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

AN INSIGHTFUL INVESTIGATION THAT GOES BEYOND INDUSTRY HEADLINES
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Executive Summary

In order to remain competitive, financial institutions must continually investigate how they can operate more efficiently. This is achieved by offering products and services that maintain or exceed customer/member expectations. Thus, the prime motivation for converting to a new solution is usually the realization of an under-performing operating system or budgetary concerns.

When a financial institution 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 issues immediately arise.

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

The purpose of this white paper is to determine when a financial institution should select a service bureau or whether the core operating system 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 industry. As a result, a deeper dive will be taken in this report to illuminate tell-tale signs as to which direction a financial institution should proceed, and how best to negotiate a fair market technology service contract.

Controlling the Core

Seeking a new technology requires thorough research, a process that identifies existing operating issues and shortfalls. In many cases, a service bureau is attractive option to financial institutions 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 preferred by many C-level executives because there is seemingly only “one throat to choke” when problems arise.

By having one point of contact, an organization, in theory, is freeing itself up to accomplish the task at hand, which is achieving customer/member satisfaction. In doing so, however, a financial institution is also giving up control, and in many cases not truly understanding the economic variables pursuant to the service bureau contract. Since a C-level executive is not witnessing firsthand 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.

For financial institutions using a service bureau, operational issues are not always with the service bureau per se, but rather a third party: subcontracted vendors. And this point of contact may change within the life of the respective contract or the vendor might not be executing contracts terms efficiently. As result, the financial institution 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 all IT contracts and related services.

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 financial institution. With regard to the latter point, many smaller financial institutions contract with service bureaus. There are inherent benefits to this approach as these financial institutions 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 financial institutions can be proactive in managing both its 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 financial institution is operating an in-house core operating system 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 agreement may or may not be in the same position when the contract matures and is ready for renewal. And this is often the case since the majority of IT contracts are between five and 10 years. As such, it is essential that C-level executives focus not only on the current needs of the institution, but to reasonable future forecasts as well.

A financial institution that has placed it faith in a service bureau must believe that all related IT contracts are being negotiated in the abovementioned 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 financial institution staffed with eight 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 financial institutions work with consultants that are well-versed in vendor contract negotiations. To this end, it is both prudent that financial institution service bureau clients as well as the in-house financial institution clients work with experienced consultants.

Perception vs. Reality: A Checklist to Selecting In-House vs. Service Bureau

<u>In-House</u>

1. Independence. Perhaps the leading reason a financial institution selects in-house is the perception that it will be able to operate independently. The reality is that the financial institution 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 financial institution operating an in-house system will pay less annually, the reality is that the organization is taking on more responsibility. Therefore, senior executives must 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 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.

<u>Service Bureau</u>

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 core provider.

As a result, financial institutions lose interoperability with key third party interfaces. Senior executives must determine the “all-in” cost per customer 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. The perception is that financial institutions 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 financial institution the following characteristics must be considered: geographic location (larger but rural financial institutions 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 decreasing. 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 financial institutions to understand that it is not merely a question of selecting a service bureau or an in-house core operating system as many times this decision is based on cost. A financial institution should never generalize services over cost as it a dangerous and often detrimental to the overall well-being of the financial institution construct.

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

The decision to select an in-house or service bureau model is greatly benefited by working with experienced consultants. Samaha & Associates, for example, has worked with hundreds of financial institutions of all asset classes. As a result, its proven team of professionals has studied and understood leading service bureau contracts as well as built piece-by-piece successful in-house core operating systems.

"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 previously noted, 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 dollars are maximized. The same approach holds true for in-house operating systems. With this model, vendor change is possible, even within the life of the contract. There are benefits to both approaches, depending on respective financial institution 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 or service bureau core operating system, managing the negotiating process properly ultimately saves time and money. The realized savings enhances the financial institution's ability to deliver quality services to its valued customer/member base.

Sabeh F. Samaha is president and CEO of Samaha & Associates, a consulting group that works collaboratively with financial institutions to help improve business processes by optimizing efficiency and increasing revenue opportunities. Whether it is vendor contract negotiations, system conversions, or mergers, Samaha & Associates, understands what gets the job done from beginning to end. Sabeh can be reached at (909) 597-2020, sabeh.samaha@ssamaha.com or www.ssamaha.com.