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

# Abstract

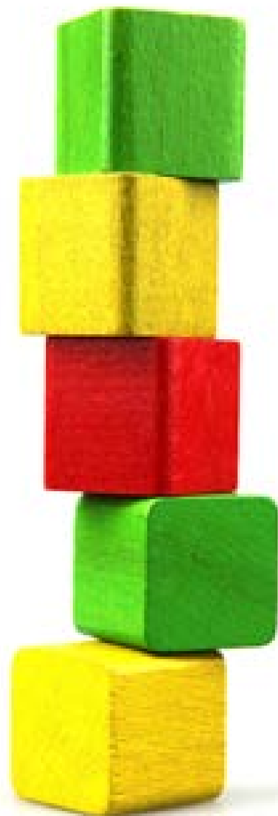
Industries typically evolve along common paths and consolidate as they become more mature. In this consolidation, we see leading players vertically disintegrate their value chains in a bid to become "leaner" and more competitive. Vertical dis-integration is defined as the emergence of new intermediate 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,"[1] 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.[2]

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.



[1] The Nature of the Firm, R.H Coase, Economica, New Series, Volume 4, Issue 16 (Nov., 1937), 386-405.

[2] Academy of Management Journal. 2005, Vol. 48, No. 3, 465–498

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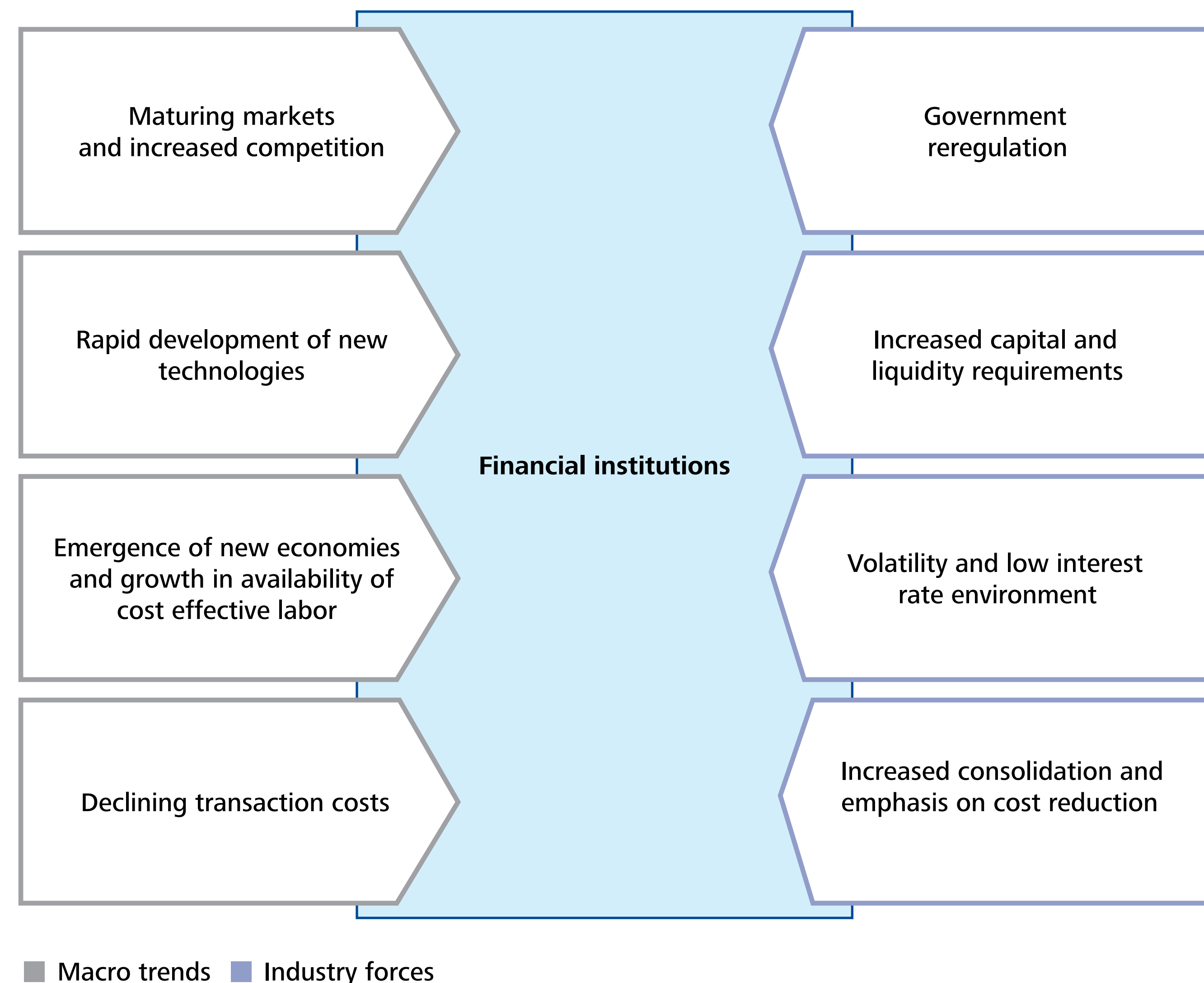
# Global trends and margin compression in the financial services industry are pressuring banks to accelerate the development of competitive advantages

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.

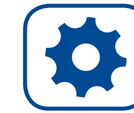
**Diagram 1. Macro and industry forces**



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

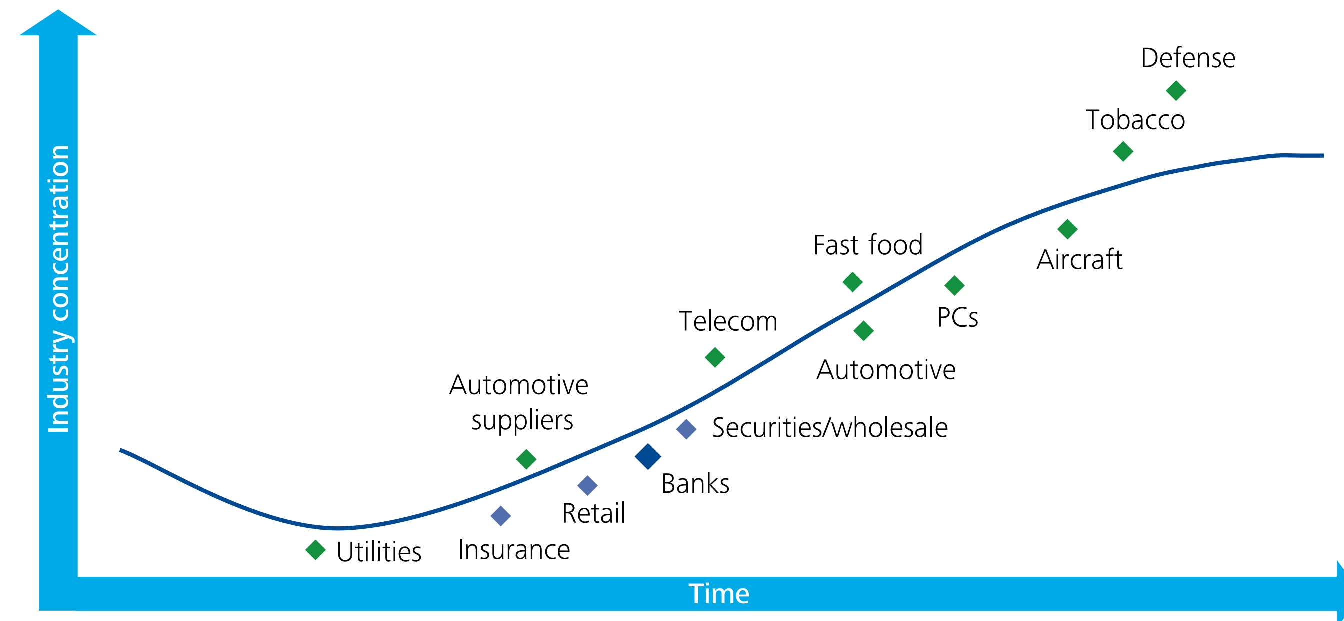
As the financial services industry matures, institutions will face increased competitiveness and reduced margins. The financial crisis accelerated the consolidation of the industry by forcing numerous acquisitions, mergers, and bankruptcies including some of the largest mergers and acquisitions activity 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.

### 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.[3]

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.[4]

[3] AIM Research Working Paper Series. Improving Performance through Vertical Dis-integration: Evidence from U.K. Manufacturing Firms

[4] Academy of Management Journal. 2005, Vol. 48, No. 3, 465–498

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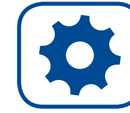


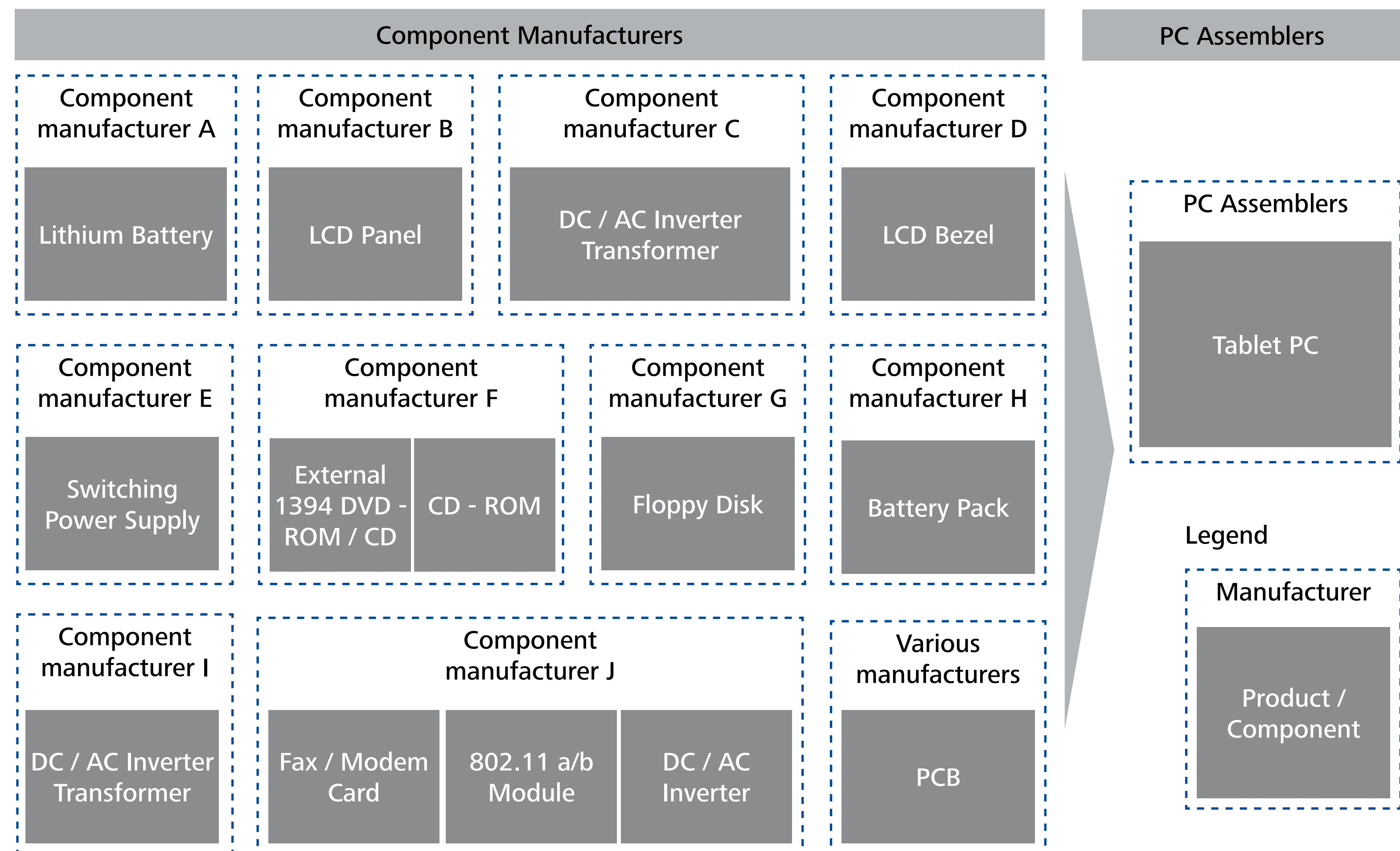
## Vertical Dis-integration in the PC industry: Case study

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

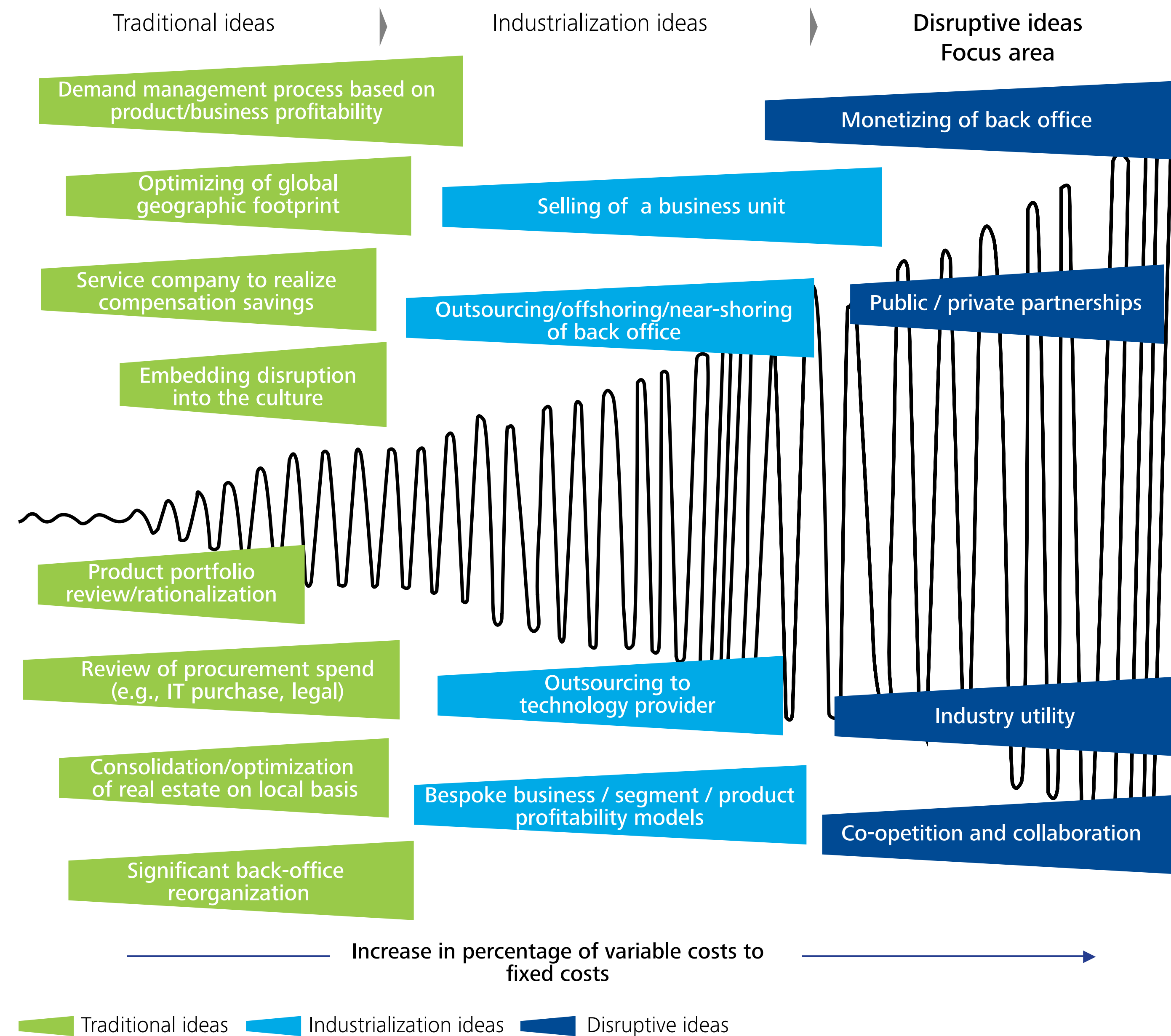
Based on trends in other mature industries, the financial institutions that have scale, focus on their core competencies, and pursue aggressive dis-integration of their value chain will have a better likelihood to become leaders in the industry as the market becomes more concentrated and competitive.

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 nonprofitable 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

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## 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

#### Demand management process based on product/business profitability

**Description:**
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

**Example:**
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

#### Optimizing of global geographic footprint

**Description:**
Optimization of an institution's global footprint to pursue revenue growth, reduce costs, or increase access to global talent in key geographic markets

**Example:**
Contracting of business processes or information technology work to third parties or establishment and relocation of operations to low-cost domestic or global locations

**Example:**
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

### Industrialization ideas

#### Selling of a business unit

**Description:**
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

**Example:**
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

#### Outsourcing/offshoring/near-shoring of back office

**Description:**
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

**Example:**
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

### Disruptive ideas

#### Monetizing of back office

**Description:**
Scaling and standardization of the back office in order to monetize and offer previously internal technology and operations services to other businesses

**Example:**
An insurance organization's expansion of its infrastructure services joint venture's offerings to the industry

#### Industry utility

**Description:**
Establishment of an industry utility to provide client management, valuation, processing, data, and/or reporting services

**Example:**
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

#### Public/private partnerships

**Description:**
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

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## Vertical dis-integration of functions/capabilities

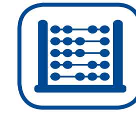
The disruptive ideas for achieving vertical dis-integration apply to numerous functions/capabilities across a financial institution's end-to-end value chain. Assessment of each idea against an institution's range of activities can reveal feasible areas of dis-integration. The diagram on next page provides 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 |
|---|---|---|---|---|---|---|---|---|---|---|
| | • Client segmentation<br>• Marketing mgmt<br>• Branding | • Client Setup<br>• Fees & Billing<br>• Client reporting | • New Product dev.<br>• Product maintenance<br>• Product reporting | • Invest. strategy<br>• Research<br>• Client Portfolio mgmt | • M&A & Corp. Advisory<br>• Equity & Debt Underwriting | • Trade Execution<br>• Trade Matching<br>• Trade Clearing | • Margining & Collateral Mgmt<br>• Trade Settlement<br>• Payments<br>• Reconciliations | • IT Strategy<br>• IT Applications & Infrastructure<br>• Data mgmt | • Risk Mgmt<br>• Legal & Compliance<br>• Financial mgmt | • Recruiting & Hiring<br>• Performance mgmt |
| 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



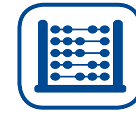
# Organizations should consider the organizational changes and challenges that will accompany the dis-integration process

## 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**

Timing Phases

Challenges/considerations

### Opportunity identification and partner/ vendor/outsourcer selection — Short term

**Execution**
- What are the potential functions / capabilities to dis-integration?
- What is the business case for disintegrating these functions, and which would realize the greater financial benefits?
- Who are the potential partners, vendors, and /or outsourcers in each of these businesses, and what is the optimal number to transact with?

**Financial**
- What are the financial impacts across the organization given the functions / capabilities to dis-integrate?

**Governance**
- Who are the identified stakeholders for the disintegrate process and of the functions being dis-integrated?
- Which stakeholders and end users will be part of the partner, vendor, and /or outsourcer selection process?

**Risk management**
- Are there confidential customer data or intellectual property risks of disintegrating?
- Are there potential regulatory restrictions of disintegrating the selected functions?
- How will due diligence be conducted on potential partners, vendors, and /or outsourcers, and what is the evaluation criteria?

**Talent/HR**
- What capabilities are needed to analyze business lines and identify core contributors to profitability and customer retention?
- Are there internal resources available to evaluate partnership types (e.g., joint ventures s vs. vendor) and structure the partner, vendor, and /or outsourcer contract?
- Which jobs / skill sets would it be more effective to keep in house?

### Transition execution — Medium term

**Execution**
- How will the organization effectively transfer businesses to an extended network of partners, vendors, and /or outsourcers and procure the required goods and services from these businesses?
- Will businesses be transferred as is, or will certain functions be modified prior to the transition?

**Financial**
- What are the expected financial costs of the transition, and how will they be managed / controlled?

**Governance**
- What governance and communication structures are required to ensure end-to-end accountability both internally and externally and manage multiple partners, vendors, and/or outsourcers?

**Risk management**
- What service-level agreements (SLAs) need to be in place during the transition process?
- What controls need to be in place to provide an effective transfer of intellectual property or confidential client information to partners, vendors, and/or outsourcers?

**Talent/HR**
- What resources and skill sets are required to manage the transition process with multiple partners, vendors, and/or outsourcers?
- How will knowledge be transferred to the partners, vendors, and/or outsourcers as well as be maintained internally?
- How will employees of the dis-integrated functions be realigned and integrated into other parts of the business?
- How will reporting lines change / be affected across business units. geographies, functions, and processes?

### Partner/vendor/outsourcer performance management and reevaluation — Long term

**Execution**
- How will long-term contracts / relationships be enhanced or expanded to other parts of the business?
- How often and against what criteria will vendors be re-evaluated?
- If required, how would partners, vendors, and/or outsourcers be changed?

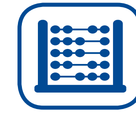
**Financial**
- How will adverse financial trends be identified and handled?
- How will costs / overhead be reduced as the organization evolves?

**Governance**
- What processes will be in place to allow for transparency and visibility across the enterprise to monitor ongoing performance and results?
- What structures need to be implemented to provide for prompt, predictable identification and response to critical issues?

**Risk management**
- How will operational risk / SLAs be managed and monitored ?
- What authority will the risk management function need to be effective?
- How will contracts and relationships be monitored to provide ongoing regulatory compliance and safeguarding of proprietary and confidential information?

**Talent/HR**
- What resources and skill sets are required long term to manage multiple partners / vendors / outsourcers?
- What resources and skill sets must be maintained to continuously assess partner, vendor and/or outsourcer performance and the ability to expand or enhance contracts?

Source: Deloitte Consulting LLP



| Opportunity identification and partner/vendor/outsourcer selection | Transition execution | Partner/vendor/outsourcer performance management and reevaluation |
|---|---|---|

### Short term: Opportunity identification and partner/vendor/outsourcer selection

Short-term challenges focus on the identification of businesses and functions for dis-integration, the prioritization and selection of vendors/partners/outsourcers, and the establishment of internal teams with the capabilities to make these assessments. Vendor/partner/outsourcer selection becomes a more complex enterprise process that requires consideration of service levels, costs, long-term strategic relationships, and time zones, among other factors.

### Medium term: Transition execution

As the organization transitions specific functions to external partners, the management of concurrent complex programs as well as talent becomes critical. In addition to strong project management, considerable effort will need to be placed on knowledge and talent retention to ensure learnings are retained from both the operation of the function as well as execution of the initiative. At this point, organizations should determine whether they want to reengineer the impacted functions or simply transfer as is to the selected partner and then drive improvements over time. Institutions will also need to develop a different and disciplined approach to governance and communication models as more vendors/partners/outsourcers are engaged and the business disintegrates.

### Long term: Partner/vendor/outsourcer performance management and reevaluation

As the migration to vendors/partners/outsourcers continues and relationships mature, the organization should establish capabilities to manage business-as-usual service levels and performance. Information transparency is likely to be critical, and protocols for the rapid resolution of issues, as well as ongoing process improvement, are expected to become critical. Managers with the appropriate skills to monitor these external relationships and address issues as they arise will be required. Consideration should be paid to ownership of data repositories, safe keeping of client data, and retention of records. Processes should be implemented that allow for the organization to scale successful contracts and relationships to other businesses, reassess contracts and relationships, and transition away from partners/vendors/outsourcers who fail to meet performance targets. Addressing this consideration early can reduce potential challenges associated with partner/vendor/outsourcer captivity during contract renegotiation.

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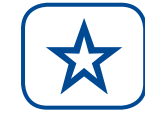

# Conclusion

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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