The Technology Service Provider Event and Reporting Program

State of the Industry Report

2006

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State of the Technology Service Provider Industry, 2006 and Ahead

For financial-institution technology service providers (TSPs), 2006 was an eventful year changing to meet the needs of their ever-larger bank customers.[1] Each TSP responded in its own way to the competitive environment in which they all operate. Challenging aspects of the TSP environment in 2006 were:

- Volatile and highly publicized issues of data security
- The need for cost control and efficiencies
- Investors' high expectations

The different paths the firms took in responding to these challenges included, for two private associations (Visa and MasterCard), choosing to go public, and for one public company (Open Solutions Inc.), choosing to go private. In addition, whereas most TSPs continued to expand their business by making acquisitions, often in new but related data processing markets, one major firm (First Data), chose to spin off its largest and most profitable business line (Western Union).

Given the environmental pressures and the firms' varied responses, predicting TSPs' future with any confidence is difficult. But it needs to be done because TSPs represent a changing risk environment for their financial-institution customers. Furthermore, most TSP information technology (IT) risks do not manifest themselves in the same ways that safety-and-soundness risks do, and regulators have less access to information about individual TSPs than they have to information about chartered banks. Thus, a broad assessment of information affecting the TSP industry during the year may enhance an understanding of banks' IT risks going forward. Accordingly, this report offers a brief look back at some of the more significant events in the TSP industry in 2006 and glances at the immediate future.

The two main aspects of the subject covered by the report are business expansion and structural changes. Banking is now a fully served market, with consolidation reducing the number of banks. While banks are being pressured to offer new products to their customers, TSPs are pressured to seek other profitable customers. Thus, TSPs are expanding their business in three areas: (1) introducing new, innovative products like remote capture; (2) entering or expanding their presence in related data processing lines of business, such as health care claims and payments processing; and (3) expanding into overseas markets. (Parallel to the expansion of U.S. firms into overseas markets is the expansion of foreign firms into U.S. markets.) The structural changes we discuss are the conversion of public firms to private firms and vice versa, major spin-offs in 2006, and speculation and projections about acquisitions and stock repurchases in 2007.

[1] This is the second annual State of the Industry report produced as part of the TSP Event and Reporting Program. The program is sponsored by the FDIC to analyze the top eight bank TSPs, and much of the focus of this report is on these top eight providers. They are: Metavante, First Data, Fidelity, MasterCard, Visa, Open Solutions (Open), Fiserv, and Jack Henry.

Business Expansion

Throughout 2006, TSPs continued the trend of enhancing their business lines both to offer broader and more comprehensive product solutions to their financial-institution customers and to explore new opportunities. The latter—expansion into new markets—may have some fairly serious implications for TSPs' banking clients. The success or failure of any expansion can directly affect the financial health of the TSP (particularly if the new business has lower margins and is highly competitive), and the financial health of the TSP, in turn, will affect the resources available for research affecting—and the development, support, and maintenance of—the products and services provided to financial-institution customers.

Key business-expansion developments in 2006 that will affect the future of the TSP industry are remote capture products for banks, data and financial processing for health care purposes, and globalization.

Remote Capture

Remote capture is the term used to describe an innovation in check processing that reduces both operational costs and "float." "Float" is the time interval between deposit of a check in a bank and its payment. In the past, each physical check would travel through a complex network of banks and service providers to ultimately arrive at the bank on which the funds were drawn ('paying bank'). The paying bank would provide the funds to the bank at which the check had been deposited. The entire process could take from one to five days depending on the travel distance of the physical check. The Check Clearing for the 21st Century Act (Check 21), effective in 2004, fundamentally changed the check processing system by allowing for the use of electronic images instead of physical checks. An infrastructure was then created enabling checks to be converted into electronic images and either presented in that form at the paying bank or converted into a printed substitute that the paying bank must accept in lieu of the original physical check. Now, the image of the check can be created at the bank of first deposit (or bank branch) or – in the case of merchant capture – by the commercial customer using equipment provided by the bank (usually through a TSP), eliminating any further use of the physical checks. The check images are then transferred electronically to their ultimate destination, vastly reducing collection time and eliminating the need to transport the checks from location to location.

TSPs provide the software and hardware that enable banks to engage in remote capture for their branches and to offer it to their business customers. Because of the cost savings[2] involved in remote capture, these products have been rapidly adopted by banks around the country. Adoption rates of 60 percent have been seen in some parts of the country,

[2] Among the savings are courier and air transportation fees, high speed sorting equipment and insurance premiums to cover losses that could be incurred while the items are not within the confines of the financial institution.

and penetration throughout the banking industry is expected within two years.[3] Jack Henry, for example, reported that demand for its remote capture technology has surged. It has 350 bank customers for the product, 300 of which signed up for the service during the previous 12 months.[4]

Unfortunately, banks may not be fully aware of the risks involved in implementing merchant capture technology and may not be performing adequate due diligence. In contrast to the situation in which remote capture takes place in the secure, controlled environment of a bank branch, the procedures employed by a commercial customer or merchant may not incorporate adequate security precautions, leaving the original physical checks and the check images insecure. Banks are subject to extensive security requirements through regulations and statutes including, for example, the Financial Modernization Act of 1999 and the Gramm-Leach-Bliley Act, and are examined and supervised according to those standards. Non-financial enterprises are covered by some mandates, but are not examined and supervised by a regulatory entity. As such, non-financial enterprises are not as likely to be familiar with underlying needs or the best practices employed to mitigate security risks. As such, merchant capture operations may impose risks to the public including:

- Physical and electronic security of checks, which may become the original source of information for identity theft or fraud;
    - Checks contain sensitive information including customer name, address, account number, and bank. Merchants may not properly store or dispose of these items. The longer the merchant retains the scanned check or physical check, the greater the risk of improper use.
    - The images created by the scanning process may remain on the merchant's computers. These devices may not meet the security standards commensurate with the sensitivity of the information. The merchant may not follow proper protocol to control for spyware, lack of encryption, Random Access Memory and cache memory clearing, or inappropriate access.
- Failure of banks to mitigate risks at the appropriate level by use of contract provisions with merchants who use this service. Since this is a new service, risk analysis is still evolving. Appropriate contract provisions may address risks posed by merchants. Some provisions could cover:
    - Merchant practices related to the security of physical checks and their scanned images.
    - Auditability.
    - Vulnerability assessments and penetration testing.
    - Liability for errors and charge-backs.
    - Transaction processing regulations such as those that address money laundering and fraud.

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[3] Compare this to internet banking which did not involve such dramatic cost savings to the financial institutions and unfolded over a period of five to seven years.
[4] Will Wade, "In Brief: Jack Henry: More Banks Using Image Tool. " American Banker Online (February 5, 2007).

Identity theft and fraud based on information from scanned checks would most likely take the form of securing credit in the name of the stolen identity, and in fact many of the operational practices associated with remote capture of check images are the same as those now known to have been associated with credit card data breaches. As the bank of first deposit, banks offering remote capture services may be liable for the full range of costs and liabilities associated with these services. However, because merchant capture is a new process, the extent of liabilities is not entirely clear, nor is it entirely clear how the liabilities would extend to the different participants.

The agencies represented on the Federal Financial Institutions Examination Council are currently pursuing several avenues for addressing the issues of security and risk and for responding appropriately.[5]

Health Care

TSPs that traditionally serve the financial services industry are expanding into the data processing aspects of the health care industry. The TSP industry's infrastructure is well suited to efficient transactional data processing. Expanding into health care transactional processing appears to be a natural transition for them. Both the banking and the health care industries are heavily regulated, are under intense pressure to consolidate, and operate with highly sensitive data. Compared with banks, however, data processing for health care is fragmented, often paper based and manually entered, with processors' market share spread among many smaller entities. Health care insurers and providers are in the early stages of seeking to achieve fundamental efficiencies through cost-effective data processing strategies.

Currently, TSPs support health care data processing in three main areas:

- Administering flexible spending accounts (FSAs) and health reimbursement accounts (HRAs) for employers and health savings accounts (HSAs) for individuals and employers (all three kinds of accounts are funds restricted to health care expenditures).

- Processing health insurance claims and pharmaceutical claims. These functions include automating claim transaction processing based on business rules, payment to providers, generation of reporting documents, and responses to claim inquiries.

- Integrating accounting and data processing systems between health care providers and insurers. An example of these functions would be a system that processes payments to providers, generates invoices for providers, and maintains interoperable accounting systems for both the insurer and provider.

[5] This section was been produced with the assistance of L. Bruce Finn, FDIC Examiner.

As indicated below, most of the top eight TSPs are pursuing HSA business. In addition, others (for example, Fiserv, First Data, Metavante) are pursuing FSA business and other types of processing services for health care providers. Fee revenue and increased bank deposits make these services attractive for TSPs.[6]

Fiserv. Fiserv is the clear leader among top TSPs in the health care service arena and is the only TSP among the top eight to make Forrester's list of top leading consumer-directed health platform (CDHP) vendors in September 2006.[7] In 2006, Fiserv used a significant amount of its resources in developing products and making acquisitions in the health care arena and devotes a major organizational unit to this line of business.

Three of Fiserv's six 2006 acquisitions involved health care companies active in platform processing, core insurance application offerings, and claims resolution. Fiserv has also announced several awards of significant service contracts, including with Blue Healthcare Bank; New York City municipal workers; Blue Cross Blue Shield; and a midwestern financial institution, Huntington National Bank. Fiserv will provide Huntington's health savings account support. Fiserv's growing health care client list is translating into significant revenues for Fiserv, contributing 29 percent of 2006 revenues through September 30.

First Data. First Data, like Fiserv, has activities in the health arena that go beyond HSAs. First Data provides a multi-purpose card that connects patients, payers, providers, hospitals, laboratories, pharmacy benefit managers, trustees, third-party administrators, FSAs, HSAs and HRAs).[8]

Metavante. Metavante, like First Data, touts what it calls the most widely used health care debit card, with more than 1.8 millions cards in use by employees of 19,000 companies. Like First Data's card, the Metavante card can access multiple accounts and process real-time card authorization at the individual and family level of HRA accounts. One of Metavante's major organizational units is devoted to the health care line of business.

Open Solutions. Open provides outsourced processing services for HSAs to major trustees, insurance carriers, third-party administrators, insurance carriers, and other financial institutions.[9] These services are provided through a division that came from Open's March 2006 acquisition of the Information Services Group of Bisys.

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[6] Peter J. Heckmann and Craig Richard, "BAI Retail Delivery Conference Takeaways Suggest an Uptick in Optimism for Industry Spending," AG Edwards (November 20, 2006).
[7] Katy Henrickson, Eric G. Brown, Julie Hanson, and Ian Schuler, "The Forrester Wave™: CDHP Platforms, Q3 2006," Forrester Research (September 8, 2006).
[8] First Data, "Healthcare." Available: www.firstdata.com (accessed February 27, 2007).
[9] Marvin Goldwasser, "Open Solutions Co-hosts HSA Luncheon for Industry Leaders, Policy Makers," Open Press Release (October 3, 2006).

MasterCard. As early as 2003, MasterCard branded an MBI health care debit card that was issued by KeyCorp.[10] In August 2006, MasterCard Worldwide announced that it was introducing a new system enhancement and service to increase the use of FSAs and other medical reimbursement plans: Third-party administrators would be able to substantiate purchases in real time by using item-level data collected at the point-of-sale.[11]

Visa. Visa revamped its infrastructure to accommodate health care payments for products utilizing its health care debit card.

Fidelity. In July 2005, Fidelity announced that its deposit systems have allowed its clients to offer HSAs since the Medicare Prescription Drug Improvement and Modernization Act took effect.[12] It is not apparent that Fidelity has pursued any health care business beyond HSAs.

Jack Henry. In 2006, Jack Henry did not appear to be active in the health care arena. The move by TSPs into health care services is an example of firms pursuing new opportunities, growing revenue, and tapping the current infrastructure for greater cash flow and earnings. New opportunities also entail risk for the TSPs and changes in how the regulatory community monitors them. TSPs may invest in new businesses that drain resources away from the financial services portion of their businesses. Financial and other information about the bank servicing portion of the business may not be reported as a separate business line or may be diluted among other information as the TSP becomes larger. It will be incumbent upon TSP financial institution customers and regulators to continue to monitor TSPs as they take on new opportunities and risk.

Globalization—2006 and After: Expansion of U.S. Firms

In 2006, TSPs embarked on expanded international activity, much of it (though not all) centered on payment processing, a business line that thrives on large volumes. Visa and MasterCard are truly operating on a global scale, with roughly half their business coming from outside of the United States. Aside from those two, although a few TSPs (Jack Henry and Open) have a limited international presence, others (Fidelity, First Data, and Fiserv) have a growing number of bank customers and offices in other countries. Some TSPs in this country have expanded their international focus beyond outsourcing call centers to other aspects of their business, such as processing centers and the writing of software code.[13] Furthermore, although TSPs have been establishing core processing operations overseas for some time, foreign firms are now poised to enter the U.S. market

[10] Ivan Schneider, "MBI, MasterCard, KeyCorp Offer Health Care Debit Cards," Bank Systems & Technology. Available: www.banktech.com (accessed: February 28, 2007).
[11] PaymentsNews, "MasterCard Item Level Authorization for Healthcare Transactions" Available: www.paymentnews.com (accessed: February 28, 2007).
[12] Michelle Kersch and Daniel Kennedy Murphy, "Fidelity Information Services Offers Health Savings Account Solution to Financial Services Organization," Fidelity Press Release (July 6, 2005).
[13] While offshore outsourcing is fundamental to TSP globalization, that topic is beyond the scope of this paper. It is important to note that if U.S. TSPs' international endeavors involve third parties, myriad privacy and security concerns arise.

(see next section). Additionally, foreign TSPs are now actively pursuing core processing business in the United States. One such firm, i-flex solutions ltd, has secured a contract for core processing for a U.S. bank, People's Bank of Bridgeport, CT.[14]

MasterCard. Internationally, MasterCard is clearly operating as a more global, integrated company than in the past; during the fourth quarter of 2006, 54 percent of its gross domestic volume was generated outside the United States. Worldwide purchase volume for 2006 totaled $1,417 billion for all MasterCard programs, an increase of 17.6 percent over the previous year's $1,205 billion.

MasterCard is well positioned to take advantage of the Single European Payment Area (SEPA) to be implemented between 2008 and 2010, designed to standardize cross-border transactions. MasterCard already generates over one-fourth of its gross domestic volume (excluding its Maestro cards) from Europe.[15]

Visa. Visa International (Visa Inc.), the new public Visa, will be a public stock corporation incorporating all of Visa's international regions except Visa Europe. Visa Inc. will have a minority interest in Visa Europe, and vice versa. Currently, the various Visa regional organizations operate relatively independently, except for branding and transaction processing. In 2006, more than 45 percent of Visa's global business in terms of sales volume derived from the United States, but much of the company's future business growth is expected to be outside of the United States.

Metavante. Metavante has recently purchased a 20 percent stake in Firstsource, the fifth largest business process outsourcing firm in India. Firstsource is a spin-off from India's largest bank, ICICI Bank. Among its current banking clients are Capital One, HSBC, and Wachovia. One of Firstsource's board members is Metavante's Executive Vice President, Donald Layden Jr. Firstsource has a strategic partnership with Metavante, which reportedly provides it exclusive rights to provide business process outsourcing services to Metavante and its clients.[16]

Fidelity. In 2006, Fidelity, Banco Bradesco, and Banco ABN AMRO Real formed a joint venture to be the largest third-party card services provider in Brazil.[17] In February 2007, Fidelity expanded its offshore outsourcing presence in India through the acquisition of Second Foundation, Inc.[18] Second Foundation is a provider of offshore global information technology services that include outsourced product development, quality

[14] Steve Bills, "Oracle, I-Flex Get First U.S. Core Client," *American Banker* (January 16, 2007) and 'People's Bank Selects i-flex's FLEXCUBE for Core Banking,' Press Release (January 16, 2007). Available: www.iflexsolutions.com (accessed February 6, 2007).
[15] Ibid.
[16] Hitesh Zaveri, Parul Inamdor, and Kunai Sangoi, "Firstsource Solutions," Edelweiss. (January 31, 2007).
[17] Mary Waggoner and Lucia Porto, "Fidelity National Information Services, Banco Bradesco and Banco ABN AMRO Real Form Joint Venture to Be Largest Third-Party Card Services Provider in Brazil," Fidelity Press Release (March 28, 2006).
[18] Michelle Kersch and Mary Waggoner, "Fidelity National Information Services Expands Offshore Outsourcing Presence in India," Fidelity Press Release (February 27, 2007).

assurance and business intelligence services, and implementation services of third-party software applications, with offices in Bangalore and Chandigarh, India.

Thirty-one percent of the revenue stream of Fidelity's Enterprise Banking Solutions division (mid-tier and upper-tier financial institutions) is international.[19]

First Data. First Data appears to be fast-tracking its move into the global market. First Data's international activities accounted for 17 percent of corporate revenues ($1.27 billion of $7.36 billion in total) and 9 percent of income ($153.6 million of $1.625 billion in total). During 2006, merchant transactions grew 69 percent internationally but only 13 percent in the U.S. First Data operates across Europe, the Middle East and Africa, Latin America, Canada, Australia, and the Asia-Pacific region.[20] In January 2007, First Data formed a strategic alliance with INICIS Co., Ltd (a leading electronic payment gateway for e-commerce transaction processing services in Korea) to offer merchant processing services to global, online merchants operating in Korea. Also in January, First Data signed a card processing agreement with Alfalah Bank, the largest credit card issuer and merchant acquirer in Pakistan .[21] First Data opened an office in Warsaw, Poland,[22] the firm's third addition to its Central European presence in the past year (earlier offices were opened in Bucharest, Romania, and Zagreb, Croatia). First Data now offers electronic processing and support services to financial institutions and large retailers in nine Central European countries.

Fiserv. Forrester Research recently evaluated five leading banking platforms worldwide, and Fiserv's international banking platform was evaluated as a strong performer.[23] Fiserv has clients in the United States and Canada, Europe, Latin America, the Caribbean, and the Asia-Pacific region, and more than 230 North American offices and 20 international offices.[24]

Sometimes Fiserv's products are launched in other countries before the United States. For example, Fiserv CBS Worldwide recently launched a U.S. version of CBS Teller, the company's "Smart Client" teller solution that is already licensed by Australian, Mexican, and Thai clients.[25]

Fiserv's Australian item processing contract hit some operational problems in 2006 because it was experiencing a different product mix from the one it had anticipated.[26]

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[19]Fidelity, "Fidelity National Information Services," PowerPoint presentation (February 2007).
[20] Uhi Hui and Jeanie Oh, "First Data International and INICIS Form Alliance for Global Merchant Processing in Korea," First Data Press Release (January 26, 2007).
[21]Suzi West and Mahtab Qayyum, "Processing Agreement with Alfalah Bank Extends First Data's Reach into Pakistan," First Data Press Release (January 9, 2007).
[22] Natalia Kristinova and Suzi West, "First Data International Opens New Office in Poland," Fidelity Press Release (March 1, 2007).
[23] Josh Hoppermann with Andrew Parker, Ashara Giodanelli, and Matthew McCormack, "Fiserv Has No Peaks or Troughs but Strong Potential in Retail Banking Platforms," Forrest Research (November 8, 2006).
[24] Fiserv, "Fiserv Overview." Available: www.fiserv.com (accessed on March 2, 2007).
[25] Bank Technology News Bulletin, "Fiserv Releases Smart Client Teller Package" (October 31, 2006).
[26] Philip A. Mickelson, "Less behind the Curtain Than We Expected," JP Morgan (September 20, 2006).

Analysts expect recent losses stemming from the underperforming item processing contract in Australia to ease as costs are reduced and pricing and volumes improve.

Globalization: Foreign Competitors' Entry into the U.S. Core Processing Market

In January 2007, i-flex solutions ltd. (based in Mumbai, India) announced that it had secured its first core processing contract with a U.S. bank, People's Bank of Bridgeport, CT. [27] Although i-flex has not had much success selling its core software in the United States, it has had more success elsewhere, with 720 customers in more than 120 countries.

Several other big international vendors, such as the Mumbai technology company Tata Group, the Geneva core processing software maker Temenos Group AG, and the Walldorf, Germany, enterprise software developer SAP AG, are trying to expand into the U.S. core processing market.[28]

Another overseas competitor is Capgemini. Capgemini is a worldwide (North America, Europe, Asia Pacific) consulting, technology, and outsourcing company headquartered in Paris, France.[29] It operates in 30 countries and has 19 offices in the United States. Its financial services division offers retail banking, compliance and risk management, insurance, payments, and wealth management. Some large U.S. investments firms are clients.

Structural Changes

The corporate structure of TSPs that support the banking industry is important because it directly affects how much company-specific information is available for analysis. Public companies are required to make public financial statements and notification of major events, and Wall Street analysts interpret that information. Private entities have no such requirements. Other structural issues, such as spin-offs, reorganizations, and mergers and acquisitions, affect the relative size and importance of the TSP within the larger corporation that owns it. More TSP-specific information is available when the TSP-related business lines comprise a majority of the company's business. Moreover, company decisions on repurchases can offer insight into near-term strategies for research, development, and acquisitions.

Motivations for taking a company private can be both strategic and financial. Private companies may pursue longer term goals with less focus on immediate financial performance and growth. They have more concentrated control, avoid the scrutiny of shareholders and shareholder litigation, and have reduced accountability of executives and directors. Private firms may also be less vulnerable to hostile take-over attempts and

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[27] Steve Bills, "Oracle, I-Flex Get First U.S. Core Client," *American Banker* (January 16, 2007) and 'People's Bank Selects i-flex's FLEXCUBE for Core Banking,' Press Release (January 16, 2007). Available: www.iflexsolutions.com (accessed February 6, 2007).
[28] Steve Bills, "Oracle, I-Flex Get First U.S. Core Client," *American Banker* (January 16, 2007).
[29] Capgemini Web site (February 6, 2007).

regulatory burden. Public companies are more likely to be taken private when they are considered to be undervalued, particularly during bear markets. Although private companies may have tax benefits and reduced compliance burdens, they have far less liquidity and may have more difficulty securing capital for growth.[30] The recent proliferation of hedge funds and other private equity funds flush with capital may make it harder to refuse an offer to go private.

Going Private, 2006 and After

In 2006, U.S. private-equity firms broke their previous (2000) record of $177.1 billion raised, raising $215.4 billion (33 percent more capital than in 2005).[31] Leveraged buyout firms, which usually purchase companies in hopes of selling them for a profit a few years later, took advantage of cheap debt in 2006 and completed bigger acquisitions, raising 69 percent of the total ($148.8 billion).

On October 14, 2006, Open signed a definitive agreement to be acquired by two global private investments firms, the Carlyle Group and Providence Equity Partners.[32] The $38 Open stock share valuation represented a 25 percent premium over the closing price preceding the announced buyout.[33]

Given that 2006 saw some of the largest merger and acquisition and private-equity deals in history (six of the largest private-equity deals of all time occurred in 2006), several analysts have noted that none of the TSPs in their coverage list is too large for a private transaction.[34] Fidelity, First Data, Fiserv, and Jack Henry are all possible private takeover candidates.[35] With respect to TSPs' acquiring other companies, major core processing vendors have said that such acquisitions are more costly than previously because of the recent influx of private-equity money into the market.[36] Private-equity fund raising is expected to continue at the same pace in 2007.

A number of analysts think First Data's business model could be particularly attractive to private-equity buyers. And since the company is currently looking for a new CEO, they

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[30] Karin French, "Considering Taking Your Public Company Private," Financial Executives International (March/April 2003) and Wendy L. Campbell and Kip A. Weissman, "Weighing the Options for Taking Your Bank Private," Community Banker (August 2003).
[31] Tennille Tracy, "Private-Equity Firms Raked in Record Amounts Last Year," *Wall Street Journal* (January 11, 2007).
[32] Open, "Form 10-Q (period: September 30, 2006)," Securities and Exchange Commission (filed: November 9, 2006).
[33] Philip A. Mickelson, "OPEN Receives $38 Private Equity Acquisition Bid," JP Morgan (October 16, 2006).
[34] CNNMoney.com, "Top Ten Deals" (February 23, 2007).
[35] Peter J. Heckmann, Timothy W. Willi, and Craig A. Richard, "Another Takeover Announced in Bank Technology Space; We Suspect There May Be More to Come," AG Edwards (December 21, 2006).
[36] Steve Bills, "Fidelity Unit May Be Closing In on Fiserv," American Banker Online (October 27, 2006).

also speculate that a new management team may not want to deal with the near-term demands of Wall Street and therefore may look very favorably on a private-equity deal.[37]

Going Public, 2006 and After

Wall Street enthusiastically accepted MasterCard's May 25, 2006, Initial Public Offering (IPO), driving up the share price from $46 per share at initiation to $98.49 on December 29, 2006—a 114 percent increase. Investors seemed to wave off concerns about MasterCard's long-term legal problems and used shares of MasterCard as a way to bet on consumer spending without the credit risk.[38] Some of the funds raised through the IPO are designated for litigation and settlement expenses. Additionally, the new corporate structure is designed to help protect the organization from antitrust charges associated with the setting of interchange fees.

Visa is following MasterCard's lead and is in the midst of transforming itself into a public company over the next 12 to 18 months. Analysts' valuations of a public Visa vary widely, ranging from $12.5 billion[39] to more than $13 billion,[40] or from $15 billion to $25 billion.[41] Whether these structural changes at Visa and MasterCard are based solely on formidable legal challenges and high potential liabilities is hard to say. Both associations are planning on yet-to-be-announced acquisitions and product development, plans that suggest greater vertical integration in electronic payment processing. With billions of IPO dollars available, Visa and MasterCard companies may be more willing to settle legal claims that are hampering their actions and strategy.

Banks will certainly have less control over Visa and MasterCard's operating rules, which have always been designed to protect large card-issuing banks. Incentives for reducing bank liabilities for payment processing are likely to disappear.

Other Significant Structural Events in 2006: Spin-Offs and Acquisition Activity

The TSP portion of Fidelity National Financial was spun off and became its own public company, Fidelity National Information Services.

First Data Corporation spun off highly profitable Western Union on September 29, 2006; the spin-off made First Data and Western Union two independent, publicly owned companies.

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[37] Tim W. Willi, Peter J. Heckmann, Mark C. Jordan, Craig Richard, and Tracey McMillin, "2007 Services Outlook—Positive Bias on the Group, But We Do Not Expect Material OutPerformance," AG Edwards (January 5, 2007).
[38] Niamh Ring, Rob Blackwell, Alan Kline, March Hochstein, Matt Ackermann, and Will Wade, "Red Flags, Purchases, IPOs, and Familiar Legislative Debates," American Banker Online (December 1, 2006).
[39] Robin Sidel, "Visa IPO Should Speed Innovations in Payments; Rivalry with MasterCard Will Encompass Investors, Acquisitions, New Services," *Wall Street Journal* (October 12, 2006).
[40] George Raine, "Visa Plays IPO Card," *San Francisco Chronicle* (October 12, 2006).
[41] Andrew Cornell, "Visa Sets Timetable for Public Offering," *Financial Review* (October 12, 2006).

In addition to major spin-offs, there was also major acquisition activity among the top eight TSPs in 2006 (see Appendix A).

Speculations for 2007: Acquisitions and Repurchases

Fidelity or Open may attempt to acquire the TSP unit of Harland.[42]

Fiserv is expected to continue making niche acquisitions rather than broad acquisitions to gain greater market share.[43] Fiserv itself says it will pursue acquisitions that are aligned with its growth strategies—specifically, acquisitions that add to its existing scale, primarily in the financial segment and the insurance segment.[44]

Citing Jack Henry's size, strong market share in credit unions, and valuation, several analysts think the firm is a potential acquisition candidate.[45] Other analysts speculate that a larger competitor or an IT or software vendor might be a potential acquirer of Jack Henry.[46] Jack Henry itself says that this past year's entrance of private-equity groups has made acquisitions more expensive, often at multiples too high for a public company.[47]

MasterCard and Visa have or will have the money to pursue significant acquisitions, but it is not yet clear what such acquisitions might be. There is some speculation that the merchant-acquiring business may be under consideration. MasterCard International has still not revealed its acquisition strategy or how it plans to use the funds garnered from the IPO, although its president has indicated that processors of payment transactions may be possible acquisition targets for MasterCard.[48]

First Data appears to be accelerating its acquisitions in 2007, with a special interest in broadening its payment processing services to merchant and financial institutions.[49]

Below are the views of some experts on technology mergers and acquisitions for 2007:[50]

> *David Parker (Piper Jaffray)* says the drivers behind last year's activity—maturing firms looking for growth and capital—are still there; however, he doubts

[42] Steve Bills, "Will Harland Sale to M&F Derail Tech Unit Spinoff?" *American Banker* (December 21, 2006).
[43] Peter J. Heckmann and Craig A. Richard, "Lowering to Gold; Current Valuation Seems to Offer Balanced Risk/Reward for 2007," AG Edwards (January 3, 2007).
[44] CallStreet, "Q2 2007 Earnings Call," CallStreet Raw Transcript (February 8, 2007).
[45] Peter J. Heckmann, Timothy W. Willi, and Craig A. Richard, "Another Takeover Announced in Bank Technology Space; We Suspect There May Be More to Come," AG Edwards (December 21, 2006).
[46] Gregory Smith, Jennifer Dugan, and Susan Kuo, "Solid Story, but Fairly Valued; Initiating at Neutral," Merrill Lynch (November 27, 2006).
[47] CallStreet, "Q2 2007 Earnings Call," CallStreet Raw Transcript (February 8, 2007).
[48] Jay Loomis,. "MasterCard Could Make Acquisitions," *Journal News* (July 19, 2006).
[49] Steve Bills, "First Data: Deals to Spur Merchant Processing Growth," American Banker Online (February 22, 2007), and SNLi, "History of Acquisitions," SNL Interactive (accessed on March 4, 2007).
[50] Marcelo Prince, "Panel Divided on Outlook for 2007," Wall Street Journal Online, (December 29, 2006).

> that technology mergers and acquisitions will be as strong in 2007 as they were in 2006.
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> *Greg Peterson (Pricewaterhouse-Cooper)* expects more telecom and software consolidation because “the consumer now wants a single wire coming into [his or her] home with everything.”
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> *Ken Marlin (Marlin & Associates)* thinks spending will moderate because the number of good companies available is limited, and some potential deals are now less attractive because of rising prices.
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> *Stephen Fraidin (Kirkland & Ellis)* believes the pace could be inhibited by the widening stock-options backdating scandal.
>
> *Paul Deninger (Jefferies Broadview)* states that private-equity firms will continue to drive mergers and acquisitions because “there appears to be no end in sight to the capital available,” and CEOs want relief from “the onerous conditions under which public companies must now be run.”

Merger and acquisition volumes tend to be somewhat cyclical; apparently some of the experts believe the cycle is still at a high point, whereas others believe it is starting to drop.

Appendix B provides information on TSP repurchases in 2006.

Projections for 2007: Stock Repurchase Plans

Fidelity. In October 2006, Fidelity’s board of directors approved $200 million in a share repurchase program.[51]

First Data. First Data is expected to repurchase approximately $500 million in stock in 2007. [52]

Fiserv. With its 4th quarter 2006 results, Fiserv announced a new 10 million share buyback (approximately 6 percent of outstanding).[53]

Jack Henry. Citing the company’s under-leveraged balance sheet and strong cash flow, some analysts stated that they expect it will continue to repurchase its stock.[54]

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[51] Michelle Kersch and Mary Waggoner, “Fidelity National Information Services’ Board of Directors Approves $200 Million Share Repurchase Program and Declares Quarterly Dividend,” Fidelity Press Release (October 25, 2006).
[52] Will Retzer, “Behind the Q/K: First Data Corp. (2006),” SNL Interactive (February 23, 2007).
[53] James Kissane, Kristen Duca, and Georgios Mihalos, “Solid Margins, Sluggish Growth,” Bear Stearns (February 1, 2007).
[54] Nik Fisken and Brett Huff, “Clean Quarter; Still Hard to Find Major Growth Driver,” Stephens Inc. (February 8, 2007).

Appendix A

Selected Details of the Top 8 TSPs' 2006 Acquisitions

TSP Name	**Total Value of Acquisition**	**Name and Type of Acquisition**
Fidelity	$2.8 million in cash and assumption of $13.3 million in debt	Proservvi (back office bank-processor)
	$8.5 million cash and earn-out incentives of $2 million	Watterson Prime (loan due diligence servicer)
First Data	$193.8 million $85.1 million N/A $18.7 million	Argencard, S.A. (payment transaction processor) Peace Software (custom information system software) Gesellscaft fur Zahlungssysteme mbH (payment processor) ClearCheck (payment processor)
Fiserv	N/A	CareGain, Inc. (health care)
	N/A	Innovative Cost Solutions (health care)
	N/A—42 employees	Insurance Wholesalers Inc. (insurance industry)
	N/A—2005 revenues were $43 million	InsureWorx (insurance/health care)
	N/A—2005 revenues were $44 million	The Jerome Group LLC (digital print provider)
	N/A	Assets of Wolters Kluwer, NV(investments)
Jack Henry	$26.8 million N/A	U.S. Banking Alliance (software provider) Two liability management software applications from CUNA Mutual Group
MasterCard	N/A	N/A
Metavante	$75.1 million $27.8 million $41 million	VICOR, Inc. (payment processor) AdminiSource Corp. (payment processor) Valutec Card Solutions (payment processor)
Open	Approximately $470 million in cash	Bisys TSP Unit
	$33 million	Raddon Financial Group, Inc. (processing software and hardware)
Visa	N/A	N/A

Source: Various Wall Street analyst reports, company Web sites, and SEC reports.

Appendix B

Selected Details of the Top 8 TSPs' 2006 Repurchases

TSP Name	**No. Shares Repurchased**	**No. Shares Outstanding**
Fidelity	4.26 million shares for approximately $160 million	192 million shares as of 2/7/07
First Data	35.5 million shares for approximately $1.3 billion	752.99 million shares as of 3/2/07
Fiserv	12.7 million shares for approximately $560 million	170.59 million shares as of 3/21/07
Jack Henry*	2.26 million shares for $48 million	90.7 million shares as of 2/8/07
Note: MasterCard only recently went public so there are no repurchases to report.		
Metavante is a subsidiary of Marshall & Ilsley so there are no Metavante shares.		
Open Solutions recently went private therefore this information is no longer relevant.		
Visa has not yet gone public so there are no repurchases to report.		

Source: Various Wall Street analyst reports, CallStreet transcripts and Yahoo! Finance.
*Jack Henry's numbers are for June 2006–December 2006—the first six months of the firm's fiscal year 2007.