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cutting through complexity

FINANCIAL SERVICES

Rethinking operations

A closer look at operational transformation

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Introduction

The market is evolving quickly and becoming more complex by the second. Firms seeking greater margins through sophisticated products also must manage an influx of new regulations, help ensure compliance, and meet rising client service demands. The challenges are straining already-stretched operational environments, which need to transform to be able to support the rapidly changing marketplace. While tactics for meeting challenging market conditions often focus on cost-reduction initiatives such as reducing headcount and offshoring tasks, those measures are a short-term fix for a long-term issue.

In addition, firms are facing structural changes to their business model. Revenue from previously profitable areas such as securities lending, net interest income on cash balances, and financing has dipped, and unprecedented concern about risk has firms searching for diversification in service providers and counterparties. Such changes signal a further move toward the principles of standardization, consolidation, and reuse from an operational infrastructure perspective. Firms urgently want to know which strategic steps can deliver sustainable operational improvement.

Does industry offer a viable template?

Automating is simply not enough, some banks have concluded. Instead they are focusing on initiatives that reduce vertical integration. Many are reinventing processes to extract greater efficiency from them and obtain economies of scale that will enable them to grow.

Is this a new phenomenon? No. Has this degree of operational transformation been done before? Yes, many times over.

What makes it different this time is that banks are assessing transformation through the eyes of their customers and the business model they want in the future. Competitiveness will come from modifying processes in a manner that can help optimize customer benefit. In turn, enhancing processes can influence the design of the product portfolio. A differentiated product portfolio supported by an operations infrastructure that can scale up or down with market trends and client needs may be exactly the kind of nimble response to competition and pressure on margins that firms need to consider.

Such a development implies specialization and horizontally integrated operations, a model other industries have followed for years. Ford, for example, underwent a dramatic systems retooling in 2003–2004 to improve performance and standardize and simplify technologies, an initiative that has been cited as one reason it weathered the downturn well. That effort included upgrading systems and processes in ways that reduced Ford's dependence on vertically aligned operations and moved it toward a flexible operational model that could focus on a differentiated product portfolio.

KPMG has helped clients in industry extract similar efficiencies. A leading oil services company undertook a top-down initiative to enhance global operational performance, for example. Sponsored by the CEO and centrally funded initially, the project focused on methods for driving efficiency into downstream businesses. Each business's strategic value was assessed from the perspective of an external investor through 14- to 16-week studies. The result was a continuous improvement process, managed by the various downstream businesses, that:

- Better aligned the company's target cost structure and shareholder expectations
- Accurately captured channel profitability for enhanced decision making
- Enabled costs of the study to be borne by the businesses that benefited
- Informs the company's planning process for new businesses.

Diversified firms are heading down a similar path.

In fact, a few firms are treading down this path, too. Leaders in this space are looking to consolidate, diversify their product portfolio, and enter into strategic technology-focused alliances in order to gain a foothold in new business and obtain new market entry. Select examples include:

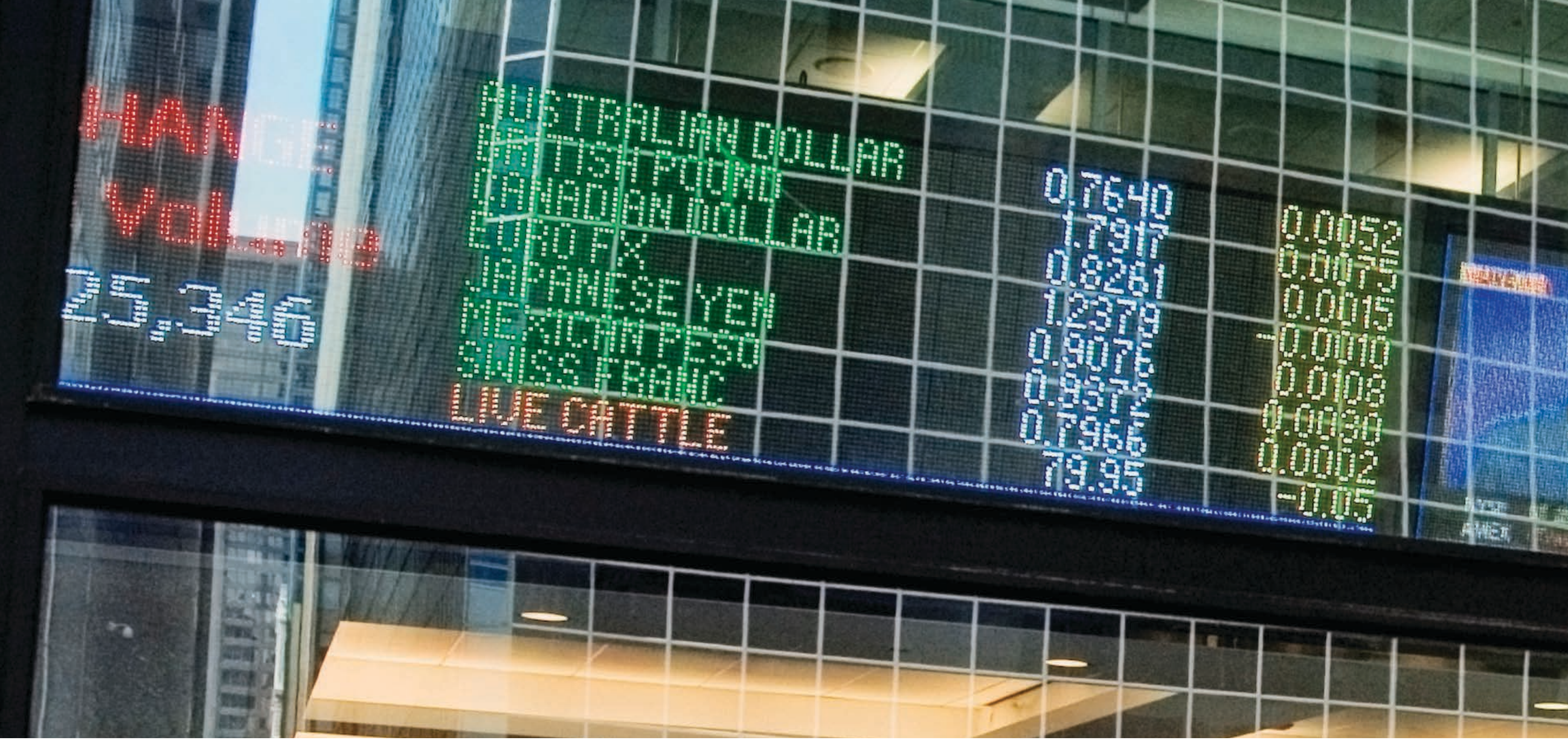
- Investment banks are looking at their franchises to leverage operational economies of scale and, where possible, combine operations across investment banking and private banking businesses with a view toward enhanced client service and a targeted product portfolio.
- Several investment banks are leveraging their operational environments to extend across businesses in the franchise, such as firms using their prime brokerage infrastructure to provide clearing, settlement, and financing services to their execution clients.
- Local custodial, transfer agency, and hedge fund servicing businesses are consolidating into global or regional groupings, especially in Europe.
- Outsourcing relationships are moving toward partnership models with key service providers. These may include two or more firms in partnership with a service provider in order to develop a key product capability using technology as an enabler. This is certainly true in emerging markets, where collaborative models (joint ventures, consortia) are being considered as a way to lower transaction costs in Asian, European, and Middle Eastern markets.
- CSPs and ICSDs are moving further into the asset servicing business, posing a threat to the custody bank dominance in certain aspects of core asset servicing.

We call this convergence. Of the competitive kind.

Where should they start? With a responsive target operating model.

The determination of whether the business model can be modified to increase its adaptability to market and client needs is one that has to be made at the top of the house. Based on the firm's business strategy and changing market dynamics, leadership's target operating model should encompass the following guiding principles:

- Operations and technology should be highly automated, low cost, robust, and scalable.
- Operations and technology should be extendable to other parts of the business.
- Old notions of geography are passé; product and client needs need to be parsed according to developed vs. developing markets, with countries such as Hong Kong, Australia, Japan, Singapore, and Indonesia in the former group, and India, Malaysia, Vietnam, and China in the latter.
- Redesigned business operating models should separate generic products from higher margin products in order to leverage scale and cost efficiency for generic products and to focus on revenue and margin for complex products.
- Combining functions (as in factory and or utility models) and costs across multiple products/services and territories can eliminate product/service and geographic silos.
- A joint venture or consortia structure that combines in-house capabilities, processes, and functions with others possessing leading capabilities, scale, and/or cost structures can deliver big benefits—but is not easy to achieve.

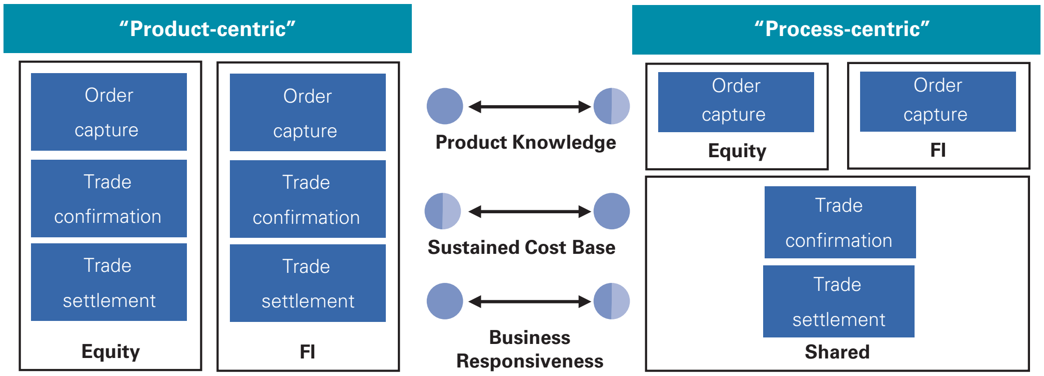


Something that has been on top of operational leadership's minds–can functions be combined across businesses?

The industry is being reshaped. Classic example is the prevalence of universal banks as compared to investment banks. Reason being diversified institutions can better leverage their 'safer' deposit– taking side as a contrast to the capital markets side of the institution. This brings about a key question–In institutions where different businesses are spearheaded as part of the franchise, can operational functions be standardized or combined? There are two models to adopt; (a) a product-centric model, and (b) a process-centric model.

The virtues of product-centric models are clear: Faster time to market (especially for products such as derivatives), strong product domain specialization, and high single-product throughput are obvious benefits. The drawbacks are the costs of excess capacity when volumes trend down and duplicative functions and systems. Excess capacity, in terms of technology assets and operations, consists of systems and staff.

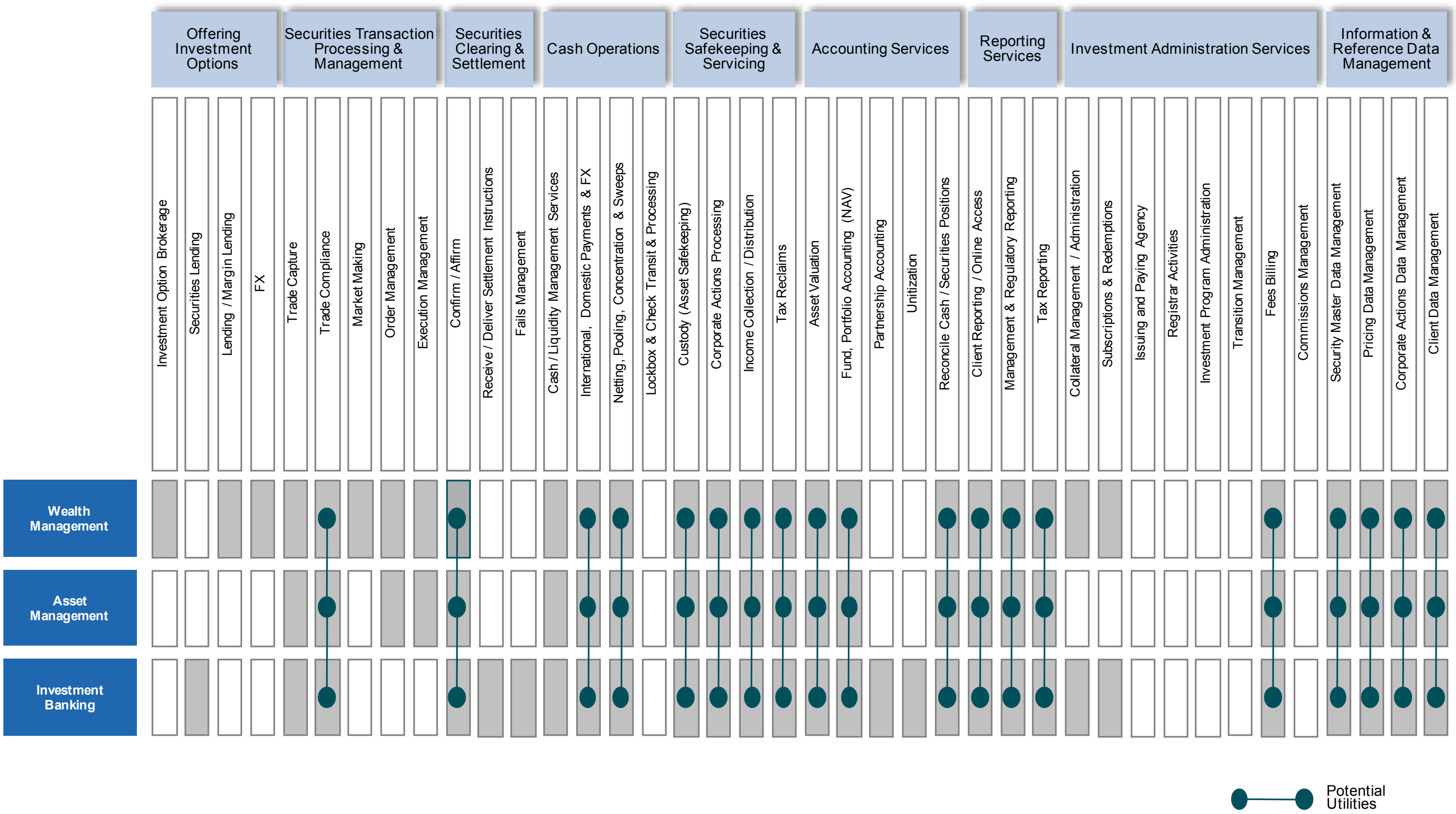
In contrast, process-centric models offer greater processing efficiency that can more effectively leverage straight-through processing (STP) to conduct the entire capital markets trade and payment process electronically (the "industrial" methodology many are moving to). There are risks, however. Some domain knowledge may be lost, or the firm may appear unresponsive if a poor service level agreement (SLA) is in place, and single product throughput may be limited.



- \+ *Faster time-to-market for product such as derivatives*
- \+ *Strong product domain knowledge*
- \+ *High single product throughput possible*
- – *"wasted" excess capacity as volumes fluctuate*
- – *High cost: extensive duplication of functions and systems*

- \+ *Greater processing efficiency*
- \+ *Any single product throughput may be limited*
- \+ *Can more effectively leverage STP*
- – *Can appear unresponsive if a poor SLA is in place*
- – *Can lose domain knowledge e.g., processing FI vs. Equity corporate actions*

A utility model, based on the concept of metered use, is another model that may be possible for operational functions that are similar across products. The illustration below shows how certain noncore operational functions can be structured as utilities that cut across businesses.



Alternative partnership models are also sparking interest.

Paradigm shifts in the financial services industry have increased firms' business costs, especially in noncore areas (client onboarding, for example). For many organizations, outsourcing offers no relief and carries the disadvantage of reduced control. Such firms may want to look at an alternative partnership model such as a joint venture (JV) or consortia structure that serves the partners or, if it is a commercial entity, the overall industry.

Joint venture model. In a JV between key players with different clients but similar burdens—perhaps an asset manager and an investment manager—both businesses will have similar reporting and data requirements. As a JV, they both bring clients (processing volume) to the new entity, yet they use only one infrastructure.

The benefits of the JV structure are economies of scale; a deal is easier to strike because only two parties are involved; and an "oligopoly" has the potential to create a competitive advantage. Trouble spots include potential regulatory, privacy, and competition issues—and how to decide ownership, since one firm must give up its infrastructure. In addition, negotiations between industry leaders in any product category could become contentious.

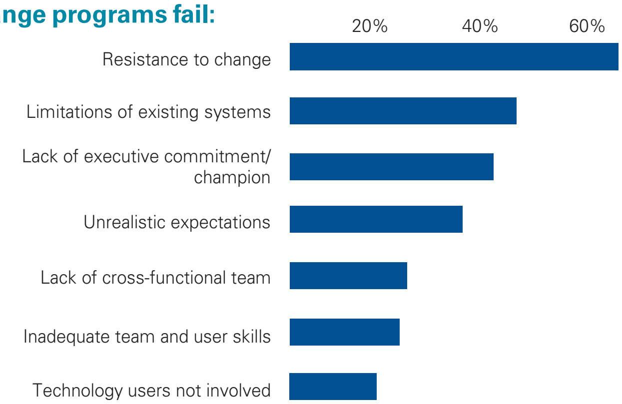
Consortia model. In a consortia model, several firms pool their resources, usually for a finite period, in an arrangement that benefits all members of the group. The parties agree on the benefits they are entitled to receive from one another, and they remain independent in their normal business operations.

Benefits include economies of scale; advantages from innovative partner choices (as with a tech provider, for instance); reduced risk of competing in lower-cost labor markets; potentially faster implementation of industry-wide changes; and establishing a framework that may facilitate industry consolidation. Consortium participants can also choose a leader to sell their excess operational capacity. Drawbacks include resistance to releasing control of key business processes (vested internal interests will assert that loss of control would be disastrous); and the need to transition organizational skill sets and management style from "doing" to "managing."

Effective change management will be the difference between success and failure.

What this paper has tried to highlight is not new. Alternative business models have been attempted before, often with poor results. Yet an organization that doesn't innovate to meet market driven needs and demands can fall behind.

Reasons why change programs fail:

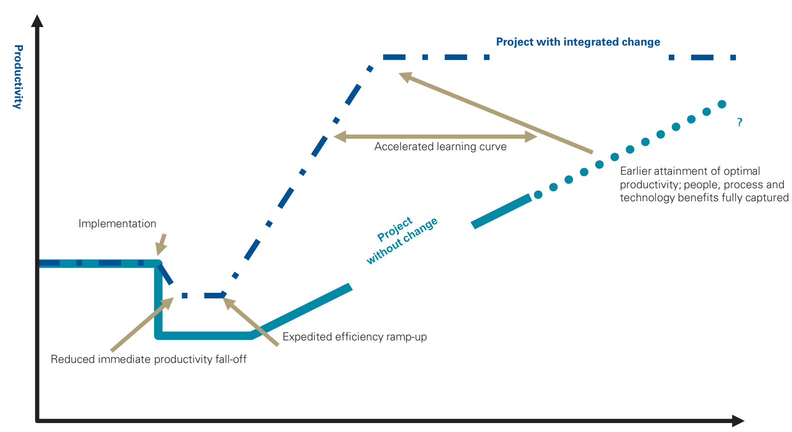


Source: Information Week

What is different today is that the structure of the market has changed. Convergence across products, markets, and services and the addition of intense new regulations have dramatically changed operations. Today, operational transformation involves everything from IT processes to internal controls.

Large-scale transformation programs are inherently high-risk, and even with the best intentions, ambitious attempts at organizational change may not deliver the promised benefits. Failure to manage people well during a change program is a primary reason for falling short of original goals. Problems include:

- Underestimating the intensity of the effort and resources required
- Conflicting interdependent change initiatives
- Insufficient motivation to change
- Mixed messages, lack of clarity, or conflicting approaches to change.



Thus when a firm attempts to transform its operations, a good plan and a robust execution strategy are not necessarily enough. Behavioral change management needs to be supported by appropriate leadership as well as strong planning. Leaders need to communicate the goals and values of change in a positive way that engages the whole company, and the goals must be realistic, achievable, and measurable. Getting people ready, willing, and able to deliver sustainable business benefit dramatically improves the likelihood of success.

Immediate next steps: putting a plan into action.

Success in managing operational change comes down to having a clear understanding of your business imperatives and operational requirements, and shifting your firm's focus to process improvement. The winning firms will be those that examine their business models and develop new approaches. This will require firm leaders to think differently about their organizations and to challenge the status quo.

Establish guiding principles. Establishing a collective, agreed upon set of guiding principles or norms will help the firm's units work collaboratively to successfully accomplish the goal. Start with a conversation on overall end strategy, risk considerations, and the investment required. Solicit and respond positively to stakeholder feedback. Help ensure organizational buy-in to make sure decisions are implemented and key operating model considerations acted on.

Address implementation barriers. After the end goals have been set, develop a high-level execution roadmap, including change management and communication plans. Design a formal process to successfully accomplish stages, and identify dependencies with other ongoing related initiatives. Sequence initiatives based on value delivered, ease of execution, and dependencies.

Conduct analysis of what needs to be done with quantifiable benefits. Develop and prioritize operational transformation initiatives. Identify quick hits that will reinforce a sense of accomplishment. Priorities typically are determined according to the overall impact to the business, operations, technology, and at the partner level, depending on whether the end goal is a JV, consortium, or something else. Take the time to analyze what the business impact will be, then determine resource requirements for a high-level target operating model. Gauge start-up costs and revenue opportunities. Define key success indicators and benchmarks.

Critical to creating, managing, and leading change is support for the firm's culture and the people in the trenches. People perform best in an environment they have been part of designing. Management has to meticulously organize, communicate, and roll out new processes in successive steps to demonstrate that the results are right, and that risks are being properly managed.

Behavioral change management requirements

These key actions are essential preparation for a transformational effort:

Organize alignment with the business.

- Articulate the vision and anticipated benefits.
- Determine the key leaders (business and technology) from the business.
- Outline each major participant's contribution requirements.
- Clarify governance issues:
  - Strategic (ownership structure, process for modifying scope, performance agreements, monitoring, escalation, arbitration, and risk management)
  - Operational (error processing, fees, "insurance" pools, revenue generation, and sharing).

Understand the financial model.

- Obtain a pro forma analysis that includes scenarios and sensitivity analyses.
- Clarify ownership structures.

Prepare for implementation.

- Design a plan that specifies participants' roles, timing, responsibilities, major steps, constraints, dependencies, critical path, and expected outcomes.
- Create an execution roadmap that specifies costs, metrics, and responsibilities.

Research the marketplace response.

- Determine whether competitors are considering similar action.

Perform regulatory due diligence.

- Determine how regulators likely will respond to massive restructuring.
- Determine whether and how transformation will affect the entity's living will.

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