

Should Card Issuers Outsource or Process In-House?

A Changing Card Industry Makes the Right Sourcing Model More Important Than Ever



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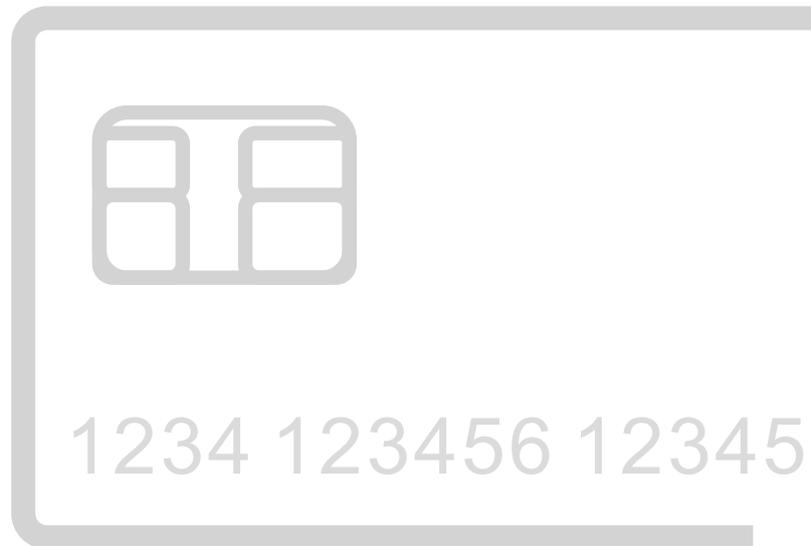
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1. Highlights

The core of card processing—accounts receivables and payment processing—has remained unchanged over the years. However, the need for ancillary services, such as fraud management, loyalty management, product pricing, and regulatory compliance has significantly. These changes are forcing issuers to examine their ability to offer these services efficiently.

A wave of mergers and acquisitions in both the issuer and the processing industry over the past two decades has changed the card industry landscape. Consolidation among issuers has led to the formation of megabanks and a move towards in-house processing. On the other hand consolidation within the processing industry has had the opposite effect and has allowed smaller issuers to capitalize on the scale benefits of outsourcing to third party processors.

With the evolution of the third party processing business, issuers are still in the process of determining which operating model best suits their internal competencies and overall sourcing strategy.



2. Introduction

Over the years, the card industry has become one of the most important non-cash payment channels, and its ability to replace cash transactions as a medium of exchange is unparalleled. Among the things that have made cards such a success is their ease of use and convenience. Banks have played a vital role in the evolution of the card industry (both as issuers and acquirers) along with other stakeholders in the value chain, including processors and card associations such as MasterCard® and Visa®.

Issuers typically act as the point of contact with cardholders and address any card-related problems related to usage, billing, lost card reporting etc. While there are several tasks that issuers must perform in their day-to-day business, it is the core tasks of payment processing and accounts receivables that have remained unchanged over the years. However, with rising competition, risks, and new regulations, the task of issuers has become more complex. They now have to take care of several other aspects of business such as loyalty incentives, fraud management, regulatory compliance, and adherence to risk management policies.

The card industry, both issuers and processors, has witnessed a massive amount of consolidation over the past two decades. Banking industry consolidation has led to the formation of megabanks such as Bank of America, Citigroup, and J.P. Morgan Chase. Consolidation within the cards processing industry has led to formation of processing giants such as First Data and TSYS.

Bigger banks generally have the resources to keep their processing operations in-house rather than outsourcing them to third party processors (TPPs). On the other hand small and medium-sized issuers mostly lack the scale and capabilities to process their card operations in-house and turn to TPPs to help them overcome these shortcomings.

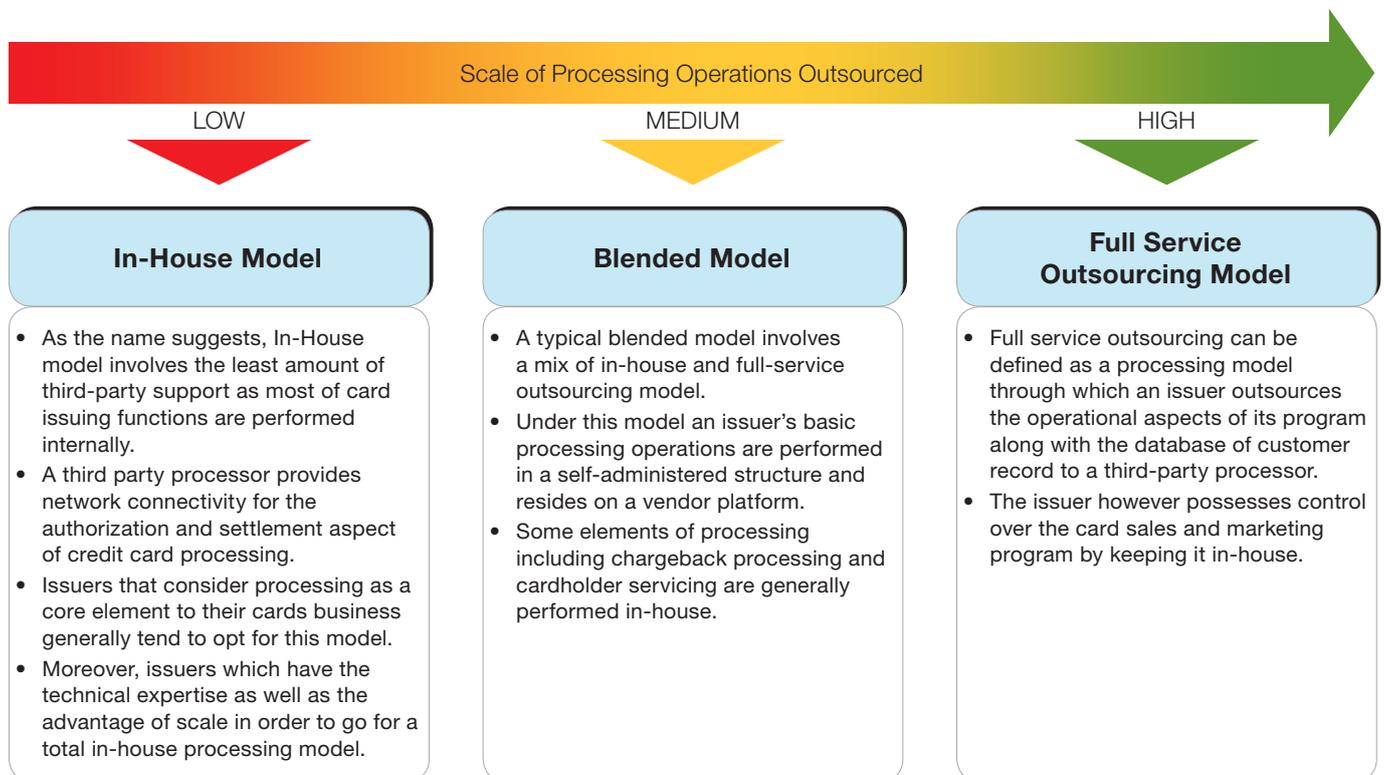
Issuers should consider the size of their card operations, level of in-house maturity, cost of processing per transaction, and the overall outsourcing strategy when considering the right outsourcing model.

The Issuer-Processor Relationship

Third party processors play an important role in driving efficiencies within the card industry. By providing a low-cost option and offering a plethora of value-added services for issuers such as increased fraud protection and business intelligence, third party processors help most small and mid-sized banks compete with their larger counterparts more effectively.

Issuers can outsource specific functions or complete processing operations, depending on various internal and external factors. The size of their card operations, level of in-house maturity, cost of processing per transaction, and the overall outsourcing strategy are some of the primary factors to be considered before deciding on the right outsourcing model. Depending on the level of involvement that the issuers have with their processing partners, the issuer-processing model can be broadly categorized into three classes: (a) in-house model, (b) blended model, and (c) full service outsourcing model.

Exhibit 1: Outsourcing Models Based on Issuer-Processor Involvement



Source: Capgemini Analysis, 2012

3. Industry Consolidation

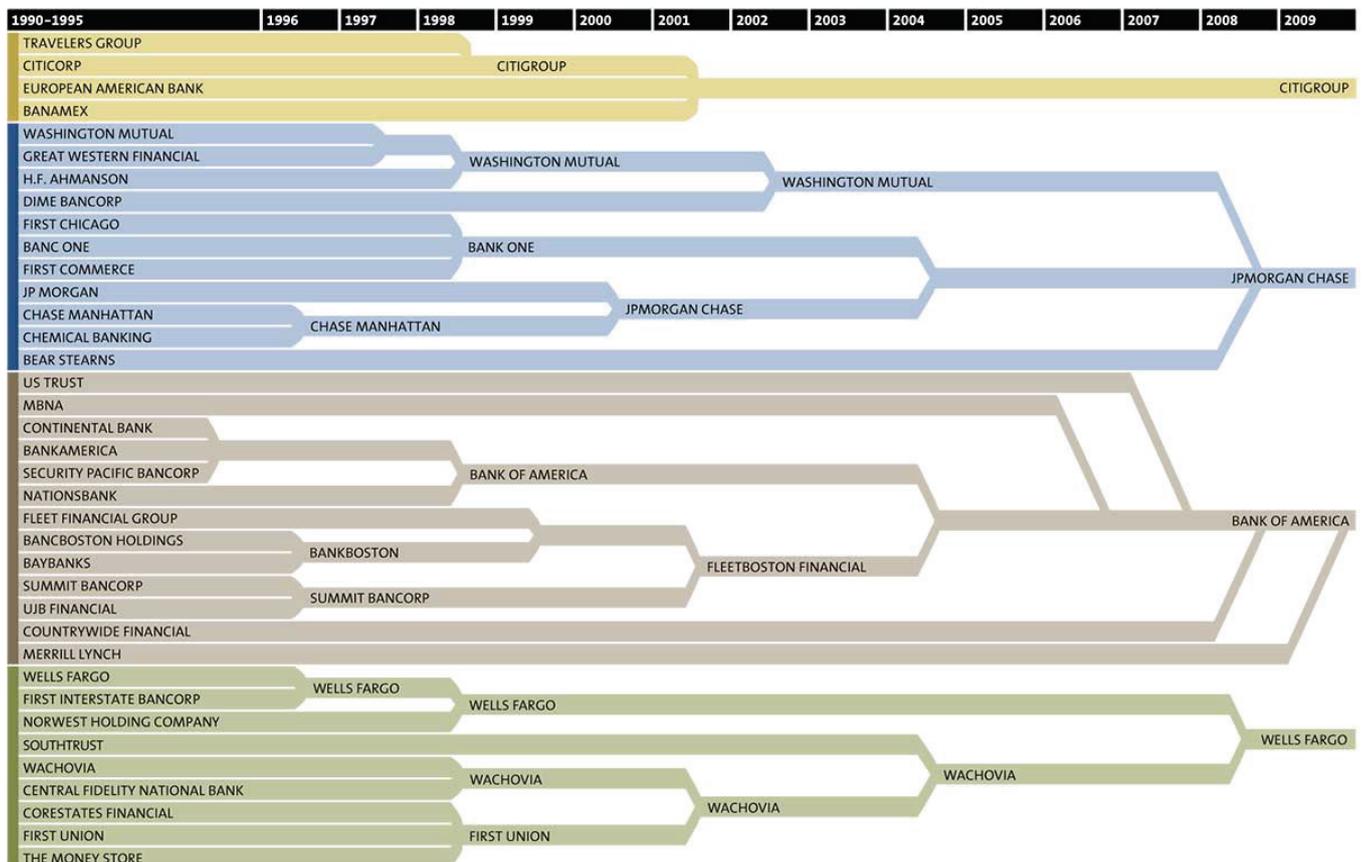
3.1. Banking Industry Consolidation and Its Impact on the Sourcing Decision

According to First Data, large issuers are moving processing functions in-house to take control of their destiny.

The global banking industry consolidation of the past two decades has been most prominent in the advanced economies of Europe and the U.S. Several factors have contributed to this trend, including the failure of smaller and more vulnerable banks in a difficult market environment, and mergers and acquisition by industry leaders to gain market share and enter newer markets.

The large-scale consolidation in the banking industry has resulted in a completely different competitive landscape compared to a few years ago. A case in point is the banking industry in the U.S., where a series of mergers and acquisitions have led to the formation of megabanks such as Citigroup, J.P. Morgan, Bank of America, and Wells Fargo.

Exhibit 2: Consolidation in the U.S. Banking Industry, 1990–2009



The situation has been no different in Europe. Increasing globalization of the financial services industry and regulatory changes (including the introduction of the Euro) have led to banking industry consolidation and the formation of megabanks in Europe. Approximately 120 domestic and 31 cross-border mergers and acquisitions transactions involving banking institutions took place between 1994 and 2000 alone, signifying the impact of the introduction of the Euro on the banking industry. ¹Some of the megabanks include BNP Paribas (France), RBS (U.K.), and UniCredit (Italy). The widespread consolidation in the banking industry and formation of megabanks in the U.S and Europe has led to banks attaining significant size in their card issuance business. The economies of scale of the card business have changed the way banks conduct their card processing operations. One important and noticeable trend has been a shift toward in-house cards processing by megabanks.

According to a Barclays study conducted in 2007, just one out of the top ten global banks ranked by assets outsourced² their card processing operations. In contrast, around 58% of banks ranked between 100 and 150 by assets had outsourced their card operations to third party processors³. The situation is likely to have remained similar since then as size has been one of the most important factors for banks in deciding whether to outsource their card processing operations or keep them in-house. By 2009, certain large card issuers including J.P. Morgan, Standard Chartered, Citibank and GE Cards opted to move their processing operations back in-house for greater control. Smaller banks have kept their options open for outsourcing due to cost constraints.

It can be inferred that with increased business volumes, the outsourcing of card processing operations has become less compelling to most large banks. Additionally, processing of card operations in-house provides banks with the increased ability to provide customized cash management products for their customers.

Size however is not the only factor in favor of in-house processing. Processing cards in-house also provides issuers with other inherent benefits including detailed access to their customers' transaction data, which provides them with valuable information about spending habits. Additionally, for banks that consider cards to be part of their overall business strategy, it provides them opportunities to cross-sell other products and services more effectively.

¹ Thomson Financial Securities, M&A database, Rym Ayadi and Georges Pujals: Banking mergers and acquisitions in the EU: Overview, assessment, and prospects, SUERF – The European Money and Finance Forum, Vienna 2005

² Outsourcing here refers to having outsourced at least some part of their main card operations

³ "Card Programs: In-Source or Outsource?" Barclays, 2007

Exhibit 3: Top Ten U.S. Card Issuers and Their Primary Cards Processing Platform (2004 vs. 2008)

Card Issuers	2004	2008	Primary Platform	2007 Transaction Volume (\$bn)
American Express	In House	In House	Proprietary	\$446.92
JP Morgan Chase	TSYS	In House	TS2	\$361.76
Bank of America	TSYS	In House	Proprietary	\$339.71
Citigroup	In House	In House	Proprietary	\$271.05
Capital One	In House	TSYS	TS2	\$125.35
Discover	In House	In House	Proprietary	\$106.62
US Bank	In House	In House	Proprietary	\$70.45
Wells Fargo	FDC	FDC	FDC	\$50.34
HSBC	In House	In House	VisionPlus	\$48.60
GE Money	In House	In House	Proprietary	\$28.18

Source: Capgemini Analysis, 2012; Nilson Reports, January 2008

The trend of banks moving their card processing in-house was apparent prior to the global financial crisis. J.P. Morgan Chase and Bank of America serve as perfect examples of megabanks highlighting this trend. The increasingly difficult operating environment since the financial crisis is expected to slow this trend for larger banks and likely reverse it for smaller banks. The current drive towards cost-efficiency, increasing regulatory scrutiny, and developments in the processing industry such as new variable pricing-based models are likely to reshape the card processing business in the near future.

3.2. Processing Industry Consolidation and Its Impact on the Sourcing Decision

While the banking industry was going through a massive consolidation phase over the past few years, a wave of mergers and acquisitions was also taking place in the card processing world. The reason was straightforward: to attain economies of scale due to the increasingly commoditized nature of the business. With all processors having more or less the same product/service to offer for issuers/acquirers, the competition has been focused on pricing. This has led to an acceleration of the merger and acquisition trend by large processors to reduce the processing cost per transaction.

Consolidation in the processing industry has led to the formation of processing giants such as First Data, TSYS, Fiserv, and Fidelity National Information Services (FIS). One of the most recent big ticket acquisitions in the processing industry was the acquisition of Metavante Technologies by FIS in October 2009 in a deal valued at \$2.94 billion in stock.

Due to their existing relationships with a large number of issuers, processors can implement any new modifications or fine-tuning to their platforms in quite a cost efficient manner.

4. The Evolving Issuer-Processor Relationship

4.1. Challenges Faced by Issuers in the Current Environment

The card industry has evolved due to the innovation-driven nature of the business, regulatory headwinds, and a subdued global economic environment. This has presented several challenges to issuers as illustrated in the following diagram.

Exhibit 4: Challenges Faced By Issuers in Current Environment, 2012



Source: Capgemini Analysis, 2012

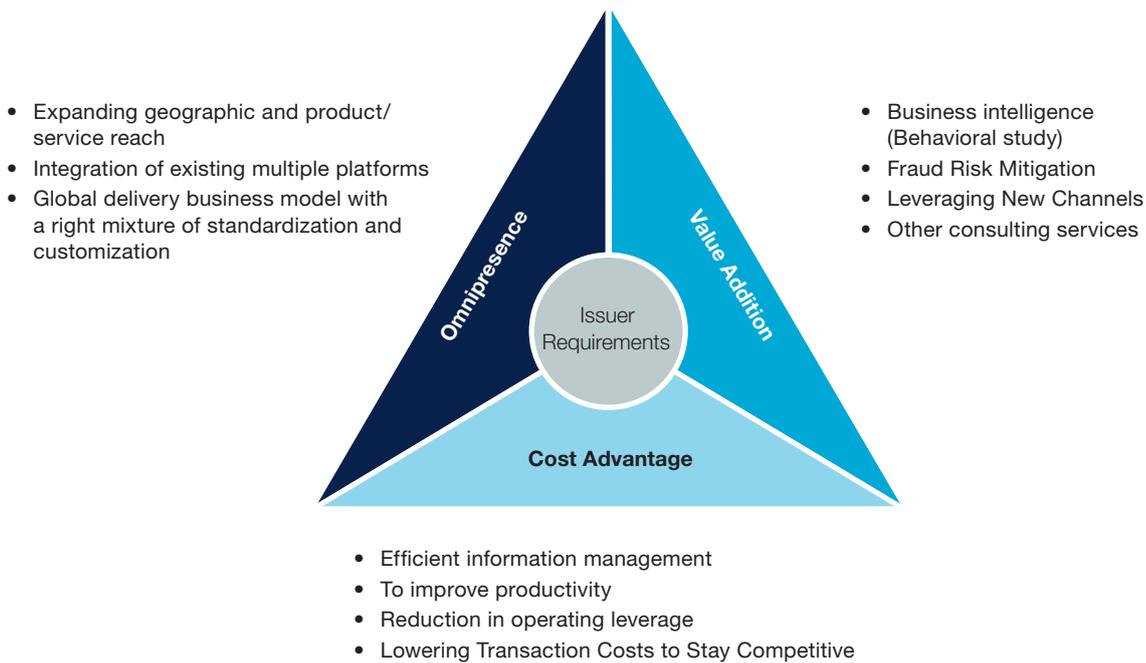
Common challenges faced by issuers include increasing complexity of regulations, data privacy and fraud risks, competition, changing spending patterns, and evolving marketing channels.

- **Increasing Complexity of Regulations.** Since the financial crisis, banks now face increasingly complex regulations aimed at protecting consumers. Compliance with these new regulations is a challenge in carrying out their day to day operations.
- **Data Privacy and Fraud Risks.** The risks to data privacy and rising incidents of card fraud are a serious challenge to issuers. They need to have sufficient risk mitigation solutions in place to avoid data theft and leakage.
- **Competition.** Issuers face competition not just from other banks and credit unions issuing cards, but also from evolving technologies such as mobile payments.
- **Changing Spending Patterns.** Customers have shown an increasing preference for prepaid and debit cards, which are less profitable for issuers than credit cards.
- **Evolving Marketing Channels.** Social media and mobile payments are now being looked on as important platforms to attract new customers and build loyalty with existing customers.

4.2. Reasons to Outsource Processing Operations

Third party processors (TPPs) can offer effective solutions to the challenges listed above. Additionally, they can offer several value-added services that are likely to make outsourcing attractive for issuers.

Exhibit 5: Issuer Requirements in Current Environment, 2012



Source: Capgemini Analysis, 2012

How TPPs Can Help Issuers That Are Looking For Omnipresence

As issuers seek omnipresence by expanding their geographic and product/service portfolio, they face certain inherent challenges. Banks that are looking to drive card usage in new markets look for TPPs with ATM/POS networks in place in specific targeted markets. Issuers will want to track customer behavior and provide customized product/service offerings, including new functionalities such as prepaid and mobile cards. Issuers that face challenges in addressing these growth markets are likely to resort to TPPs in the near future.

Some banks that have been left with multiple legacy platforms as a result of consolidations and mergers, are now contemplating replacing them. Technological advances and new functionalities offered by modern systems have significantly increased the potential benefits of replacing legacy systems rather than investing in a combination of quick fixes and homegrown workarounds.

The benefits outweigh the costs and risks involved in platform replacement, which makes a strong case in favor of a system upgrade. In such cases firms that do not want a huge capital expenditure on system upgrades are likely to benefit by partnering with TPP services.

As banks grow their business in foreign markets they also need to build a capability to manage multiple geographies. In order to build a global business model, issuers rely on standardization to simplify their product features. To achieve this standardization, issuers need to fine tune their products and services in order to comply with regulatory requirements across regions. Certain newly entered geographies may have different cost structures due to the price-sensitive nature of these markets. To cater to these variations, issuers need to have a flexible cost service delivery, which helps them to have varied cost structures for their global operations. Newly-entered markets also need time to gain scale, so processing operations in-house might be a challenge. This is where TPPs can offer cost-effective solutions.

How TPPs Can Help Issuers That Are Seeking Value-Added Services

Issuers can help maximize revenue potential by institutionalizing the way they capture, store, and use client data. TPPs can provide expert business intelligence solutions aimed towards enriching the customer experience, increasing customer loyalty, and enhancing cross-selling opportunities.

A rise in data breach incidents in the payment card industry has resulted in a required, heightened level of protection in the way issuers store and use confidential customer data. Issuers should look for TPPs that follow best practices regarding data privacy regulations.

Internet and social media popularity has grown enormously over the past five years. Many issuers have yet to utilize them to their maximum potential. Social media for example provides a good platform for banks to interact with customers (existing and potential) and to monitor what their customers think of their products and services. Issuers should look for TPPs that value-added services involving social media.

How TPPs Can Provide Cost Advantages to Issuers

Smaller banks, which understand the needs of their customer groups and want to provide customized solutions can benefit by partnering with TPPs. Most TPPs have advanced systems which have multi-channel collection services that can enhance the issuer's agent productivity by reducing charge-offs. Also TPPs can improve the customer experience by providing them access to highly customized self-service payment options. TPPs can provide a fully-integrated, multi-channel customer interaction platform, which allows users to interact with the issuer through various channels including e-mail, phone, website, and text-messaging.

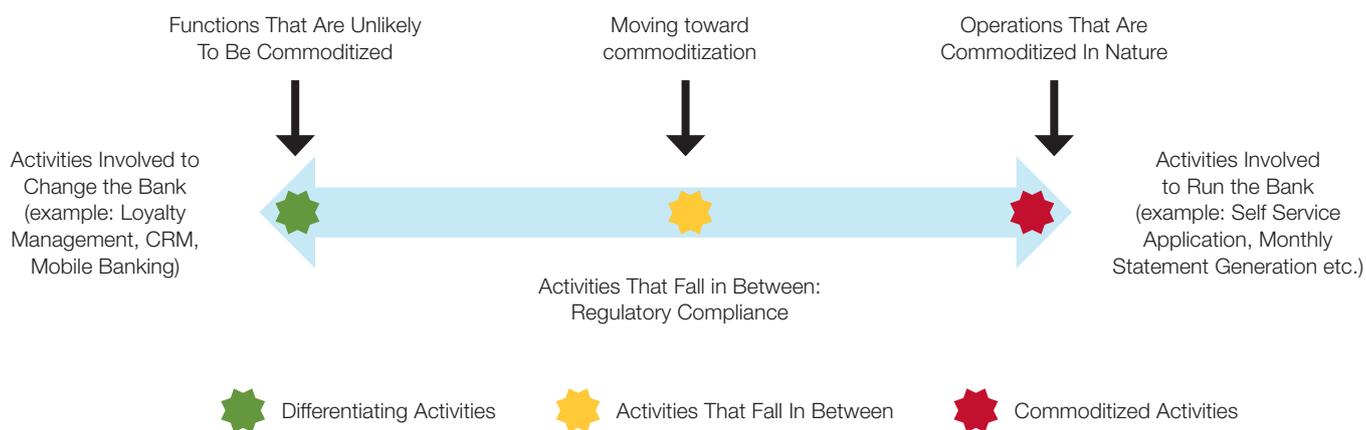
In general, changing consumer demands and regulations are requiring issuers to make significant upgrades to their technology platform, which could require a large capital expenditure. In the current uncertain economic environment, issuers can benefit from efficient alternatives in the form of TPPs. Issuers can transfer their fixed cost overheads to the TPPs under a pay-per-use model, and use the freed-up resources to address future business needs..

As processors have become larger due to mergers and acquisitions, they have gained the volume advantage to reduce costs per transaction. Banks who lack these economies of scale can partner with TPPs for cost-effective solutions.

5. The Way Forward for Issuers

Issuers contemplating using third party services to process their card operations have to take into account many different aspects. The best way forward for an issuer which has not previously outsourced any of its card processing operations is to outsource certain functions in the initial phase:

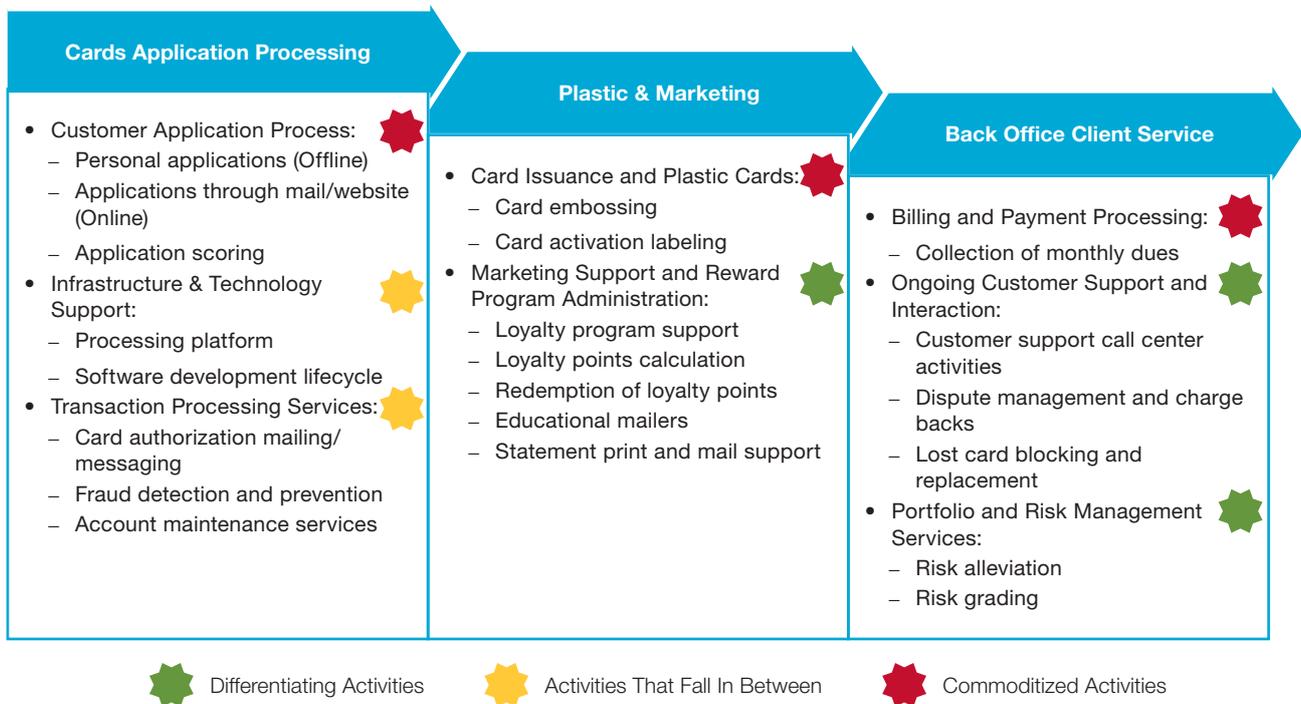
Exhibit 6: Business Operations and Outsourcing Decision



Source: Capgemini Analysis, 2012

Banks in general carry out activities on a regular basis which can be categorized as changing the way the bank operates (change the bank) or running their regular business (run the bank). Additionally, there are certain activities which naturally fall between these two categories. As most of the initiatives that are aimed at just taking care of the day-to-day initiatives (run the bank activities) are commoditized in nature, they are easy for issuers to outsource. As the issuer-processor relationship matures the issuer can begin to outsource more complex activities.

Exhibit 7: Primary Processing and Support Functions in a Card Issuing Business



Source: Capgemini Analysis, 2012

Factors that should be evaluated before making a final sourcing decision include:

- (a) cost of ownership and cost of transition,
- (b) flexibility offered by TPPs,
- (c) control features and functionalities,
- (d) in-house maturity,
- (e) staff inertia to outsourcing, and
- (f) firm's overall affinity towards a particular sourcing model.

The issuer's activities can be grouped into three broad categories: (a) cards application processing, (b) plastic & marketing, and (c) back office client services. Among these activities, handling the application process, issuing plastic cards and processing payments are the most commoditized in nature. As a result, these activities are likely to be the first activities that issuers look to outsource. Marketing support activities and program administration offer scope for differentiation and it makes sense to keep them in-house based on cost feasibility.

As issuers decide which functions to keep in-house and which to outsource, they need to analyze each activity from the perspective of their own capabilities and what the TPPs have to offer. Some of the primary factors that need to be evaluated before making a final sourcing decision include (a) cost of ownership and cost of transition, (b) flexibility offered by TPPs, (c) control features and functionalities, (d) in-house maturity, (e) staff inertia to outsourcing, and (f) firm's overall affinity towards a particular sourcing model.

6. Conclusion

The period prior to the global financial crisis has seen most large issuers keeping their processing operations in-house. By keeping their processing in-house, issuers are more in control of their destiny and have increased opportunities for cross-selling. However, with a slowing down of big-ticket mergers and acquisitions in the banking industry today, it is unlikely that we will see the same shift towards in-house processing as seen in the past. Developments on the processing side have made TPPs more cost-efficient and enabled them to offer value-added services, which will help reverse the trend towards keeping processing in-house.

Small and medium-sized banks are expected to outsource cards processing due to the cost advantages and improvement in business intelligence and fraud management. Even large issuers who have moved their processing operations in-house in the past may opt to outsource specific functions to TPPs. Fraud detection is one such area where a large issuer may be better off partnering with TPPs.

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