CORNERSTONE ADVISORS

Seizing the Upper Hand in Contract Negotiations

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METHODOLOGY

In May 2021, Cornerstone Advisors surveyed 70 client banks and credit unions regarding their technology vendor contract negotiations. This study summarizes the findings and presents our recommendations for efficient, effective, and profitable contract negotiations.

EXECUTIVE SUMMARY

"Trust, but verify."
—Russian proverb

Far too often, financial institutions (FIs) are spending too much money and subjecting themselves to unfavorable technology contract terms by entering negotiations with little to no knowledge of market pricing, letting too many contracts auto-renew, and failing to prioritize contracts that need the most attention.

- **70% of our survey respondents enter negotiations without adequate market pricing knowledge**
- **Over 50% of FIs allow emotional factors to influence the negotiation process**

Frequently, FIs take an overly polarized approach to negotiations: they allow too many contracts to auto-renew, or they use the C-suite in full force to negotiate contracts. Both of these practices lead to fewer strategic projects on the FI's list because too much time and money are being spent on contracts that do nothing to differentiate the FI.

A third approach is needed—one that puts the resources best equipped to negotiate a fair contract in position to do exactly that without distracting C-suite execs from the transformational projects they are rightly focused on. **The key is to ensure that everything gets done and is done well,** whether the FI handles the contract negotiation work or outsources it.

Even for the most trustworthy vendor representatives and successful vendor relationships, perhaps we should all increasingly pay attention to that old Russian proverb. Trust, but verify, baby!

WHAT'S AT STAKE?

Before we dive too deeply into the survey results, let us first establish that millions of dollars are in the offing for financial institutions that improve their technology contract pricing.

Data from the *Cornerstone Performance Report* shows that banks annually spend between .18% and .31% of assets on technology. Credit unions spend between .27% and .53% of assets. The gap between the two poles adds up significantly in overspending and represents millions of dollars that could be realized in contract negotiation savings (Table A).

- A typical $5 billion bank could save $6.6 million annually — or more than 13 basis points of ROA — by renegotiating its high-priced contracts into lower-priced contracts
- A $1 billion credit union could save over $2.6 million annually by renegotiating its high-priced contracts

TABLE A: Savings Potential Based on Annual Tech Spending

	Annual Tech Spending as a % of Assets			
	Low	High	Example FI Size (Assets)	Annual Savings Potential
Bank	0.1825%	0.3147%	$5 billion	$6.6 million
Credit Union	0.2738%	0.5344%	$1 billion	$2.6 million

The dollars at stake are real. As this study illustrates, many banks and credit unions approach their contract negotiations with too much emotion and too little strategy, market knowledge, planning, and prioritization. There's too much money on the line for this not to change.

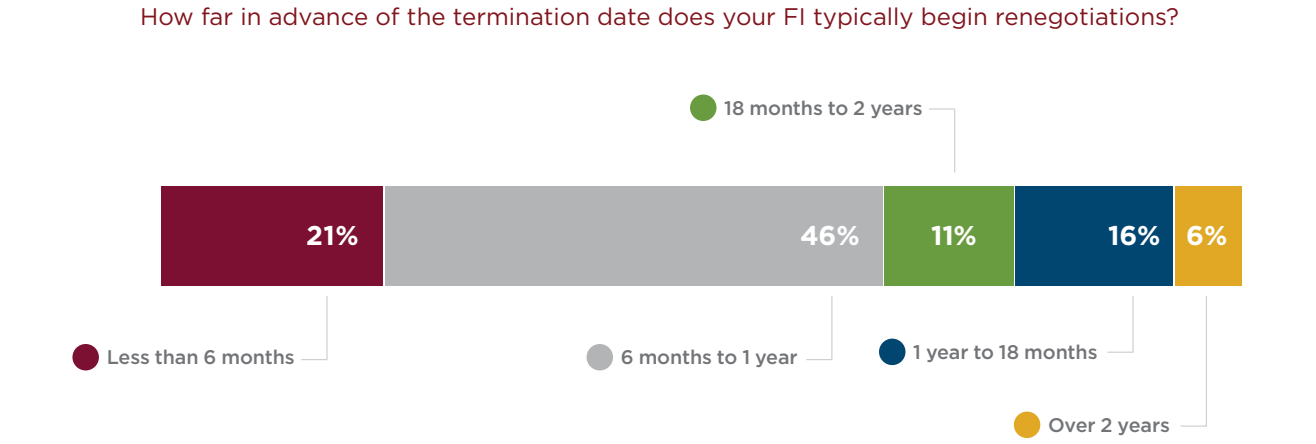
POSITIONING FOR A WIN

Before an FI even begins negotiation discussions, some basic blocking and tackling needs to be done. Proper timing of the negotiations and intentional avoidance of costly auto-renewals are critical steps in negotiating a winning contract.

Well-Timed Negotiations

The right timing can help an institution maximize its leverage and execute a fair-priced contract with superior business terms and conditions. In Cornerstone's experience, most FIs enter into contract negotiations far too late in the game to put any real fear into the hearts of their vendors. In this study, two-thirds of respondent FIs said they did not begin renegotiations until a year or less before the contract termination date (Figure 1).

FIGURE 1: Contract Negotiation Termination Lead Time

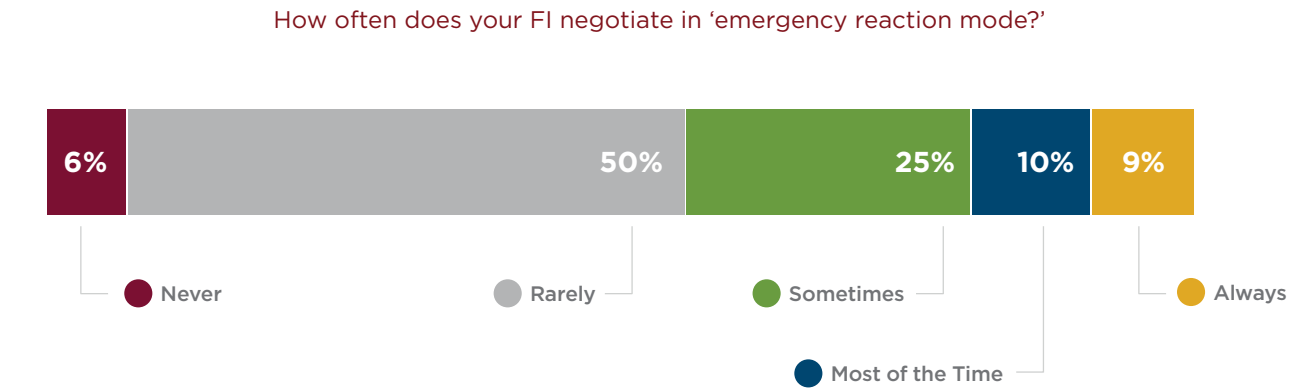


Source: Cornerstone Advisors survey of 70 bank and credit union clients

For most FI technology contracts, starting this late tells the vendor that the institution has no real ability or intent to leave its product for a competitor's. When the institution doesn't turn this into "positive leverage," i.e., the client's power of choice/threat of leaving the vendor, the vendor maintains the upper hand in the negotiations.

Negotiation leverage can be almost nil when operating in emergency reaction mode (ERM), which we define as starting a negotiation with an auto-renewal or contract term expiration looming in less than 30 days. While Cornerstone was pleased to see that 56% of survey respondents rarely or never renegotiate under ERM, 44% apparently find themselves in this unenviable position every year (Figure 2).

FIGURE 2: FIs Negotiating in 'Emergency Reaction Mode'



Source: Cornerstone Advisors survey of 70 bank and credit union clients

Cornerstone's rule of thumb for good-faith negotiation timing is this: Beginning negotiations at the right time enables the FI to start discussions, pause if negotiations are not fruitful, research and review alternative products, collect competing financial bids, and implement a new system by the time the current contract terminates or auto-renews. If an FI does not have time to take all of those steps, the vendor is less likely to worry about it leaving for a competitor. So, price discounts are held to a minimum. In extreme cases, poor timing can even lead a vendor to press its luck and raise prices on what it considers to be a captive client.

The correct lead time varies depending on the type of technology contract being considered and, to a lesser extent, the FI's asset size. For a complex core contract, beginning renegotiations two to three years in advance is appropriate. This timeframe can be reduced to 18 months for a digital or loan origination contract.

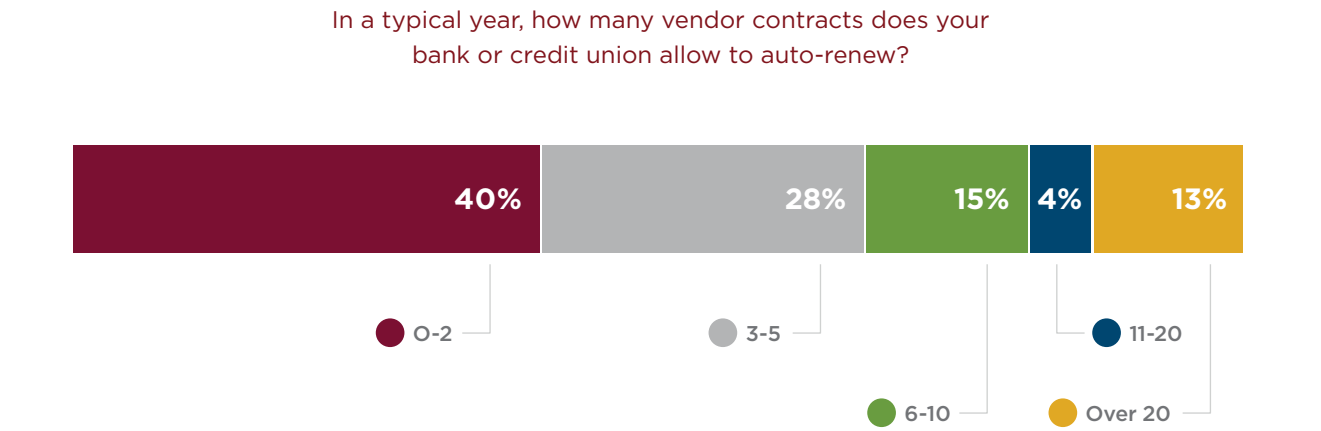
IT IS WISE TO TRACK CONTRACT TERMINATION DATES, BUT THE DATE TO START RENEGOTIATIONS IS EVEN MORE CRITICAL.

Auto-Renewals

In rare instances it can be satisfactory to let a contract auto-renew, maybe to achieve a very short-term renewal until longer-term decisions can be made. However, with millions of dollars on the table, auto-renewals should be the rare exception.

An institution that allows its contracts to auto-renew at pricing and terms that were written by the vendor is forfeiting valuable cost-saving benefits. In fact, many auto-renewals include an automatic price increase. While over two-thirds of this year's survey respondents allow only six or fewer contracts to auto-renew annually, 17% still accept the dangerous and costly practice of permitting more than 10 contracts to auto-renew each year.

FIGURE 3: Number of Annual Auto-Renewals



Source: Cornerstone Advisors survey of 70 bank and credit union clients

Market pricing for financial technology changes constantly and trends downward for core processing, digital delivery, payments, and card processing systems. Data from Cornerstone's Contract Vault[1] shows that prices paid for key technology contracts are declining, not increasing. So, locking into an auto-renewal ensures that any potentially beneficial movements in market pricing are lost.

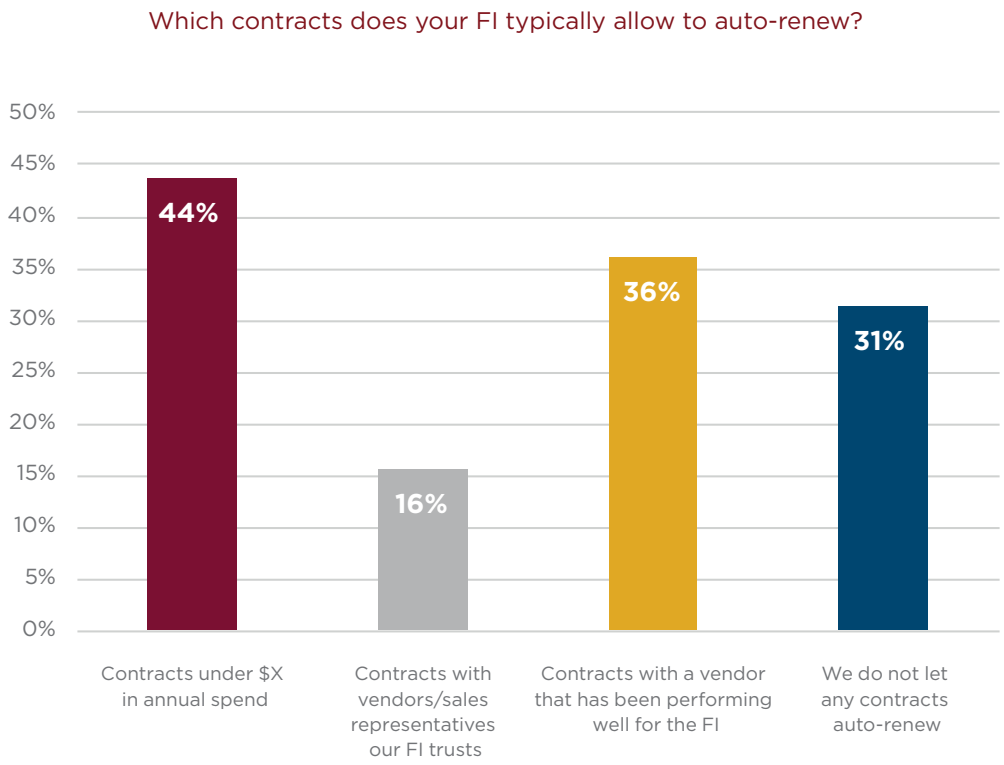
[1] *A proprietary database containing 15,000 pricing points from more than 2,630 contracts negotiated by Cornerstone on behalf of banks and credit unions, including hundreds completed in the past year.*

Another clear downside to auto-renewals is that, in effect, FIs are ensuring that unsatisfactory business terms and conditions remain uncorrected. Remember, these contracts were written by the vendor with the vendor's benefit in mind. Examples of contract terms that, without a careful negotiation strategy, can sneak up on an institution include the following:

- **Mergers and acquisitions.** If future mergers or acquisitions are even a glimmer in the Strategic Planning Committee's eyes, these circumstances at a minimum should be addressed in the contract:
    - o Pricing for significantly increased account, transaction, and asset volumes
    - o Merger-related implementation and deconversion costs
    - o Special rules dictating fees for the combined FI, depending on which of the two combining FIs' systems will survive
- **Unspoken "deconversion" fees.** Fees charged for data resident on the outgoing vendor platform can limit an FI's strategic flexibility and make it less attractive as an acquisition target. If the contract does not have a stated deconversion fee (in terms of actual dollars versus "at our then-current rates"), the institution is essentially allowing the vendor to charge whatever it wants to if and when the FI decides to leave this vendor.
- **Unstated service level agreements (SLAs).** Many vendor contracts don't specify uptime, application response times, issue resolution or other basic service features. Most SLAs initially offered by vendors also exclude any penalties for nonperformance, which, in effect, removes the incentive from the vendors to take the SLAs seriously.
- **Annual price increase clauses.** Price increases can compound quickly and are especially toxic when combined with auto-renewals.
- **Auto-renewal terms.** Many vendor contracts include, by default, excessively long terms for auto-renewals. Cornerstone looks for one-year auto-renewals.

Emotion plays too big a part in decisions about which contracts to allow to auto-renew, leading to far too many auto-renewals in the industry. While many FIs use a contract value to determine their willingness to let the contract auto-renew, over half use emotional factors such as the FI's trust in the vendor or past performance with the vendor in making auto-renewal decisions (Figure 4).

FIGURE 4: Type of Contracts FIs Allow to Auto-Renew



Source: Cornerstone Advisors survey of 70 bank and credit union clients

A tactic vendors frequently use to elicit an emotional contract signing is the unsolicited renewal bid. This is where a sales rep proactively provides a renewal offer marginally lower than current pricing and says this is the best deal she has ever seen. She might even say that the price is so low, the offer is only valid for two weeks and the FI cannot share the offer with consultants, attorneys, etc., so sign up now! The desired outcome is a play on the client's ego, hoping the client will believe they are so important that they merit "the best deal ever" and accept the bid without challenge. This tactic promises a win-win situation, but an unsolicited bid is more often a win-lose in the vendor's favor and a towering red flag that the institution is about to leave a lot of money on the table.

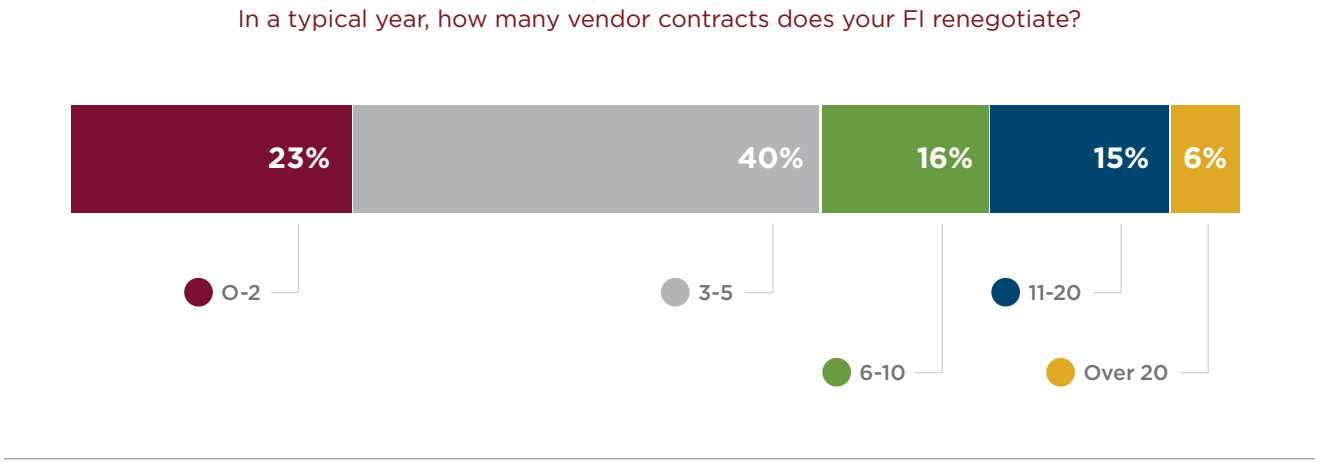
DOING IT RIGHT

Once an institution prioritizes where to spend negotiation time, gets educated on market pricing, removes emotional factors as much as possible, and identifies the right negotiator for the job, it's positioned correctly for negotiations.

Prioritized Negotiations

Understanding the volume of negotiations and who will lead those negotiations is critically important. Nearly 40% of Cornerstone's survey respondents are negotiating between six and twenty-four contracts annually (Figure 5). This time-consuming effort requires FIs to strategically prioritize the contracts they negotiate.

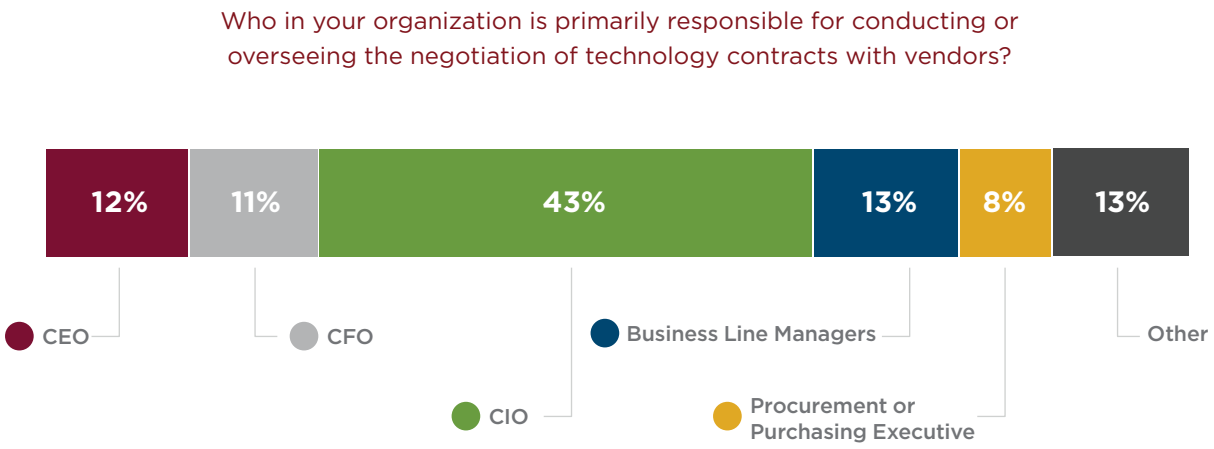
FIGURE 5: Number of Contracts Negotiated Annually



Source: Cornerstone Advisors survey of 70 bank and credit union clients

Of these negotiations, two-thirds are being led by the CEO, CFO, or CIO (Figure 6). The involvement of these busy (and expensive!) executives further underscores the need to prioritize negotiations. C-suite executives should be deeply involved in the FI's strategic projects and planning, and contract negotiations can be a distraction from that effort.

FIGURE 6: Responsibility for Contract Negotiations



Source: Cornerstone Advisors survey of 70 bank and credit union clients

One way to prioritize which contracts merit the most attention is to review them all in terms of annual spend. Clearly, placing more emphasis on contracts that result in greater FI spending makes infinite sense. We were glad to see that almost three-fourths of survey respondents use contract size (spend) as a way to determine negotiation priorities (Figure 7). That said, we find it alarming that 26% of survey respondents do not use contract size to dictate strategy.

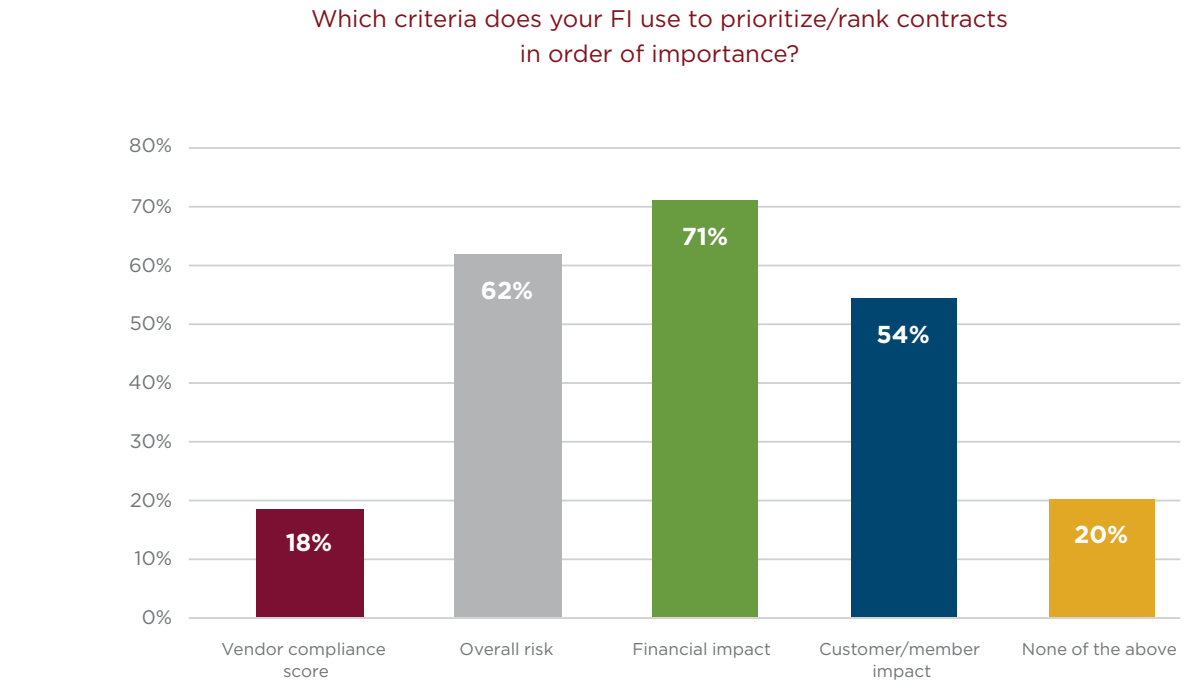
FIGURE 7: Contract Negotiation Strategies Based on Contract Size



Source: Cornerstone Advisors survey of 70 bank and credit union clients

Financial impact is the key driver in prioritizing contracts to negotiate, and most FIs use some combination of financial impact, overall risk, and customer/member impact to help chart their negotiations course (Figure 8).

FIGURE 8: Criteria Used to Prioritize Contracts



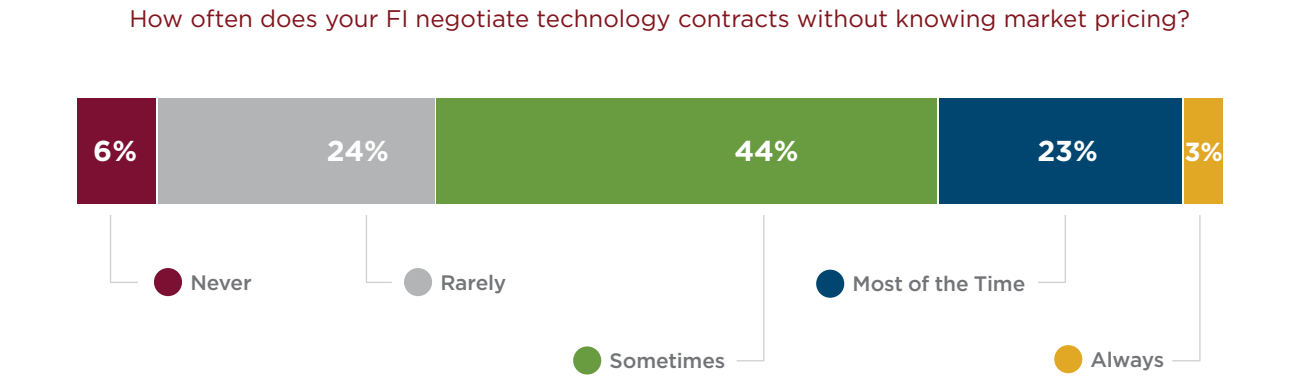
Source: Cornerstone Advisors survey of 70 bank and credit union clients

Educated Guesses

With huge dollars hanging in the balance, financial institutions can bet that the technology vendor community will use numerous creative ways to maximize contract value. Compensation for vendor sales managers and negotiators is very often tied to their ability to maximize revenue per contract. Vendors prey on the likelihood that their prospects and clients do not know or take the time to uncover the true market price of a system. Without valid pricing knowledge, even a hardened negotiation team that can quote Chris Voss's *"Never Split the Difference"* from memory is flying blind against a vendor with 20/20 vision.

Seventy percent of surveyed institutions said they sometimes enter negotiations without knowledge of market pricing. Incredibly, 3% stated that they ***always*** enter negotiations without market data. Only 6% said they never enter negotiations uninformed (Figure 9).

FIGURE 9: Frequency of Negotiating Contracts Without Knowledge of Market Pricing

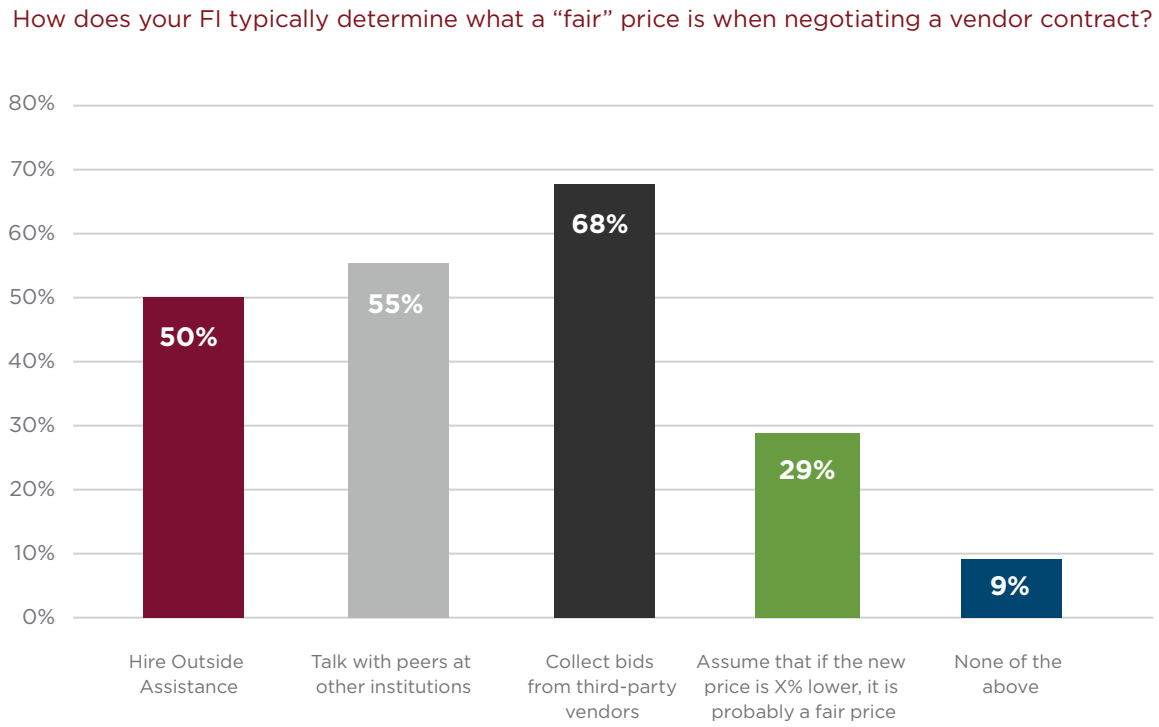


Source: Cornerstone Advisors survey of 70 bank and credit union clients

Collecting, maintaining, and utilizing market pricing is the most difficult and time-consuming aspect of contract negotiations. Working on its own, an FI could easily burn hundreds of hours and four to six months soliciting, analyzing and validating bids, and ensuring that proposal scope is comparable across vendors. On the other hand, an FI can hire an outside consultant and have up-to-date market pricing on Day One. This gritty data is tough to find, even more difficult to validate, and nearly impossible to maintain for institutions that do not review many contracts each year.

Most FIs use a combination of outside consulting assistance, peer conversations, and third-party vendor bids to estimate current market pricing (Figure 10). Hiring outside experts that negotiate hundreds of contracts each year is an FI's surest way to get current, deep market pricing.

FIGURE 10: Resources Used to Determine Fairness of Vendor Pricing



Source: Cornerstone Advisors survey of 70 bank and credit union clients

Third-party vendor bids are still legitimate methods to collect accurate market data, but they are filled with peril. Vendors can smell a pricing tire-kicking expedition from miles away. Even if the vendor submits a bid, it ***never*** provides real pricing in these situations. Instead, it will submit high level, "head fake" pricing that puts the institution in the ballpark of market pricing but isn't particularly competitive.

Even bankers who understand that pricing is steadily declining have difficulty obtaining market pricing information that they can use in contract negotiations. Why? Because vendors and peer FIs alike have an incentive to maintain a decidedly opaque pricing environment. Vendors, above all else, aim to maximize margins and profits, and vendor contracts frequently include provisions barring institutions from sharing pricing data with other banks or credit unions. For this reason, institutions that look to peers for pricing data may not only receive unreliable information, but they may put their peers in a precarious legal position by asking them to discuss confidential vendor pricing.

FIs that have recently signed contracts also have an incentive for keeping the details private. Vendor contracts are increasingly where strategy, technology, and execution come together. Most contracts contain hefty doses of customization and special terms to help FIs differentiate themselves in a crowded marketplace. The last thing they want is to share those details with other institutions.

No one can negotiate effectively with a counterpart who knows more about the market than they do. In many cases, a lack of market pricing information makes it difficult for management to decide if it's even worth the time and effort to pursue negotiations. (It almost always is.)

But I Really Like My Vendor!

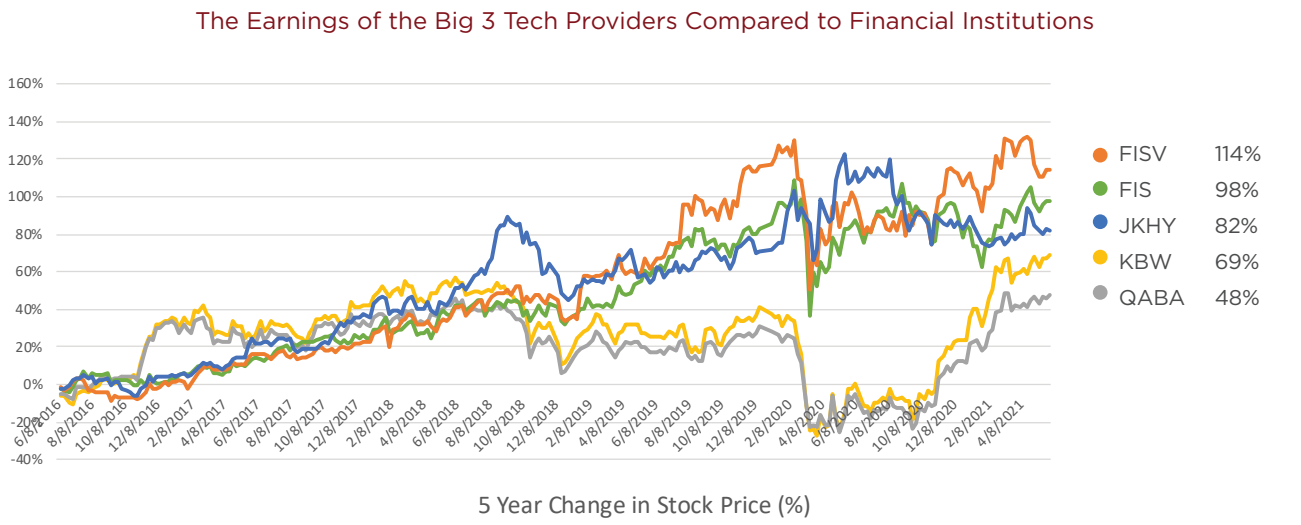
Uneducated or overly emotional negotiations typically lead to poor, long-term decisions that do not assign enough importance to the FI's financial health. But we get it. Sometimes an FI works with a vendor rep with whom it shares mutual admiration and trust. Or maybe the vendor has delivered a truly useful product and provided stellar service, and the FI does not want to put that at risk with negotiations. Those are all positives in any vendor relationship, but that does not mean the FI should not negotiate.

How does an FI protect its positive vendor relationship but still not get taken to the cleaners? It hires an expert to be its arms-length negotiator. This enables the FI vendor relationship owner to point to the consultant when price reductions are discussed: "It's not me… it's the consultant! I can't get this contract approved by the board without my consultant's blessing." It works.

Let us not feel sorry for the financial technology vendors that serve our market. They are doing just fine. Vendors bemoan the scrutiny on their publicly traded stock as a reason to hold firm on price. They may also complain that they cannot afford to negotiate price due to their high commitment to research and development (R&D).

If we look at a comparison of the five-year stock performance of the Big 3 financial technology firms (FIS, Fiserv, and Jack Henry) to the KBW and QABA indices (both benchmark stock indices of the banking sector), we see that the Big 3 have been delivering much higher and more stable stock price growth than banks — by a significant margin (Figure 11). Financial institutions should think about this before deciding to let contract pricing go unnegotiated.

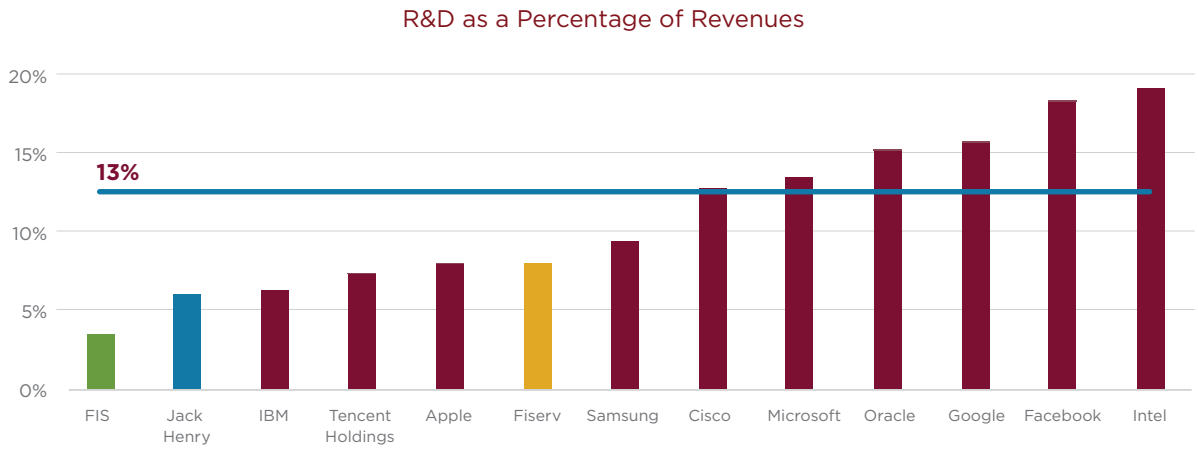
FIGURE 11: Earnings Comparison—Big 3 Tech Providers vs. FIs



Source: Cornerstone Advisors analysis based on publicly reported information

A comparison of the relative amount of R&D spending at Big 3 versus other well-known technology providers paints a frightening picture for financial institutions that are relying on a Big 3 vendor to steer their technology innovation—particularly at an above-market price (Figure 12).

FIGURE 12: Technology R&D as a Percentage of Revenues



Source: Cornerstone Advisors analysis based on publicly reported information

Financial institutions should think about how the Big 3's stocks are outperforming bank stocks and how the vendors are under-investing in R&D the next time they consider allowing a contract to auto-renew or sign a contract with no price discussions.

CONCLUSION

The vendor community is simply making too much money on the backs of financial institutions, and the approach to negotiations that an FI takes can make a significant difference. It might make sense to allow a rare contract to auto-renew, but for the most part, an FI needs a negotiator that knows market pricing, how to time negotiations to maximize negotiation leverage, and has the FI's best interest at heart.

"Trust, but verify," the Russian proverb that President Ronald Reagan was so fond of quoting, certainly is an apt morsel of wisdom for any FI negotiating a contract. However, President Reagan's Russian counterpart, General Secretary Mikhail Gorbachev, preferred to quote Ralph Waldo Emerson: "The reward of a thing well done is to have done it."

Both quotes apply to the challenge of contract negotiation. Decide which contracts have to be negotiated and make sure you assign the task to someone who has the knowledge and experience to do it right

REDUCE AND REDIRECT: Cornerstone's stated purpose in contract negotiations is to negotiate savings for every financial institution, enabling reduced spending on commoditized technology and redirecting funds into new, differentiating technology. We set up our troublemaking clients for success — not just to survive but to **THRIVE!**

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