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Data Processors, Forced to Reevaluate Pricing Strategies?

Product development among vendors of information technology outsourcing for financial institutions typically has been limited to feature/function creation and enhancement and to pricing based upon delivery cost structure. This limited view of product development has been supported by a traditionally stable customer base and minimal risk experience. Coming, dramatic changes in contract term (*i.e.*, length) and risk exposure will alter the landscape.

Product Change

For many years vendors have valued each data processing customer relationship on the basis of a guaranteed revenue stream over an extended term and the minimal incremental cost of adding an additional customer to the already existing base. As a "specialist" the vendor promised to do it better, faster and cheaper. This valuation methodology, plus limited risk exposure, made the "cheaper" part of the outsourcing equation possible, even with the "better" and "faster" requirements.

Financial institutions and data processors committed to long-term outsourcing relationships that ranged from five to seven years; some even ran for ten-year terms. Now many, if not most, of those "committed relationships" have terms no longer than five years, and some are as short (or long, depending upon your point of view) as three years. Even renewal terms in current agreements are narrowing. They had often been the same as the initial term; now many are for a single year.

... contracts need to be flexible, and therefore, should not be long-term (over five years). It is difficult to foresee and contract for every possible contingency that may arise. Also, business needs change or the market may evolve in unexpected directions. For these reasons, OTS

discourages long-term contracts. Shorter contracts may provide more flexibility to meet the challenges of a changing environment. (emphasis added)¹

OTS's *TB-82a* (and similar regulatory releases by other Federal bank regulators) has placed further restraints on the standing tradition of longer-term third party arrangements. OTS examiners and supervision staff apply *TB-82a*, which purports to be "guidance" and to offer "important things to consider when contracting with third parties," to require contract provisions in addition to term limitations that even further narrow the contract term.²

Further, in the past, when a financial institution outsourced its data processing, the vendor has figuratively (and even literally in the case of a facilities management arrangement) lifted the software, hardware and people out of the bank's hands into its own. But, by charging only a "buck" an account for core processing or "pennies" for each processed item, the vendor could only accept responsibility to perform the functions previously performed within the bank. The vendor must leave the risk where it had always been, with the bank.³

This has not been a necessarily conscious business decision, but rather one occasioned by vendor's legal counsel; and financial institutions have not, at least until recently, vigorously negotiated the point. Data processors have accomplished this "static risk" result by including in the outsourcing agreement a number of qualitative and quantitative limitations on their liability for performance failure. For example, recovery from the vendor by the financial institution for "special" damages such as lost profits or loss of reputation has been excluded, and the vendor has imposed a dollar cap (usually an amount that is a function of contract revenues) on claims by the financial institution.

Term of Agreements

Long-term customer/vendor relationships have, in the past, had a great deal to do with a data processor's pricing. Incremental investment to maintain a relationship declines over time and has inured to the benefit of both financial institution and vendor. In what has been, at least in the early years of a contract, a very low margin business, term has meant almost everything to

¹ OFFICE OF THRIFT SUPERVISION, THRIFT BULLETIN 82, THIRD PARTY ARRANGEMENTS (2003) 15 (hereinafter TB82) available at <http://www.ots.treas.gov/docs/8/84261.pdf>. TB82 echoed, and somewhat mandated (at least for the thrifts that OTS regulated), a change – the shortening of contract terms – that had already begun taking place in outsourcing by U.S. financial institutions of back office business processes. OFFICE OF THRIFT SUPERVISION, THRIFT BULLETIN 82A, THIRD PARTY ARRANGEMENTS (2004) 15 (hereinafter TB82A) available at <http://www.ots.treas.gov/docs/8/84272.pdf>, the current bulletin, renews the mandate.

² The OTS and bank regulators generally are enforcing not only the term limits, but also other requirements that effectively limit the length of contracts. For example, the OTS says: "You should include a termination provision for any third party arrangement when OTS requires termination, such as when your association becomes troubled or in the event the OTS formally objects to the arrangement. The termination provision should be effective upon reasonable notice and without penalty." TB82A, at 13. And, the FDIC carries forward this theme by suggesting: "Contracts with foreign-based service providers should also include a provision that enables the financial institution to terminate the contract in the event that a U.S. regulator formally objects to the particular third-party arrangement." Fed. Deposit Ins. Corp., OFFSHORE OUTSOURCING OF DATA SERVICES BY INSURED INSTITUTIONS AND ASSOCIATED CONSUMER PRIVACY RISKS (2004) 15 www.fdic.gov/regulations/examinations/offshore/offshore_outsourcing [hereafter OFFSHORE OUTSOURCING].

³ A dollar is merely representative of a broad range of per account prices that exist for core processing, like the "pennies" per item pricing. In any event, none of these includes risk assumption.

the vendor.⁴ In fact, investors have often valued the data processing enterprise based on contractual revenues without much regard for the legally enforceable life of such revenues.

Two factors will almost certainly modify that practice: First, narrowing contract terms (*i.e.*, their shortening) will force a much harder look at the sustainability of contractual revenues. Second, because “business needs change or the market may evolve in unexpected directions,”⁵ financial institutions will be less reluctant to change processing applications. And, browser-based teller and platform systems will render re-training less costly and more palatable.

Vendors have often provided for a termination at the customer’s convenience, but with substantial agreed upon exit payment. The long-time favorite is a liquidated damages calculation that allows a customer to terminate its data processing agreement upon payment of 80% of the remaining value of the contract. Many vendors start lower (some as low as 40%); most will negotiate to 60%. But, in any event, such substantial and previously agreed upon damages further underscore the value to the vendor of its sustainable revenue stream.

Shorter terms now pressure vendors, who have not previously offered term-tiered pricing. (Product concessions, rather than tiered pricing, have been the norm.) Shorter terms now operate to reduce the value of even the higher percentage liquidated damages clauses. And, the regulators’ requirements that in certain supervisory situations the termination must be “without penalty” further depress data processor enterprise value.

Risk Limitations

Just like contract term, challenges to relax

OFFSHORING REVISITED GE CAPITAL “SPINS OFF” INDIA

In December 2004 GE Capital will reportedly follow several other major IT players in selling control of its India-based GECIS business process outsourcing unit to two equity firm partners. GE, a company not known for taking unacceptable risks, is implicitly challenging banking regulators’ risk evaluation of offshore outsourcing models.

The FDIC identifies the “captive direct” business process outsourcer – GECIS, under GE Capital control – as the least risky of outsourcing choices. GE Capital’s new “joint venture” model moves GECIS further along the FDIC’s risk continuum.

GE Capital, along with others like insurance giant Aon, is seeking the economic advantages of shared-services. And, by separating themselves from these offshore units, their parents are buying protection from the added political risk in foreign-based outsourcing operations.

This move may not have much immediate effect on GE Capital because many of its financial services units are not regulated banking entities. But, others will watch to see if cutting the ties does in fact increase the risks. A positive experience could modify industry response to the risk analysis scheme that bank regulators have advanced.

The previous client newsletter about offshoring titled “Offshore Outsourcing – An Inevitability” is available at <http://www.carpenterlaw.net/images/Offshore Outsourcing Nov. 2004 2007.pdf>.

⁴ True, qualitative and quantitative legal liability limitations have been there, too. But, they have only become important when a problem arises. These legal liability limitations have more recently become the most negotiated and compromised provisions in data processing agreements. Many vendors rely on the “law of large numbers,” rather than these limitations, to provide risk limits. As the number and kinds of risks increase (*e.g.*, with respect to customer data privacy and security), this reliance will no doubt prove unfounded.

⁵ TB82A, at 15.

risk limitations pressure vendors and will force them to reexamine pricing and to introduce some kind of risk-based regime. The most negotiated risk limitations in information technology outsourcing agreements are the quantitative cap on damages and the qualitative prohibition for damages other than actual monetary losses (*i.e.*, incidental, consequential, special or punitive damages).

Often, a financial institution asks for a damages cap that exceeds what it will have paid for the particular services that have resulted in a claim. Such exposure to a vendor exceeds the typical limit of liability for a seller of goods and services—that is, the purchase price. Allowing for special damages above and beyond actual damages, particularly with regard to data security and privacy, could subject a vendor to business crippling liability.

Both vendors and financial institutions must carefully evaluate any new regime for risk apportionment. Further, both must evaluate the role that the insurance of each should play in that risk apportionment.

Revised Pricing

Financial institutions expect “better,” “faster” and “cheaper,” and the attorneys representing them are persuading their clients that vendors should assume all risks for the business processes that vendors perform and that maximum flexibility in technology agreements is necessary. Data processors have never before explicitly priced such risk shifting and flexibility.

And, as legal counsel more clearly articulate to their data processor clients, and convince them of, what such risks could mean in a “meltdown” scenario, data processors will be forced to factor the risk element into their pricing. Regulators, as well as the shortening “shelf-life” of technology, will result in less certainty with respect to sustainable contractual revenues and will cause re-pricing in yet another dimension.

In short, data processors and financial institutions must rethink pricing for outsourcing. Data processors must better understand their costs and their profits. Data processors will be forced into carefully structured pricing arrangements that reward term and assured contractual revenue and that include a balanced risk/reward component.

Financial institutions must expect that new contract terms mandated by regulators – part of the so-called “regulatory burden” – and the changing outsourcing landscape will affect pricing. And, they must react as rational consumers to the value proposition that they seek from their vendors.

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