Banking cost-management series

Tackling the intricate web of inter-company expenses (ICE)

Problems we see in banks

A decade has passed since the financial crisis, but its effects are still being felt. Banks continue to face pressure on margins in light of changing customer habits and new regulations. There is a high level of scrutiny on cost bases and cost management, particularly at group level, and inter-company expenses (ICE) remain a problem for management and Finance teams in banks.

It is largely thanks to the fast-paced economic and competitive environment in which banks operate. With so much upheaval they are struggling to keep their systems and processes up to date. This has led to several issues, such as a lack of a clearly defined cost-allocation methodology, inadequate controls, a lack of end-to-end (E2E) ownership and poorly integrated legacy systems – all of which are key to successfully tackling the intricate web of ICE.

Why is the focus on ICE higher now?

ICE allocation is important if banks hope to accurately determine the profitability of each of their entities. Those that address these challenges early tend to get more out of their strategic and operational decision-making.

The lack of cost-allocation transparency and an appropriate control process can lead to significant internal disputes, typically in relation to invoicing, billing and payment. Some entities may in turn find it difficult to fully recover their costs. Remedying this under-recovery after the event requires a 'fire drill' exercise, a process that would not only increase the already significant year-end workload, but also cost a bank an unnecessary amount of time and money.

An increased focus on both cost optimisation and structural reform has led to many banks migrating their costs to service companies. However, if the allocation process is broken, the problems of under-recovery could magnify following this migration. Profitability and liquidity problems could ensue and also lead to greater regulatory scrutiny for a service company.

Top challenges facing banks when dealing with ICE:

Increasingly complex entity structures are resulting in an increased level of ICE

Systems and processes have not kept pace with changes in the operating environment

Inaccurate cost allocations can result in external and internal concerns for management, such as regulatory pressures and diminished decision-making ability

Case study

An international bank engaged KPMG to review their ICE allocation. After discovering a material under-recovery of costs in one of their entities, KPMG worked with cross-functional stakeholders to identify the source of the issue. The under-recovery was driven by data leaks, due to ineffective ICE allocation and management processes as well as a lack of a clear accountability matrix.

The team documented the current state of the bank's ICE allocation process and, subsequently, designed the end-state process. A plan was developed to help the bank reach its desired target state and also automate the end-to-end process. Moreover, we identified the potential for automation at the activity level for the end-to-end process in order to help the bank benefit from process standardisation.

All the stakeholders in the project acknowledged the value that the new target-state would achieve, especially in reducing data leaks, manual error and key personnel risks.

What are the two main operating models for ICE allocations?

Across the banking industry there are two popular operating models for tackling ICE issues. The distinction between the two methods lies in the degree of centralisation. The 'local model' takes a decentralised approach, while the 'global model' takes a centralised approach.

The local model requires each entity to run its own ICE process, from allocations through to recovery. This is typically the first model implemented by banks and, when run effectively, can remain a sustainable long-term model. The advantages of this model are a shorter governance structure, entity-level ownership of cost recovery and an increased flexibility in the local operating model. Assuming there are strong processes, effective local ownership of activities and sufficient tooling, the local model offers scalability to bank with multiple entities. As the number of entities offering services to other group entities grows, so does the business case for the global model.

The local model:

Entity-level ownership

Shorter governance structure

Under-recovery risk sits with each local entity

The global model

Global ownership

Easily scalable

Globally standardised process

Needs greater scrutiny from a tax point of view

The global model is typically more effective. In this model, each entity that incurs ICE can recharge the entire amount of the cost to a global entity. This moves the cost allocation and recovery effort to a centralised entity. This model is most valuable for a global bank with a complex entity structure and significant ICE to recharge. This is due to the additional recharge — which can result in increased cost, driven by regulatory, transfer-pricing requirements.

With sufficient complexity and recharge volume, however, this additional cost can be recovered through standardisation and streamlining efficiencies. Issues such as cash management, ensuring compliance with legal and regulatory requirements and under-recovery will become global. They can also be managed centrally by technical SMEs. Furthermore, as the bank grows and more entities are established, they can leverage the existing structures and processes by plugging in to the existing global model.

Deciding which model to adopt is based largely on the operating structure of the bank. Key considerations should revolve around complexity of the entity structure and the magnitude of ICE.

How to improve ICE management?

Regardless of the strategic choice of operating model, the key to successful ICE management is effective process, with strong governance and controls to maintain data quality and in turn reduce the risk of cost leakage.

E2E process	**Budget approvals**	**Cost allocations**	**Finance housekeeping**	**Reporting and forecasting**	**Invoicing and recovery**
Major leakage risks	— Missing approvals — Inadequate communications to paying entities	— Poor data quality — Lack of standardised documentation — Misaligned systems	— Poor employee timesheet integrity — Manual postings of pass through accruals	— Limited MI for budget holders — High degree of manual error risk	— Lack of clarity of cost drivers invoices for paying entities — Ineffective, lengthy escalation processes
Controls	— Threshold driven sign off requirements — Paying entities feedback loop	— Data validation checks — Clearly articulated documentation of allocation — Identified and trained accountable parties	— Performance scorecards — Better integration of source systems that feed billing	— Automated variance reports to budget holders — Defined feedback loop and escalation process — Clear link to the Bank's planning process	— Well defined invoice template — Clearly articulated escalation processes involving senior stakeholders
Owners	— Project sponsor	— Budget holders — Project managers	— Finance	— Finance	— Finance
Escalations	— Transformation lead — CFO	— Project sponsors — Transformation lead	— Transformation lead — CFO	— Project sponsors — Transformation lead	— Transformation lead — CFO
Automation potential	Workflow tools will introduce: — Governance and speed — Standardisation	Agile tools will: — Drive transparency of allocation — Improve data validation	Workflow / BPM tools will: — Run the process efficiently	Visualisation which: — Highlights intercompany breaks	Workflow tools will introduce: — Governance and speed — Standardisation

Principles for successful management of ICE

To ensure the successful management of ICE it is necessary to have a well-defined process supported by clear and meaningful communication. It is particularly important to get messaging right between the incurring and paying entities. Banks should also consider setting clear accountability across the E2E process, standardising key documentation and incorporating formally defined validation and escalation loops. Budget holders will want to see accurate and timely MI to provide stakeholders with better transparency on the flow of ICE.

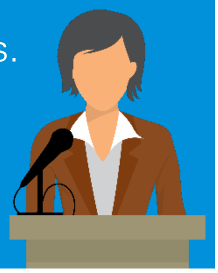
Once a well governed process with controls is in place, and cost-allocation data across all involved systems is cleansed, the final step is to future proof the process by implementing an automation tool. Automating repetitive, production-heavy activities will reduce key personnel risk and labour in the E2E process. This will help enable cross-functional, cost effectiveness and enable finance to focus their time on activities that add strategic value to a bank.

Summary

Cost leadership is becoming increasingly focused on ICE management.

A well governed process with appropriately selected allocation keys and a controlled operating model framework results in cost control that helps strategic decision making.

Furthermore, the process can be future-proofed by automating workflow and repetitive, production-heavy activities.



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