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OUTSOURCING: silver bullet or golden handcuffs?

During July 2005, GFG Group launched GFG:Utility, a package of products and services designed to enable new credit, debit and finance cards to be launched without the traditional overheads, costs and time constraints. Available now in Australia, in partnership with Fujitsu, this outsourced credit and debit card hosting and processing service is also intended for other markets. In this issue of The Goldfinch Report, GFG Group's general manager for South East Asia, Peter Goldfinch, puts the pros and cons of outsourcing of credit and debit card services under the microscope

Outsourcing is nothing new. Back in the day, when computers were mainframes, only the largest organizations had their own. Most used a data processing bureau to handle the payroll and crunch the annual accounts. With the advent of the minicomputer, and then the personal computer, organizations could afford to have their own IT department with their own IT infrastructure. In the 1980s and 1990s – amidst buzz words such as the 'new economy' – all in business admired the Emperor's new suit of technology clothing. But the dawn of the 21st century saw business sobering up from its thirty-year technology binge. Today's Chief Information Officer is driven by ROI (Return on Investment). Each year he or she is expected to reduce the costs of the existing IT infrastructure, while any new IT projects are only approved following a rigorous analysis of ROI.

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As the Economist recently observed, the early owners of automobiles often had chauffeurs. This was not so much because owners couldn't drive themselves. But rather because the early motor car had such poor reliability that a specialist operator, skilled in maintenance, was required to get satisfactory 'uptime'. In the same way, when electricity first began to power industry, companies had Vice Presidents of Electricity and often owned their own generating equipment. Electricity was 'strategic'. Today, it is just a commodity and companies are only concerned with buying it as cheaply as possible.

These same dynamics are affecting the use of IT. Today, the single most effective way of taking out cost from existing IT infrastructures is outsourcing.

In the payments market – and in particular with the major card organizations – outsourcing is undergoing enthusiastic adoption as larger players sell their facilities, supporting functions and staff to an outsourcing organization. These organizations then charge back based on a card or transaction basis. Often the existing internal staff and the existing IT infrastructure remain – although the outsourcing company employs the staff and takes over ownership of the physical IT infrastructure. In essence a blend of capex and opex is transformed to be fully opex. Through some form of accounting wizardry costs are saved and profits made by the respective parties.

In the credit card business, outsourcing has always had its adherents – particularly in the USA where there are large outsourcing organizations such as EDS, FDR, TSYS etc. The UK market has shown in recent years a liking also for the practice.

In some markets, banks have formed consortia to establish processing centers to deliver the economies of scale associated with size and volume.

Individual banks have offered outsourcing to smaller competitors, gaining scale and volume to improve their own ROI, while enabling the smaller competitors to enter the market without requiring new capex.

Outsourcing is not for every institution, however. Size does matter as well as the strategic importance of cards to the total product portfolio of the institution.

Trends in outsourcing and insourcing by the major players

By the larger card issuers (those with more than 750,000 cards), card products are viewed as a mass market commodity where profit comes from high volume and low per card and per transaction costs. An increasingly popular strategy is to outsource these commodity products and 'insource' those products targeted at high net worth customers where product features and service needs to be tailored to a customer's specific need.

The business rationale is to off-load a function that is not core business, that is difficult to understand and manage, often expensive and always demanding of regular capital injection. This allows the business to concentrate on what it does best. "Our core business is financial services not Information Technology."

As mentioned, often the physical presence does not move but the ownership of the IT assets and people changes. The institution in fact may take a shareholding in the outsourcing provider. In effect not wanting to give up total control and to benefit from improved efficiencies over and above what is represented in the charges.

The Midrange Institutions, (200,000 –750,000 cards)

These issuing institutions are facing increasing pressures from both the larger players and new entrants. Profits are reducing, costs are increasing, and the resources available to do anything that may lead to a gain in market share are being absorbed in dealing with the scheme compliance changes. This compounds as these mid-range institutions are most likely issuing two brands and support merchant acquiring. They are running faster and going nowhere.

The arguments for outsourcing among the midrange players are the same:

- Conversion of capex to opex and therefore tying costs to business volume.
- Allowing management to concentrate on the core functions of the business and not be preoccupied with managing IT.

However outsourcing for these institutions also means giving up the dream of offering customers a unique and appealing proposition and accepting mediocrity.

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Trends among smaller Institutions, (less than 200,000 cards)

The smaller Institutions are generally offering a card product with no choice of scheme. They either issue Visa or MasterCard and possibly two products, classic and a gold card. The service they offer their cardholders is probably consistent with their other products: personal, at a reasonable cost. Typically these are the Community Unions, Building Societies operating in the smaller cities and towns, plus the smaller regional banks.

Such smaller financial institutions often have similar product strategies as the larger players, in they are issuing a commodity product to complete their portfolio. The features and service levels need to match what is generally available in the market. But it is other products in the portfolio which deliver a unique customer proposition and the profit.

The smaller institutions are in a difficult position in today's cards market because:

- Generally speaking their customers demand a branded card product as part of the total banking package.
- Cards have become an increasingly competitive and price sensitive business delivering lower profits.
- Regulators especially if you are based in Australia are out; if unwittingly to kill off a major source of revenue, interchange.
- They typically have no direct merchant relationships and therefore are enforcing an interchange model.
- Card associations are mandating changes every 6 months therefore absorbing most of the institutions' IT resources and making it difficult to introduce systems changes that could provide a competitive edge.
- Existing IT systems are typically ageing and require replacement. This capex has a dubious ROI.

There will be exceptions in this category, such as institutions targeting a niche market with specialized products and services where cost is not a significant issue. But often the card products are still not the focal point of the business and are only offered to complete the product range

New market entrants

The new entrants are often not banks and are entering a crowded market with a new or unique cardholder proposition they expect to be successful. But in recognition of the risk, initial capital investment needs to be minimized.

Outsourcing may be considered as short-to-medium-term strategic decision, with the longer-term intention of moving the operation in-house when business targets are reached.

Finding an outsourcing provider able to deliver the unique cardholder proposition quickly, at an acceptable price and with the required security is a challenge.

Some outsourcing caveats

For many organizations and especially card issuers and acquirers, IT is a core component of their product offering. Even for those institutions who consider their card to be a commodity will want, at some point, to change a product's attributes or even launch a new product.

For the new entrants a unique customer proposition is often core to their business case. Outsourcing providers often find exceptions to the norm difficult to satisfy. Again such exceptions come at a high price. Outsourcing pricing is driven by high volume and conformity to a standardized product.

Out-sourcing providers typically look to the “off the plan” requirements for system changes as the opportunity to increase their profitability. Issuers can expect and do pay a high price for these changes. The timeliness of change can also be a challenge. The shorter the go to market period the higher the price. Again changes put the outsourcing model out of balance.

About Peter

Peter Goldfinch, GFG Group's General Manager South East Asia, is a respected analyst and commentator on global trends in payment technology.

One of the original founders and shareholders in GFG Group, Peter has a background of more than 23 years in the information technology industry, most of which has been involved with consulting and systems development for banking and finance customers in 25 countries.

He has particular expertise and experience in payment systems, including mobile payment systems. His career highlights include pioneering work on the first ATM and EFTPOS networks.

In the mid-1990s, he played a key role in the introduction of credit and debit cards into the Russian market, working with GFG's customer SBRF.

About GFG

GFG Group is a highly-specialised payment solutions company, providing its clients with products, advice, and systems integration and outsourcing services. Accredited by the World Bank, the company has established a global presence over the last decade - delivering leadership payment solutions to more than 50 customers in over 40 countries.

A key element in GFG Group's success is its focus on development and investment in five high-demand payment solution areas:

- Card Management Systems
- Mobile Payment Solutions
- Customer and Merchant Loyalty Systems
- Managed Services
- Payment Tools

The company's core research and development team is based in Auckland with consultants and technical staff located in the international offices to provide front line 24 x 7 support for customers in multiple geographies.

This situation is experienced even by the larger institutions who generally have more sway with their outsource provider. Exceptions and changes cost because they disrupt.

If a smaller institution is using the same facility as a larger competitor their priority in any IT queue will be subject to variation based on the demands of the larger institution - frustrating their ability to have both "on and off plan" changes made in a business acceptable timeframe. The danger is that cost savings are eroded away or the business cannot justify new initiatives, adversely impacting their marketing strategies.

Outsourcing decisions are generally made at 40,000 feet. At ground zero the relationship between the cards business unit and their outsourced provider are frequently tense and highly charged. Real disrespect and bitterness often exists.

And when it's time to leave?

Any relationship will come to an end, either in mutual agreement or in a climate of hostility.

Before taking up an outsourcing service a issuer must ensure the exit strategy is worked through in detail. The contract should cover the implementation of the exit strategy.

Often issuers moving away from an outsourced service will experience a lack of co-operation. Concerns over whether they will be able to extract their cardholder details and history. Often these concerns prove to be real.

Converting from one processing platform to another always carries risks and a fallback process is often developed and in worse case situations executed. Converting off an outsourcing service is usually a one shot event with no recourse.

What Kind Of Outsourcing Services to Select

The large volume driven services are best suited to the larger institutions while the new entrants, and smaller institutions, will struggle with the service levels. The mid range institution will find using a large outsourcer even more of traumatic experience.

The cost justification for using an outsourced service is often compiling. Comparing only software licenses a 100,000 card issuer can expect to pay four and half times more per card than a 2 million card issuer will need to pay. This difference will be reflected in support and compliance charges as well.

Smaller institutions and new entrants need to consider a few key factors in selecting an out-source provider. These are:

- Consider the total cost of ownership and do not under-estimate the need to undertake solution enhancements. Lower standard processing charges do not necessarily mean a low cost of service.
- Ensure the outsourced solution will manage unique requirements without a disproportioning processing surcharge.
- Match your size to the other customers and avoid providers who have one or more large customers who dwarf all other customers.
- Seek out an outsource provider who owns their software solution and sells licenses plus implementation and support services for in-house processing. Thus providing an exit strategy and an incentive for them to ensure a migration to in-house processing is successful.

Conclusion

Outsourcing is not a silver bullet. It will prove costly if an inappropriate provider is chosen. Growth from product development and enrichment will be inhibited unless the provider is responsive to their customers' ongoing requirements and supported by a solution that is feature rich.

Provided the above issues are addressed, outsourcing can be an excellent way for new entrants to test and establish card-based services in the market without high capital investment. For larger players, outsourcing (provided it is well conceived and managed) will reduce the capital costs of supporting commodity card products, although transaction costs may not be reduced. Changes and updates are likely to be expensive and detailed formulae for these need to be specified in outsourcing contracts.

In selecting an outsourcing partner, ensure there is a match in size and in culture. Ensure that changes, add-ons and customisation required to differentiate your product can be carried out quickly and cost-effectively. And, ensure you have an exit strategy worked out before committing. A sound pre-nuptial contract is recommended.