered, rather than the number of “teams” competing for business have shrank significantly.

For Credit Unions using a service bureau, operations are not always with the service bureau per se, but rather third party, subcontracted vendors. This point of contact may change within the life of the respective contract or the vendor might not be executing contract terms efficiently. As a result, the Credit Union continually loses its leverage and knowledge base. Thus, they have to place all faith in the service bureau, especially as it pertains to the knowledge of IT contracts and related services.

As vendor consolidation continues to occur throughout the industry, the BPI Network report found that the vast majority of institutions (72 percent) “do not have sufficient information to know whether they are not overpaying.” If a core hosted Credit Union were to handle core contracts in-house, they could rely on a Request for Proposal process, which is cumbersome at 1,000-plus questions, but could serve to level the playing field.

**In-house vs. Service Bureau**

As noted in the introduction, the decision whether to go in-house or select a service bureau is closely tied to the complexity (e.g., geographic location, infrastructure, culture, et al.) and asset size of the Credit Union. To this end, it’s important to note that the BPI Network report found that Credit Unions with $500 million to $1 billion in assets “appear” to have the greatest opportunity to reduce costs, with an average savings of 29.1 percent, or approximately $1 million over a five-year contract.

The aforementioned data supports the need for smaller Credit Unions to contract with service bureaus. There are inherent benefits as these Credit Unions have a “dedicated box” of IT services. There is no question that this approach simplifies the IT management process and provides a sense of security and relief, especially with issues of compliance, security and disaster recovery, among other action items.

However, even smaller Credit Unions can be proactive in managing both their relationship with the service provider as well as the state of the market as it relates to vendors. While this may require time and resources outside the service bureau relationship, it could prove useful during contract negotiations.

Whether a Credit Union is operating an in-house core data processing platform or relegating to a service bureau, it is critical to understand that contract negotiations should include a “long-term view” approach. For example, many well-intended c-level executives who negotiate an in-house IT contract, or a service bureau negotiating on behalf of the Credit Union, may or may not be in the same position when the contract matures and is ready for renewal. As such, it is essential that c-level executives concentrate on future metrics as opposed to only the present needs of the institution.

“It’s a tendency that when you sign a contract for five years that you don’t start thinking about it until after four years. As it turns out, that’s a mistake,” Shami Patel, managing
director for Cohen & Co. stated in the BMI Report. To this end, industry experts suggest that a Credit Union should begin restructuring contracts with 18 to 30 months remaining. “This is the time period Credit Unions have the greatest leverage with their existing vendor and enough time to negotiate a new contract with another vendor if that becomes necessary,” the report stated.

A Credit Union that has placed its confidence in a service bureau must believe that all related IT contracts are being actively negotiated in this time frame. This, however, is simply a belief or a faith-based approach as they are not privy to the contract negotiations between its service bureau and the third party vendors providing services.

For a Credit Union staffed with 8 or 10 IT employees, including an IT Director, the same concern arises. It is one thing to have the technology know-how to manage vendor projects, especially as they relate to core system operations, but understanding the varied contracts timeframes and stipulations is another challenge.

It is for these noted reasons that industry experts suggest that Credit Unions work with consultants that are well-versed in vendor contract negotiations. To this end, it is prudent that Credit Union service bureau clients, as well as the in-house Credit Union client, work with experienced consultants.

“Nobody likes to negotiate these contracts, particularly from the bank side...you’re going up against professional negotiators, and if you only do this every eight years, you can’t possibly know some of the negotiating tricks or ploys they may be playing on you,” Chief Financial Officer of Dedham Savings, Mark Ingalls, noted in the BPI Report. “So I think hiring a third party who’s experienced in this makes an awful lot of sense.”

Perception vs. Reality: a Credit Union Checklist to Selecting In-House vs. Service Bureau

In-House

1. **Independence.** Perhaps the leading reason a Credit Union selects an in-house system is the *perception* that it will be able to operate independently. The *reality* is that the Credit Union is limited by the flexibility and capability of the system. For example, how easily can the IT department create interfaces, customize and manipulate data?

2. **Lower Costs.** While the *perception* is true that a Credit Union operating an in-house system will pay less annually, the *reality* is that the organization is taking on more responsibility. Therefore senior executives have to employ a 10-year view and determine the “all-in” costs, which include hardware, software and manpower.

3. **Service Quality.** The *perception* is that by selecting vendors for specific solutions rather than an umbrella service system, the level of service per contract will be
elevated. The reality is that since the Great Recession, there has been a change in vendor attitude, which has adversely impacted service and is not in line with the cooperative spirit of the Credit Union industry.

**Service Bureau**

1. **No Independence.** While the **perception** is that all services are operating under one system and one point of contact, the **reality** is that many of these services are outsourced from the hosted core provider. As a result, Credit Unions lose interoperability with key third party interfaces. Senior executives must determine the “all-in” cost per member over a 10-year period. At a certain point, possibly after the first five years, there will be a financial inflection point where switching to in-house is cost effective.

2. **Assets.** As per the aforementioned Callahan & Associates statistics, the **perception** is that Credit Unions selecting a service bureau are operating at a lower asset class and without an IT department. The **reality** is that in many cases this theory holds true; however, despite the “size” of the Credit Union the following characteristics must be considered: geographic location (larger but rural Credit Unions are at a disadvantage), infrastructure, culture and financials.

3. **Aging Technology.** The **perception** is that service bureau core systems include cutting edge technologies. The **reality** is that the ratio of old, proven technology companies to new technologies is increasing. As such, there is more concentration on service bureaus “patching” together older legacy systems than developing cohesive, up-to-date solutions that look past the present and determine future technology needs.

**Conclusion**

The financial technology market is dynamic and in a state of flux, especially as more vendor consolidation is realized. It is important for Credit Unions to understand that it is not merely a question of selecting a service bureau or an in-house core data processing platform as many times this decision is based on cost. A Credit Union should never generalize services over cost as it is a dangerous and often detrimental to the overall well-being of the Credit Union construct.

When moving through the selection process for a major project, the ultimate objective is to negotiate the most comprehensive deal possible. This requires a Credit Union to remain focused on its strategic goals, which, in turn, maintains a competitive edge. Therefore, it is beneficial that a Credit Union’s negotiating team understands the financial-services industry and how related technologies develop.

So, how is the decision to select an in-house or service bureau determined? As Ingalls noted, it is done so by working with experienced consultants. Samaha & Associates Inc.,
for example, has worked with hundreds of credit unions of all asset classes. As a result, its proven team of professionals have studied and understood leading service bureau contracts as well as built piece-by-piece successful in-house core data processing platforms.

“While Alternatives Federal Credit Union decided to update its core technology, we faced a daunting, immediate problem—we didn’t know what we didn’t know,” said Alternatives Federal Credit Union CEO, Tristram S. Coffin. “Samaha Associates were an invaluable resource, working with us through the vendor selection process right up to, and beyond the conversion date. The Samaha staff helped us pick a system that met our needs, negotiate the best possible contract and work through and organize the myriad of operational tasks necessary to ensure a successful conversion.”

As noted previously, a service bureau will simplify the vendor management process, but it removes flexibility in both dollars and dependencies. This agreement must be managed in a similar way so that all dedicated funds are maximized. The same approach holds true for in-house core data processing platforms. With this model, vendor change is possible, even within the life of the contract. There are benefits to both approaches, depending on respective Credit Union criteria. However, in order to maximize opportunities, both options require professional oversight.

“Undertaking a core system conversion is a huge task for any organization with great rewards and also potential risks. Samaha Associates really helped us identify those risks and worked with the Stanford team to mitigate them,” said Stanford Federal Credit Union SVP/Chief Information Officer, Jim Phillips. “The Samaha consultants kept our staff focused on completing the work that matters with the right amount of process and methodology for us.”

While there are a number of essential variables to consider when deciding between an in-house and a service bureau core data processing platform, managing the negotiation process properly ultimately saves time and money. The realized savings enhances the Credit Union’s ability to deliver quality services to its valued member base.

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