WHITE PAPER

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Level the Playing Field When Negotiating Long-Term Vendor Contracts

When financial institutions partner with outside parties to provide mission-critical services, they are making long-term commitments. Some less industry-specific relationships (landscaping and janitorial, for instance) may be short-term and easily swapped out. However, for solutions connected to institutions' financial mission, particularly those directly touching the customer, the stakes are far higher.

These vendor contract decisions can have long-lasting effects on a bank or credit union's market image for quality service and innovation. They are typically negotiated for terms of between three to five years, though some critical systems such as core processing, may feature agreements with terms that stretch out to seven or more years. This means that decisions associated with these contracts, such as choice of vendor, type of pricing model and service levels, will have impacts on the institution and the individuals within it who are responsible for handling negotiations well into the future.

The vendors who provide the services covered by these contracts have certain advantages over the banks and credit unions during negotiations. e

9.15%

is the average impact to bottom-line performance that results from weaknesses in contract management.

Source: IACCM Value of Contract Management Survey 2013

IT'S THE VENDOR'S CONTRACT

Most commonly, the vendor contract under consideration is written by the vendor's business and legal teams. The person or persons in the negotiation most likely understand the purpose of every clause and can negotiate the complexity inherent in such an agreement. No matter how often the financial institution has negotiated similar contracts, the vendor maintains the advantage of knowing how the contract has evolved and what in its current state has been revised.

VENDORS NEGOTIATE CONTRACTS FOR A LIVING

Vendors earn their keep by successfully delivering the products and/or services a bank or credit union needs to serve customers and members. However, that cannot happen unless a contract is executed between a vendor and the financial institution. Therefore, vendors are very good at negotiating contracts because if they were not, they would not be in business.

In addition, many vendors negotiate literally hundreds of contracts a year. In other words, they have a lot of time to practice and hone their skills to determine what does and does not work when getting a contract closed. Usually, the person or people representing a bank or credit union in these type of negotiations do not have this level of experience. Most will not negotiate as many contracts in their careers as a vendor does in a month.

VENDORS KNOW INFORMATION IS POWER

Selling products and services that are central to an institution's ability to serve the public is not just about price. It also is about building a relationship between two parties that in the best case is based on trust. That's why, at the end of the day, it is in the vendor's best interest to make sure a financial institution feels that the multi-year contract they just signed is good for their bank or credit union.

Yet it is difficult to know precisely what you do not know, and often in the relationship between a financial institution and a vendor, the vendor does know things that the bank or credit union does not; e.g., how the deal the institution is getting compares with the deal that other similar banks and credit unions signed. A contract may seem to be a "win-win" when in reality there was money left on the table by the party that does not have the comparative knowledge needed to evaluate how their arrangement stacks up against those of their peers.

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This is not to say that vendors are trying to "trick" anyone but it is important to remember that it is the vendor's job to get the best deal for their company, too. Being able to benchmark the deal they are doing against others they have signed with financial institutions is invaluable to achieving this goal.

There are seven best practices that financial institutions can put into practice to help level the playing field when negotiating longer term contracts with vendors. Each should be incorporated into the processes banks and credit unions utilize around contract management.

1. MAKE IT THE PRIORITY

Many financial institutions approach vendor contract management as a side project. It's no secret that managers are stretched thin in the modern workplace; therefore, professionals asked to run these processes in their "spare time" are bound to struggle, particularly when it's an exercise they only find themselves addressing every few years. There are tales of harried inexperienced managers pressed for time simply handing a current invoice to vendors and asking, "Can you beat this price?" The vendor contract or contracts under consideration often represent multi-million dollar investments for a financial institution. The "part-time" approach most likely will end with a bank or credit union either sacrificing bottom line performance or their flexibility concerning the choices they will have later. Sometimes both.

Banks and credit unions above the $5-10 billion asset threshold are more likely to have a dedicated procurement department leading a structured Request for Proposal (RFP) process. Such a level of focus is certainly a step in the right direction; however, it only addresses a portion of the issue. Procurement/Vendor Contract Management professionals bring much-needed process expertise to the table, but they often are generalists, rather than specialists. This means that when the contract involves complicated areas such as payments, security or core processing, the knowledge necessary to evaluate options at the level required is missing. Even those leading, rapidly-evolving lines of business within banks and credit unions such as mobile banking may not be fully up to speed on industry dynamics. Even if a procurement professional can extract favorable pricing, not asking the right market-focused questions of a variety of vendors during contract negotiations constitutes a missed opportunity that may have longer-term implications.

2. UNDERSTAND THE HOW AND WHEN ASSOCIATED WITH CONTRACT RENEWAL

Many banks and credit unions are aware of this information, but, even so, certain details can slip through the cracks. Vendors, on the other hand, closely track these details, and a sales representative or account manager for the vendor certainly isn't going to bring them to the attention of a bank or credit union customer unless it serves his/her purpose. Pricing for technology services is on a general downward trend, with a few exceptions, so your provider is probably more than happy to let agreements continue under existing terms, which are in all likelihood above prevailing market rate. Bank and credit union vendor contracts typically require formal notice of the intent to terminate 90-180 days prior to expiration, and in some cases as long as a year. This requirement applies even when the intent is simply to renegotiate terms, not change vendors. Miss the deadline, and most agreements automatically renew for another twelve months.

Given the deceptively high number of agreements in place at any given bank or credit union spanning numerous functional areas, it's easy to see how the terms of a single contract can be overlooked. For banks and credit unions that rely on individuals to track the particulars rather than a structured, centralized vendor contract management process administered by a team of professionals with the necessary expertise, this risk is heightened. Sadly, there's no shortage of examples of relationships allowed to roll over under existing terms, while the expense gap relative to fair market value continues to widen.

3. KEEP IT PROFESSIONAL

Close communication is essential to a strong working relationship with vendors. Unfortunately, these same traits can become negatives during the vendor contract management cycle. Managers can develop personal relationships with their vendor counterparts, gradually coming to assume the account manager has the institution's best interest as their top priority. Some of these sales representatives and account managers may be former co-workers hired to work with vendors based on their area of expertise.

This creates the concept that because the vendor representative was in the banking industry, he/she knows what it is best for the bank or credit union and will do right by the institution. This is not necessarily true. The situation can even become more difficult to conduct properly if a vendor representative has family ties to board members or senior executives. While this doesn't necessarily imply wrongdoing, it certainly complicates the execution of an impartial process. Taking steps to put some distance between those evaluating the options under consideration and others within the institution is in the best interest of all parties.

4. TAKE A LOOK AROUND

Incumbents hold a significant advantage in any vendor contract renewal process. This is particularly true when renewing contracts given banks' and credit unions' aversion to conversions as it relates to potential customer impacts, resource commitments, fear of the unknown and a host of other possibilities. Nonetheless, if it's clear an institution is unwilling to entertain even the notion of a change, it will severely limit or, in some cases, eliminate any negotiating leverage it has. To prevent placing itself in this kind of position, a financial institution should establish a list of conditions that would make it worthwhile to move to a new provider.

This can be price, savings, revenue improvements, support levels or functionality. Naturally, the happier a bank or credit union is with its incumbent provider, the more incentives it will need to make the move to another provider. There is a key point to remember in all this: successful vendor contract negotiations do not have to end with a change in providers. The goal of approaching other vendors for pricing and terms can be about getting the best possible price from the incumbent. It is not unreasonable for financial institutions to realize an additional savings of 10-20 percent when they solicit bids, simply by neutralizing some of the advantages the incumbent has. Certainly, if the incumbent doesn't feel it necessary to prove what value the relationship with the institution has to them, then the likelihood of achieving this outcome is almost zero.

5. NEGOTIATE THE TERMS ASSOCIATED WITH A REPLACEMENT OF THE VENDOR

This is an often-overlooked factor, because when the contract negotiations are underway, a number of details having relevance in the nearer term are receiving all the focus. Since a replacement – or de-conversion – is an event most likely to occur years in the future, vendors tend to be willing to make concessions in this area. If/when a decision is made to change vendors, the de-conversion is the most painful and time consuming component of that exercise. It usually can't be accomplished without the incumbent's resources and cooperation. If you haven't negotiated those details upfront, you'll be at the vendor's mercy.

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A respectable vendor will handle the situation gracefully. Still smarting from their loss, however, some vendors may be willing to burn bridges in pursuit of one final payday. If the ground rules for a de-conversion are not established upfront, the provider being replaced may opt to charge punitive rates for IT resources, eroding a meaningful share of the projected savings to be realized from the decision to switch vendors. Even in cases where there is no vindictiveness in play, the outgoing vendor's resources may be constrained, and who could blame them for prioritizing the onboarding of new clients and the ongoing support of existing customers over a de-conversion unless there are specific agreements they have made that compel them to act otherwise. In addition, addressing these issues upfront not only avoids later contention, but also makes future threats to leave more credible by removing the barriers that would make acting on that threat feasible.

6. ACCOUNT FOR GROWTH

Even for banks and credit unions not presently on a significant growth curve, some early stage products (e.g., mobile banking) may be poised for significant volume increases. This factor can have implications that have an exponential effect on a financial institution by leading to unexpected costs and missed opportunities. Too often banks and credit unions simply assume – implicitly or explicitly – that volumes will remain static at present day levels. The key is to develop realistic usage projections and pricing tiers that generate logical results under a wide range of scenarios. Financial institutions should be sure to insert price breaks and/or bonuses for a progression of stretch goals.

It may feel good to create a volume incentive you can blow through in the first year, but it may also be a sign you've left money on the table – the equivalent of making Platinum frequent flier level but later discovering you could have had a shot at Diamond. On the other hand, be on guard against assuming too much growth, as can happen when newly launched products generate overheated expectations. Don't assume you'll quickly move into the lower-priced tiers and fail to negotiate down the entry-level pricing, where you may find yourself staying longer than expected. This is not a reflection of the product's value, but rather an acknowledgement of the unpredictability of adoption curves.

7. USE ALL THE TOOLS AVAILABLE FOR THE JOB AT HAND

The vendor contract negotiating process does not need to be adversarial. Many vendors actually appreciate a bank or credit union utilizing all the tools available to them, including bringing a high-quality resource management partner into the equation.

Utilizing such firms leads to a more efficient vendor contract negotiation process including clear feedback and a quicker progression to the decision stage. If there are areas of contention or hostility, the presence of a skilled, outside party as a facilitator can serve to isolate hard feelings and preserve the all-important working relationships. Of course, success is also dependent upon the skill set of the resource management partner.

We suggest that when considering a firm of this type, financial institutions ask these four questions at a minimum: Do they have a good working relationship with industry providers? How do they manage the vendor communication process? How do they quantify cost savings? Does the firm's revenue model align with the best interests of the bank or credit union? Of course, vendor selection ultimately lies with the financial institution. However, an expert partner can greatly clarify the decision criteria – guiding what questions to ask, separating salient points from marketing spin while also providing informal input on cultural fit and organizational factors.

A study conducted by the International Association of Contract and Commercial Management (IACCM) found that poor vendor contract processes cost companies as much as nine percent of their total revenues. Although this was a cross-industry study, there is little reason to believe the financial services sector fares any better or that the picture has improved since 2015.

The guidelines provided above will help banks and credit unions that are looking for ways to lessen the impact of poor processes and practices in this area. However, there are a host of other, more nuanced areas where there are opportunities to optimize the value of vendor contracts. Seeking the assistance of firms experienced in negotiating vendor contracts and experts in the subject matter related to the service under review – e.g., payments – will further aid institutions in unlocking hidden cost savings and revenue enhancements that deliver more value to their stakeholders.

SRM's 25 years of experience in contract negotiations provides financial institutions with the benchmarks and processes necessary to improve their bottom line. More than 700 banks and credit unions have received savings of more than $3 million for every $1 billion in asset size. In total, SRM has helped clients gain $2.2 billion in projects across business areas including cards, payments, core processing, and more. SRM's compensation is performance-based with the firm's fees dependent upon its clients' actual, measurable savings.

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