

Refining the target operating model

Increasing benefits from Lean and Six Sigma initiatives

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Though many banks pursue Lean and Six Sigma initiatives only few are able to reap the full benefit from those. This article will show how looking at your operating model will allow you to define an integrated set of initiatives to increase their total return well above a level where it becomes visible not only in your P&L.

Low industry growth and ineffective initiative-based cost cutting

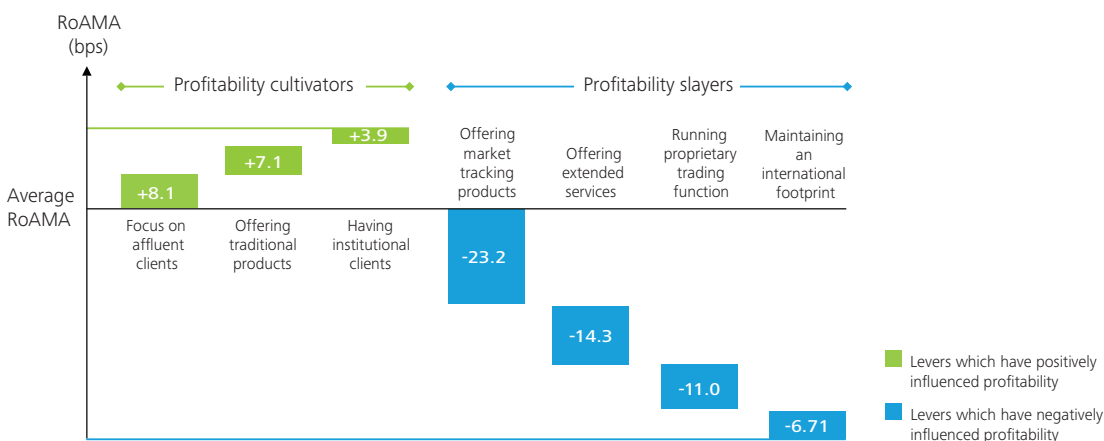
Since 2008 the asset management industry has been confronted with cautious private investors and, on average, net outflows of invested money in retail funds. Retail fund managers are additionally confronted with a situation where private investors no longer favour managed funds with traditionally high margins for the asset managers—with fees of around 110 bps on average—but passive products (such as ETFs) with lower margins of around 45 bps on average. As a consequence the basis on which to generate management fees is decreasing across the retail business.

This outflow of money from private investors is partially compensated by institutional investors whose investments reached an all-time high in 2011. With traditionally lower management fees—which range around the 45 bps charged for passive products—the average profitability is decreasing over all investments.

On the other hand, capital requirements and regulatory requirements are increasing. As a result, the cost of implementing and complying with new regulations on a day-to-day basis is raising the cost base for asset managers. This shift in assets to low-margin, passive products, coupled with higher costs originating from regulatory requirements, is resulting in pressure on profitability across the industry.

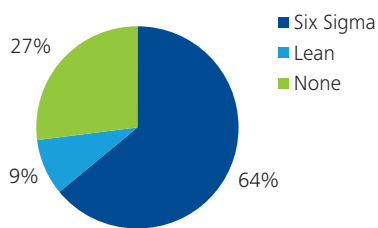
This is in line with Deloitte’s internal research depicted in graph 1 which summarises the key elements of a business operating model acting either as profitability levers or factors to reduce profitability. The results of Deloitte’s research indicate that traditional products (active retail funds) and a focus on affluent retail clients are the two most important profitability drivers as measured by their impact on Return on Assets under Management and Administration (RoAMA). Offering passive market tracking products and an extended service offering have the biggest negative impacts on RoAMA.

Graph 1: Bottom line impact of individual profitability levers



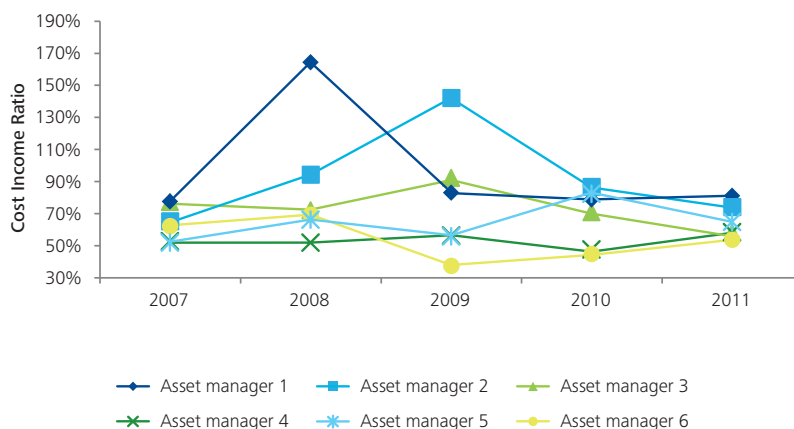
Source: Deloitte research

Graph 2: Use of process optimisation techniques among German asset managers



Source: Deloitte research of 47 asset managers, custodians and asset service providers (2012)

Graph 3: Cost-income ratios of six leading German asset management companies



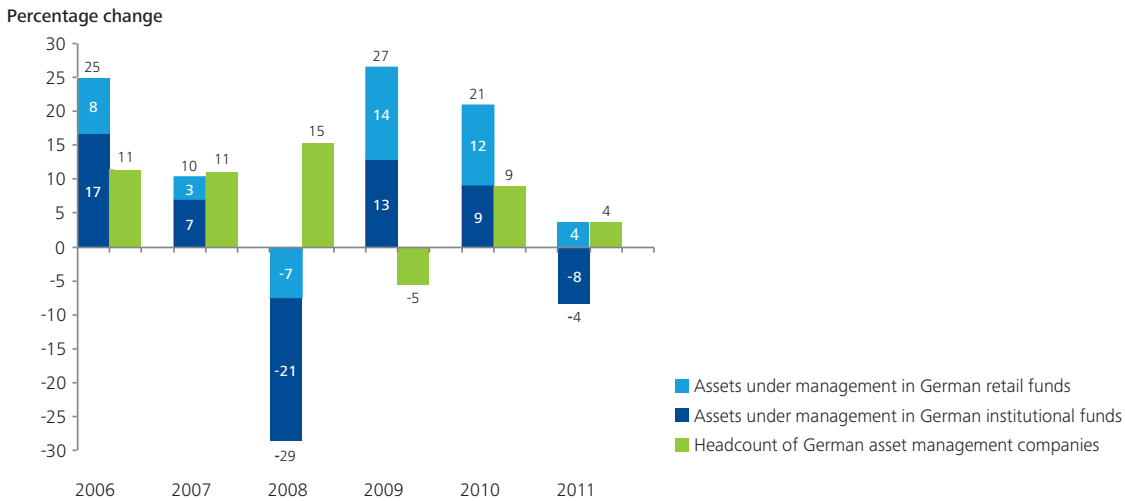
Lean as well as Six Sigma should allow organisations to adapt to volatile market environments in a timely manner

Asset managers have started to react and many have launched either comprehensive efficiency initiatives or at least one-off cost-cutting projects. Among the ongoing efforts, Lean and Six Sigma-related initiatives especially are among the favoured actions to counter pressures on profitability. Only 27% of the analysed asset managers did not show any institutionalised initiative like Lean or Six Sigma. However, looking at the balance sheets in graph 3, these initiatives have not had a significant impact so far.

The positive effect of these Lean and Six Sigma initiatives on CIR might be absorbed by other external effects. Hence, looking at the cost-income ratio only might not show whether these were successful or not. Looking at the Assets under Management (AuM)—as the biggest source of revenue—and the headcount of asset managers—as one of the two biggest cost contributors (next to IT)—provides an additional indication.



Graph 4: Percentage change in assets under management and headcount



Source: BVI

Depicting the growth in AuM against the rise in headcount shows that headcount follows AuM growth with a time lag of one to two years (compare graph 4): this is not timely. In its extent it is nearly equal to the change in assets over time: it is not reduced in scale. These findings are exactly what one would not expect of a Lean organisation or of one applying Six Sigma.

Lean as well as Six Sigma should enable organisations to adapt to volatile market environments in a timely manner. Tools like productivity KPIs, flexible and utmost scalable processes, and other instruments which are at the heart of any Lean and Six Sigma initiative provide the basis for this.

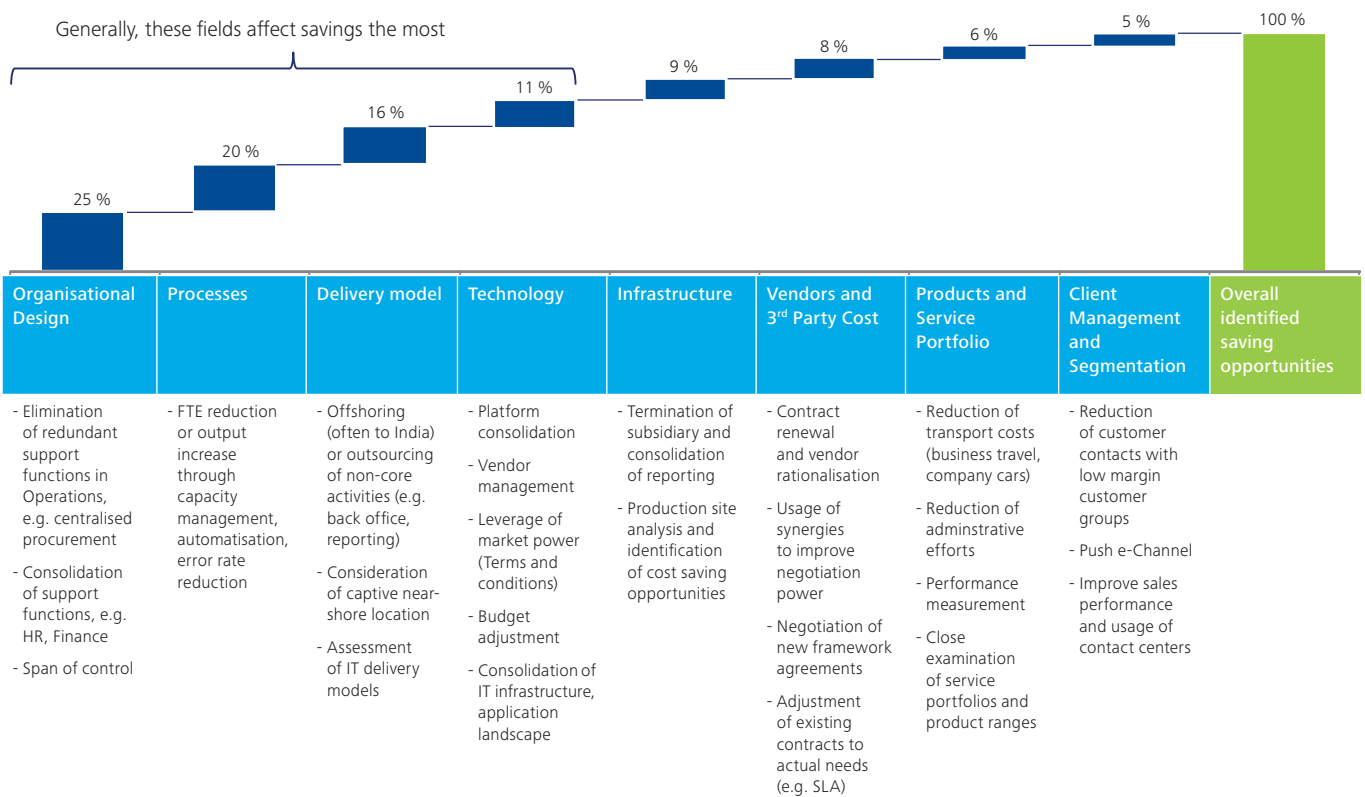
For example any increases and decreases in AuM should be mainly absorbed by Lean organisations. Lean organisations leverage external service providers or have implemented highly automated processes to increase their scalability. Either way, changes in headcount would stay well behind AuM growth. As another example, Six Sigma initiatives should increase the process quality and continually reduce manual effort, e.g. for re-work or error handling.

Hence the required headcount should be reduced over time, independent of any AuM growth. Therefore we should expect headcount to remain mainly stable or to be reduced constantly over time. Only permanent growth would justify a headcount increase. Any required adjustments in headcount which cannot be offset should take place on a timely basis as KPIs would provide an early warning.

So, the probability is high that it is not as a result of compensatory effects overruling the savings from Lean and Six Sigma that we cannot see an impact on CIR. It is much more likely that these methodologies were not implemented correctly so as to generate an effect. Optimising an organisation should not start with looking at internal processes only, like many Lean and Six Sigma initiatives did. The first step should be on a higher level, looking at the overall organisational landscape—your (Target) Operating Model (TOM). A TOM comprises customers, channels, products, information flow, technology, organisational structures, people and locations in addition to processes.



Graph 5: Main levers to generate cost savings



Source: Deloitte project results

Large-scale efficiency or cost-savings programmes need to look at all levers which have an influence on operational efficiency to be successful

Fear of tampering with the operating model

There are two reasons why any asset manager needs to look at their TOM first if they want to generate savings effectively. The first is that optimisation of the organisational structure alone—e.g. span of control, team structures and work allocation—promises even higher savings than process optimisation on its own. The second reason is that addressing one lever only disregards several others which can contribute to increasing the total savings.

Graph 5 shows the eight main levers which contribute to savings. In Deloitte's projects in the asset management industry 'Organisational Design' usually contributes 25% to any savings generated compared to only 20% for 'Process Optimisation'. Subsuming changes in the 'Delivery Model' under 'Organisational Changes', these two initiatives usually contribute more than 40% to any savings generated compared to 20% for 'Process Optimisation'.

If organisational changes are not addressed first, though, process optimisation would generate fewer savings than stated in graph 5. As organisational changes often contribute to the optimisation of interfaces between departments they also contribute to process optimisation. All mentioned levers can only gain as much as 60% of all possible savings. This leaves room to increase savings significantly by addressing other means such as (information) technology or third-party spend.

Hence, large-scale efficiency or cost-savings programmes need to look at all levers which have an influence on operational efficiency to be successful. To ensure that all levers are considered adequately,

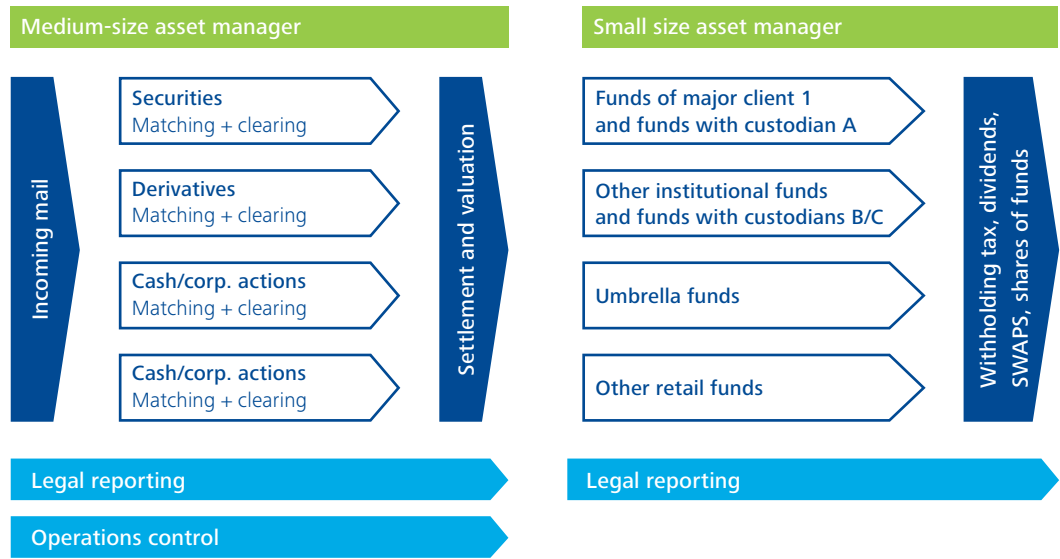
we recommend a three-step approach starting with designing the TOM. While developing the TOM blueprint, all levers shown in graph 5 are examined to determine their impact on the different levels of the target operating model (stage 1).

After having finished blueprinting, Organisational Design, Delivery Model, 3rd Party Relations and Product and Client Portfolio are considered in more detail (stage 2). During this phase, a significant portion of savings will already be achieved by simply reducing overhead and management costs as well as leveraging specialised (captive or external) sourcing providers and external partners for process delivery.

Addressing the 'Organisational Design' provides opportunities for all asset managers independent of their individual size. Economies of scale from reorganising can be generated even at small asset managers, for example by reorganising the fund administration department so that activities which are similar are grouped together. This way economies of scale can be leveraged. The bigger the organisation in terms of headcount, the more design options need to be considered. Graph 6 (see following page) shows two different organisation structures for the fund administration departments of one small and one medium-sized asset manager which were developed for Deloitte's clients.

At the medium-sized asset manager teams were grouped around different kinds of transactions with the type of funds playing no role. A small-sized asset manager with smaller numbers of transactions to distribute across teams grouped its staff around the different kinds of funds they serviced.

Graph 6: Alternative organisation structures for fund administration departments



Only transactions which were regarded as particularly complex were grouped and processed in a dedicated team across all funds. This way both companies were able to develop specialised and specially trained employees while generating economies of scale from repeating similar working steps. Only then were the specialised teams asked to work on their processes applying Six Sigma methodology and entering stage 3 as depicted in graph 7. A key success factor is to enable internal functional experts to identify and execute the required optimisation steps under the guidance of Six Sigma navigators. Self-empowered employees will become multipliers for ongoing process improvements once they have been trained. However, an ongoing strategic review of the production setup (stage 1 and 2 in graph 7) needs to be ensured, overseen and steered by senior management. With a lack of senior management supervision, a full transfer of organisational and process improvements into line organisations will not help to achieve ambitious savings targets.

As stated above, organisational improvements are the biggest contributor to savings and together with sourcing/shoring decisions contribute up to around 40% of the total savings potential on average. Process improvements are most efficient once the organisation is stabilised and processes can be aligned to the new organisational structure. Following this holistic approach will create more satisfying and sustainable results than traditional stand-alone initiatives.

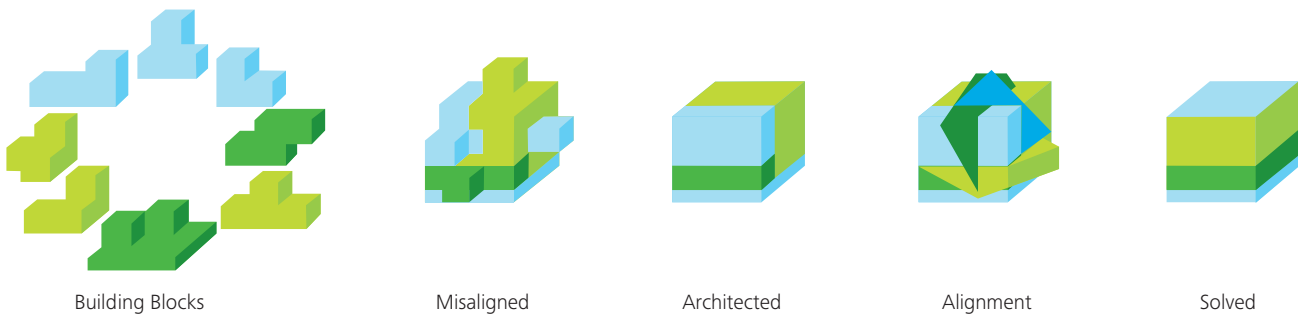
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Graph 7: Proceeding to reach optimal results in efficiency improvements

	Strategic target blueprint	Organisational and operational framework implementation	Process and infrastructure alignment
Organisational Design	●	●	
Processes	●		●
Delivery model	●	●	
Technology	●		●
Infrastructure	●		●
Vendors and 3 rd Party Cost	●	●	
Products and Service Portfolio	●	●	
Client Management & Segmentation	●	●	

Source: Deloitte

Graph 8: TOM approach



Bringing the pieces together

The biggest challenge in re-designing the entire operating model is to configure the components in such a way that they work together smoothly.

We observe that many organisations struggle to simultaneously manage initiatives that each have different objectives, ignoring interdependencies between various functions. In particular, necessary interaction between top line growth and efficiency improvement programmes is often ignored. Many organisations are also overwhelmed by the complexity of their business model and simply give up aiming for coherence across all layers.

The TOM method’s main goal is to seamlessly align all components of the business model, thereby eliminating inefficiencies. Business complexity is reduced by de-constructing the organisation into its constituent parts, enabling management to clearly map and visualise interdependencies and to understand the key gaps between the current and target state.

The Deloitte TOM methodology breaks the operating model down into its nine key constituent layers, starting from customers/channels through to the processes that will be required to deliver the strategic objectives such as organisation, technology and people. This approach ensures that Lean and Six Sigma projects are combined with other performance improvement initiatives to form a single model where interdependencies, conflicts and overlaps can be better managed, resulting in greater and more effective cost reductions.

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Graph 9: TOM layers

Customer segments	which customers: e.g. high net worth individuals, institutional investors or retail clients
Channels	via which channels: e.g. call-center, key-account, adviser teams, internet
Product/ services	offering which products: e.g. retail funds, index funds, closed funds or sector funds
Processes	supported by which processes: standardised, standardised and automated, manual or segmented
Information	requiring what information, e.g. customer details
Technology	using which enabling technologies: e.g. SWIFT, Fax, paper copies vs. electronic fund files, automated vs manual settlement, etc.
Organisation	organised in which way to deliver, e.g. shared services
People	requiring what resources and skills, e.g. FTEs, roles, costs, culture
Physical locations	in which locations, e.g. properties, costs

To the Point:

- Asset managers are confronted with lower revenues and higher costs arising from regulation
- Discrete cost-reduction and performance-enhancing initiatives like Lean and Six Sigma have been initiated but are not enough to significantly affect the CIR
- To achieve significant CIR improvements more cost-reduction levers than affected by Lean and Six Sigma need to be addressed
- Refining the Target Operating Model helps to address all available levers for cost reductions and achieve a significant impact on CIR as well as operational efficiency