Big, Bold Bank Cost Transformation

Costs won't fall out unless you overhaul the operating model.

By Peter Stumbles, Mohit Wadan, Andrew Carleton and Jason Heinrich

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"Where are the cost savings that everyone promised?" It's a chronic lament of bank CEOs and COOs after yet another session with their senior teams, reviewing progress from digital or productivity initiatives that have not delivered their projected savings.

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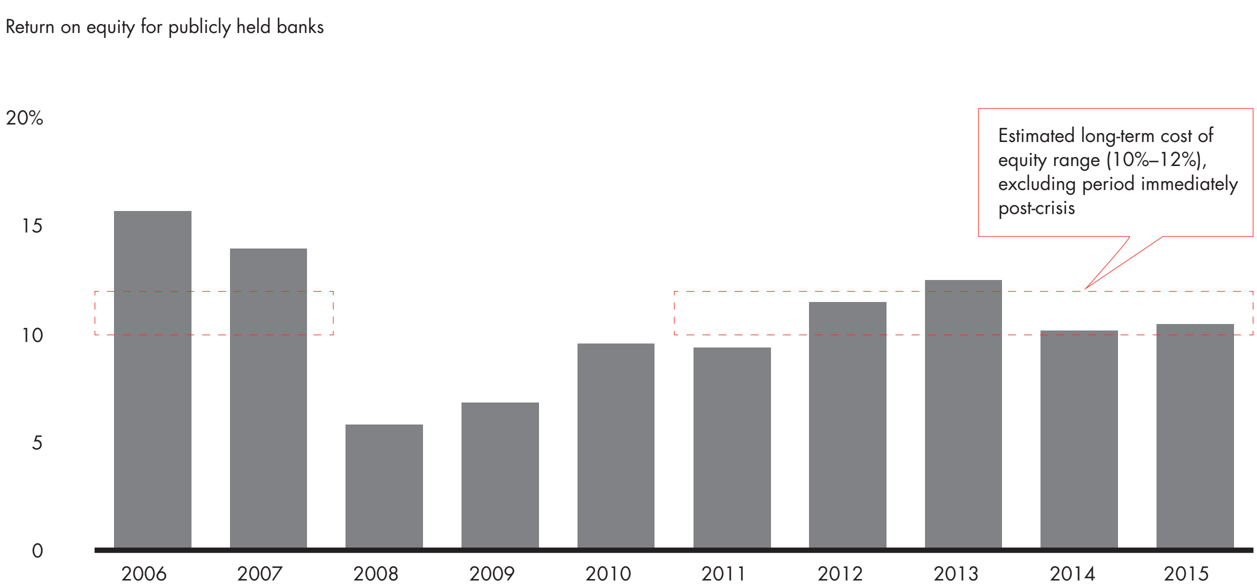
Any number of issues seem to derail programs that aim for big cost savings. Functional heads play the regulatory or risk-aversion card, while frontline managers assert that cuts within their own group will compromise growth or the customer experience. IT projects take forever and a day, and they often leave legacy cost structures intact. Through it all, costs keep creeping back.

It's no wonder that stalled cost controls persist like a low-grade flu. Eight years since the financial crisis, banks remain under pressure to improve profitability. On average, banks barely meet return-on-equity (ROE) levels that surpass their cost of equity, and banks in several markets, including the UK, Germany and Japan, are significantly underwater (see Figure 1). Of the various levers to achieve a higher ROE, such as revenue growth and greater leverage, productivity has become more important given macroeconomic and regulatory constraints.

How important? Globally, the top 20 banks by market capitalization need to shave off almost $50 billion, or 9% from their 2015 cost base, in order to deliver an ROE that is at least 1% above their waterline cost of equity, Bain & Company estimates. If the near future brings

Figure 1: Banks have struggled during recent years to cover their cost of equity



Notes: Cost of equity range based on investigation of 519 publicly held banks by market capitalization in 64 markets; individual equity and geographic markets differ significantly with a range broader than shown in chart
Sources: Capital IQ; Bloomberg; Bain & Company analysis

greater capital requirements, low interest rates, slow income growth and greater regulatory pressure on sales incentives, then earnings pressure and the corresponding cost challenges will only grow.

Banks thus face a major management challenge as well. They have already harvested the easy cost savings in response to the financial crisis by shrinking their branch networks, shedding riskier and less profitable business lines, and attacking shared services and individual categories such as procurement. Those gains, however, have been largely offset by cost creep, particularly in discretionary support and nonlabor expense categories, and in digital projects and regulation-driven investments such as risk management and compliance. The "efficiency dividend" once held out for significant technology investments has not materialized because many transactions still go through legacy processes. Most banks have focused on streamlining and automating existing processes, but they have not seriously considered removing some of the processes in the first place. Meanwhile, they have layered on complexity with new digital channels and additional compliance activities.

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Banks around the world commonly encounter several problems as they pursue the next wave of cost savings.

Failure to tackle the politics of issues that must span functions. If a bank reengineers and automates processes to reduce duplicate work and minimize delays, shouldn't it be able to drastically simplify decisions and reduce costs? That's fine in theory. In practice, to paraphrase Peter Drucker, the strong organizational silos in banking eat Six Sigma black belts for lunch. Almost two-thirds of lean programs fail to deliver the desired level of cost reduction, and 80% cannot sustain the savings, a Bain & Company assessment of 17 financial institutions found. Boundaries remain rigid among product, distribution, operations and IT groups, and the voice of the customer is faint. For processes such as obtaining a mortgage, there are too many handoffs from one function to another. Unless a bank commits to fundamentally changing the operating model itself, dismantling the silos and clarifying who is accountable for each component of cost, the odds of success for an initiative remain low.

Reluctance to deal with complexity. Too often, bankers focus only on how people work rather than on what work they do. Yet one of the biggest sources of cost is complexity. In the product portfolio, for example, maintaining too many legacy products and processes raises cost in the back office and confusion in the front office. Simplifying the product portfolio requires the courage to sell fewer, simpler offerings and then to migrate existing customers to the new offerings.

An overly incremental, conservative culture that prevents real progress. Most banks resist major change and tend to structure incentives so as to limit perceived risk. The accretion of small changes, however, adds complexity in its own way. For example, compliance staff are motivated to add more checks and balances, not remove redundant ones. Major changes require large targeted investments rather than evenly spreading allocations over many priorities. This doesn't mean taking excessive risks, but it does mean cutting deeper where warranted, being thoughtful where delicate and being wary of a veto culture that can prevent a bank from being more efficient.

Betting on digital to do it all. The business case supporting digital investments often assumes substantial savings from lower variable costs per transaction on a shared fixed technology cost base. In practice, digital investments have often added costs, without banks also migrating routine transactions from the branch and contact center in sufficient volumes to offset those costs. New, multiyear IT systems built through the traditional waterfall sequence rather than Agile methods wind up adding lots of fixed costs and complexity to an already fragmented IT landscape. Managers who avoid removing old channels and customized processes then have to maintain them. And Bain's recent surveys of consumers show that banks have been slow to deal with the "last mile" of digital, neglecting to guide and inform consumers on how to migrate from high-cost branch routine transactions to self-service mobile and online.

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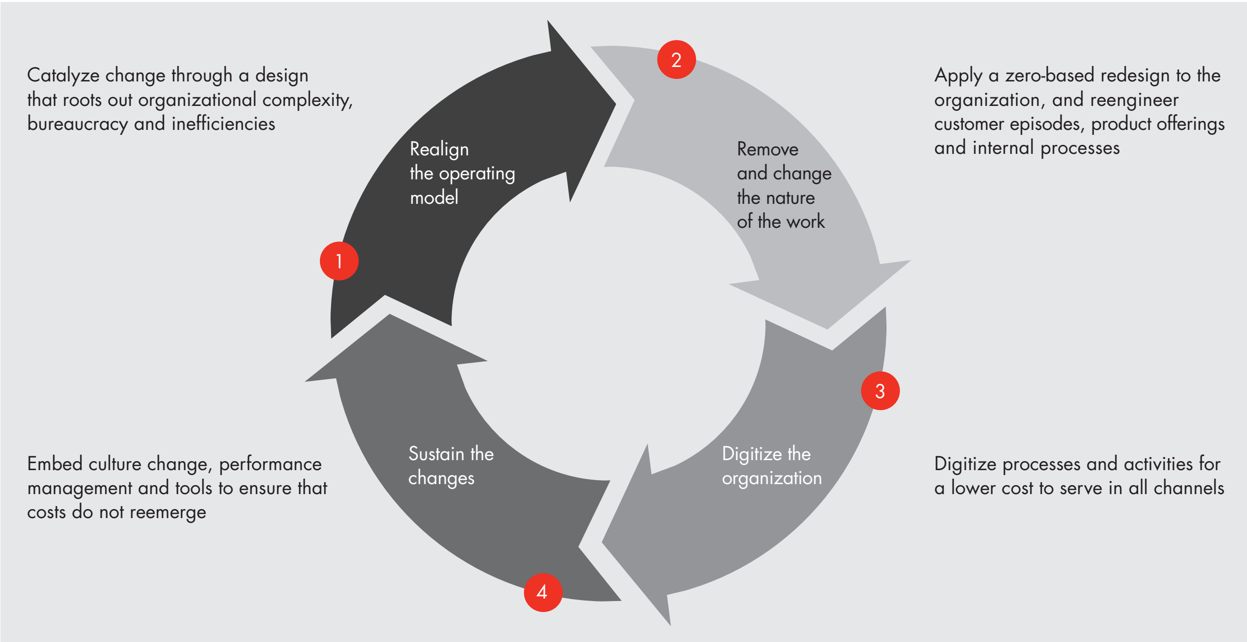
Chasing imagined regional or global economies of scale. Global universal and regional banks have tried to streamline costs through centers of excellence, aiming for a single fixed-cost structure of shared services, operations or common IT platform. But a global approach works only in select areas such as tight common governance for financial, risk management and capital allocation; specialized global product lines; or serving multinational customers with needs that cross borders. Beyond those and a few other instances, economies of scale have been elusive because country markets often require a high degree of direct, local, customized support, and large shared services raise overhead and duplication for all but the largest country markets.

Reducing cost and complexity in a major bank requires careful planning and orchestration yet at a fast pace. From our work advising and analyzing banks, we have discerned four practical guidelines that can help senior leaders balance the short- and long-term concerns in order to achieve a successful transformation (*see Figure 2*).

Figure 2: The four steps to bold cost transformation



Source: Bain & Company

1. Realign the operating model

To catalyze a transformation program, most banks will have to realign their operating model so that silos get dismantled and entrenched positions get shaken up. In recent years, we have seen some banks make overdue realignments on a number of fronts. Some revisited regional or global shared-services functions, devolving more control to country markets or customer-facing divisions. Others shifted from product-led structures to customer-led structures, with little loss of scale economies. Some revised their top three or four levels of management, removing redundant positions. Many reduced the number of branches or other nodes in the organization.

Depending on the magnitude and nature of the change required, the way a bank approaches the transformation will differ. A bank that significantly changes its operating model first will likely need a centrally designed and managed program. Incremental changes to the operating model, by contrast, might benefit from a more distributed program.

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When determining the right adjustments to the operating model, it pays to look in the seams. Every organizational structure creates boundaries among departments, geographic units or lines of business, and people must collaborate across them. What's important is to define these seams in a way that reflects how the bank creates value, that promotes better decision making and that balances business unit accountability with economies of scale. Realignment thus involves how people interact across these seams. A decision taken by the product group will have implications for the distribution and IT groups. Where two parts of the business don't align, complexity abounds—and costs and customers suffer.

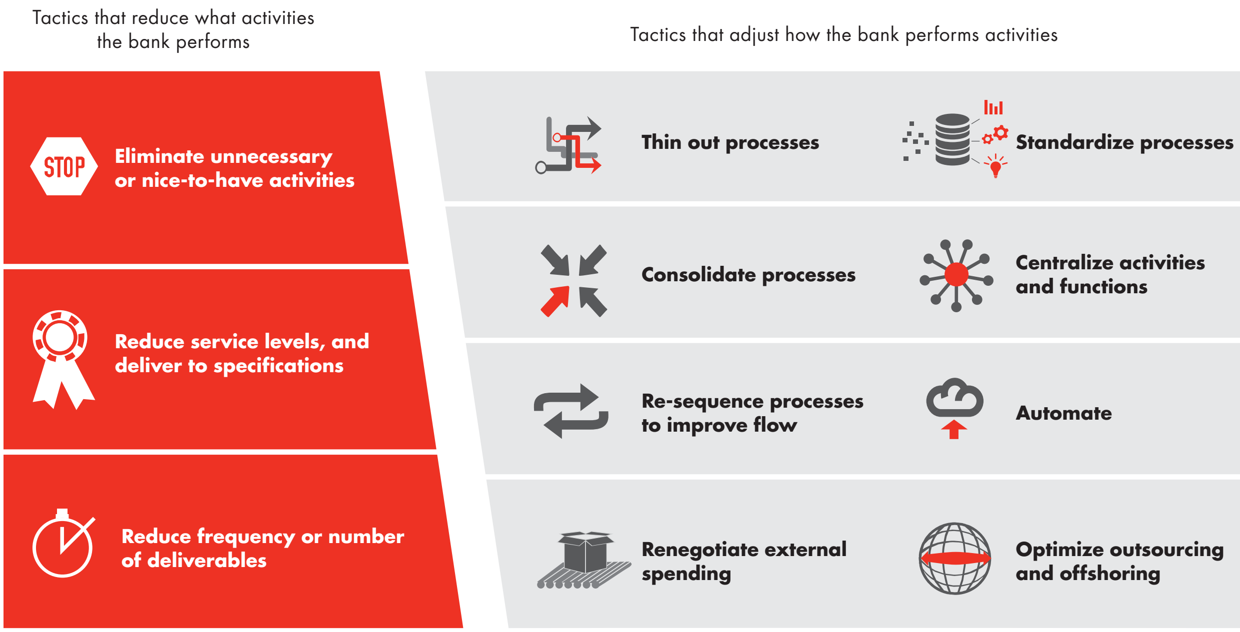
An example from insurance illustrates the point. One global insurer found that different parts of its business needed substantial realignment. Senior management changed the structure of accountability for the core business units. Those parts of operations (which had previously been run as a separate vertical) were brought under the direct control of the unit while the remaining operations shifted to a shared-services group in order to realize benefits of scale. To pull this off, the company clarified the relationship and accountability between business units and the shared-services group. That ensured clear ownership of the businesses without fragmenting operations. The company sorted out a similar balance in other parts of the business.

These and other changes to the operating model helped the insurer permanently reduce costs by more than hundreds of millions annually while improving the overall experience for both customers and employees. Fewer layers led to better, faster decisions with less effort. And reducing matrix reporting relationships allowed employees to spend more time on high-priority customer segments and initiatives.

2. Remove and change the nature of the work

Once a bank commits to a particular operating model, it can further tackle complexity in every corner of the organization. To do this, managers often need to put a stop to some work and change how the remaining work gets done (*see Figure 3*). They should redesign processes and customer episodes to be simple and digital. That means far simpler digital interfaces for customers and staff, and simplified product suites that are more easily understood by customers and more easily sold by employees. Digital self-service channels should be powered by backstage systems that enable straight-through, automated processes.

Figure 3: Reengineer to take out low-value work



Source: Bain & Company

For example, even when banks introduce a simplified new proposition for customers, they typically do not extend the improved product portfolio to their existing customers for fear of cannibalizing earnings. In the UK, though, Santander in 2012 simplified its current-account product suite from roughly 100 to fewer than 10 products under its 1|2|3 branding, which refers to the mix of interest rates and cash-back rates. Critically, Santander migrated all of its existing customers to the new system, even though the higher rates compressed its margins. (The bank recently announced a reduction in interest rates as the runaway success of 1|2|3 combined with record-low central bank rates have made the program prohibitively costly to run in light of the new Brexit circumstances.)

Other decisions can further rein in costs. Banks might reduce service levels where appropriate or control the internal demand for services. And they could shift procurement volumes to a handful of suppliers that offer the best value.

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Redesigning how work gets done based on an assessment of the company's *current* state will likely generate only incremental improvements. Projecting the *future* state of the market and the bank's desired position in that market provokes a very different approach. It forces management to consider all the activities and conditions that must change in order for the bank to survive and thrive in the future. To achieve that prospective future, external benchmarks must be combined with other determinations of cost, notably what activities should cost given their role in the bank's strategy.

A "future-back" perspective reveals that not every cost dollar is created equally and that regular reviews of spending are essential to ensure efficient allocation. Zero-based redesign is an effective approach that resets the cost structure to align with the strategy. Zero-based redesign examines all expenses, not just incremental expenditures in obvious areas. It forces managers to justify every expense item that should be kept—which activities should be performed at what levels and frequency; which could be better performed through streamlining, standardization, outsourcing, offshoring or automation. In compliance, for instance, this means going back to the regulations and asking what the bank is required to do, what is the value of each control, then determining how those activities should be performed.

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One European bank has taken this approach. The bank has decided to remove and fundamentally change the nature of its work in several ways. It is in the process of outsourcing standardized services to a lower-cost region. It is raising efficiency of the middle office and front office by, for instance, imposing one clearly defined method of order processing per distribution channel and eliminating low-value tasks such as multiple data checks. It is also digitizing documents such as orders from clients or branches, which speeds up client response time.

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3. Apply digital to the right processes

Targeted investments in digital can unlock the next level of productivity—and also materially improve the experience for both customers and employees *(see Figure 4)*. The key is to mesh the digital transition with the principle discussed above on changing the nature of the work. Otherwise, digitizing a cost-ridden, complex process will yield a cost-ridden, complex digital process.

Using digital to its full potential requires tight integration across the entire value chain, from the mobile apps that customers use to a bank's legacy IT systems. This is a multifaceted design challenge that requires a deep understanding of customers, current processes and economics. It also entails cross-functional teams, which might not naturally work together, to make countless design decisions and trade-offs.

One major North American bank aimed to achieve a 5 percentage point reduction in its cost-to-income ratio. As just one component of that effort, analysis showed that roughly 65% of its branch transactions were bad or avoidable, caused by complex processes or employee errors, or better routed to lower-cost digital channels. Management also sought higher productivity in branch operations because branch staff spent an average of 70% of their time on low-value activities. A big component of its transformation was to migrate many transactions from the teller counter to self-service digital channels.

For consumers, a cross-functional team designed a process to encourage and guide greater adoption of digital channels. For commercial customers, the bank made it easier to manage cash digitally and to adopt

Figure 4: Digital technologies can improve both operations and the customer experience

Operations		Customer experience	
Branch	Reduced branch footprint and improved service levels	**Accessibility**	Access to information, transactions and customer service anytime and anywhere
Contact center	Improved first-contact resolution and reduced need for support	**Simplicity**	Fewer steps to perform a task or accomplish an objective
Back office	Efficient processes through automation of forms and filing	**Ease of use**	Simple, intuitive interfaces that are easy to learn
Compliance	Increased compliance through greater and automated checks and balances	**Personalization**	Personalized products and services, reflecting individual wants and needs

Source: Bain & Company

digital solutions for other needs during the onboarding process. The pilot test achieved the desired results in the first four weeks, and the bank is now on track to realize a more than 20% reduction in frontline branch staff, worth $50 million to $60 million in annual savings, part of more than $300 million in targeted savings. In parallel, the bank accomplished a similar cost takeout in its contact center operation.

Leaders at all levels need to become aware of how their decisions can compound to add hidden costs and complexity to the organization. And accountability must be public and enforced.

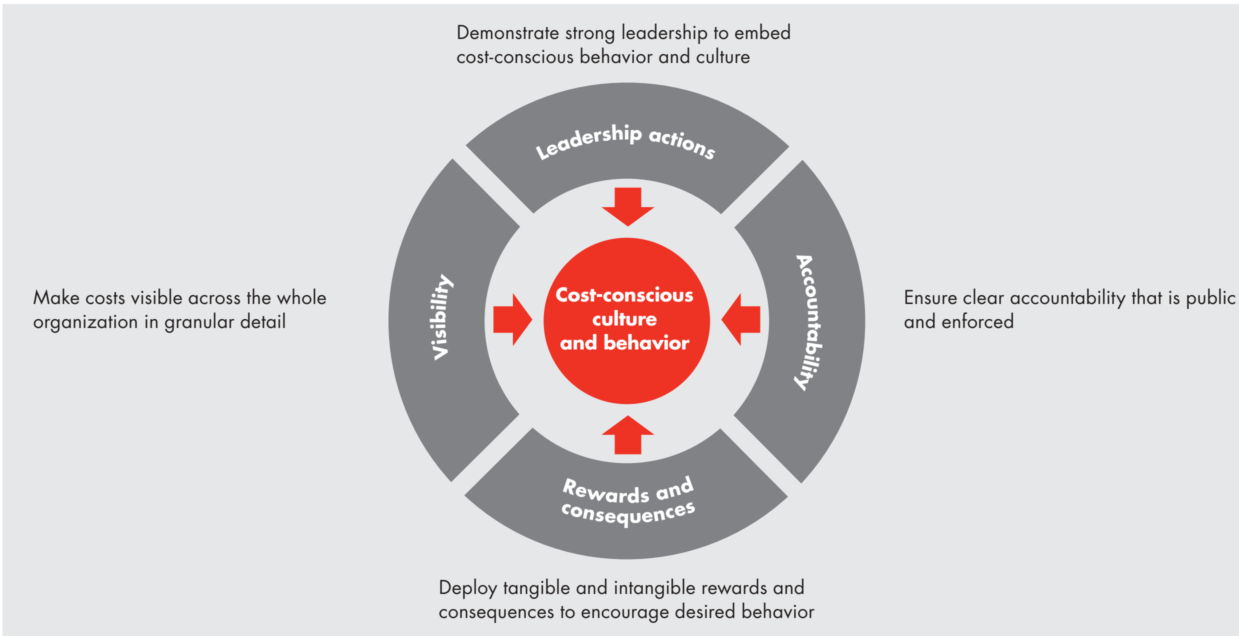
4. Sustain the changes to keep costs from creeping back

Ultimately, a realigned operating model and a focus on doing the right work in a more digital fashion should put a bank in a better position to sustain a cost-efficient stance over the long term. Of course, promoting change and instilling a receptive culture is not easy. Banks' slow progress to make this second wave of cost reductions underscores that complexity is an insidious enemy, moving from products to geographies to customer segments in an attempt to reemerge in new seams.

At a minimum, senior-level controls can be put in place, such as elevating all new spending requests to the CFO. Digital dashboards should give management the ability to see historical and real-time costs at the "fighting unit" level of each business division.

A permanent solution, though, involves building a culture obsessed with simplicity. To change behavior accord-

Figure 5: Behavioral change requires a mix of incentives and reinforcement



Source: Bain & Company

ingly, banks must introduce a mix of incentives and reinforcements that will overcome the ingrained culture of death by a thousand small vetoes (see Figure 5). Leaders at all levels need to become aware of how their decisions can compound to add hidden costs and complexity to the organization. And accountability must be public and enforced. Each cost packet should be assigned to an individual who will be accountable for meeting budgets. Once a bank has reset costs through a zero-based redesign, the most effective method to manage costs over time is zero-based budgeting, which focuses the organization on funding the activities necessary to execute the chosen strategy.

Finally, what keeps a company on track to embrace simplicity is the behavior of executives. Employees who can see the senior team resist adding bad costs and complexity will have a greater motivation to do the right thing. With the entire organization focused on keeping out complexity and bad costs, banks raise the odds of accelerating toward their target ROE.

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