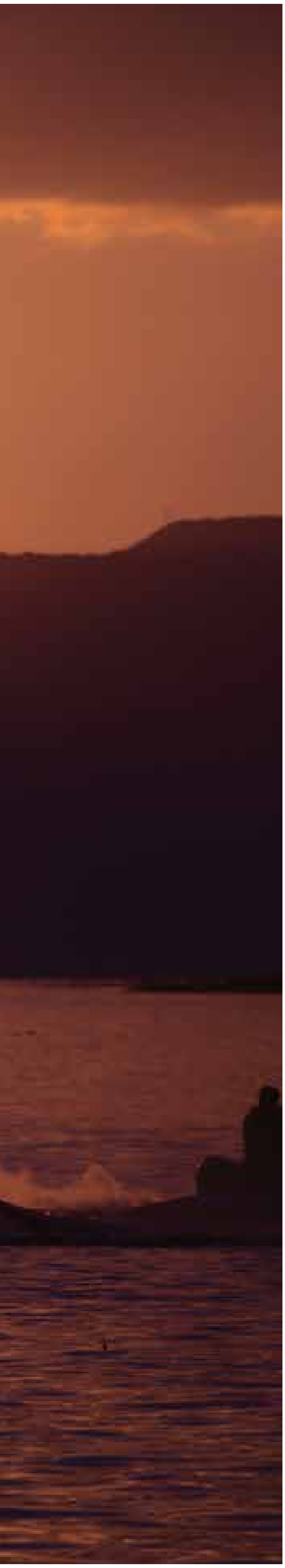


Unlocking efficiency through industrialization

Patrik Spiller
Partner
Consulting
Deloitte

Dr. Stefan Bucherer
Senior Manager
Consulting
Deloitte

Dr. Thomas Ankenbrand
Lucerne University of Applied Sciences and Arts

Wendy Spires
Head of Research
WealthBriefing

The banking industry has been under cost pressure and regulatory scrutiny since the onset of the financial crisis. At the same time, the industry is facing significant technological developments with disruptive potential. After nearly a decade of challenging market conditions, banks are now seeking solutions to improve cost-to-income ratios, secure regulatory compliance, and foster innovation to deal with market disruptions. Industrialization is not a new concept in the industry. However, the benefits are still to be sowed, as little emphasis has been placed upon it. Going forward, nine levers of industrialization can guide banks toward the sought-after solution to unlock the efficiency and agility in banking.

Key banking industry trends

Source: Deloitte (2016), "Industrialization in banking"

Challenging market conditions have pressurized profitability margins among banks. This has happened on a global scale through a combination of both increasing costs and declining revenues. The ones that are particularly affected are European banks: According to ECB calculations, the average return on equity of Euro-area banks has decreased from over fifteen percent in 2000 to a mere five percent in Q2 2016. This is a result of various factors, such as record low interest rates, unfavorable market conditions, more stringent capital requirements, risk-averse clients, and increased competition.
Tightening regulatory requirements add their share on the challenges for banks. This has resulted in banks being tied up in remediation activities at the expense of focusing on clients. Finally, the emergence of new technology-centered players (FinTechs and tech giants such as Apple, Google, or Alibaba/Ant Financials) has increased the need for innovation to avoid being disrupted.

In order to cope with the situation of decreasing margins, banks have primarily focused on "quick wins" to improve profitability. Frequently, these were achieved through cutting the number of employees without fundamental changes in how banks operate. Now, the focus of financial institutions is changing. In a recent survey by WealthBriefing and Deloitte, 85 percent of globally selected wealth managers named increased focus on their core businesses as a key priority.

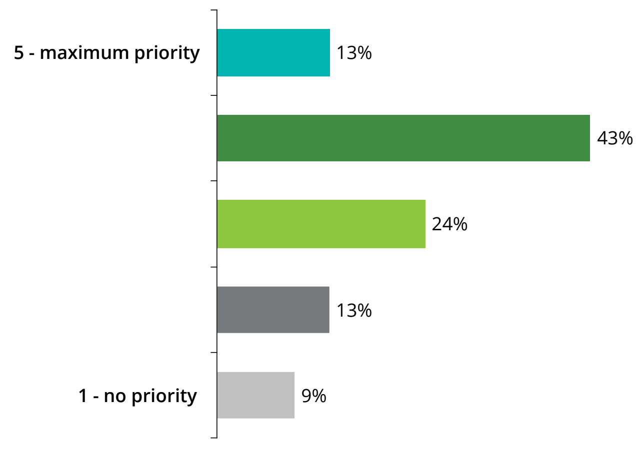
> Our research has confirmed that industrialization can also increase the speed of innovation and agility.

In the same survey, wealth managers expressed their intent to significantly invest into developing client-facing and client-adviser enabling technologies.
Still, with "quick wins" off the table, the question remains: How will banks be able to fund the development of new competitive advantages while re-establishing long-term efficiency?

Industrialization as a response...

One compelling answer is industrialization, which is characterized as the elimination of redundancies, the review of sourcing options, and the standardization of processes. While industrialization in banking is not a new topic, it has recently been gaining increased attention. Around 90 percent of banking executives surveyed in a recent Swiss study agree that the key benefits of industrialization are reduced costs and enhanced scalability.

Priority given to reduce efforts on standardized processes in order to focus on value-adds



Source: WealthBriefing & Deloitte (2016), "Evolving operating models in wealth management"

Additionally, more than 50 percent of respondents in a global survey among wealth managers consider reducing effort on standardized processes as a high priority. Instead, they plan to focus on value-add processes and to invest into client-facing activities. These findings are consistent with insights from Deloitte's global outsourcing survey 2016, whose participants view outsourcing as a means to cut costs, focus on the core business, and solve capacity issues.

Furthermore, our research has confirmed that industrialization can also increase the speed of innovation and agility. Industrialization fosters innovation, as resources will be freed up from standardized processes and can subsequently be redeployed in innovation efforts. Particularly smaller institutions benefit from the outside expertise of their outsourcing or collaboration partners and can shape and participate in "innovation ecosystems." Streamlined processes, effective organizations, and lean IT systems of an industrialized institution allow it to react quickly to disruption and incorporate new innovative offerings.

...but facing significant challenges

Considering the perceived benefits of industrialization, the question remains why financial institutions are not more advanced in their industrialization efforts. For instance, 30-50 percent of Swiss banks admit that they have exploited the industrialization potential to no extent at all or only limited for most industrialization levers except for the fundamental ones (process excellence, organizational efficiency, and product rationalization). Similarly, even for the most standardized functions (corporate action processing, payment processing, and securities transaction processing), less than 40 percent of wealth managers globally report those as highly standardized.

According to our research, the biggest impediment for further advancement of industrialization principles is change resistance and cultural barriers. This is understandable, as industrialization may require that working habits will change and certain jobs may even be at risk, but with other jobs to be created.

It is the leadership's responsibility to provide clear direction and identify change agents within the organization to lead the transformation from within. Indeed, banking executives have revealed in interviews that for sustainable change, the full buy-in of the organization is required, and therefore expertise on tools and methods needs to be built internally.

Today, this knowledge is often not widely spread within organizations, but needs to be brought in from the outside. This explains to some extent why executives view high costs as another important challenge for implementing industrialization efforts. Therefore, financial institutions are advised to invest in line with their strategy, industrialization maturity levels, and core competencies.

What is industrialization?

Based on the experience in other industries, five principles of banking industrialization can be derived that drive the overarching objectives of the elimination of redundancies, the review of sourcing options, and the standardization of processes:

For a successful implementation, nine actionable industrialization levers implementing the five principles can be defined. These can be categorized according to their maturity: Foundational levers target short-term improvement in the execution of existing processes; transformational levers target long-term redesign of the operating model; while disruptional levers target the reinvention of a bank's business model, organization, and culture. Whereas the nine levers can be applied independently, it is important to highlight that the full benefits of industrialization are only obtainable for the banks that holistically base their strategy on the five principles of industrialization.

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Five principles of banking industrialization

Front-to-back service alignment	• Coordinate services along the value chain in order to maximize client-and service orientation • Focus on improving availability, service quality and processing improvements
Distinct process orientation	• Build banks' operating models around processes • Steadily and consistently improve productivity of all processes
Cultural shift	• Instill a district mind-set among staff to value efficiency and evolution • Reward employees for suggesting improvements and involve staff early in the change process
Resource optimization	• Introduce a meaningful performance measurement system at optimizing resource allocation • "You can't manage if you don't measure"
Value chain decomposition	• Re-think your value chain regularly and source smartly • Be aware of core competencies and differentiating activities

Source: Deloitte (2016), "Industrialization in banking"

The Deloitte banking industrialization framework

Process Excellence
Introduce front-to-back process management by assigning process owners and applying advanced process analytics; apply continuous improvement principles; standardize processes across the bank.

Organizational Efficiency
Reduce hierarchy levels and optimize span of control; breakup vertical silos to increase front-to-back alignment to client services; centralize common functions; tailor organization to cross-function interactions, decision-making, and agility.

Product Rationalization
Optimize and standardize product and service shelf; balance a broad offering while reducing duplicate and non-differentiating low-volume products; leverage open architecture principles for product platforms.

FOUNDATIONAL
Improving execution of existing operations and value creation (short term)

Value Chain Reengineering
Align value chain to clients and services, not products; make choices and focus on core competencies; rethink non-value-added activities; buy managed services for activities which are not sufficiently differentiating or strategic.

IT Simplification
Decommission end-of-life applications; leverage standardized multi-product and multi-entity capable systems; minimize software customization; optimize IT infrastructure; introduce software as a service and infrastructure as a service.

Location Optimization
Apply workspace concepts fostering innovation and collaboration; optimize footprint per employee; consolidate locations; expand global reach to leverage talent supply; optimize employment costs through near- and offshoring.

TRANSFORMATIONAL
Re-design of operating model (longer term)

Industry Utilities and Joint Ventures
Establish industry utilities to commercialize own capabilities; build joint ventures with peer banks or non-financial services providers in order to create economies of scale and capability networks.

Process Digitalization and Robotics
Introduce digital processes such as paperless client onboarding; leverage big data analytics for superior client services; use robots for rules-based, repetitive processing; increase connectivity with digital ecosystem.

Economic Value Management
Introduce business analytics to measure client value, costs to serve and process performance; optimize allocation of resources in producing and offering products and services to clients; closely link KPIs and rewards.

DISRUPTIONAL
Re-invention of banks' business model, organization and culture

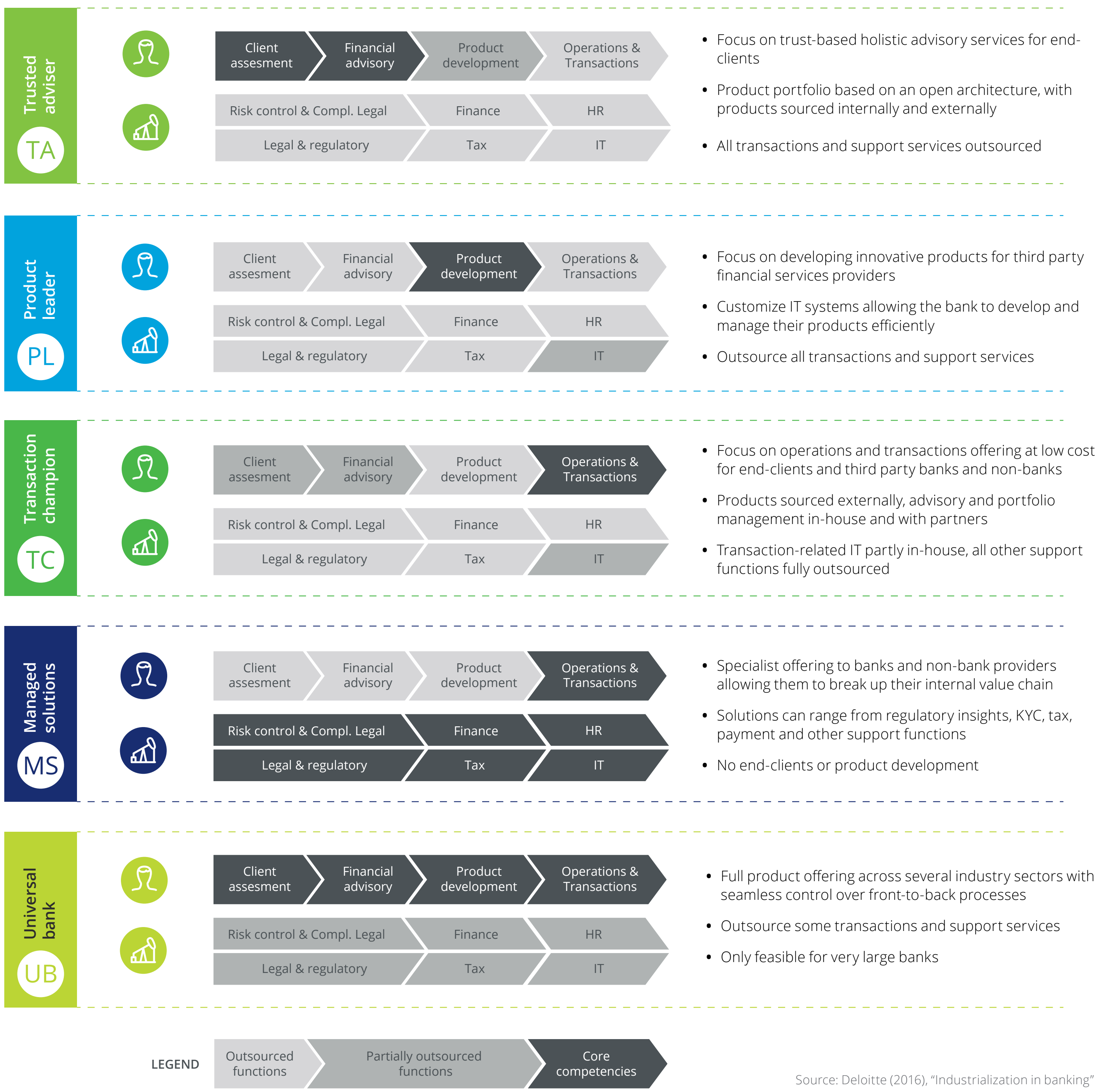
Source: Deloitte (2016), "Industrialization in banking"

Emerging operating models

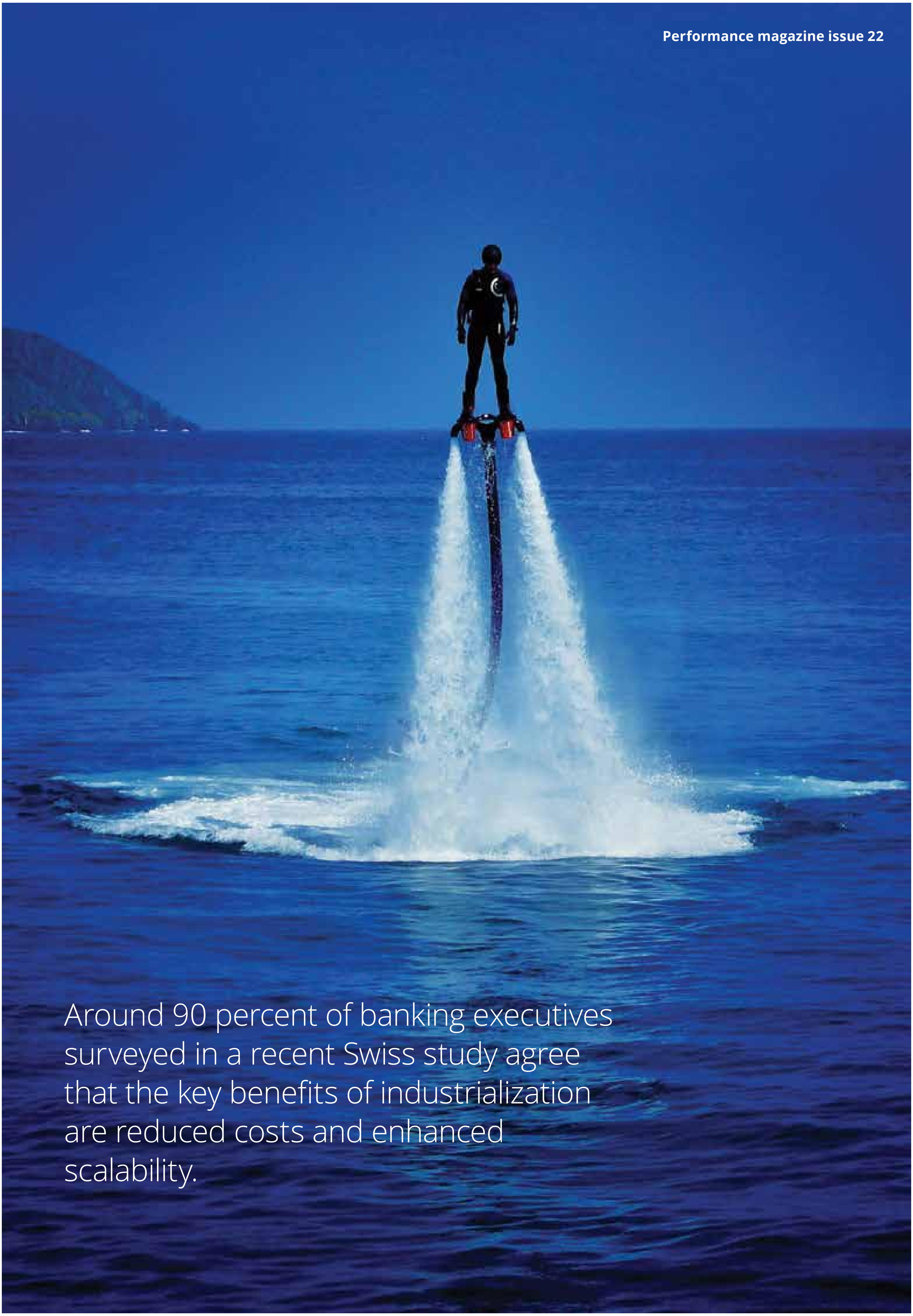
Industrialization will have an impact on the operating models of banks depending on their chosen business model. In particular, by applying value chain reengineering and considering partnering and joint ventures, financial institutions will focus only on certain parts of the value chain. We anticipate five distinct future banking business models to emerge and the success of these banking models will partially rest on the results of industrialization efforts.

The implementation of these emerging operating models depends strongly on the institution's capabilities and business model. When asked about the expected timeframe to implement business process outsourcing, a key element of a holistic value chain reengineering, all asset managers reported 6 to 18 months. Other institutions—such as universal banks, who have more complex value chains and tend to outsource only selectively—expect much longer implementation timelines.

Banking business models of the future



Source: Deloitte (2016), "Industrialization in banking"

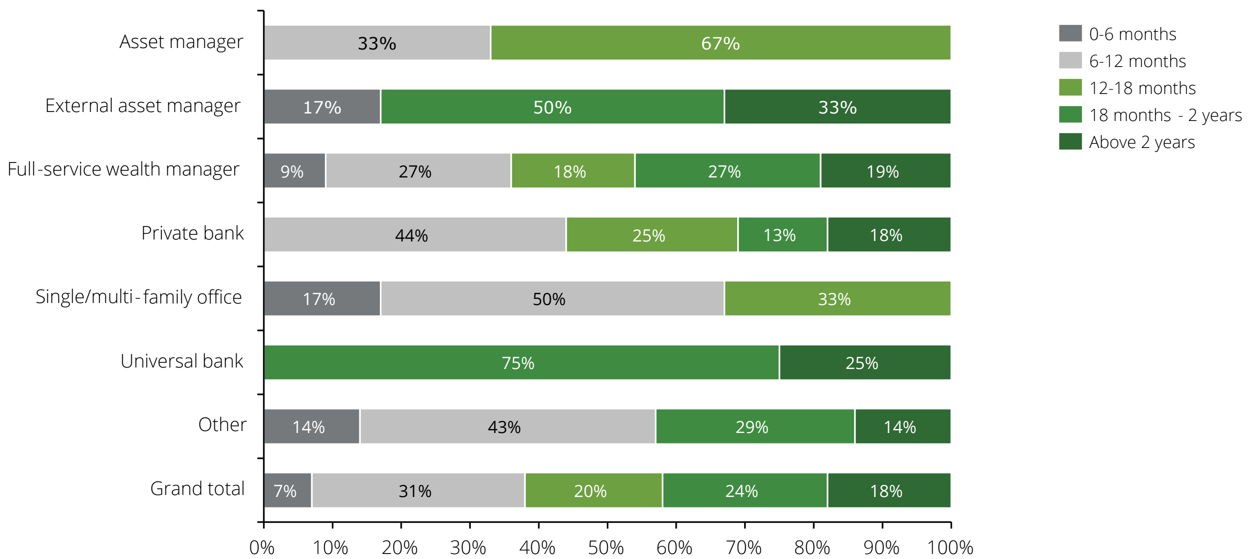


Around 90 percent of banking executives surveyed in a recent Swiss study agree that the key benefits of industrialization are reduced costs and enhanced scalability.

If financial institutions indeed want to achieve much higher industrialization levels within the next five years, as Swiss banks have expressed in a recent survey, this calls for action today. However, not every value chain reengineering opportunity will be implemented, as the efficiency gains offered by BPO providers will not meet the expectations of the outsourcing institutions. Over 90 percent of globally surveyed wealth managers expect a minimum efficiency gain of 20 percent in order to enter a business process outsourcing contract. BPO providers are therefore challenged to increase their own maturity and efficiency in order to offer an attractive value proposition to their clients. Institutions that have achieved high process excellence or that already have a scalable platform may opt for the managed solutions business model and become a BPO provider themselves. In fact, 12 percent of surveyed wealth managers consider offering services to other industry players, and a further 21 percent are unsure whether they want to offer this type of service to other institutions. At the same time, other non-traditional BPO providers such as the Big 4 are extending their offering—particularly for asset managers.

As the maturity of the BPO providers increases and industrialization efforts pick up pace among financial institutions, the level of outsourcing will rise and become increasingly important. Even data confidentiality and IT risk concerns, which today are seen as important risks of outsourcing, will be reduced as better solutions are implemented and the industry gains more experience with such setups. As a result, financial institutions will increasingly focus on their businesses where they can leverage their core competencies and add value for their clients.

Implementation timeframe expectation against type of institution



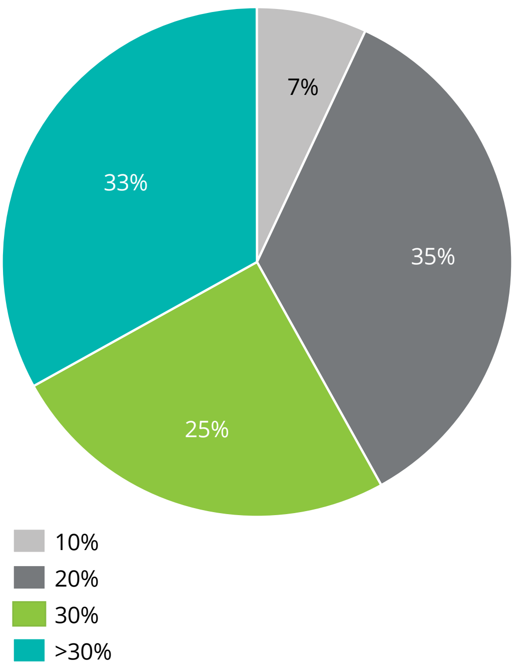
Source: WealthBriefing & Deloitte (2016), "Evolving operating models in wealth management"

However, as noted in the study by WealthBriefing and Deloitte, the definition of what is value-adding will vary between industry players, as different players have different core businesses. As an investment manager, investment research is pivotal to its value creation, whereas IT software development is not. An online retail banking player will likely decide the other way around. Thus, there is no clear-cut definition as to what is value-adding for each industry player. In the same research, the majority of wealth managers stated relationship and quality of service as their key value-add, which is typical for the business model of a trusted adviser. Accordingly, a more radical evolution of operating models is perceivable, allowing trusted advisers to focus even more on client relationships and service.

In various countries, groups of banks have started to establish service companies, which serve competing banks. In Germany, several of such service companies have been established a while ago already, not only as part of regional and mutual banking groups but also as service centers for large banks. UBS's CEO Sergio Ermotti recently proposed an even more radical step for Swiss banks. His idea of a "super-back-office" serving most domestic banks might sound ambitious, however, once foundational and transformational industrialization levers have been exploited, such a disruptive step toward the creation of industry utilities seems logical.

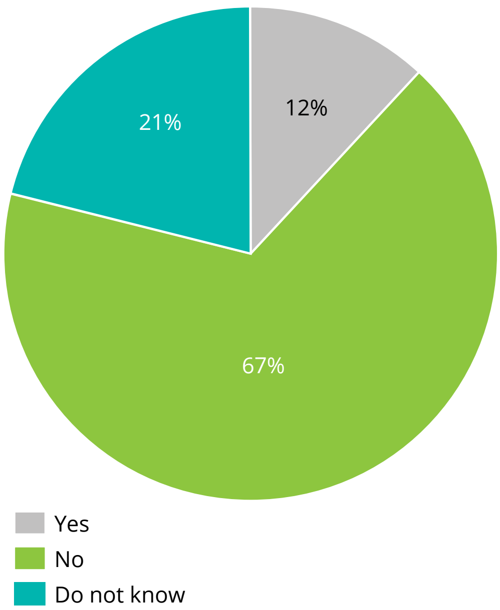
If financial institutions indeed want to achieve much higher industrialization levels within the next five years, as Swiss banks have expressed in a recent survey, this calls for action today.

Minimum level of prospective efficiency gains institutions are looking for in order to enter a BPO contract



Source: WealthBriefing & Deloitte (2016), "Evolving operating models in wealth management"

Institutions offering or considering offering BPO services to other institutions



Source: WealthBriefing & Deloitte (2016), "Evolving operating models in wealth management"

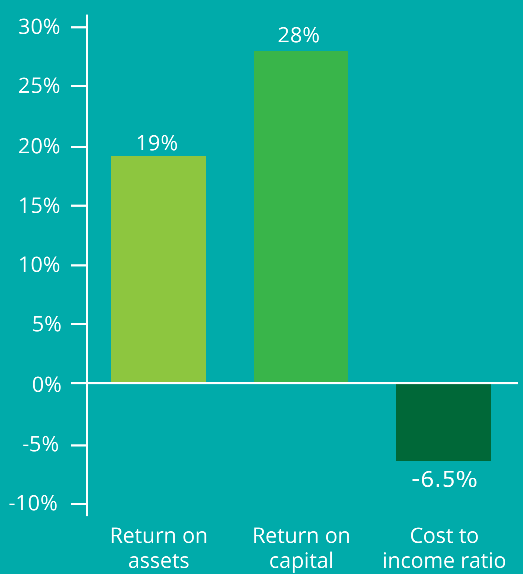
IT simplification and process digitalization

Besides changes to the value chain and the organizational setup, financial institutions consider simplifying their IT landscape and automating their processes. Many banks have targeted programs in place or are planning to establish one in the next three years to reduce their IT complexity. Yet, the majority counts on continuous improvement. Such efforts include the usage of Software-as-a-Service (26 percent of Swiss banks plan to mostly or fully implement such a solution within the next five years), Infrastructure-as-a-Service (29 percent), or even Platform-as-a-Service (31 percent).
Also, today most financial institutions consider implementing modern, third-party core banking systems. Indeed, Deloitte research shows that European banks using such platforms significantly outperform peers using legacy systems in terms of return on assets, return on capital, and cost-to-income ratio.

Such technological changes require significant investments with payback periods of multiple years. In a fast changing world with new technological developments breaking through (blockchain, cognitive computing, and the like), many institutions might be reluctant to undertake such investments now. How can financial institutions increase processing efficiency while avoiding the pitfall of investing in an obsolete system? Leaders are adopting a “two speed technology” approach to this challenge, investing in a stable core while deploying an agile approach to the client interface and connecting to technology partners to exploit the potential of such innovation ecosystems.

Many institutions are also considering process robotics and digitalization to increase automation by substituting repetitive tasks executed by humans through rule-based engines. This is a tactical yet powerful alternative to upgrading core banking systems for better straight-throughput-processing rates. In a recent Deloitte study of industrialization in Swiss banks, more than 60 percent of surveyed banks indicated that in five years they plan to exploit process digitalization in areas such as product suitability, risk control, accounting, and reporting—today less than 40 percent exploit process digitalization. Typical robotics use cases in investment management include the compilation of research data from various sources, creation of customized benchmarking, MiFID transaction reporting, or derivative exposure reporting.

Performance improvement over five years of banks running on third-party banking applications relative to those using legacy applications



Source: Deloitte (2014), “Banking disrupted”

Achieving 20-30 percent cost savings

Across all levers, the potential financial implications of industrialization are significant. Based on our experience with implementing industrialization levers, we have estimated the potential cost savings for fully industrializing an average bank to be 20-30 percent. This relates to a reduction in FTEs of 30-40 percent, which includes personnel shifts to third parties. However, differences among banks may be extensive, depending on the starting point.

How to get started

Financial institutions aiming to reap the benefits of industrialization should first get clarity on their general strategic direction and their core competencies. Next, institutions may conduct a maturity assessment across the industrialization levers by looking at front-to-back processes. Through identifying the biggest gaps and by focusing on what is core and what is non-core, institutions can define a change portfolio. In this phase, buy-in from various stakeholders and from key employees is pivotal.

Only if the principles of industrialization are embraced by the organization, the necessary changes can be sustainably implemented. The leadership in the institutions is on the hook to lead the way into the future. When the right measures are taken today, the necessary resources for unlocking future value through increased agility and innovation can be made available.

To the point:

- The banking industry is under pressure from multiple sources, such as decreasing revenue streams, regulatory scrutiny, and market disruptors
- Industrialization can help financial institutions increase scalability, decrease costs, and foster innovation, which is ever more important today
- Yet, change resistance needs to be overcome by institutions through comprehensive change efforts with constant focus from senior management, while investments need to be planned wisely
- Reengineering of the value chain and leveraging business process outsourcing are key means of industrialization, but need to be aligned with the institution's target business model
- IT simplification and robotic process automation complement each other in achieving higher straight-throughput-processing rates, increasing agility and readiness for new business models
- 20-30 percent cost savings are achievable through industrialization

Impact of industrialization levers on revenues and costs of banks

	Revenue growth	Cost reduction	FTE reduction
Process excellence	0-5%	10-20%	10-20%
Organizational efficiency	0-5%	5-10%	5-10%
Product rationalization	5-10%	10-20%	5-10%
Value chain decomposition	5-10%	10-20%	>20%
IT simplification	0-5%	>20%	10-20%
Location optimization	0-5%	>20%	0%
Joint ventures and industry utilities	5-10%	0-5%	>20%
Process digitalization and robotics	>20%	10-20%	10-20%
Economic value management	0-5%	5-10%	0-5%

Increase in revenues/decrease in costs: 0% · 0-5% · 5-10% · 10-20% · >20%

Source: Deloitte (2016), "Industrialization in banking"