

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & Scott McCallum
DATE: August 31, 2017
SUBJECT: **Community Bank Vendor Contracts—*Do Something Now Before It's Too Late!***

We try to keep these E-Memos to 1,000 words. This time around, we gathered such great insights from others in our research, that we needed to exceed our self-imposed limitation by 313 words. We hope you enjoy it!

As directors of community banks, we've been involved in four bank mergers in the past three years. We know that as part of the acquirers' acquisition customary due diligence procedures, vendor contracts were carefully reviewed to determine what if any impact those contracts would have on pro forma profitability of the acquisition. While we know that this scrutiny took place, we are not aware of any explicit pricing adjustments resulted, although they may have served to constrain total consideration paid.

We also know as directors that vendors and their contracts are subject to written bank policy about which we as directors are expected to be knowledgeable and to approve. We don't recall, for example, the vendor policy requiring the review of legal counsel. That's not surprising because when drafting vendor policy, the review by legal counsel (most likely outside counsel) can be viewed as too expensive (as the thinking goes) for a contract that the vendor has said is "standard," inferring that many other banks have signed ones like it. We also note that "contract negotiations" are referenced in our April E-Memo entitled "Is in-house counsel a solution for some of your bank's challenges?" as a reason to employ an attorney (either in-house or outside counsel).

Of all the vendor contracts banks execute, the core processing contract, one of several today's community bank is likely to enter into, is probably the single highest cost and value to the bank and yet, the likelihood of legal review and the review of a bank technology consultant is somewhere between slim and none.

One bank consultant we've talked with, **Ed Depenbrok** of the **dbrok group, llc, Brookfield, Wisconsin**, a community banking consulting firm whose advisers each have a least 25 years of direct experience in financial services, points out that the bank core processing system industry has consolidated into an oligopoly (and, we infer, has adopted oligopoly pricing and terms). The big three vendors have master core processing contracts with just about all the banks not owning their own proprietary processing software. The result is that contracts are extremely long in term (not to mention verbiage) restricting bank's flexibility to deal with changing technology and industry products thereby creating a potentially high "breakage" cost in M&A transactions.

In addition to restricting flexibility, accepting the core processing contract as "standard" because it sets forth the services being offered and to be performed, to and for other banks, ignores the fact that the contract is written by the vendor to protect the vendor by minimizing its risk if your bank does not complete the contract term or if the vendor does not perform or if new regulations are passed. The foregoing view is from **Steve Heckard, Senior Consultant, ProBank Austin, Toledo, Ohio & Louisville, Kentucky**, a consulting firm in financial management, strategy and technology, and investment banker to financial institutions, from his *From the Experts* post on August 15, 2017, entitled "Lawyers and Money".

In our discussions with Ed Depenbrok, he asks whether the length in contract term restricts flexibility in dealing with changes in technology and:

- Are the oligopoly players sufficiently innovative to provide small to medium sized community banks with tools and products that will allow community bankers to effectively compete with large banks?
- How do small banks gain enough knowledge to negotiate contracts or deal with issues with vendors?
- Will there be a "disrupter" [that] will change the landscape of the industry with API – Application Programming Interface – a systems integration device—with a particular technology or component making the "big three" irrelevant overnight?

Innovation. Our experience tells us that a larger organization tends to be less likely to promote innovation within its organization. Rather, as a matter of past practice, it watches other companies competing in bank technology. When it finds one that has a good product, has demonstrated success in marketing that product to banks, and banks successfully adopted the product to benefit their customers or to improve operating efficiency, one of the oligopolies will acquire it, tuck it into their organization and then forget about it, not spending a nickel over time to improve it. For example, just 10 days ago, on August 21, Fiserv announced the acquisition of Dovetail Group Limited, a provider of bank payments and liquidity management products.

Gaining Knowledge to Negotiate. As bank investors (and bank directors) we expect a lot of our CEOs and CFOs including the ability to understand all the nuances in a 150-page master processing agreement with attachments covering such things as core processing, item handling, Electronic Funds Transfer (EFT), Internet banking, mobile banking and bill-pay, as Steve Heckard articulated in his *From the Experts* post on April 26, 2017, entitled “Contracts – It’s All About the Fine Print”. Years ago, when our typical community bank CEO or CFO were beginning their respective careers in banking, the typical master agreement was four to five pages long. Our experience in banking goes back at least 5 decades and yes, we recall those short agreements. Heckard went on to comment that while he is not a betting man, he bets that the majority of bank CEOs and CFOs have not read nor do they understand the core processing agreements they have entered in to.

As bank investors and bank directors, we should insist that our vendor policies require the review by an outside bank technology expert and by legal counsel familiar with bank technology contracts.

What about disruptive technology that will change the landscape of banking? How about Application Programming Interface which is basically a program integrator. Bank technology vendors will tell banks that they all “integrate”, but at what cost? One thing bank technology vendors will never tell you is “no, we don’t integrate with [fill in the blank other vendor’s solution]”. While there may be a robust, full-featured integration between one vendors core platform and your favorite Internet banking solution, bankers are going to need to confirm this with calls and/or on site visits with that vendor’s reference customer(s). Don’t be afraid to ask the question “how many of your customers have this same integration” and demand the response in writing. As always be wary of smaller vendors and newer solutions. Banking vendors need to have and maintain rich application programming interfaces, the aspect of their software that allows it to talk with other software—without “knowing” each other or being connected.

Jim Savage, founder and CEO of Concurrency, Inc.; Brookfield, Wisconsin, a Microsoft National Solution Provider, weighed in with some additional advice to bank CEOs and CFOs.

- **Get multiple proposals:** give yourself a healthy point of reference and let the vendors feel the inherent competition in their market. There is plenty of inertia within each of the major vendors to get your deal done; to them more revenue is still more revenue. It can be quite advantageous to leverage all your organization’s services as you consider vendors. To that end make sure contracts for all services end up coterminous.
- **Give yourself enough time:** the vendor agreements are not 5 pages anymore and banking is not just deposits, general ledger and lending anymore. Make sure that you have enough time to understand their product distinctions.
- **Include vendors outside the Big 3:** While the Big 3 typically have the most complete offerings they also commonly have higher prices. Carefully consider your organization’s current (and future) product and underlying technology requirements.
- **Take your future into account:** With M&A even more relevant these days, you need to carefully consider all potentialities of your business and ensure they are accommodated within your final agreement.

All of this leads us to ask you to comment on the practical aspects of bank technology, vendor management and your view of the use of third party legal and technology experts to help community banks navigate what we view as particularly tricky waters of community banking's new frontier.

Please let us know what you think!

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