

Aaron McPherson,
Research Manager, Payments



Insourcing Highlights New IT Approach for Banks

FIN VWP, September 2004

Adapted from *Chase Chooses TSYS: A Tipping Point*
by Aaron McPherson, FIN #1491

Financial Insights believes the banking industry has passed a tipping point towards in-house processing of credit cards. Ongoing mergers have changed the balance of power in the banking industry. The largest banks have grown so much that they can achieve the economies of scale of the largest third-party credit card processors.

These banks no longer have any financial incentive to outsource this activity. While the move towards insourcing of credit card processing is nowhere near complete — the largest current deals won't be fully in place until at least 2006 — it has passed a point where almost all of the large banks are at least strongly considering the idea, even if they have not yet enacted it.

Banks see insourcing of credit card processing not only as a short-term way to save money but as part of a longer term strategy of providing a closer relationship to customers with real-time brokerage services, financial advice, and other services. Insourcing adds the flexibility to create new card products, tailor product attributes to smaller groups of consumers, and provide private-label card products to retailers. Major growth areas in the card industry, such as stored value cards, increase the value of an in-house card platform.

These developments will have profound implications for companies that provide services and IT to financial institutions. For third-party providers of credit card processing services, it means they must compete for the shrinking number of smaller banks. The bright spot for credit card processors might occur as these smaller banks are forced to outsource processing in order to compete with the economies of scale created by larger banks. However, even this improvement will be temporary, giving way as these smaller banks are acquired or themselves move to in-house processing.

These forces have been furthering consolidation among the companies that provide IT goods and services to financial institutions. However, even the winners are finding that their role is changing. With insourcing on the rise, these companies are giving up processing revenue in return for substantially lower software licensing payments. Even in software sales, the real money these days is not in the sale price but in long-term maintenance and professional services contracts. While most major banks will need help setting up these systems, they clearly plan to exert control over them going forward. As more large banks move towards an insourcing model, even processing software is likely to become commoditized, pushing prices even lower.

For third-party processors, this will mean a decline in revenues at the exact moment when they will need capital to revamp their businesses. Overall prices for outsourced credit card processing will decline as more competitors fight for the remaining banks that still outsource. Competition in third-party processing will now shift to debit cards, retail cards, and stored value cards, where the margins are lower.

ABOUT THIS PUBLICATION

This publication was produced by Financial Insights Go-to-Market Services. The opinion, analysis, and research results presented herein are drawn from more detailed research and analysis independently conducted and published by Financial Insights, unless specific vendor sponsorship is noted. Financial Insights Go-to-Market Services makes Financial Insights content available in a wide range of formats for distribution by various companies. A license to distribute Financial Insights content does not imply endorsement of or opinion about the licensee.

COPYRIGHT AND RESTRICTIONS

External publication of Financial Insights information and data that is to be used in advertising, press releases, or promotional materials requires prior written approval from the appropriate Financial Insights Vice President. A draft of the proposed document should accompany any such request. Financial Insights reserves the right to deny approval of external usage for any reason.

For permission requests contact Financial Insights at 508-620-5533 or email press@financial-insights.com. For more information on Financial Insights visit www.financial-insights.com.