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Moving Beyond Cost-Cutting

Leaders in Financial Services Focus on Performance Improvement

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The Industrialization of Financial Services

Banking used to be a relatively simple business, only slightly more complex than the old industry joke that claimed the business operated on a 3-9-3 rule: take deposits at 3 percent, lend them at 9, and get to the golf course by three o'clock. But those days are long gone. To capture a larger share of the market, most leading banks have extended their product portfolios, and many of the largest banks have diversified into new lines of business that range from financial advice all the way to insurance. At the same time, they have looked overseas and across borders toward new markets and sought greater scale through acquisitions.

Cost Challenges in Financial Services

Unfortunately, those new undertakings have frequently introduced complexity. Over time that complexity has dramatically increased costs, putting at stake the profitability banks hoped to gain through expansion. In the quest for rapid growth, many acquisitions have been acquisitions in name only. Often, historic silos and structures have endured long after the business reason for their existence no longer exists. As a result of this haste, much of the labor used to run operations remains in high-cost locations. When next-generation back office processing centers are put in place, they tend to be built specifically to serve the old silos and processes. This practice fails to capture

the opportunity to improve the structure and maximize operational efficiency. To make matters worse, the rise in cross-border operations has multiplied the number of regulations that must be observed, even as the regulations themselves (most notably Basel II and Sarbanes-Oxley) have grown so burdensome they might almost be considered a kind of tax on complexity.

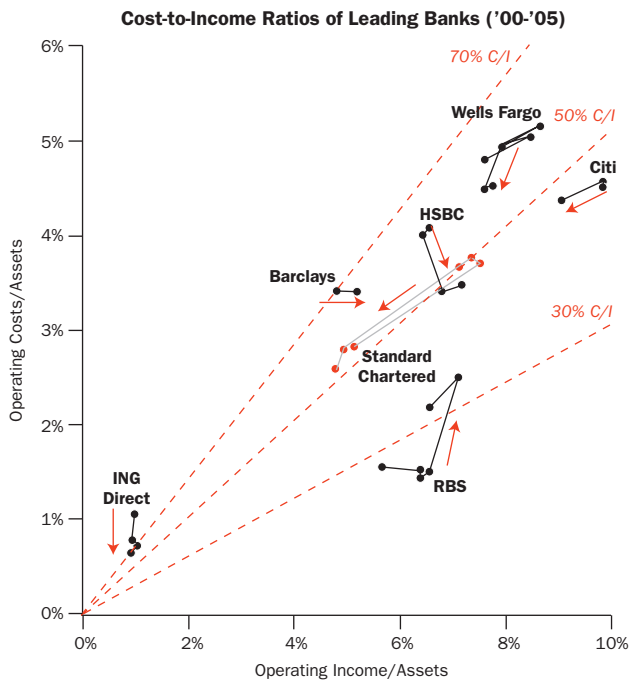
Not surprisingly, profit margins have suffered. Many banks have responded to this pressure by trying to cut costs, but those cost-cutting efforts have often increased customer dissatisfaction, hurt revenue, and left competitive openings for younger, more nimble banks and non-bank financial service providers.

Yet even after all that painful effort, the banks have succeeded only in maintaining their old cost-to-income ratios (see Exhibit 1, page 2). Why? First, the impact of cost-cutting initiatives was offset by lower incomes resulting from increased margin pressure. Second, and more important, these kinds of cost-cutting plans have failed to address the root cause of cost increase: complexity.

Faced with similar, but more extreme, challenges 20 years ago, manufacturers learned how to make significant, sustainable improvements to their profitability by taking a more holistic look at their overall cost structures. Through such disciplines as lean supply, Six Sigma, and activity-based costing (ABC), manufacturers developed a much deeper understanding of how to deliver higher levels of value

Exhibit 1

Few Retail Banks Have Significantly Changed Their Cost-to-Income Ratios

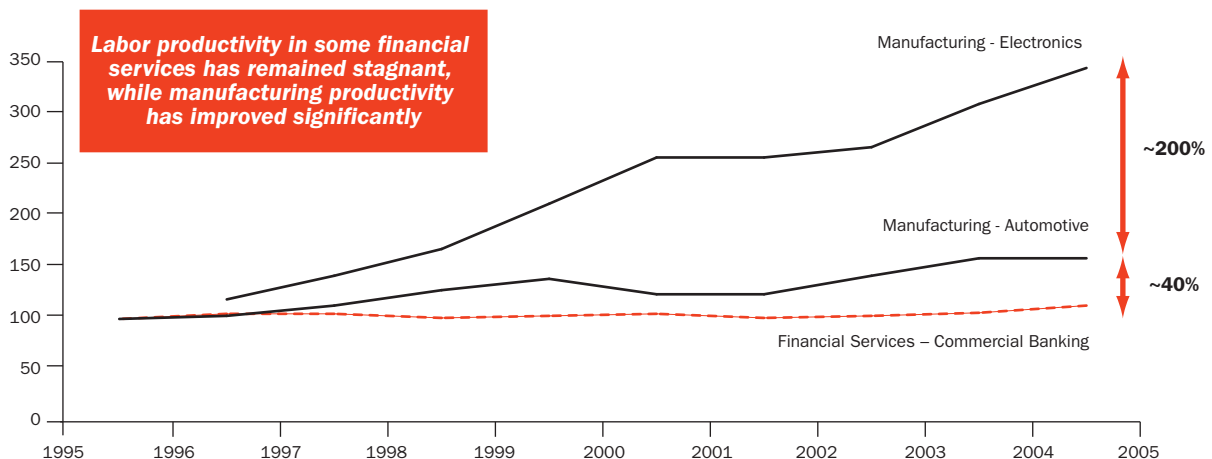


Sources: Company annual reports; Booz Allen Hamilton

to the customer at a lower overall cost. Since then, many firms have reduced costs still further through other kinds of strategic moves, such as sending labor-intensive work to low-wage countries and reengineering products by applying modular design. The result of such efforts is startling. According to an analysis of FTSE 100 companies, financial services experienced virtually no net gains in labor productivity since 1995.

Exhibit 2

Labor Productivity Growth by Industry



Sources: Bloomberg; U.S. Bureau of Labor Statistics; company annual reports

By comparison, the auto industry grew its labor productivity 40 percent more than financial services in the same period and electronic manufacturing 240 percent more (see Exhibit 2).

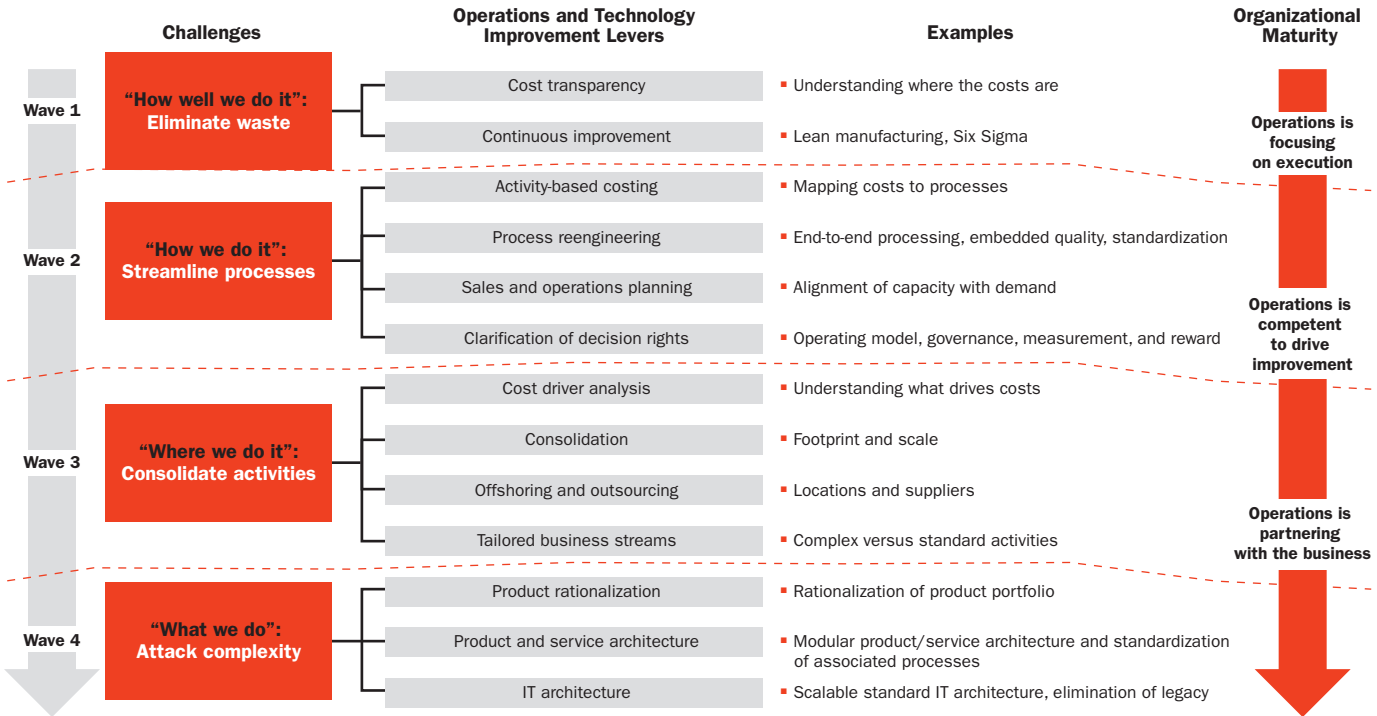
Four Waves of Operations and Technology Improvement in Banking

Fortunately, there is a way for banks to catch up. Using insights gained from the manufacturing revolution, some leading banks are now experiencing analogous cost improvements. They are beginning to undertake extensive cost transformations and are starting to achieve some dramatic gains. A few banks have even gone so far as to hire operations experts from the manufacturing world to help them redesign their value chains. These industry leaders have realized that even in a business where the products are not discrete (for example, computers) but are virtual exchanges of value, unnecessary process steps add cost.

Most of these initiatives can be thought of as proceeding in a series of waves (see Exhibit 3, page 3):

In **Wave 1**, banks seek to make minor modifications that can yield incremental gains in efficiency. Wave 1 cost improvements focus on how well activities are carried out without fundamentally changing how or where activities take place or what activities are executed. Lean manufacturing and Six Sigma initiatives are examples of Wave 1 improvements. These efforts are focused on eliminating waste and

Exhibit 3
Four Waves of Operations and Technology Improvement in Banking



Source: Booz Allen Hamilton

taking variability out of existing processes. The key requirement for success in Wave 1: cost transparency. Without a real understanding of cost, a Wave 1 campaign can go badly astray—the victim of inter-silo politics and all-too-fallible gut instincts.

In **Wave 2**, banks try to optimize how processes take place by streamlining and optimizing them as much as possible. This optimization can be realized in many ways, including cutting out unnecessary steps, avoiding duplication of activities, and minimizing the number of hand-over points within processes. Banks pursuing Wave 2 initiatives typically try to standardize processes as much as possible, embed quality within those processes, and align capacity to demand through sales and operations planning to create more efficiency. The importance of technology in Wave 2 savings cannot be underplayed either. Many leading banks look for gains through increased automation, developing straight-through processing (STP), whereby transactions are conducted electronically without

the need for re-keying or manual intervention. STP shortens processing cycles, reduces operational risk, improves certainty of settlement, and minimizes operational costs. Finally, in Wave 2 many banks also address governance issues such as key decision rights, roles, and responsibilities. All of these activities require an advanced understanding of cost. Using activity-based costing enables banks to map costs to processes, and prevents process architects from making shortsighted trade-offs that actually hurt overall performance.

In **Wave 3**, banks look to optimize processes by determining where activities should take place. Banks consolidate their footprint to realize economies of scale, rationalize their sourcing and supply base, and consolidate operations toward locations that make the most sense operationally, typically either nearshore or offshore. Leading banks separate standard from complex activities to create tailored business streams that allow them to balance the value of variety with

the cost of complexity. In this wave, an even more sophisticated understanding of costs is necessary. Through activity-based costing, leading banks generate a thorough understanding of the root causes and drivers of costs. Based on these insights, they are able to make the right choices in Wave 3 optimizations focused on where activities should take place.

In **Wave 4**, banks attack the sources of complexity even more directly by optimizing what activities should take place. Banks rationalize products and services to eliminate variety that does not create sufficient value. Banks also modularize the underlying product and service architecture of the remaining portfolio as a means to enable standardized processes. In this wave, banks create end-to-end, standardized IT architectures and eliminate IT legacy, allowing them to achieve even more dramatic cost savings than they were able to with other technology-related initiatives, such as STP. At the same time, they try to align executive incentives so that silos help reinforce the company's overall objectives rather than competing with each other. The key to success in Wave 4 is true partnering between the operations and technology function and the business lines, allowing for optimization of the products and services that are delivered to customers.

Where Leading Banks Are Focusing Today

So far, banks that have undertaken manufacturing-style cost reduction campaigns have focused mostly on Waves 1 and 2. Although these steps are important, they yield mostly incremental benefits. More dramatic results can be gained by pursuing the more difficult stages of cost transformation, Waves 3 and 4. Unfortunately, for a variety of reasons, these advanced cost transformation initiatives have been out of reach for many banks. But that is beginning to change.

Today, a number of leading banks are undergoing Wave 3 and Wave 4 transformation programs. Two especially strong Wave 3 initiatives have been undertaken by Citibank and the Royal Bank of Scotland, which are profiled here. Although these industry leaders have gone about their Wave 3 programs in different ways, both are similar in that they have not only learned to

generate cost savings by sending more work to low-labor-cost markets but by learning to improve and operate on a global scale. Citibank has created a large centralized core, while minimizing the capabilities of its local operations; the Royal Bank of Scotland has sought to gain efficiencies by breaking out the operations function under its own P&L responsibility, as a way to create a lasting institutional driver for greater cost-savings efficiency. Other banks, perhaps most notably Standard Chartered Bank and ING Direct, are pursuing ambitious Wave 4 programs, leveraging the capabilities created by technology as a way to gain more scale and consistency throughout the organization—Standard Chartered Bank through IT centralization; ING Direct through rigid standardization of processes and systems in each market.¹

▪ **Citibank—Global Consolidation**

Citibank Global Consumer Group has proceeded in its Wave 3 initiative by creating a large centralized core while leaving local operations extremely lean.

The mantra for operations is, “Think Global—Deliver Local.” Virtually all operations in the 100+ countries in which Citibank operates are controlled centrally. Many product lines are operated from e-Serve service centers in India. Other operations, such as call centers, are not consolidated to quite that degree, but do operate on increasingly standardized platforms and technology.

Organizationally, this centralization is reinforced by the reporting structure. The in-country chief operating officer, for example, reports not to the local head of that market but to the global COO. The relationship with the local head is considered a dotted and not a solid line, which helps ensure that decision rights regarding operations and technology remain in the heart of the organization. This knowledge sharing may even be helping Citibank Global Consumer Group to move more quickly on opportunities. For example, the bank has been able to leverage in Mexico its deep travel card knowledge gained from the U.S. market, and it is now taking that same expertise to China, where it plans to soon introduce China's first dual-currency credit card.

¹ Case studies were written using information in the public domain as well as Booz Allen expert interviews

- **Royal Bank of Scotland—A Manufacturing Approach**

Many banks now pay lip service to the idea of operations as a separate entity. Often, however, traditional reporting lines endure. One exception is the Royal Bank of Scotland (RBS), which has organized its operations into what it calls its Manufacturing Business Unit, a group with separate P&L responsibility.

Keeping operations centralized under this umbrella makes RBS's cost of operations very transparent, which helps executives see further opportunities for gains in efficiency and productivity. Although RBS made operations a separate unit, it has not walled off operations in other respects. On the contrary, RBS has made gains in part by working to improve communications between sales and operations. Now the manufacturing unit is a closely integrated part of the organization's planning process, which has helped the bank better align its capacities with its marketing plans.

At the same time, care was taken to ensure that the separation was not seen as a degradation of the value of operational functions. On the contrary, the CEO of this unit is also a board member—another important signal that operations is taken very seriously.

- **Standard Chartered Bank—Standardized End-to-End IT Platform**

In a time when many bank executives just dream about bringing their IT systems into some degree of alignment, Standard Chartered Bank (SCB) has already developed a common core banking platform that it uses throughout its worldwide operations.

Developed in-house in the United Arab Emirates in 2002, the electronic branch banking system (eBBs) now provides end-to-end homogenous technology for both front- and back-office systems in more than 25 countries where SCB does business.

Rolled out to 25 different markets in only 18 months, the system is extremely flexible and scalable. Adding new products is relatively simple with eBBs, because little local customization is

required. The system has given SCB a tremendous boost in its speed to market, because a new product can now be rolled out throughout its branches in less than three months.

- **ING Direct—Simple, Standardized Products and Processes**

ING Direct is a bank that has succeeded through refraining from complexity. By keeping a tight rein on the complexity of its product portfolio and processes, the fast-growing global bank has expanded into 10 countries while remaining extraordinarily lean.

Operating out of Amsterdam with a small central staff, ING Direct manages to maintain a radical degree of efficiency for a fast-growing bank. It maintains its lean profile in three ways. First, it offers very few products—mostly savings and simple mortgages. Second, it operates entirely over the Internet and maintains no branches. Third, it works because every aspect of the operation in each country follows a standardized plan. Any deviations from what might be called its “bank-in-a-box” standard must be approved by a small—and conservative—committee consisting of experts who are selected case by case.

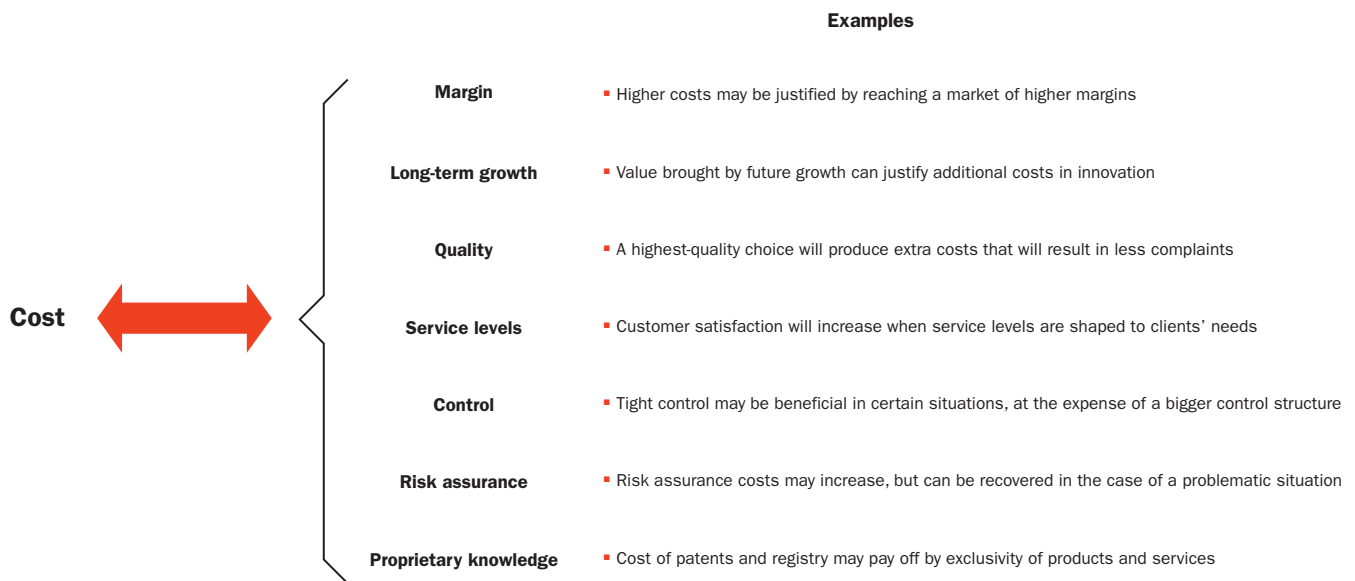
Unlike most global banks, ING Direct has not tried to consolidate its call centers and back-office processing in low-cost labor markets. Saying no to offshoring is an unusual strategic decision, but one that continues to work well in ING's case: The bank keeps bringing down its cost-to-income ratio by 40 basis points year after year, even as its revenues grow and its operations expand—and in spite of the fact that its non-marketing operations costs are already only roughly one-fifth those of the average bank.

Preparing to Transform

Each of the total cost transformation efforts profiled here differs in detail and in general strategic thrust. Some banks decentralize, others centralize; some outsource extensively, one does not outsource at all. However, they all have a common denominator:

Exhibit 4

Trade-Offs: Cost Versus Value of Strategic Imperatives



Source: Booz Allen Hamilton

They are working to bring Wave 3 and Wave 4 of the manufacturing revolution to the banking world through the disciplined execution of long-established manufacturers' insights.

To reach this point, each of these banks first had to overcome a number of hurdles. The first, and most general, was that they had to recognize their key challenge was not containing costs but learning to grow more profitably. In this fast-changing market, they saw that cost control must never come at the expense of profitable growth. They had to focus on making cost/value trade-offs to arrive at the right cost level, instead of the traditional benchmarking against lowest costs. They did not focus exclusively on reducing costs as much as possible; instead, they balanced cost containment against the strategic imperatives of the business and the value they deliver (see Exhibit 4). This insight allowed the banks to define strategic initiatives and determine what additional cost might be borne, given the expected future value of these initiatives. The concept of the right cost level allows a complete, integrated business

view and ensures that strategy, business model, operations, and technology are all aligned. Interfaces between organizational units are taken into account, as opposed to a less holistic geographic focus of business unit by business unit and function by function.

As we studied these four banks and others, we found that those successfully realizing Wave 3 or 4 cost transformations satisfied the following five prerequisites:

- *Centralized operations governance.* There is strong central guidance for the program. Senior management provides both authority and funding.
- *Balanced dialogue between operations and business.* The objectives for business and operations need to be aligned, and operations should be involved in business decision making.
- *Equal emphasis on local revenue and global cost control.* The bank must be able to increase revenue locally while trying to gain scale advantages from its global operations.

- *A manufacturing-style approach to operations.* As has been suggested earlier, the bank must draw on a manufacturing approach to operations, focusing on sustainable, ongoing results by optimizing end-to-end value chains and cutting across organization boundaries.
- *Disciplined execution.* Regardless of the levers chosen to implement improvement initiatives, a bank prepared for Waves 3 and 4 has strong, disciplined follow-through on its new policies and procedures.

Cost transformations pose many questions and challenges, which may discourage executives from deciding to embark on the venture to significantly increase sustainable profitability (see Exhibit 5).

Recognizing the questions and challenges that cost transformation poses, Booz Allen's Total Cost Transformation approach typically consists of three steps to make the transformation happen:

1. Strategy—Diagnosis and Target Setting. We begin by examining the gap between cost and performance, looking at where the bank is now and where it should be. Next, we analyze and understand the root

causes of that gap in efficiency. Finally, we analyze the potential for improvement, set a performance target, and build a commitment among the company's executives to drive the necessary changes.

2. Design. In this step, we work with the bank's executives to prioritize areas for improvement and set up an overall program structure. Before work begins, we develop a detailed understanding of the baseline and cost drivers that fall within each initiative and set out the specific steps that will be taken in the implementation phase.

3. Implementation. In this final step, the bank executive team takes charge of the process to ensure a high level of commitment to the transformation program. Working closely with executives, the consultants develop implementation and roll-out plans and later track the progress of each initiative via a designated program office. We train staff in the new processes and determine the right metrics and staff incentives needed to ensure the change endures.

Throughout the process, Booz Allen takes a cross-functional approach that combines our deep functional knowledge of operations and IT with our extensive

Exhibit 5

Critical Challenges Posed by Cost Transformations

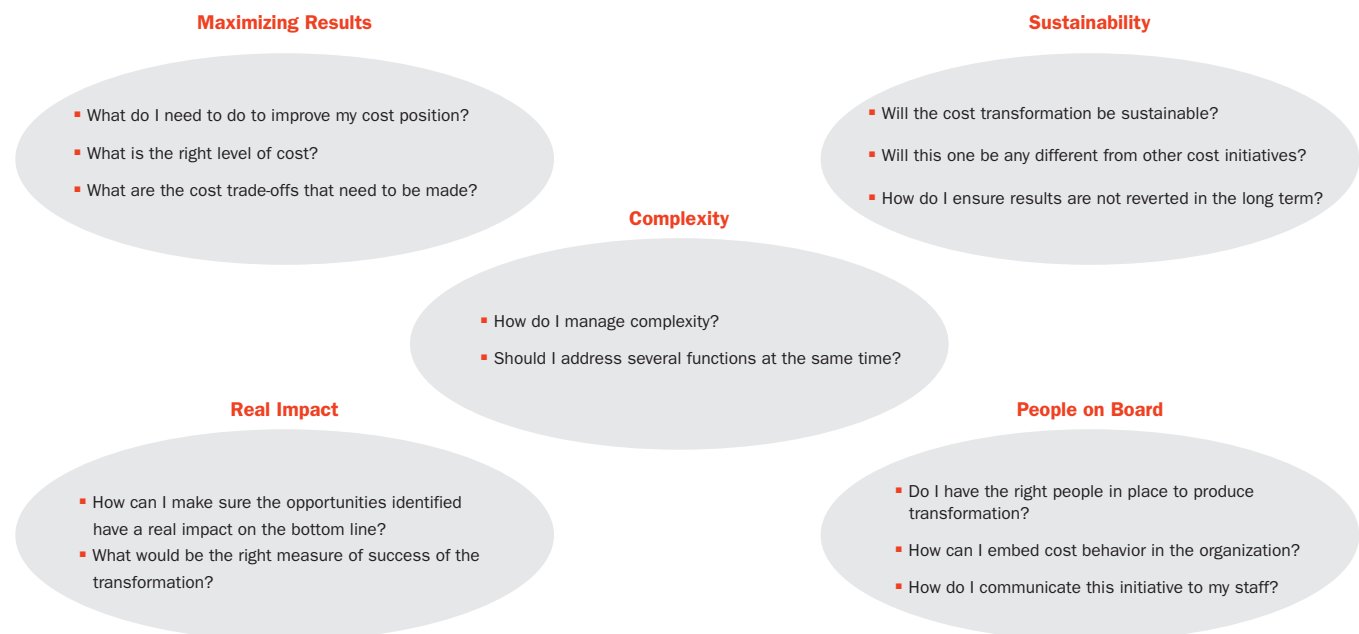


Exhibit 6

Booz Allen's Total Cost Transformation Approach



Source: Booz Allen Hamilton

industry experience in financial services. While every Total Cost Transformation differs in its particulars, every solution is typically built on this approach.

Conclusion

Clearly, manufacturers' approach to cost and efficiency is no longer exclusive to their industry. As the experience of the leading banks shows, despite their lack of a discrete, physical product, bank executives have an opportunity to make outsized improvements to cutting costs and inefficiencies—much as their counterparts in manufacturing did 15 to 20 years ago. Their experience also shows that sustainable improvements are not viable without a proper foundation—or rather, that the foundation is only the first step in such a campaign. Banks succeed in their Total Cost Transformation programs only after

satisfying a series of prerequisites that allow them to define a winning strategic plan. At the heart of that winning strategy is a fundamental rethinking of what products and services are offered and where the business is executed, as a means to address the underlying complexity that drives increased costs.

The required changes are difficult to realize and cannot be undertaken without the full support of top management. Yet, as executives at the leading banks have started to realize, the highly competitive market for financial services means that continuing to do business as usual is only an alternative in the short run. As the quality guru W. Edwards Deming once quipped, "It is not necessary to change. Survival is not mandatory."

What Booz Allen Brings

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 90 years. Providing consulting services in strategy, operations, organization and change, and information technology, Booz Allen is the one firm that helps clients solve their toughest problems, working by their side to help them achieve their missions. Booz Allen is committed to delivering results that endure.

With 19,000 employees on six continents, the firm generates annual sales of \$4 billion. Booz Allen has

been recognized as a consultant and an employer of choice. In 2007, for the third consecutive year, *Fortune* magazine named Booz Allen one of “The 100 Best Companies to Work For,” and for the past eight years, *Working Mother* has ranked the firm among its “100 Best Companies for Working Mothers.”

To learn more about the firm, visit the Booz Allen Web site at www.boozallen.com. To learn more about the best ideas in business, visit www.strategy-business.com, the Web site for *strategy+business*, a quarterly journal sponsored by Booz Allen.

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