KPMG

Beyond savings: Strategic cost optimization for the modern bank

Executive summary

Focusing on a combination of metrics to optimize cost and value

Cost management in the banking industry often falls into focusing solely on cost-cutting. However, for cost improvements to be successful, they should be sustainable. This requires a continuous review of spending, optimizing current resources, driving efficiencies, and shifting savings to investments that deliver value to the bank and its customers.

This is the *cost and value transformation mindset*. And it requires additional metrics for gauging success.

KPMG International's initial analysis of global banks' results, indicates a consistent decrease in banks' cost-to-income ratio (CIR) pre-COVID, followed by an increase during FY19-21 likely due to COVID driven staff, technology costs, and loan loss provisioning. Recently, improvements in CIR have been observed, largely due to top-line gains from rising interest rates that have helped to boost profitability.

However, with rising inflation, cost management has become more crucial for banks. Services and people costs tend to increase in line with inflation, and the risk of reduced income is becoming a reality in many countries due to the cost of living/borrowing crisis.

While bank profitability is increasing, so are customer expectations. The *KPMG Global Customer Experience Excellence Report* indicates that cost-of-living concerns and customer deflection to low-cost channels are negatively impacting customer experiences.[1] Advancing technologies offer lower-cost channels to support customers, but they can often be a poor substitute for human interaction.

About the report

In November 2023, KPMG International conducted a survey with over 250 banking leaders, supported by extensive benchmarking and 1-1 interviews with leaders who are developing the next wave of strategic cost and value optimization investments.

While CIR and return on equity (ROE) are widely used to gauge bank performance, a deeper focus is needed to measure performance more broadly.

By considering customer metrics such as the cost-to-serve (CTS) and full-time equivalents (FTE) per customer, banks can focus on productivity, efficiency, and profitability. Implementing new technologies, simplifying processes, and introducing efficiency initiatives can increase customer value.

Even though banks have seen a positive shift in CIR and ROE, customer experience has started to decline despite significant investment. Understanding the rationale behind these ratios is crucial and should align with banks' strategic business model choices.

To address the true inefficiencies in the underlying operating model, KPMG banking professionals suggest that banks should cascade the analysis from the overall bank CTS through to the functional and value stream elements with associated productivity metrics. This needs to be done within each function, while also connecting the front, middle, and back offices to truly understand value and costs from front-to-back in order to shape the right efficiency levers.

[1] KPMG International, "Artificial Intelligence and the orchestrated customer experience: KPMG Global Customer Experience Excellence Report 2023-24," (January 2024).

Adopting a cost-culture mindset

In the KPMG banking cost transformation survey, 82 percent of respondents identified deep cultural challenges in achieving sustainable cost reductions, despite significant technology investments. Most banks aim to reduce costs, but their cost-reduction objectives often do not align with their broader ambitions, and a cost-culture mindset is not embedded throughout the organization.

Cost and value transformation in banks does not always trickle down through the organization, even when executives are compensated for meeting cost objectives. Some banks have implemented horizontal and vertical cost structures to align business needs with spending. Executives responsible for a vertical, such as retail banking, are also responsible for its associated costs.

This approach has been an effective spending control mechanism among some European banks and those with the lowest CIRs and CTS targets. Several banks have reoriented their operating models to ensure clear accountability to 'domain executives' who understand, influence, and own the full end-to-end profit and loss (P&L) of their units.

Alternative models outside the banking industry, such as those developed in manufacturing, have potential for ensuring accountability. These models empower executives to assume ownership, transparency, and accountability for an entire value stream. This is common in Japanese automotive manufacturing where strategic problem solving is cross-functional.

Hoshin Kanri, for example, is widely used in Japanese automotive firms, it challenges the organization to continually focus on the North Star (the 'Hoshin') and adopt management principles ('Kanri') that enable continual learning, organizational problem solving, pace, and agility.

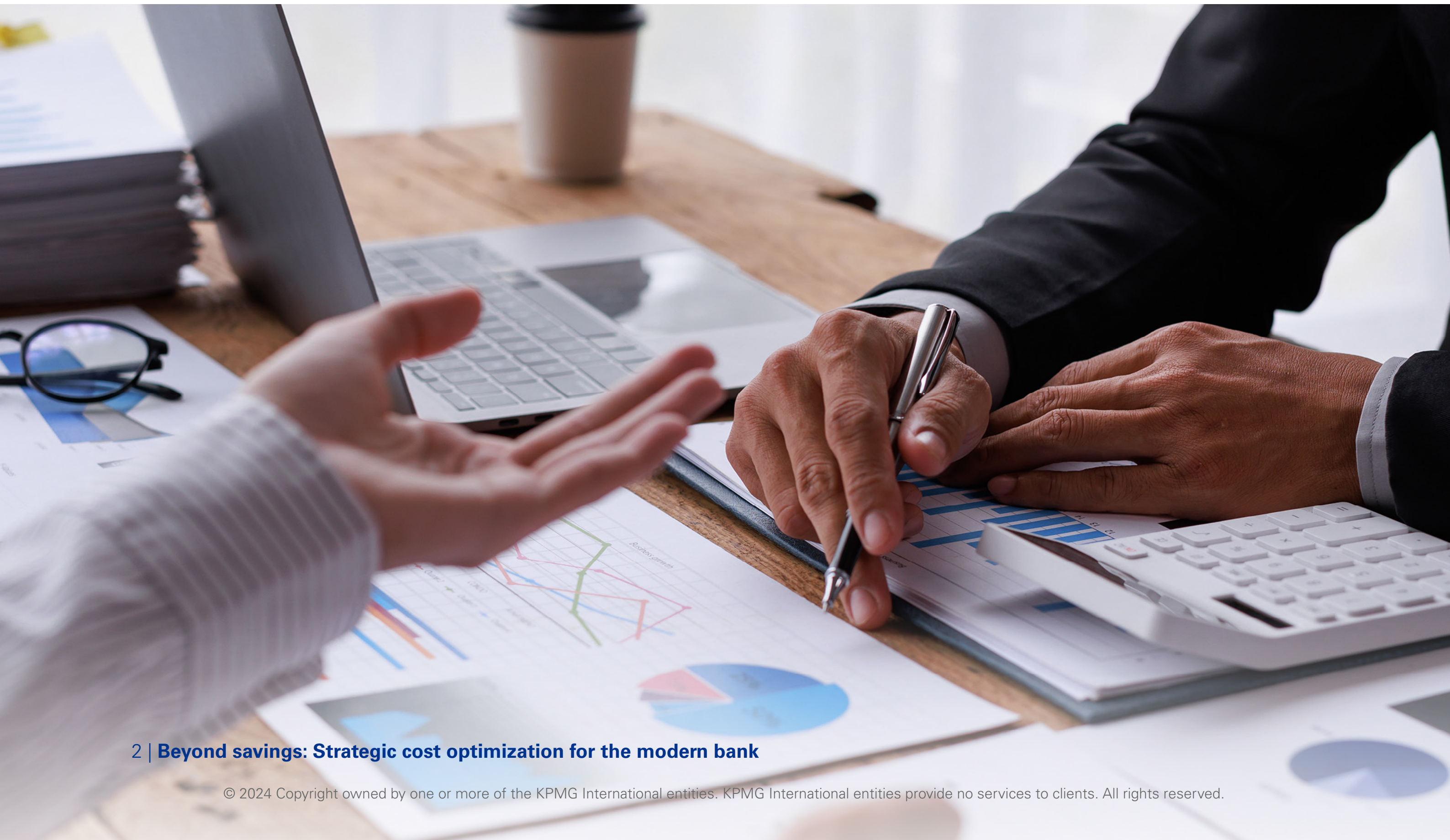
When combined with a relentless focus on value that exists in manufacturing environments and tools such as value analysis/value engineering (VA/VE), banks have the opportunity to focus on where value can be created and costs can be reduced. However, this step is often not managed effectively, with many banks focusing on costs that can be removed, without further analysis on the value that could be created through the services they provide to their customers.

82% of banking leaders identified deep cultural challenges in achieving sustainable cost reductions.

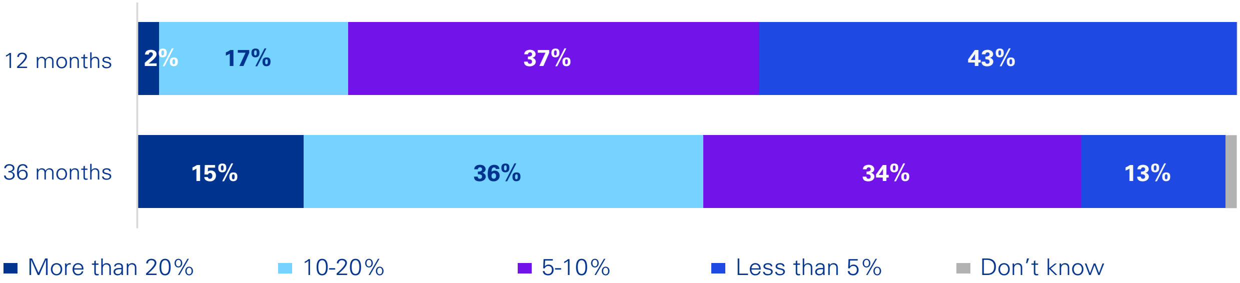
Source: KPMG International, "Banking cost transformation survey", November 2023.

Get ready for the next wave of cost and value transformation

The KPMG Banking cost transformation survey showed that despite recent improvements in CIR, there is a clear need to deliver additional value — and at a greater pace — in the next wave of cost and value transformation investments. Research suggests that this will be in the region of 10 percent in cost efficiencies over the next 12 months and as high as 20-30 percent over the next three years. Set against an inflationary headwind, these will be significant targets to achieve.



What are the cost-saving targets for banks over the next 12-36 months?



Source: KPMG International, "Banking cost transformation survey" (November 2023).

Based on the foundational work that many banks have already put in place, leaders are more confident about where the costs sit. Eighty-six percent of bank executives feel they have strong cost-base mapping in place, with three out of four believing they have the right incentives in place for leaders to achieve their targets.

In KPMG professionals' experience working with bank executives, many examples point to the impact of these executives' investments on the operating expenses of contact centers and branches that shift to digital channels, the front-to-back digitization of core value streams such as personal lending and mortgages, and the consolidation of functions to drive scale. However, unanticipated headwinds, changes in customer demands and the challenges of stopping to do certain things means that all too often the gains made are reversed as other costs are added.

As banks look at the next wave of cost and value transformation investments, the themes are consistent as the strategy begins to extend beyond traditional frontline functions into the FTE base in corporate-headquartered departments and functions such as Finance, Risk and Compliance and Marketing.

86% have mapped the economic cost base to support their future operating model, up from **74%** in 2020.

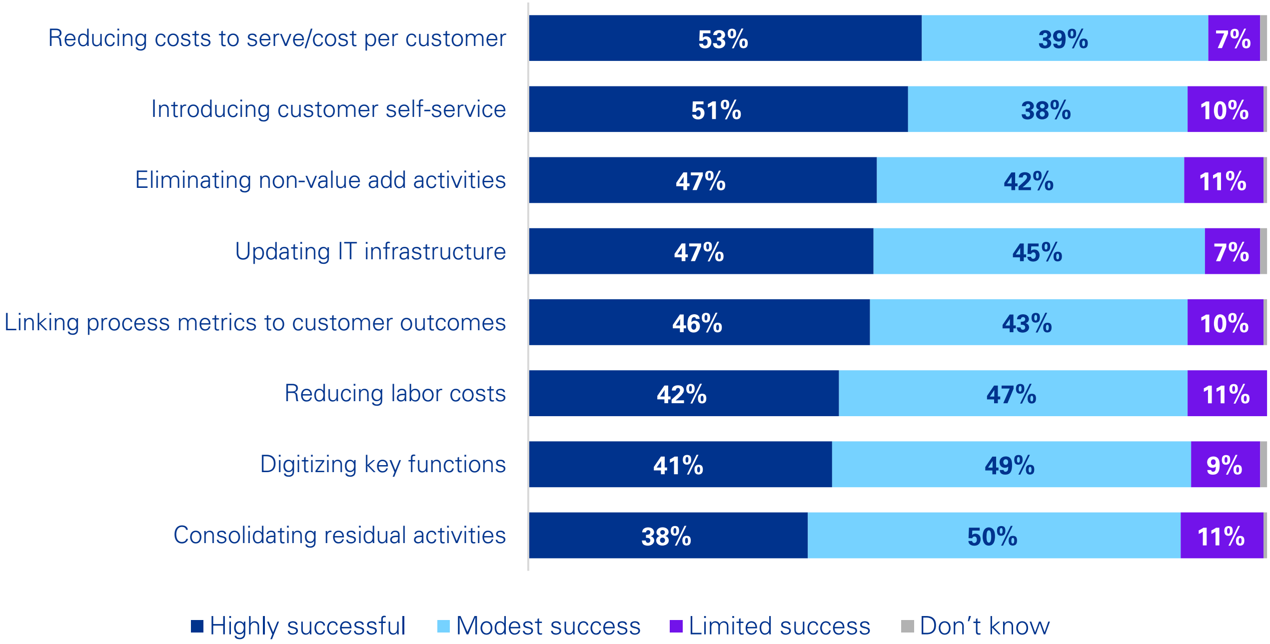
75% rate themselves highly for exec performance measured against cost reduction KPIs, up from **58%** in 2020.

Source: KPMG International, "Banking cost transformation survey" (November 2023).

There's also more focus on controlling and optimizing third-party spend as a faster way to savings than what has sometimes been achievable with internal functions. And outsourcing is becoming another important lever in the effort to reduce costs by becoming more central to their operating models.

During the survey, banking executives ranked the considerations that were highest in their strategies, and these are consistent with firsthand observations of KPMG banking professionals.

The biggest factors that banks are considering to drive cost efficiencies



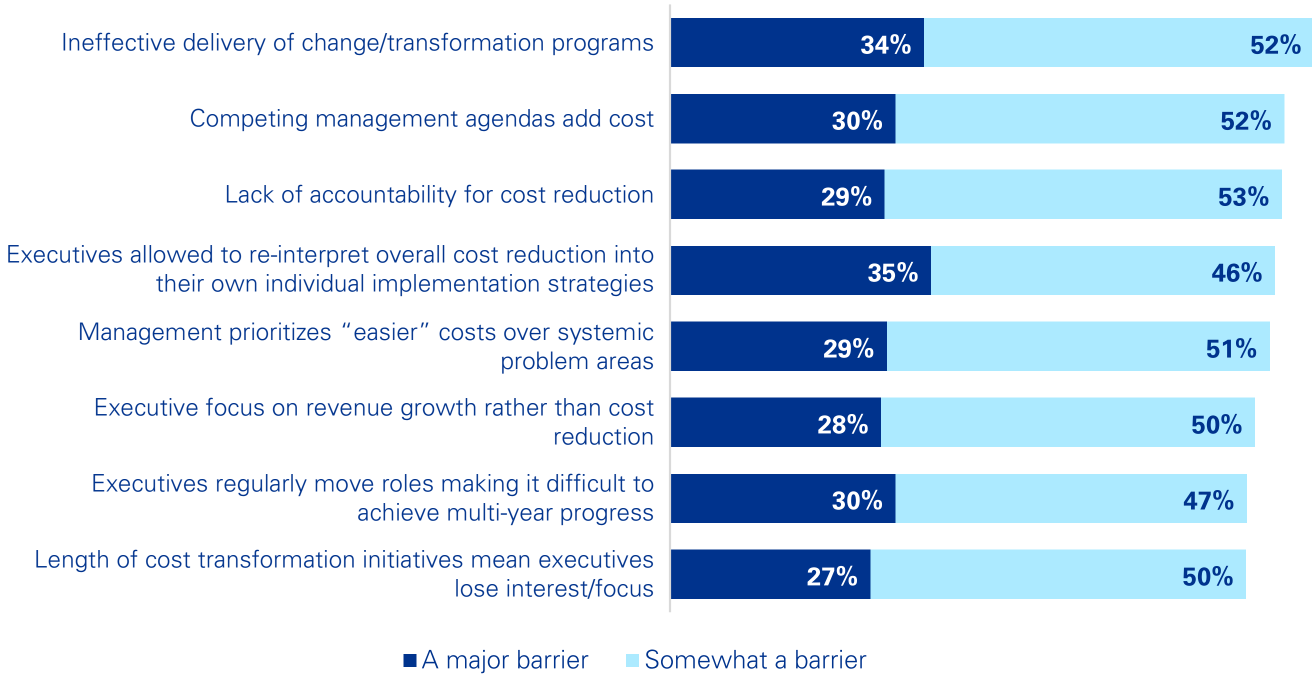
Source: KPMG International, "Banking cost transformation survey" (November 2023).

Key challenges that bank executives are facing in delivering their cost ambitions

Banks, despite their ambitious goals, face significant challenges in executing and delivering on their cost and value transformation commitments, while also needing to adapt and innovate. This is highlighted in the KPMG banking cost and value transformation survey, where respondents from all regions identified current economic conditions as the primary obstacle to achieving their future cost reduction targets.

The delivery of change programs also presents a significant challenge, with nearly 90 percent of respondents indicating that their organizations frequently struggle to deliver complete and successful outcomes. There are often short-lived bursts, sometimes spurred by strategy refreshes and benchmarks. However, these can result in low employee morale, with staff feeling as though they have been subjected to yet another imposed project, rather than being actively engaged in the development of the process.

Potential barriers to realizing the benefits of cost and value transformation



Source: KPMG International, "Banking cost transformation survey" (November 2023).

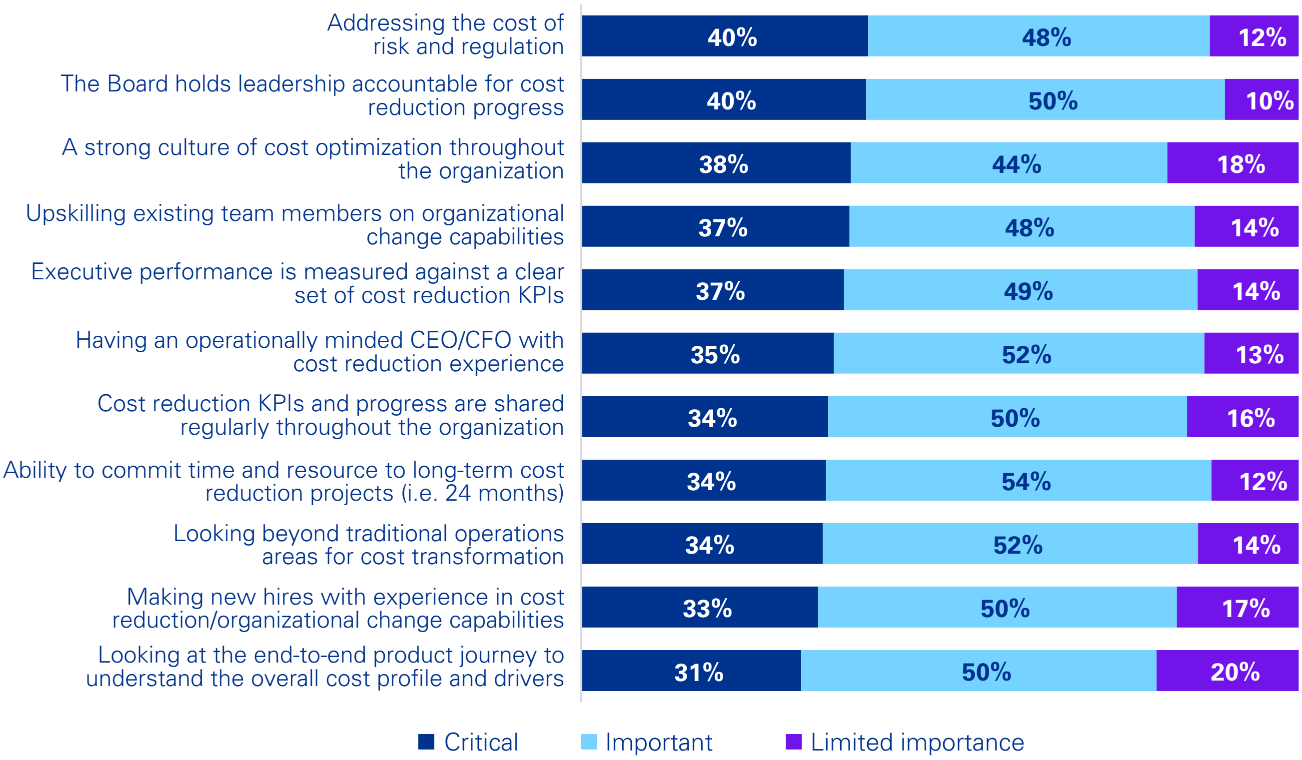
In the survey, bank executives identified several barriers to successful cost and value transformation initiatives that contribute to business and customer value. Many of these barriers related to a set of key topics: leadership, momentum and senior stakeholder buy-in.

Eighty-six percent say that ineffective delivery of transformation programs has prevented their ability to fully execute and realize the benefits in recent years. Executives need to drive accountability by committing to the plan and making hard decisions to reshape the workforce.

The implementation of technology solutions as enablers of cost and value transformation is a significant challenge for banks. Often, these institutions rely on a matrix of legacy systems, and integrating new technology with these existing platforms can be complex. This is further compounded when you consider the need to upskill employees to support the transition, particularly in areas such as data skills and generative artificial intelligence (genAI). Balancing immediate needs with future requirements is another challenge.

Financial investments needed to implement new technology to achieve sustainable cost reductions also raise concerns. Despite these challenges, digital transformation remains a global priority for organizations seeking value creation through improved processes, products, services, and experiences. However, achieving these objectives requires time and money.

The main focus areas for banks in unlocking cost and value optimization opportunities



Source: KPMG International, "Banking cost transformation survey" (November 2023).

The survey findings highlight the importance of leadership in determining the best ways for teams to adapt to regulatory requirements and maintain a focus on risk management. Banks are exploring ways to break down different types of risk and find efficient mitigation strategies, often through a common taxonomy for defining the banks' functions and processes. This approach has allowed some banks to identify synergies and opportunities to implement digital capabilities across the risk and compliance agenda.

In terms of cost and value transformation, banks often focus on areas such as contact centers and operations, with renewed interest due to the potential of genAI and 'chatbot' agents.

However, banks are increasingly looking beyond these traditional areas towards head office functions, where the volume of repeated activity may be lower, but the cost per FTE is often higher. The justification of purpose and value in delivering customer outcomes in these areas can sometimes be challenging.

Finally, having the right capabilities is crucial for achieving cost reduction targets. While the language of cost reduction is common among bank executives and managers, those responsible for setting strategies, designing initiatives, and leading complex implementation programs may need to build or acquire additional capabilities. This could involve developing a strategy benchmarked against peers, or bringing in experienced individuals to help deliver the outcomes. This is a key consideration in developing people within the organization or contracting outside help.

Can banks be efficient and effective in managing risk?

The banking sector is under pressure to manage risk and reduce costs while limiting exposure, especially in the wake of the March 2023 banking crisis and changes in the interest rate environment. Banks are now required to efficiently manage the implementation and running costs of regulations across their operations, which includes identifying synergies and automating and standardizing processes.

According to a report by KPMG in the US, 68 percent of executives consider compliance and risk as the top priority for the application of genAI.[2] This technology can be used to analyze historical data for better simulation of risk scenarios and stress-testing of investment strategies and portfolios.

Financial service organizations are facing increasing pressure to grow and innovate while managing costs. The complex risk, regulatory, and compliance landscape presents unique challenges. Emerging risks such as cyber risk, ESG, and geopolitical risks may require different resources and potentially increase business costs.

However, addressing these challenges could unlock unused potential.

Offshore capabilities for mature and standardized elements of the risk framework could provide additional cost savings. The journey starts by asking the right questions: "Why does the bank need different frameworks for financial and non-financial risks and different styles of KPIs?" "Why are these KPIs monitored and reported differently from a process perspective?"

> "Strategic Cost Management is a core discipline that drives material shareholder value. To harness that value, it needs to be fully embedded in the culture and business as usual (BAU) operating rhythm of an organization; both in near term actions and longer term decision making. Driving day-to-day efficiencies continues to be important, but how you make effective investment and choices is where you can really unlock the creation of value."
>
> **Simon Parsons**
> Global Head of Strategic Cost Management, HSBC

[2] KPMG in the US, "The generative AI advantage in financial services" (March 2023).

88% of banking leaders agree that AI and other automated technology will play a more central role in their future operating model.

Source: KPMG International, "Banking cost transformation survey", November 2023.

AI technology is growing rapidly and has shown potential for increasing productivity and reducing costs in various risk functions. While initial implementation may pose additional risks and costs, long-term efficiency gains make AI a viable option for standardizing and automating processes.

Collaboration with advanced technology partners on AI presents opportunities for innovation. However, new potential risks associated with AI, such as algorithm hallucination, lack of customer consent, and incoming regulations like the EU AI Act, need to be managed across banks' risk areas.

Driving value through digital transformation and generative AI

Banks worldwide are acknowledging the high potential of AI and automation for cost reduction, with 88 percent of survey respondents agreeing on its central role in future operations. They anticipate significant improvements in efficiency and effectiveness in customer service through AI integration. Banks are investing in efficient, automated processes, including AI and digital solutions, to enhance cost and value transformation activities.

These technologies have proven successful in automating and streamlining processes, reducing costs, and analyzing large data sets. However, 65 percent of executives in the KPMG global tech report 2023 expressed concerns about the substantial financial investment required for new technology implementation and employee training.

Despite these concerns, neglecting innovation and settling for existing technology could be a mistake from a cost reduction perspective. A common challenge is overemphasis on technology delivery without ensuring the right structures and mechanisms for cost reduction. An appropriate operating model is crucial for realizing cost savings.

Effective automation implementation significantly impacts group operation functions, and mature AI areas, like AI-enabled chatbots, also make a notable difference.

Bringing it all together. The way forward…

Despite the challenge to achieve sustainable cost outcomes amidst global economic cycles, there is renewed enthusiasm among banking leaders.

There is also a shift in banks' thinking, where they are integrating cost and value in their strategies. This approach aims to deliver improved customer experiences and more efficient operating models, rather than viewing these aspects separately.

This isn't easy. It takes time and lots of learning to achieve this level of strategic execution.

KPMG can help

KPMG has developed a 12-lever model that sits alongside Value Analysis/Value Engineering thinking and provides banks with an opportunity to consider their options for increasing value and reducing the cost to serve. With most banks endeavoring to drive value with one or more of the levers, it continues to maintain its relevance.

The broad learnings gained from KPMG professionals' experience with banks and other financial services organizations (and what is seen in other industries such as the manufacturing sector) leads to three steps for banks to consider in developing their cost and value transformation strategies and assessing, funding and executing the supporting business cases.

1. Value and cost are the primary objectives. In some banks, there is more investment in contact centers or relationship managers to drive differentiated service and increase market share. When tied with AI supported co-pilots, this can be a powerful resource for banks to invest in.
2. Design the cultural mechanisms that will have the biggest impact for your organization. For some, this can be top-down cost boards and cost management units tied to zero-based budgeting concepts. For others, more value may be achieved through a Hoshin Kanri-style concept to fully align your organization around the highest-impact investments.
3. Measure the real costs that exist across entire value chains and the options you have that will move the value equation in the right direction vs. just cutting costs, leaving the functional elements underdeveloped and finding that costs begin to creep back into the business over time.

KPMG firms have an international team of cost and value transformation professionals who have worked with the world's leading global, regional and local banks. We can help assess potential earnings improvements, define functional cost-saving strategies and develop an execution plan tailored to your organization. KPMG professionals:

1 Have deep experience in helping clients drive value by creating integrated digital strategies, improving M&A integration and organizational alignment and restructuring operating models. We dig deep into the root causes of inefficiencies and provide holistic insights that can help make your organization more responsive, cost efficient and effective in the face of change.

2 Are driven by data, providing you with data-led insights on your position against global and regional industry trends, enabling:

a. Knowledge of where to focus cost and value optimization efforts.
b. Identification of cost and value optimization opportunities.
c. Holistic views of cost anatomy at both enterprise and functional levels.

3 Know how to facilitate true organizational alignment around change, with engagement and commitment at the C-suite level and visible ownership by the organization's leaders. We help to embed sustainable change by working back from the target state and identifying the key steps to get there.

4 Have broad and deep expertise. The breadth of our cost, change and functional expertise means we can identify, design and deliver change across the organization. Our sector experts understand the key drivers in your industry, the competitor set and the sector-specific risks that need to be mitigated.

5 Will work with you as a collaborative partner; comprehensively understand your business and constructively challenging you along the way.

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