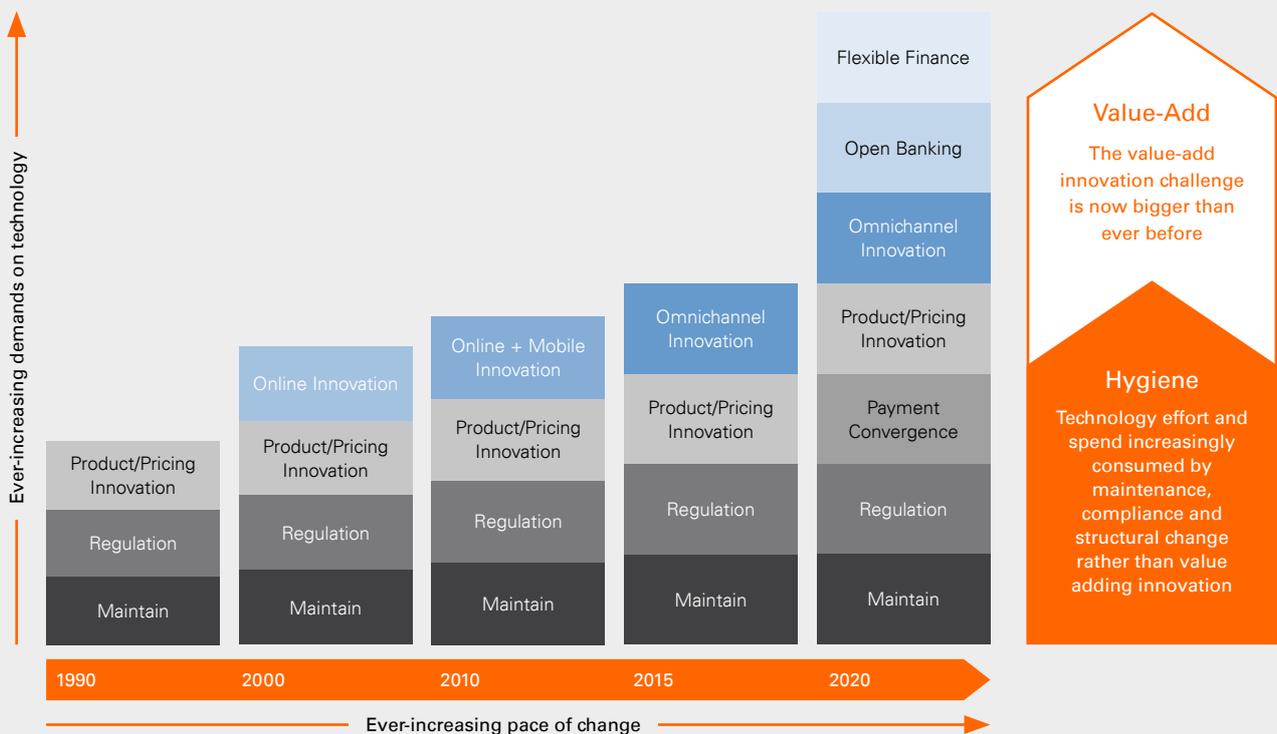


The Case for Payments as a Service (PaaS): Why Sticking With Legacy Technology Is No Longer an Option





Many banks are still operating using legacy technology dating from the days of product – rather than customer-centricity – which puts them at a large disadvantage to competitors that are unencumbered with this baggage. Barry Tarrant, Director – Product Solutions at Fiserv, examines how the additional costs and risks of this approach can be mitigated by a transition to Payments as a Service (PaaS), plus the strategic gains this can also deliver.



The demand on Financial Services technology has increased and the pace of change continues to accelerate creating an imbalance between maintain/comply versus innovate/value-add.

The banking industry is at a tipping point, having faced an onslaught of changes from multiple sources in recent years, including:

- Regulators
- Governments
- New and evolving technology, payment schemes and competitors
- Expanding customer needs and expectations

Fifty years ago, during the installation of much of the legacy technology upon which many still depend, banks had a relatively simple technological task. A modest amount of product innovation and some platform maintenance were all that were required. Issues such as remote servicing didn't exist, as everything was essentially branch-based.

Today, the demands on technology have multiplied, with seemingly endless change required across a growing and increasingly complex range of needs. This represents a major problem in relation to bank legacy technology, which was designed and implemented in the context of an almost static environment.

Whilst technology at most banks appears to have weathered the COVID-19 storm intact, it has surely highlighted the increasingly risky nature of

this approach. Perhaps the crisis has emphasised just how reliant some banks are on a few key personnel, and the risks this creates (even before the crisis, succession planning may have been a concern); maybe it has demonstrated the lack of depth in bench-strength and flexibility to deal with the consequences of a crisis of this nature.

COVID-19 has undoubtedly had an impact on earnings and future investment plans, and should serve to make those banks question their strategy again. Is their technology running as efficiently as it could be? As capital expenditure becomes constrained, just where should they be making that type of investment? Where could they more effectively change the model in order to reduce capital expenditure?

If nothing else, the crisis has served to drive a step change in how customers behave that will accelerate the need for more digital innovation, adding further to the demand on technology resources that are stretched to the limit.

After taking all of these factors and changes into account, it is apparent that persisting with and continuing to invest in legacy technology makes minimal financial sense in the current conditions, and is no longer a tenable strategy. The banking landscape over the next 5–10 years is likely to be defined by those that make the right decision at this pivotal moment.





The True Cost of Legacy Technology Today: Do or Demise

The challenge of maintaining legacy simply gets harder and riskier the more it evolves. Every expedient workaround for an immediate fix gives another hostage to fortune. As multiple layers of these accumulate, so too do the resulting operational risks. What makes this even more of a concern now is that innovation challenges and expectations have become far greater and exist on multiple simultaneous fronts. Today, there is the need for product innovation (for example, more dynamic and integrated flexible finance propositions), plus the need to deliver consistently across multiple channels (with COVID-19 exacerbating the situation as more customers have switched to digital). On top of this are structural changes, such as the convergence of payments.

Faced with this combination of imperatives, it is hard to fathom why some banks would still maintain their payments technology in-house. One possible reason is that they may not appreciate the true costs of this strategy, as they are so opaque. For instance, the common practice of apportioning IT costs outside the technology function to the business lines that use it obscures the total expense. Other reasons for invisible, unaccounted or understated legacy IT costs include:

- Failing to fully acknowledge capital costs
- Not factoring in missed opportunity costs
- Ignoring costs caused by regulatory or payment scheme compliance
- Failing to account for inevitable one-off costs that arise from time to time due to step changes in technology or infrastructure upgrades required to persist with legacy strategy

- Not recognising the incremental cost savings of leveraging shared payment innovation
- Overestimating the comparative costs of migrating to an alternative mechanism, such as PaaS

Adjusting for these factors can often reveal a very large top-level figure that would almost certainly exceed current cost assumptions. Furthermore, much of the 'investment' in legacy technology drives minimal added-value or growth. Industry estimates of real total legacy IT costs obviously vary, but some sources state that banks typically spend ~80 percent of their IT budgets on simply maintaining legacy technology, with a tier-one bank potentially spending up to USD300 Million a year on existing software. According to ECB Supervisory Board Member, Pentti Hakkarainen, the consequences of this approach are not positive: "Strategies that forego investment in innovation and instead focus on short-term fixes for legacy IT systems will cost banks dearly."²

The reasons underpinning this forthright view aren't hard to detect. Banks that persist with legacy infrastructure are expending large sums to just survive, rather than thrive. They are effectively running to stand still, which is no longer the case for all of their competitors. In the past, all banks were essentially playing on the same legacy field with similar issues, so competitive pressure to replace legacy technology was largely absent. That is no longer true in today's environment, where digital challenger banks and Fintechs can quickly spin up new operations in the cloud. This puts them in a strong position to erode traditional bank franchises slice by slice, such as first attacking the FX payments space and then going on to acquire a full banking licence. One challenger has already done this, while others are delivering simple invoice products that evolve into fully-fledged revolving credit accounts. All this topped with customer experiences that are transformational compared to the incumbents' capabilities.

¹fnlondon.com/articles/banks-face-spiraling-costs-from-archaic-it-20170912

²bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog200508~f6f8de4b66.en.html

As if all that wasn't enough, the industry is now on the crest of a wave that will demand a more fundamental structural change in payment processing technologies. As the options available for customers to initiate card and non-card payments multiply, this will drive a converse convergence of the technology that supports the processing of those payments.



Why PaaS?

The obvious alternative to these excess risks and costs is to outsource the payments activity currently run on legacy platforms to a PaaS provider with best-of-breed technology and a long-term commitment to enhancing that technology. The most obvious advantage here is cost reduction. Benchmarking exercises completed by Fiserv with a number of clients over the years consistently demonstrate that net savings of 30 percent to 50 percent are readily achievable. It's not difficult to understand why – a leading provider in this space will be making substantial economies of scale that it can share with client banks, as it may be running tens, if not hundreds, of millions of accounts on their collective behalf.

In addition to the very obvious operating expense benefits that will be realised, there are positive and very significant financial benefits that will be realised in terms of reduced capital expenses and the associated effects on balance sheet and free cash flow. It is essential that these are factored into any assessment of the business case to truly understand the true scale of the opportunity – and in the current situation this assumes even more importance as capital investment comes under even more scrutiny.

These economies provide an overall benefit that is greater than the sum of its parts. For instance, running a robust platform is a PaaS vendor's core business – whilst for a bank it is just one of the many things it has to invest in. Therefore, this encourages and enables a process of





continual reinvestment that ensures that the outsourcer's technology never stands still long enough to become legacy itself, while also facilitating recruitment of high-calibre personnel to support/advance it.

Geographical scale also plays an important part in such a provider's proposition and brings with it further benefits in terms of access to innovation. An outsourcer with clients around the world, sees and delivers innovation globally, which can be redeployed elsewhere rapidly and at a lower cost. Regions like APAC that are further ahead in the use of various mobile payment and servicing technologies, or LATAM which has advanced and complex instalment product capabilities provide tangible capability that can advance product proposition and customer experiences in other regions.

A global processing network can also serve as a global payments intelligence network in detecting trends, such as new payment types, or consumer payment behaviour, or cyberthreats. Any necessary innovation can then be quickly deployed globally at a far lower unit cost and timeframe than would be possible for a single bank.

This proposition would be compelling just in the context of bank legacy technology, but a further consideration is how payments have become increasingly commoditised in recent years. As traditional revenue streams from payments have declined, it makes even less financial sense to retain their processing in-house. By adopting PaaS and benefiting from the associated cost savings, retained payment margins can be maximised. At the same time, resources will be released that can be diverted to innovation and value-added activities, such as enhancing the customer experience and building the franchise. In short, outsourcing not only drives obvious cost-saving benefits, but also enables revenue growth by allowing more resources to be focused on value-generating activities which can be delivered more rapidly.



Debunking the Mythology

Despite the compelling business case for banks with legacy technology to adopt PaaS, some remain reluctant to do so because of various myths. One example is the erroneous belief that outsourcing data is inherently risky. The reality is, in fact, the complete reverse, because if a leading PaaS wishes to maintain its leadership status then investment in cybersecurity specialists and procedures to address such concerns will be central to its strategy – in short, it has the scale, resources and very strong incentive to make investment in these areas a priority. By contrast, keeping things in-house, where the bulk of available budget is being swallowed by legacy technology maintenance, actually runs a greater data security risk because of resource constraints.

Another myth is that upgrading legacy technology to a new in-house platform carries less risk than outsourcing. However, a number of recent high-profile and high-impact mishaps have clearly debunked this by underlining just how high-risk, in-house bank implementations of new technology really are.

Budgetary considerations aside, experience and specialist tools are also major points of difference here. A typical bank IT manager might experience perhaps two or three major transition projects in their entire career. Contrast this with the implementation team at a major outsourcer, which will typically be running multiple such projects so the collective transition experience of such a team may run to literally hundreds of years. In addition, because these projects are an everyday task for these teams, they will have also developed a whole range of specialised implementation adapters and toolkits that are continually enhanced and expanded. Replicating this level of experience and expertise within a single bank, on an ad-hoc basis, simply isn't financially feasible.



There is also the hypothesis that effort expended on an outsourcing transition could be better spent in-house, because stopping the existing legacy platform will cause a business hiatus. In practice, choosing a competent outsourcer will minimise the impact of any such pause to make it almost negligible and the subsequent business growth benefits of freeing up resources from legacy maintenance for value-add activities will massively outweigh this anyway.

Finally, the vendor motivations that drive a software sale, that would facilitate an in-house legacy upgrade, are completely different from the motivations that lie behind an outsourced solution business. This can make a very significant difference in their respective outcomes. For a software sale, the vendor's interest lies primarily in selling the software to the client, with the success of the buyer's project in utilising the software being largely inconsequential. For a credible outsourcer, the exact opposite applies, with revenue being almost entirely dependent upon successful implementation and migration of the business onto the target platform. The outsourcer will, therefore, be looking to minimise its time to revenue, thereby naturally aligning its objectives with those of its client. This is evidenced by high profile examples of failed bank software implementation projects, whilst the same is not true of bank outsourcing projects. It is also precisely why a credible outsourcer will have demonstrable expertise that it can deliver the project successfully.

Conclusion

It's hardly a secret that for many banks, legacy technology has long since morphed from asset to liability, which makes it an unsuitable foundation for supporting and expanding the franchise and innovating around the customer experience. While COVID-19 has highlighted this stark reality for some, and is putting capital investment decisions under an even more focused spotlight, truly appreciating it requires a brutally honest and frank assessment of the real costs and risks of legacy technology and the long-term drag on the business it represents.

Outsourcing through PaaS can radically transform this situation for the better. Costs and risks decline, freeing up resources and personnel to compete and innovate effectively, while margins on increasingly commoditised payment activities can potentially even increase. Ultimately, the enterprise also becomes more agile at the tactical and strategic levels. Indeed it may not be an exaggeration to suggest that for established banks continued success depends upon it.



The Case for Payments as a Service Transformation – Commercial Considerations Checklist

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|---|--|
| Are the true costs of capex investment and impact on balance sheet and cash flow factored in? | |
| Is the risk and cost in terms of reliance on key personnel understood? What is the true cost of succession planning, or in worst case, the non-availability of key personnel for any period of time? | |
| What costs are created by limited bench strength, for example, the ability to respond to shock effectively? | |
| What is the true cost of delivering industry-wide service and product innovations such as Apple Pay? Are the savings that would be realised through a shared innovation delivery model enabled by PaaS fully understood? | |
| Is business growth slowed down by having to compete with other product/business lines for a share of pooled internal resources or by the simple fact that internal capacity is constrained – what growth impact does this have? | |
| What opportunity cost exists more generally, for example, what additional revenue/business growth could be realised through faster delivery of innovation and value-add change? | |
| Is the cost of scheme and regulatory compliance fully understood and included, for example, Scheme, PCI-DSS, Legal and Regulatory? What savings would be realised through the PaaS model? | |
| Are costs associated with running your own Business Continuity and Disaster Recovery capabilities fully factored in? | |
| Have inevitable one-off expenses of the future been factored in, for example, infrastructure renewal, hardware and software upgrades and security improvements? | |
| Have all shared costs of in-house approach been factored in, for example, training, HR, finance, legal, compliance and so on? | |
| Is the cost of all additional software required to support processing factored in, for example, Database, Operating System, Schedulers, Monitoring Tools and File Transmission? | |
| What percentage of your IT spend is value-adding versus simply maintenance? | |

Connect With Us

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