

Evolution through dis-integration  
How the future of the financial services industry will be shaped by dramatic changes in the value chain





## Abstract

Industries typically evolve along common paths and consolidate as they become more mature. In this consolidation, we see leading players vertically disintegrate their value chains in a bid to become “leaner” and more competitive. Vertical dis-integration is defined as the emergence of new intermediate markets that divide a previously integrated process between specialized areas. This division of responsibility allows a firm to specialize and concentrate on the parts of its business where it has a competitive advantage to help reduce costs and increase profitability.



In his article “The Nature of the Firm,”<sup>1</sup> Ronald Coase argues that businesses tend to expand until the costs of organizing an extra transaction within a company become equal to the costs of carrying out the same transaction by means of an exchange in the market. Thus, business units that produce goods or services that can be acquired in the market at lower prices tend to be dis-integrated.

In addition, the financial crisis, globalization, technology, and an increasingly restrictive regulatory environment have squeezed margins, created immense cost pressures, and reduced return on equity for financial institutions. This, in turn, has accelerated restructuring and cost reduction initiatives as well as a significant shift in industry consolidation.

Vertical dis-integration is a natural course for the financial services industry, with many institutions already disintegrating their businesses by outsourcing commoditized functions. More dramatic examples of dis-integration can already be seen, for example, within the mortgage sector, where firms have divided responsibilities for brokering, originating, servicing, and securitizing loans.<sup>2</sup>

The financial services industry is at a natural inflection point in its maturity, where the most innovative players will accelerate their reduction of costs and businesses that remain unprofitable may more aggressively pursue vertical dis-integration to differentiate themselves and win competitive advantages. In some cases, there may be no alternative but to exit from select lines of business where market share is low or does not pay a sufficient return on cost of capital.

<sup>1</sup> The Nature of the Firm, R.H Coase, *Economica*, New Series, Volume 4, Issue 16 (Nov., 1937), 386-405.

<sup>2</sup> *Academy of Management Journal*. 2005, Vol. 48, No. 3, 465–498



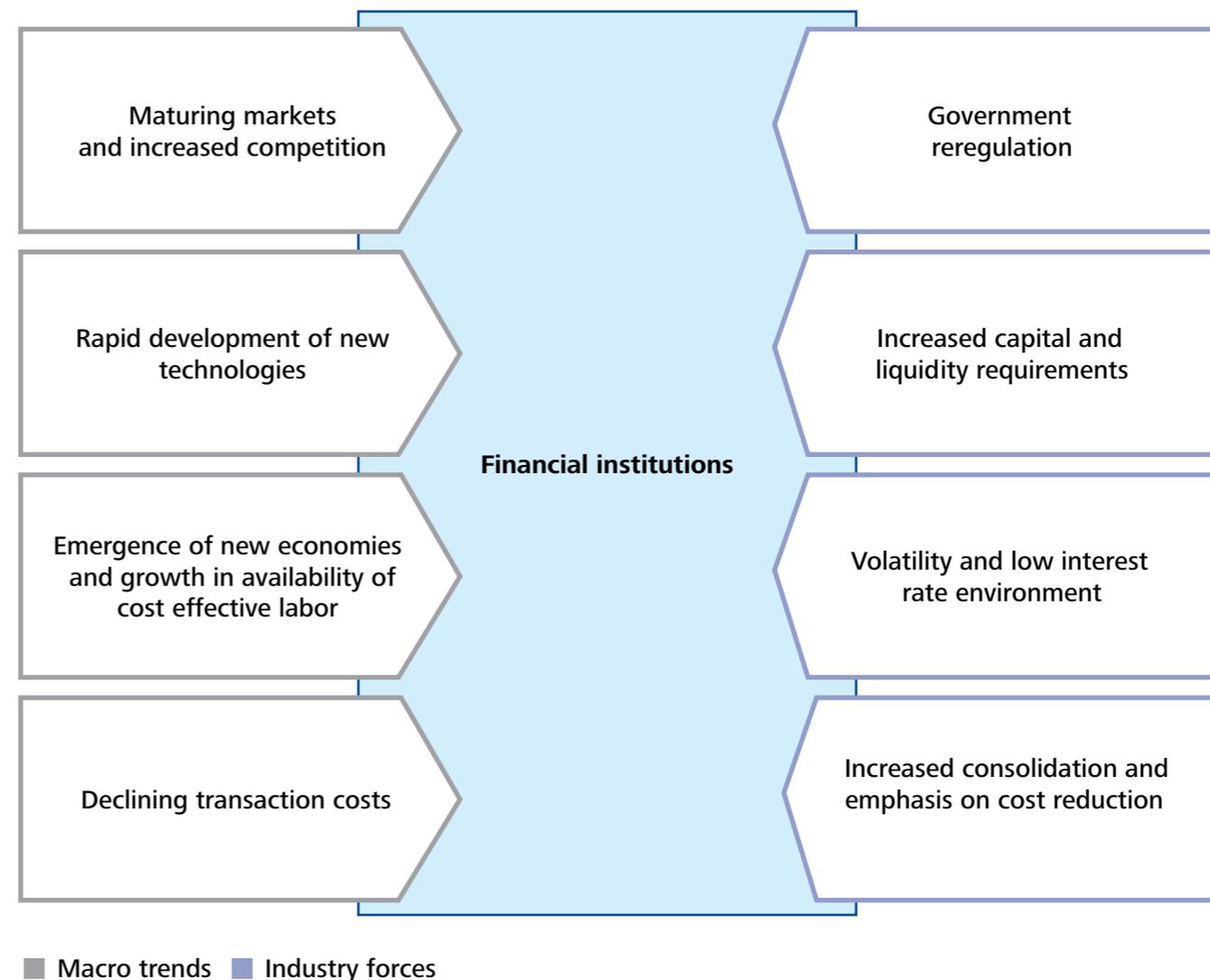


## Global trends and margin compression in the financial services industry are pressuring banks to accelerate the development of competitive advantages

The global landscape continues to transform with the emergence of new major economies, rapid changes in new technologies at significantly lower costs, the maturing of existing markets with associated increases in competition, the growth in availability of cost-effective labor, and declining transaction costs. These macro trends are impacting a wide range of companies across industries.

In addition, a number of factors are reshaping the financial sector. Government regulations to reduce risk and increase transparency are forcing banks to reevaluate their own businesses and fund costly compliance initiatives. Low interest rates and increased capital requirements have depressed margins and required banks to relentlessly reduce costs. Increased consolidation of the industry through mergers of key market participants has increased competition within the industry. These forces are pressuring banks to reshape their long-term operating model to become more competitive within a maturing industry.

**Diagram 1. Macro and industry forces**





## It is crucial for financial institutions to increase efficiencies and lower fixed costs as the industry becomes more concentrated and competitive

As the financial services industry matures, institutions will face increased competitiveness and reduced margins. The financial crisis accelerated the consolidation of the industry by forcing numerous acquisitions, mergers, and bankruptcies including some of the largest mergers and acquisitions activity in its history. It is more important now than ever for financial institutions to concentrate on becoming more efficient and improving their cost-to-income ratios (CIRs) to increase profitability and shareholder value.

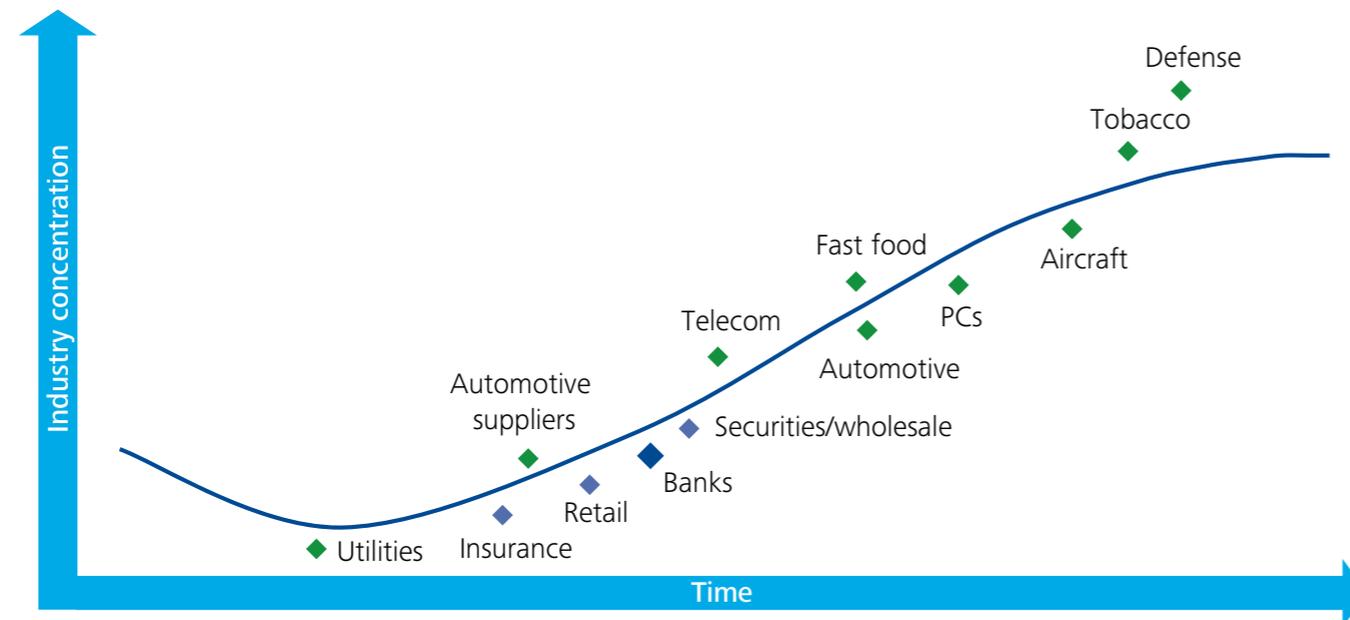
In addition, revenue growth in saturated markets is expected to slow, and as a result, financial institutions should consider focusing on reducing their fixed costs as a percentage of total costs by moving to a higher variable cost model. This can be important to adapt to changing market conditions. As the industry becomes more concentrated, firms with higher variable costs may be able to moderate their costs relative to anticipated demand and revenue growth projections, which will likely result in these firms holding competitive advantages over their peers.





## Maturing industries exhibit increasing dis-integration of their value chains as organizations compete more aggressively

Diagram 2. Consolidation curve



Source: Consolidation Curve, Harvard Business Review and Deloitte Consulting analysis

The concentration of an industry is typically measured by the percentage of market share owned by the largest firms. As industries mature, consolidation occurs and competitive advantage comes less from the production process and more from product development, branding, and marketing. This evolution has been seen numerous times, where a few major players emerge who account for a large percentage of the market. An example of this concentration is found in the commercial aircraft industry where Boeing and Airbus have emerged as a duopoly for large passenger aircraft after years of consolidation through mergers and acquisitions.

During market consolidation, companies focus on further expanding their core businesses to gain competitive advantages and outgrow their competition in these areas. Focusing on core competencies becomes crucial as concentrated industries are characterized by saturated demand, excess supply of competition, eroding margins and profits, and increased cost cutting.

<sup>3</sup> AIM Research Working Paper Series. Improving Performance through Vertical Dis-integration: Evidence from U.K. Manufacturing Firms

<sup>4</sup> Academy of Management Journal. 2005, Vol. 48, No. 3, 465–498

### Industry vertical dis-integration

To focus on growing core businesses, companies in mature industries often pursue the vertical dis-integration of their value chains. Based on Coase's theory of limitations on organization size, dis-integration is driven by divestitures of business functions/capabilities that no longer financially and competitively benefit an organization because the goods or services produced can be acquired in the market at cheaper prices. By divesting noncore business functions, firms can move to a higher variable cost model and can focus their efforts and resources on growing and gaining competitive advantages in their core competencies. This may result in a more flexible cost structure and increased efficiencies in other businesses. In addition, firms may realize additional benefits by acquiring these products or services in the market at lower costs.<sup>3</sup>

Firms in markets such as the automotive, personal computer (PC), financial services, health care, and airline industries have pursued forms of vertical dis-integration. In the PC and automotive industries, companies have sold their low-margin manufacturing arms to focus on their higher-margin product design, sales, and marketing businesses. In the financial services industry, the mortgage sector has experienced the dis-integration of its brokering, originating, servicing, and securitizing functions, with mortgage brokers, mortgage banks, government-sponsored enterprises, and investment banks each offering specialized services.<sup>4</sup>





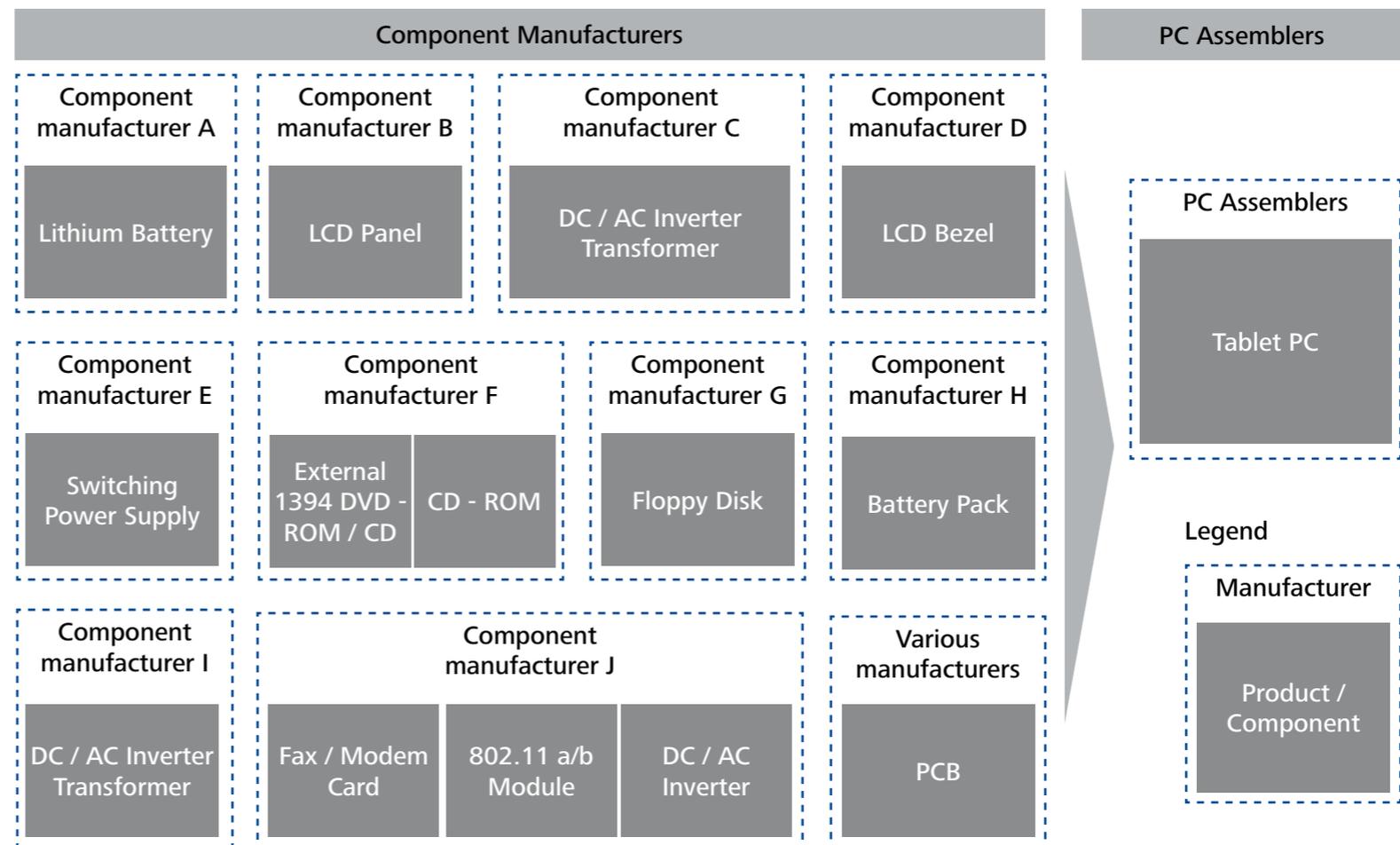
### Vertical Dis-integration in the PC industry: Case study

A hardware and electronics corporation that sells desktops, laptops, smartphones, storage devices, and other electronics, throughout the 1980s and 1990s, was focused on expanding its research, manufacturing, and sales businesses through acquisitions. Concurrently, the PC industry was rapidly maturing and moved from a high-profit margin business to a low-margin commodity business. Competition within the industry drastically pushed prices down and threatened the company's profits.

In the early 2000s, the company spun-off its manufacturing units and transformed itself from a manufacturer to a designer, marketer, and distributor of computer products. The company created its unique channel business model to strengthen relationships with suppliers that manufactured and assembled most of their products. Following the restructuring, the company's sales increased as the company shifted to a customer service-oriented company.

Vertical dis-integration of the company's businesses is better understood by examining how different suppliers/manufactures contribute to the assembly of its tablet PCs shown in Diagram 3

Diagram 3. Supply chain for the company's PC





# Financial institutions should consider more aggressively pursue high-impact, disruptive ideas to disintegrate their value chains and improve CIRs and operating leverages

## High impact ideas

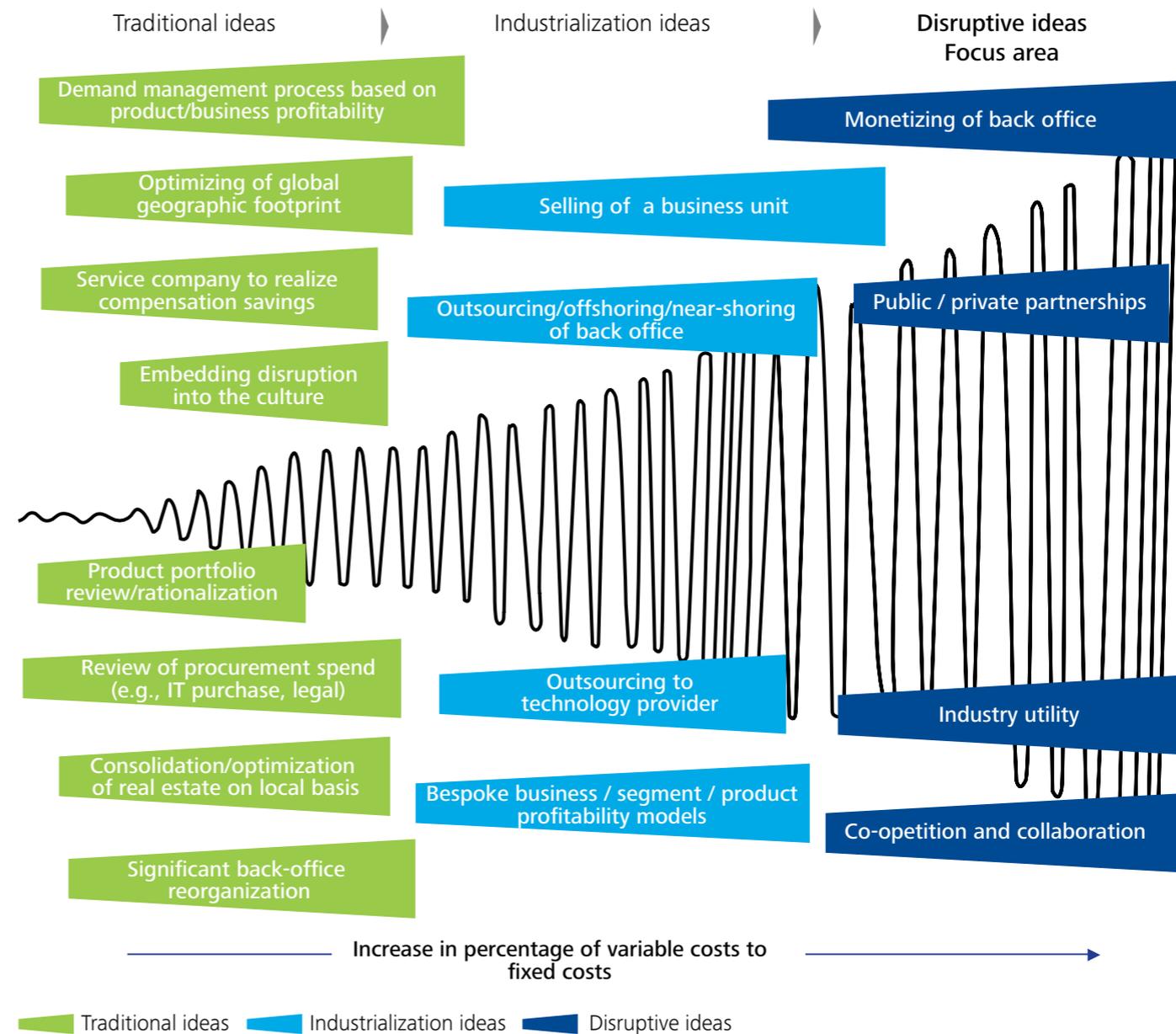
Based on trends in other mature industries, the financial institutions that have scale, focus on their core competencies, and pursue aggressive dis-integration of their value chain will have a better likelihood to become leaders in the industry as the market becomes more concentrated and competitive.

There are a number of initiatives banks can undertake to offload noncore businesses and focus on reducing costs for services that are kept in house. These measures can reduce operating leverages and CIR ratios by divesting non-profitable and noncompetitive businesses. In some cases, there may be no alternative but to exit from select lines of business where market share is low and/or that does not pay a sufficient return on cost of capital.

For divested services, the decline in transaction costs; the increase in availability of skilled, low-cost labor; and growth of industry technology solutions may allow financial institutions to procure these services at lower costs from companies who can provide them more efficiently. For the businesses that institutions do not divest, there may be opportunities to either reduce their costs or transform their previously costly units into revenue generators to cover and reduce operating expenses.

The diagram to the right outlines the cost-cutting methods traditionally deployed by financial institutions and high-impact, disruptive ideas that could be pursued to more aggressively achieve vertical dis-integration and competitive advantages

Diagram 4. High-impact ideas



Source: Deloitte Consulting LLP





## Descriptions and examples of ideas

The information below provides a description of select traditional, industrialization, and disruptive ideas and examples of when these strategies have been deployed by financial institutions:

Traditional ideas	Industrialization ideas	Disruptive ideas
<b>Demand management process based on product/business profitability</b> <b>Description:</b> Balancing of supply and demand for products and services through an enhanced view of critical business issues and costs to effectively staff projects and realize the full potential of investments <b>Example:</b> A financial institution's implementation of demand management leading practices in its law department to increase accountability, buy-in, and transparency into requests for legal spend	<b>Selling of a business unit</b> <b>Description:</b> Divesting of noncore business units that are no longer competitive in the market or have low market share and do not pay sufficient returns on capital <b>Example:</b> An American bank's sell-off of its overseas wealth management back office operations to reduce risk, scale back its size and reach, and focus on its lending business	<b>Monetizing of back office</b> <b>Description:</b> Scaling and standardization of the back office in order to monetize and offer previously internal technology and operations services to other businesses <b>Example:</b> An insurance organization's expansion of its infrastructure services joint venture's offerings to the industry
<b>Optimizing of global geographic footprint</b> <b>Description:</b> Optimization of an institution's global footprint to pursue revenue growth, reduce costs, or increase access to global talent in key geographic markets <b>Example:</b> Contracting of business processes or information technology work to third parties or establishment and relocation of operations to low-cost domestic or global locations <b>Example:</b> The establishment of subsidiaries in India, Costa Rica, and the Philippines by an American bank to expand its shared-services capabilities and offer low-cost back-office operations and transaction support	<b>Outsourcing/offshoring/near-shoring of back office</b> <b>Description:</b> Receipt of funds or incentives from a public entity (e.g., financial institutions providing capital loans to developing countries, governments) to cover the costs of establishing or growing a business <b>Example:</b> The corporate tax exemptions offered by the Philippines' Bureau of Internal Revenue for businesses that establish offshore call centers or business processing outsourcing entities in the Philippines	<b>Industry utility</b> <b>Description:</b> Establishment of an industry utility to provide client management, valuation, processing, data, and/or reporting services <b>Example:</b> The creation of a financial information services company by a group of banking executives to provide enhanced valuation data for credit default swaps and products for enhancing transparency and risk management
		<b>Public/private partnerships</b> <b>Description:</b> A global investment bank's transfer of back-office jobs from Singapore to India and Poland in an effort to cut costs as Asian financial hubs become more expensive





### Vertical dis-integration of functions/capabilities

The disruptive ideas for achieving vertical dis-integration apply to numerous functions/capabilities across a financial institution's end-to-end value chain. Assessment of each idea against an institution's range of activities can reveal feasible areas of dis-integration. The diagram on next page provides an illustrative sample of investment banking functions for large financial institutions and outlines possible ways to vertically disintegrate these functions:

**Diagram 5. Vertical dis-integration for a large investment bank**

	Corporate strategy	Client management and service	Product management	Investment management	Underwriting and advisory	Trade execution	Operations	Technology and data management	Risk, compliance, and financial management	Human resources
	<ul style="list-style-type: none"> <li>• Client segmentation</li> <li>• Marketing mgmt</li> <li>• Branding</li> </ul>	<ul style="list-style-type: none"> <li>• Client Setup</li> <li>• Fees &amp; Billing</li> <li>• Client reporting</li> </ul>	<ul style="list-style-type: none"> <li>• New Product dev.</li> <li>• Product maintenance</li> <li>• Product reporting</li> </ul>	<ul style="list-style-type: none"> <li>• Invest. strategy</li> <li>• Research</li> <li>• Client Portfolio mgmt</li> </ul>	<ul style="list-style-type: none"> <li>• M&amp;A &amp; Corp. Advisory</li> <li>• Equity &amp; Debt Underwriting</li> </ul>	<ul style="list-style-type: none"> <li>• Trade Execution</li> <li>• Trade Matching</li> <li>• Trade Clearing</li> </ul>	<ul style="list-style-type: none"> <li>• Margining &amp; Collateral Mgmt</li> <li>• Trade Settlement</li> <li>• Payments</li> <li>• Reconciliations</li> </ul>	<ul style="list-style-type: none"> <li>• IT Strategy</li> <li>• IT Applications &amp; Infrastructure</li> <li>• Data mgmt</li> </ul>	<ul style="list-style-type: none"> <li>• Risk Mgmt</li> <li>• Legal &amp; Compliance</li> <li>• Financial mgmt</li> </ul>	<ul style="list-style-type: none"> <li>• Recruiting &amp; Hiring</li> <li>• Performance mgmt</li> </ul>
Monetization of back office	○	◐	○	○	○	○	●	◐	◐	○
Public/private partnerships	○	◐	○	○	○	◐	●	◐	◐	◐
Industry utility	○	◐	○	◐	○	●	●	◐	◐	○
Co-opetition and collaboration	◐	●	◐	○	◐	●	●	●	◐	◐

○ Low ability to apply Disruptive ideas → ● High ability to apply Disruptive ideas

Source: Deloitte Consulting LLP





## Organizations should consider the organizational changes and challenges that will accompany the dis-integration process

### Characteristics of dis-integrated institutions

Managing the dis-integrated financial institution may be a significantly different challenge from managing a more integrated one. Dis-integration of the value chain is likely to result in fundamental organizational and structural changes as elements of the organization's operations are dispersed globally across multiple third parties and management needs to rely more heavily on outside parties to run the business and triage issues. Examples are already apparent of the increase in external touchpoints and handoffs that arise as a result of outsourcing back-office functions and personnel. The diagram below outlines the typical pre- and post-dis-integration characteristics of a financial institution:

**Diagram 6. Characteristics of a typical financial institution**

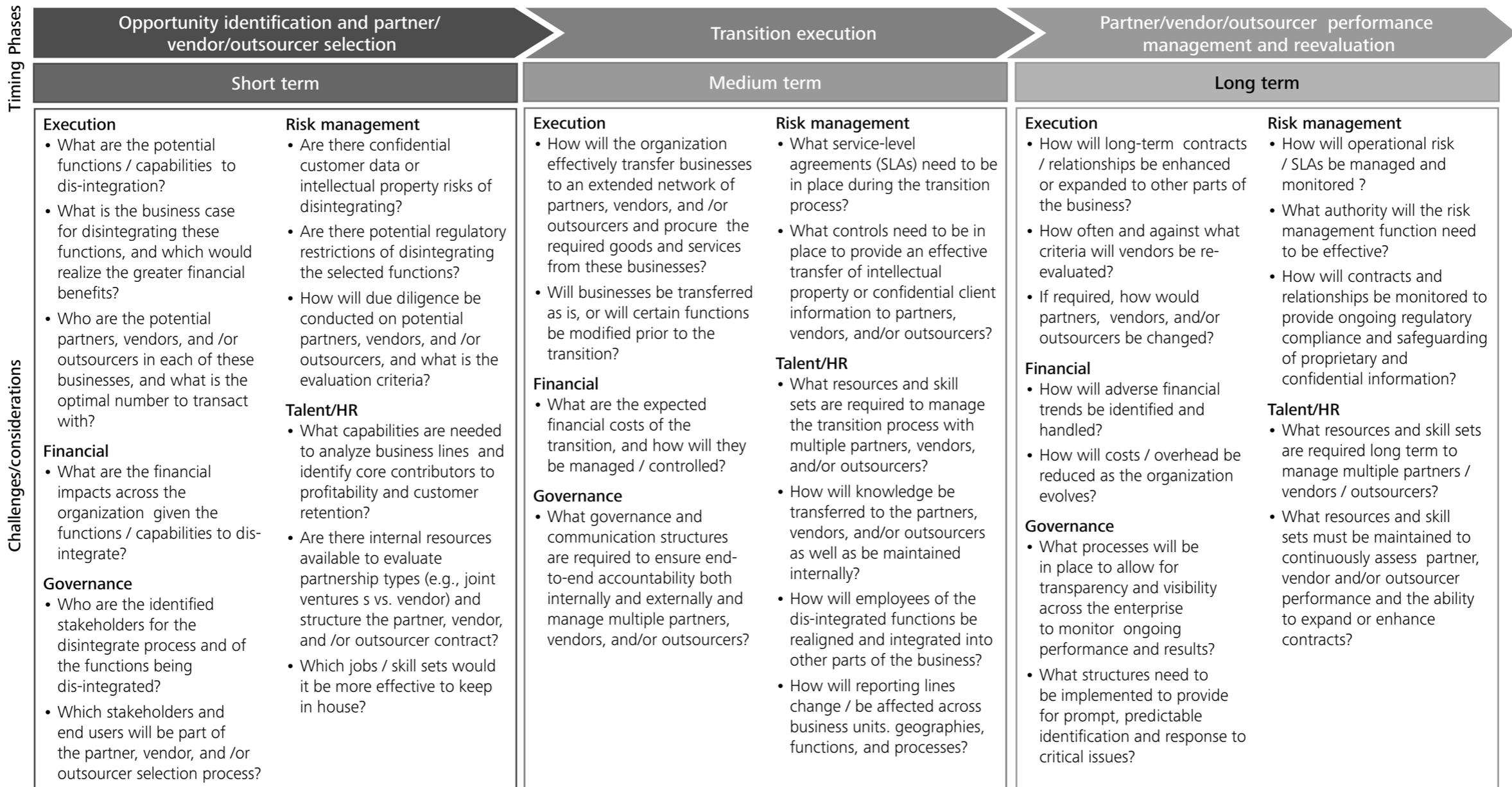
Today	Post dis-integration
Few geographies/time zones	Multiple geographies
Homogenous, concentrated workforce	Heterogeneous, distributed workforce
All required skill sets in house	Selected skill sets in house
Single Human Resources (HR) model	Multiple HR models
Simpler lines of control/reporting	More complex lines of control/reporting
Straightforward accountability	More distributed accountability
Mainly internal handoffs	Internal and external handoffs
High degree of ownership of infrastructure	Limited/shared ownership of infrastructure
Limited flexibility, constrained leverage	



## Challenges and considerations of dis-integration

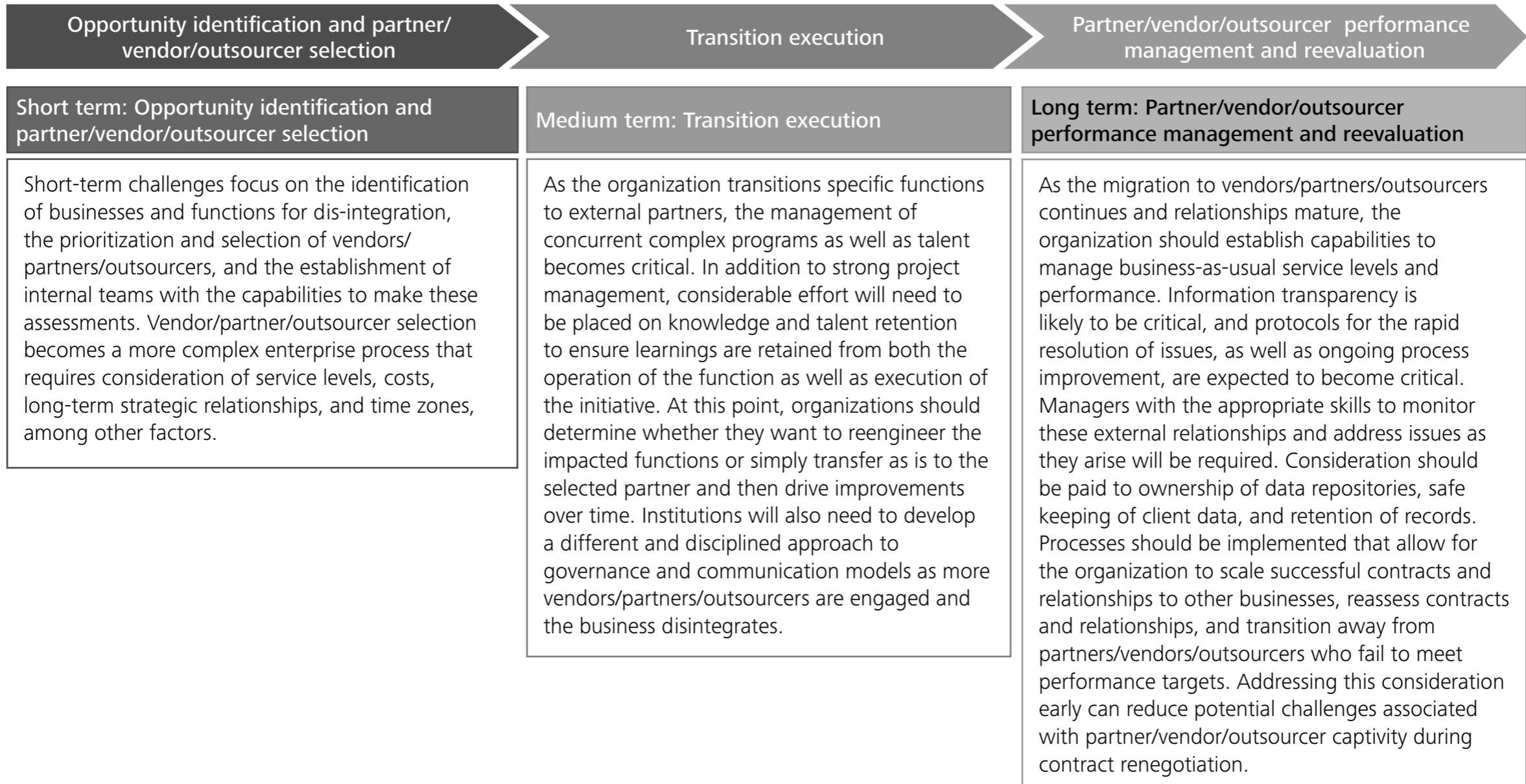
Dis-integration is likely to bring multiple new challenges, which will evolve over time. The diagram below outlines the dis-integration life cycle as well as associated timings/phases and considerations. Challenges and considerations can be grouped into five categories related to execution, financial, governance, risk management, and talent/HR.

**Diagram 7. Common challenges and considerations**



Source: Deloitte Consulting LLP







## Conclusion

The financial services industry has reached a level of maturity where the vertical integration of the value chain no longer drives competitive advantage or profitability. Like numerous mature industries before it, large institutions in the financial services industry are already on a path to dis-integration. Managing and coordinating this process of dis-integration will present new challenges on a very different scale to the past in both executing the transaction as well as managing the extended organization during and after the process. While being mindful of the challenges, leading organizations should consider accelerating the transition to a dis-integrated enterprise to maintain a competitive advantage.



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