

CUSTOMER NEEDS AND STRATEGIES

IBM's "Secret Weapon": IBM Global Financing Funds 10-Year Deal With CLS Bank International

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IDC OPINION

In 2002, CLS Bank International signed a complex, 10-year financing deal with IBM Global Financing to fund a 10-year outsourcing agreement with IBM Global Services for developing and managing the infrastructure for CLS Bank's foreign exchange settlement service. The outsourcing agreement was signed as a follow-up to a large-scale project, where IBM helped CLS Bank design and implement the settlement system.

Although CLS Bank is owned by 71 of the largest financial institutions in the world, the Bank chose IBM Global Financing for its ability to construct a finance deal with fixed interest rates over the period, speed of implementation and flexibility in the funding arrangements.

IDC believes that the ability to offer extensively tailored finance agreements to its customers in complex, transformational projects could provide IBM with a competitive advantage. However, we also believe that there are a few caveats:

- ☒ Only few IT service providers, such as IBM and HP, have their own finance organizations to handle these complex deals.
- ☒ Customers may consider the dual proposition of financing and service delivery as tying them too close to one service provider. However, according to CLS Bank, IBM has demonstrated an arm's length relationship between the financing and the delivery of service. IBM needs to emphasize this with new clients. It could also do well by underlining that clients may have more leverage as IBM has more skin in the game due to the dual proposition.
- ☒ Offering the financing of a long-term, high value deal as well as delivering on the service contract is a major commitment on the part of the service provider. Consequently, IDC expects that IBM will choose carefully which customers it wishes to offer the full deal.

IN THIS STUDY

This study describes a major project financing deal that IBM's Global Financing division has signed with CLS Bank International. The study further briefly describes IBM's overall engagement with CLS Bank — an engagement that started independently of the financing agreement but where IBM Global Financing has played an instrumental role in securing a continuation and expansion of the relationship. Finally, the study offers IDC's view of the role of project financing in the context of major business process and transformational outsourcing engagements.

SITUATION OVERVIEW

CLS Bank

CLS Bank International was launched in November 2001 as a private sector initiative with the purpose of handling settlements in the foreign exchange market for its shareholders (see Ownership section below). CLS Bank further settles transactions for over 170 third-party banking customers via its CLS members. In September 2004, CLS Bank set a new record when it settled 143,896 payment instructions in one day with a gross value of \$.536 trillion. On average, the bank settles over 130,000 payment instructions a day derived from foreign exchange deals with a gross value in excess of \$1.4 trillion.

CLS Bank uses a Continuous Linked Settlement process to enable cross border currency transactions to be settled intra-day on a payment versus payment basis. Before the introduction of this process, banks had to rely on a global network of correspondents to ensure that they received their payments in one currency as they paid in another. The settlement, and hence the risk incurred, could leave the financial institutions in open positions for a couple of days or more. CLS Bank offers a real time, global settlement system that eliminates the settlement risk caused by delays arising from settlements across time zones. This represents a major improvement for the participating banks and a substantial elimination of risk.

CLS Bank links to the Real Time Gross Settlement systems operated by Central Banks in eleven currencies (US Dollar, Euro, UK Sterling, Japanese Yen, Swiss Franc, Canadian Dollar, Australian Dollar, Swedish Krona, Danish Krone, Norwegian Krone and the Singapore Dollar) with additional currencies being added over time.

Ownership

CLS Bank's shareholders count more than 65 of the world's largest financial institutions, including Bank of Montreal (Canada), Danske Bank (Denmark), BNP Paribas (France), Deutsche Bank (Germany), Bank of Tokyo-Mitsubishi (Japan), ABN AMRO Bank (Netherlands), Banco Santander (Spain), UBS (Switzerland), Barclays Bank (UK), Citibank, Goldman Sachs Group, and J.P. Morgan Chase & Co.

CLS Bank, a subsidiary of CLS UK Intermediate Holdings, is an Edge corporation — a U.S. banking corporation organized under section 25(a) of the U.S. Federal Reserve Act to carry out international banking transactions.

CLS UK Intermediate Holdings is the intermediate holding company of the CLS Group and is a limited company incorporated under the laws of England and Wales. CLS UK Intermediate Holdings is a "shell" company from a governance perspective and its principal role is to provide corporate services to CLS Bank and its affiliated companies (such as Finance, Human Resources, Audit, and Communications).

CLS Group Holdings AG is a company incorporated under the laws of Switzerland and is regulated by the Federal Reserve as a bank holding company in the United States. The CLS Group further counts CLS Services Ltd., a limited company also incorporated under laws of England and Wales. The principal role of CLS Services is to provide operational and back-office support to CLS Bank and its affiliated companies.

The Relationship with IBM

The relationship between CLS Bank and IBM started before the involvement of IBM Global Financing. IBM was responsible for the system design, development, and implementation of a global straight through processing (STP) infrastructure to support CLS Bank's foreign exchange settlement system, which went live in September 2002. In late 2003, this relationship was expanded to a 10-year outsourcing agreement worth €244.2 million to support and manage the infrastructure supporting CLS Bank's settlement service. As part of the agreement, IBM will deliver a range of extensions both in terms of capacity and new functionality.

IBM Global Financing

IBM established its financing arm in 1981, primarily to help customers finance their IBM purchases. However, over time the offerings have been expanded dramatically so that IBM Global Financing (IBM GF) is now able to offer a broad range of finance services for OEM, as well as IBM, technology and services. IBM GF claims to be the world's leading provider of multi-vendor IT financing solutions. In 2003, IBM GF had assets of \$36 billion and operations in over 40 countries.

IBM GF has three main strands of offerings, handled by three separate organizations:

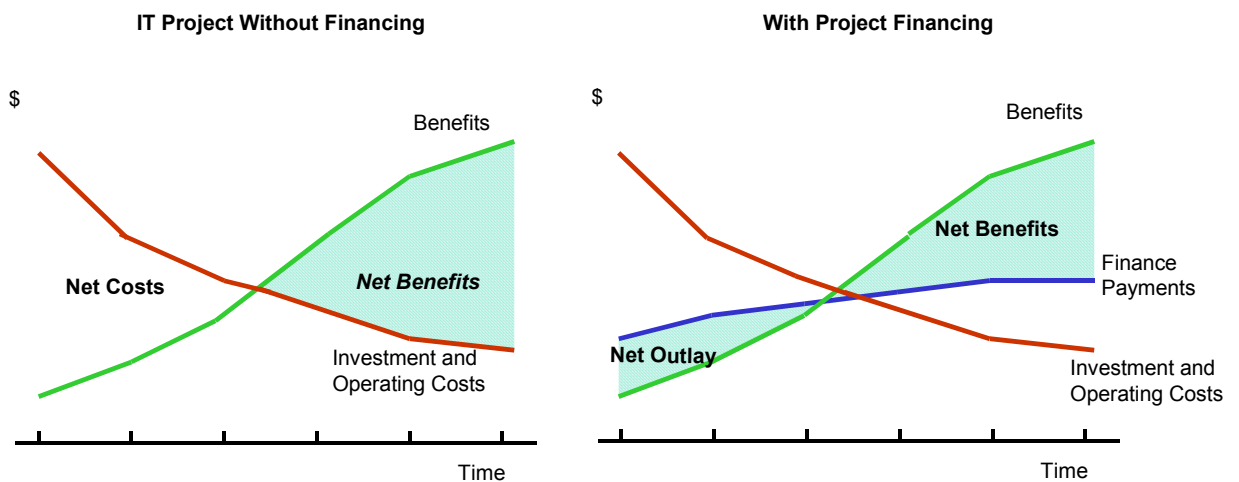
- ☒ **Customer IT Financing.** This part of IBM GF offers leases, loans, and project financing for IT-based solutions. IBM GF finances IT solutions for 95 of the Fortune 100 companies. In 2003, Customer IT Financing had assets of \$26 billion and \$14 billion in originations (contract value signed). Finance offerings range from specialized small business lease arrangements, offered through partners, through to international cross-border leasing arrangements for large enterprises.
- ☒ **Asset Recovery Services.** IBM GF's Asset Recovery Services handles the return of used equipment and manages residual values through remarketing or refurbishment of this equipment where possible. Worldwide, Asset Recovery Services handles 22,000 end-of-lease machines weekly. The organization is also responsible for data cleaning and safe deposition of used equipment.
- ☒ **Channel Financing.** This organization is focused on supporting IBM partners and suppliers through financing, principally, inventory and accounts receivables. In 2003, Channel Financing had \$6 billion in assets and \$24 billion in originations.

Project Financing

Recently, IBM GF has started to focus more on developing highly customized, tailored finance solutions for its customers to support them in large, complex project deals or long-term transformational outsourcing projects. The concept behind IBM GF's project financing offering is illustrated in Figure 1.

FIGURE 1

IBM Global Financing: Project Financing Concept



Source: IBM, 2004

The figure on the left illustrates a typical flow of costs and benefits realized in an IT project without financing. The customer will have to pay out an initial investment sum and will continue to pay project and operating costs over the term of the project. Outlays will typically decrease over the period as project costs decrease or as a result of improved processes or efficiencies leading to lower operating costs. There will typically in any project be a time delay before the customer starts seeing real benefits — or indeed before the benefits outweigh the costs.

The issues relating from this schism, and ones that IBM GF believes it can help alleviate, are that companies will have to consider whether their cash flows will be able to sustain the initial phases of the project or whether they should down-scale the project in order to address budget constraints.

The figure on the right illustrates how financing the project can help match outlays with realized benefits by smoothing out payments over the duration of the project. IBM GF further claims that project financing also simplifies the financial arrangements since all costs and payments can be integrated in one place and outlays over the project life become regular and predictable.

These benefits are present in most finance agreements. However, for project financing IBM GF has added various complementary and specialized lending lines that can be used to create the tailor-made and often complex finance solution.

The CLS Bank / IBM Global Financing Deal

The Challenge for CLS Bank

As described above, the key challenge for CLS Bank was to launch its global foreign exchange settlement service for the world's largest trading banks and their customers. Despite the fact that CLS Bank is effectively owned by 71 large financial institutions, the bank is essentially a start-up, facing a challenge common to other start-ups: how to handle the significant up-front project costs related to establishing its core business systems while ramping up its revenue streams in the first three years of its existence.

Selection of the Financing Deal

CLS Bank was looking for financing for the full 10-year deal with IBM. It also wanted to have a flexible financing deal to match the project, while at the same time being able to anticipate future outgoings. The Bank felt that it was important to have financing specifically related to the project so that it was able to preserve other lending needs. Finally, CLS Bank wanted to fix all project costs in the finance deal, while leaving room for future funding needs.

As a financial institution, CLS Bank has good access to the finance market. The bank essentially saw three main alternatives for funding:

- Approach its owner banks for extra equity funding
- Go to the financial market for funding
- Use IBM's Global Financing offerings

The first two options were discarded for a few different reasons: firstly, CLS Bank was looking for a 10-year term on the finance agreement, with a loan required in tranches to match expenditures. This is not a common finance option for banks to handle. Typically, tranches of loans at different stages would require each tranche to be treated as a separate loan. This would also typically mean that the interest rates on the loans would be determined at the time of inception of each. Consequently, CLS Bank would not be able to accurately predict cash flows over the full life of the funding. Secondly, CLS Bank expected that raising funding via the first two options would be a drawn-out process since it involved negotiations with several parties.

The IBM Project Financing Solution

The finance deal that IBM GF offered to CLS Bank has the following main components:

- A 10-year rolling funding plan** worth €244.2 million
- Flexible early termination points.** IBM GF included a number of flexible early termination points in the contract, which did not penalize CLS Bank if it wanted to change IT service provider. This reassured the board of CLS Bank that IBM would not use the financing agreement to tie the bank to its IT services. Along with the flexible early termination points, CLS Bank was given the option of repaying up to €19.3 million of the original loan after the first year. This would reduce interest costs associated with the whole deal without introducing any

penalty payments and address the uncertainty of exactly how much financing was required and for how long.

☒ **Trust account to hold funds.** CLS Bank wanted the option to withhold payment for IT services should they fail to meet acceptance standards. IBM GF agreed to set up a trust account into which money is drawn from the loan each month. CLS Bank controls payments from this account and none have yet had to be withheld. The fact that funding is signed off only if acceptance standards are met introduces a built-in monthly review ensuring tight project management and early identification of any potential issues.

☒ **Fixed interest on future milestone loans.**

The Experience So Far

CLS Bank has been very happy with the deal that it struck with IBM GF. It feels that it has managed to get a fully tailor made finance agreement that suited its needs. Although CLS Bank outperformed its growth plan by the end of the first year of the finance contract it chose not to make the repayment allowed within the terms of the agreement. This allowed it to keep the working capital base it had established. According to CLS Bank, this decision was also made because it has had a positive experience of working with IBM GF. If this had not been the case, it may have chosen to reduce its indebtedness to IBM.

CLS Bank also believes that the ability to withhold payments if IT services do not meet acceptance standards is a major advantage. So far, it has not had to withhold any payments, but it is still aware that it is in control of the payments.

An added benefit from the trust fund is also that it has increased the board-level attention and visibility of the outsourcing agreement in CLS Bank, and quick resolution of any issues that may arise.

CLS Bank states that despite the fact that both the outsourcing and financing agreements are with IBM, it has not seen any dependencies between IBM as a service provider and a financier.

FUTURE OUTLOOK

CLS Bank

Although nothing is currently on the cards, CLS Bank expects to consider IBM GF for further financing deals.

IBM Global Financing

Project financing is an area of investment for IBM. The offering and supporting organization has been established in North America and EMEA and will be rolled out as a worldwide offering across all industry sectors. IBM says that it has already seen significant traction for project financing, including wins in the government sector. The company reports a solid pipeline building for global, U.S.- and Europe-based clients, which it claims shows the broad appeal of project financing across industry sectors and services segments.

ESSENTIAL GUIDANCE

In the past few years, the outsourcing markets — IT and BPO — have been the most buoyant segments of the services market. A high number of large, complex, long-term deals have been signed — but little attention has been given to how these deals are financed. There has been much discussion about different types of contracts, such as risk-reward arrangements. However, risk-reward contracts are most often focused on providing peace of mind for the customer by showing financial commitment from the service provider. Perhaps the underlying issue in large projects should be focused on how to ensure that there is the closest possible match between benefit realization and cost of the project, not just ensuring that the project actually delivers the expected benefits.

Project financing can therefore play an important role in structuring and funding large-scale transformational projects. After all, many of these large deals run into the hundreds of millions — if not billions — of dollars. Project financing is widely used in many other sectors, such as transportation, construction, and the energy sector. It seems only logical that it can also play a major role in financing IT infrastructures. IDC has the following observations regarding IBM's project financing offer:

- ☒ Only a few IT service providers, such as IBM and HP, have their own finance organizations to handle these complex deals. Instead, many IT service providers deal with specialist financiers, e.g. GE Capital. However, to the best of IDC's knowledge, IBM is fairly unusual in having the in-house capability to facilitate an integrated offer of a large-scale transformation project and the means of funding it.
- ☒ By offering financing options and associated benefits that would not be available in a "non-financed" engagement, IBM is in a position to compete effectively for large projects without having to resort to dubious contract pricing levels. Effective financing can provide differentiated financial benefit to customers which in turn allows IBM to deliver the project with levels of quality and profitability that are not compromised by a "rock-bottom" pricing strategy. This thinking can prevent the corner-cutting issues that often affect delivery performance in major outsourcing deals.
- ☒ The challenge for IBM will be to provide customers with the big-picture view of the financed option, particularly in a market with a strong focus on short-term cost reduction and a high level of sensitivity to pricing issues. In the CLS Bank example, financing was a key requirement for the customer, but this is unlikely to be the case for many potential clients, for whom complex, long term financing might not be seen as a leading argument — quite possibly because they are not aware of IBM's capabilities in this field. Shorter term, technology-focused deals seem less likely candidates for this treatment (beyond the more traditional leasing constructions), but the complex, long-term transformational deals that are currently emerging seem like an excellent fit. It is now up to IBM GF to raise levels of awareness and provide the necessary educational support to build a focused financing message that can be leveraged across IBM's customer base.

- ☒ However, IBM must ensure an arm's length relationship between fulfilling the service commitments under the contract and the finance arrangement. The customer must be in control of payments on the service contract, based on acceptance levels. The set-up in the CLS Bank deal seems to address this issue. However, some customers may feel that having this dual relationship with their service provider is to have all their eggs in one basket. This could be one of the challenges for IBM GF when taking its project financing offering to market.

- ☒ Offering the financing of a long-term, high value deal as well as delivering on the service contract is a major commitment on the part of the service provider. The risk that it takes on is that one customer engagement becomes significantly higher. Consequently, IDC expects that IBM will choose carefully which customers it wishes to offer the full deal. However, for service providers of a smaller scale than IBM and with less experience in financing, offering this type of deal is not feasible. Hence, IBM could use its IBM GF division as a weapon in the increasingly competitive outsourcing market.

LEARN MORE

Related Research

- ☒ *IDC's Top 100 European Outsourcing Deals of 2003*, (DC# RI02L, April 2004)

- ☒ *Europe's Top Performing Outsourcers of 2003*, (DC# RI53L, April 2004)

- ☒ *Lessons Learned from the Top 10 Western European Service Players in 2003*, (DC# Q09L, September 2004)

Synopsis

This IDC study describes the project financing deal that IBM has won with CLS Bank to fund an IBM Global Services project to design, implement, and run CLS Bank's global foreign exchange settlement system. It briefly describes the project but focuses on the finance deal signed between IBM Global Financing and CLS Bank.

"Only a few IT service providers have their own finance organizations to handle these complex deals and even fewer are able to offer an integrated approach of service delivery and complex financing agreements," said Marianne Kolding, director, European Services. "The challenge for IBM will be to provide customers with the big-picture view of the financed option, particularly in a market with a strong focus on short-term cost reduction and a high level of sensitivity to pricing issues. However, if IBM can effectively take this offering to market, then project financing could prove an added differentiator in the increasingly competitive outsourcing market."

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