A Strategic Approach to Cost Reduction in Banking

Achieving High Performance in Uncertain Times

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Senior banking executives face a vexing dilemma. In this difficult economic environment, there is great urgency to reduce costs and improve efficiency. But cutting indiscriminately or too deeply may severely hamper the ability to grow revenues when the economic outlook improves.

In Accenture's view, arbitrary cost reduction—based on rationales of "sharing the pain equally across the organization"—is no longer sufficient, and risks cutting muscle as well as fat. Instead, financial institutions need to take a more strategic approach by viewing cost-cutting as part of a broader efficiency effort. Balancing short-term tactical cost reductions with longer-term strategic cost initiatives will leave banks much better positioned for future high performance.

This approach can yield cost reductions up to 20 percent, help variabilize a high fixed-cost base, and enable banks to weather the credit storm. Just as important, this strategy aligns with banks' efforts to simplify processes and systems, standardize products and facilitate market differentiation. Those attributes are what we consider the blueprint for a high-performance bank.

This brochure examines how banks can solve the dilemma by taking out costs in a judicious way that also supports future growth.
Rethink Traditional Cost Strategies

For the first half of this decade, banks largely operated in an extraordinarily benign environment of low interest rates, rising home prices, expanding loan volumes and robust economies—all of which created opportunities to generate substantial organic growth and shareholder value. Most banks were able to steadily improve their cost-to-income ratio during that period.

But today, high energy prices, sluggish economies and the continuing fallout from the credit crunch have put a damper on the banking industry globally. Many financial institutions have posted huge write-downs, particularly in North America and Europe. Japan’s major banks have reported weak earnings results, due in part to the subprime mortgage meltdown in the United States. The International Monetary Fund estimates that losses related to the credit crisis could approach $1 trillion.

The short-term outlook isn’t hopeful. Many North American and Western European financial institutions, for example, are under severe liquidity pressures due to loan losses, slowing or even negative revenue growth due to the weak housing market, tighter credit standards and sluggish economies. Fortunately, many banks in the Asia-Pacific region, as well as those in central and eastern Europe have been largely shielded from the turmoil. But few banks, regardless of location, have escaped the major impact of the current economic downturn: the far higher cost of capital and significant increase in funding costs.

Efforts to stem the tide by raising capital and additional dividend cuts haven’t entirely succeeded. Increasingly, banks are turning to internal costs savings including headcount reductions. Tens of thousands of bank staff have lost their jobs in the past year, and further layoffs have been announced.

But traditional cost reduction strategies that worked in previous banking slowdowns, such as in the early 2000s, won’t suffice this time because banks face:

- Uncertainty as to when the bottom of this downturn will be reached.
- Unprecedented levels of operational risk.
- Highly complex operating models which make it difficult to reduce costs quickly and sustainably.

It is clear that the recent cycle of easy credit and growth in lending and revenues has masked serious underlying problems. The widespread focus on growth, combined with lack of discipline around operating models, product streamlining, margin control and organizational structures, has led many banks to build up highly disparate and complex operating models. This, in turn, has resulted in high cost bases as well as inflexible and duplicative operations.

On a more positive note, the current environment continues to offer global banks attractive growth opportunities, particularly in emerging markets such as Brazil, Russia, India and China. Therefore, global banks with a presence in emerging markets must be judicious in their cost reduction initiatives, so that their growth agendas do not suffer. Deep cuts in the number of IT personnel, for example, need to be properly examined since expansion into emerging markets typically requires significant investment in IT capabilities and support.
The cost-cutting and efficiency agenda will vary among regions and from bank to bank. For institutions most affected by the crisis, particularly those in North America and the United Kingdom, tactical cost reductions are the immediate priority. On the other hand, many banks in the Asia-Pacific region are pursuing a broader efficiency agenda focused both on decreasing costs and building capabilities to support growth. Some European banks, such as those in Italy and Spain, are also emphasizing efficiency and growth.

To achieve high performance, banks need the right balance between short-term tactical cost decreases such as headcount reductions, and longer-term strategic cost initiatives such as streamlining processes or outsourcing certain noncore functions such as learning, human resources or finance and accounting. Banks that pursue only traditional cost reduction programs will achieve cost benefits quickly. But in the long run, that approach will leave them unable to sustain those cost reductions, resulting in a competitive disadvantage.

Suppose Bank A consolidates multiple mortgage processing centers in an effort to quickly extract costs. Bank B, its competitor, also consolidates its processing centers and in addition, reengineers its lending processes and migrates them to a standard platform, and enters into a business process outsourcing arrangement for post-closing functions, which enables a variable cost base. When a stronger market returns, Bank B’s costs will remain in check, but Bank A’s are likely to rise again. By balancing short- and long-term objectives, Bank B has achieved competitive advantage over its rival and is on the path to high performance.

The key is for banks to evaluate their business model now against scenarios ranging from best case to worst case, and to act before the full impact of the credit crunch plays itself out. Many banks continue to have relatively strong short-term earnings momentum, but the outlook remains highly uncertain. This leaves a small window of opportunity to tackle the size and flexibility of the cost base.

Precisely how banks do this will depend on their operating model and strategic priorities. But whatever route they choose, the long-term winners will be those that begin stabilizing and building for the future by adopting flexible operating models to accommodate threats and opportunities as they emerge.

Leading banks realize the importance of taking out costs and investing the savings in strategic programs that will help them bring products to market more quickly, interact with customers more effectively and gain competitive advantage.

As part of its Basel II compliance effort, a European bank spent substantial amounts in the past two years building a new technology platform to track, measure and manage its credit risk exposure. The bank completed the project well within its allotted program budget. But instead of terminating the commitment at that point, it used the remaining budget plus an additional investment to develop better insight into managing credit risk limits for its customers. As a result, the bank is aiming to reduce the amount of risk capital on its balance sheet (thereby decreasing its cost of capital) and also hoping to price its customers far more effectively. For a relatively small investment, and by leveraging capabilities built for a compliance program, the bank is seeking to cut its cost of capital and potentially improve revenues on its balance sheet.
It may be necessary to take a counterintuitive approach to cost cutting. Rolling out new products, for example, intrinsically would appear to be a sound business strategy. But, particularly in a weak economy, investing in new products may just add unwanted complexity to the product portfolio without generating profits. For some banks, it may make sense to shrink their product portfolio and channel the savings into more strategic, longer-term programs such as credit risk management.

Process automation is another undertaking with which few would argue. But instead of automating processes on a piecemeal basis, banks may find that, upon analyzing their processes from end-to-end across the enterprise, several processes can be eliminated altogether.

Sometimes, across-the-board cutbacks don’t go far enough. A uniform 10 percent reduction across expense budgets makes little sense when a bank’s lending function could withstand deeper cuts due to sharply depressed loan demand.

Avoid Arbitrary Cuts

With the onset of an economic slowdown, the temptation is to reassure investors by cutting indiscriminately—10 percent across all departments, for example (Figure 1). However, banks emerging most successfully from previous downturns were not necessarily those making the deepest cost cuts. Instead, the winners focused on optimizing their cost base.

**Figure 1:** In a downturn, most banks pursue traditional, instead of differentiating tactics

<table>
<thead>
<tr>
<th>Traditional Tactics</th>
<th>Differentiating Tactics</th>
</tr>
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<tbody>
<tr>
<td>Cut costs</td>
<td>Cut the right costs</td>
</tr>
<tr>
<td>Conserve cash, and eliminate / delay discretionary spending</td>
<td>Direct discretionary spending to only those programs that add value</td>
</tr>
<tr>
<td>Forecast more often</td>
<td>Continue an accurate and meaningful forecasting process</td>
</tr>
<tr>
<td>Reduce headcount</td>
<td>Target headcount reductions at specific sub–organizations and / or low performers</td>
</tr>
<tr>
<td></td>
<td>Consider adding specific headcount at lower rates than would otherwise be required</td>
</tr>
<tr>
<td>Take advantage of the downturn to justify unpopular moves</td>
<td>Continue value–driven moves justified by their impact on shareholder return</td>
</tr>
<tr>
<td>Communicate lower earnings expectations</td>
<td>Expand the quality of communications to more fully describe value–drivers and the expected impact of differentiating tactics</td>
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When implementing tactical measures—such as headcount reductions—to deliver a quick payback, banks should reinvest the resulting savings in strategic initiatives that provide longer-term benefits (Figure 2).

This is an approach which Lloyds TSB has been using successfully for several years. Lloyds recently announced that "The Group’s programme of productivity initiatives has continued to deliver significant benefits, improving underlying cost efficiency and creating greater headroom for investment in the business," with net cost reductions in 2007 of £145 million (US$290 million) and a further £103 million (US$206 million) reinvested in further productivity program initiatives.

As Figure 2 shows, a tactical cost-cutting approach will quickly yield substantial savings which rapidly level off after the first year. A bank taking a more strategic, transformational path won’t receive a similar quick benefit in year one because it plows the savings into optimizing its operating model, consolidating systems and employing sourcing where appropriate to variabilize its cost base. By funding these longer-term initiatives, however, the bank enjoys a far greater uplift in benefits in the following years, compared to the tactical approach.

Take a Broad View of Costs

The path to high performance starts by understanding your bank’s cost anatomy. Banks’ cost structures are not spread evenly across operations. Figure 3 is an example of the cost distribution of a typical universal bank, based upon Accenture’s research and experience with European financial services companies.

Figure 3 demonstrates that, contrary to conventional wisdom, the back office—with only 14 percent—is not the primary source of banks’ cost base. Automating and making the back office more efficient will undoubtedly help, but not fully solve, banks’ cost challenges. Senior executives looking to remove significant costs must also focus on distribution operations (with nearly two-thirds of the cost base) and enterprise-wide functions (21 percent of costs). While in most cases, banks would be well advised to aggressively cut costs in enterprise services and information technology, they should proceed more cautiously in attacking front office costs.

Of course, banks’ cost distribution varies widely from region to region, and even within regions. But the point is clear: high-performance banks will take a broad and intelligent view when cutting costs to be competitive both now and in the future. Banks in Italy, Spain and other European countries that have made substantial progress in streamlining their back offices and IT operations are focusing on making distribution more efficient. North American banks, on the other hand, are still targeting inefficiencies in the back office.

Figure 3:
Costs distribution across universal bank’s functions

<table>
<thead>
<tr>
<th>Segment Management</th>
<th>Brand Management</th>
<th>Channel Integration and Management</th>
<th>Marketing, Sales and Servicing</th>
</tr>
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<tbody>
<tr>
<td>~65%</td>
<td></td>
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<table>
<thead>
<tr>
<th>Customer management</th>
<th>Customer pricing</th>
<th>Product aggregation</th>
<th>Product pricing</th>
<th>Third party management</th>
<th>Service integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>~14%</td>
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<table>
<thead>
<tr>
<th>Deposit / cash management</th>
<th>Lending</th>
<th>Investment</th>
<th>Insurance</th>
<th>Payments</th>
<th>Product development</th>
<th>Product accounting</th>
<th>Document management</th>
<th>Knowledge management</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>~21%</td>
<td></td>
<td></td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>Finance</th>
<th>Human Resources</th>
<th>Purchasing</th>
<th>Legal and compliance</th>
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<table>
<thead>
<tr>
<th>IT application</th>
<th>IT infrastructure</th>
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</table>

Source: Accenture analysis of major European bank data, 2007
There is a clear imperative to address the cost base without impacting revenue generation. A winning strategy, for instance, might be to streamline back-office and IT operations, and redeploy the savings in front-office efficiency initiatives to enable more consistent customer service across channels, provide tools and support for customer-facing staff, and enhance self-service channels.

Based upon our experience working with the world’s leading banks, we have identified six key ways that high-performance banks demonstrate efficiency:

• **Lean operational model:** Minimal management layers, clearly defined roles and extensive use of shared services to eliminate duplication of activities.

• **Rationalized product portfolio:** Significant reduction of product portfolio, rationalized product portfolio with standard components and reusable product features, coupled with a clear understanding of product profitability.

• **Optimized sourcing and procurement:** Utilization of offshoring and outsourcing to variabilize costs while reducing fixed cost base, and tight control of external expenditures.

• **Streamlined processes:** Broader use of image and workflow technology to automate manual, paper-based processes; minimization of process duplication, strong culture of end-to-end process ownership and continuous improvement.

• **Effective customer experience:** High levels of customer self-service for simple sales and service transactions; sales and marketing activities focused on most profitable customers, and differentiated service based on customer profitability and future value.

• **Simplified technical infrastructure:** Simplified IT architecture and supporting applications to reduce total cost of ownership and boost responsiveness and flexibility, and aligning IT spending closely to business strategy.

By examining a bank's cost anatomy against these attributes, the opportunities and scale for cost reduction initiatives can be mapped across the entire organization. Accenture’s approach to efficiency contains a portfolio of tools and assets—the Accenture High Performance Bank Framework—that can help a bank achieve high performance. We believe there are significant opportunities to reduce costs in a transformational way across banks’ operations, realizing as much as a 20 percent reduction in operating costs over two years.

For example, up to 10 percent of a bank’s distribution cost base can be eliminated—with a 5 percentage point reduction in cost-to-income ratio—through greater reliance on self-service channels, rationalization of contact centers and other initiatives. Procurement is another area where significant savings can be generated. With the appropriate combination of automation and self-service, consolidation of suppliers and selective outsourcing and offshoring, a universal bank can reduce its purchase spend by between 6 and 8 percent (the rough equivalent of 1.2 to 1.6 percent of revenues).
Positioning for Growth through Smart Cutting

A major European retail bank embarked upon a bold strategy to reignite future market share growth, with equal focus on revenue generation and cost reduction. Targets for cost reduction were set by analyzing requirements for market competitiveness and the level of savings achievable in the back office.

In light of market pressures, rationalization of operational activities—a main source of savings—had to be realized in a quick and sustainable manner without disrupting ongoing business.

Accenture was engaged to help drive the reorganization and cost reduction initiative as part of a two-year plan. The plan focused on consolidating shared activities and removing duplicated or unnecessary processes.

Accenture supported the bank in realizing its goals by helping to:

- Establish a detailed financial baseline.
- Analyze the financial baseline to identify consolidation and cost savings opportunities and develop a common roadmap to help secure delivery.
- Define and establish a target operating model for optimized back-office operations.
- Re-engineer key banking processes to deliver the target model.
- Mobilize and deliver key cost savings initiatives.

With its newly consolidated back office, the bank quickly achieved its cost reduction targets by eliminating duplicate activities, rationalizing management layers, sourcing and implementing more efficient processes. Further savings are likely through ongoing optimization. A carefully managed transformation road map helped ensure that these changes were delivered without compromising operational stability or customer service, and positioned the bank to meet aggressive growth targets.

Industrialize Operations

Taking a balanced approach to cost cutting requires banks to develop an operating model that is not only cost efficient, but can respond quickly to unforeseen market changes such as further deterioration or an upward trend. As a result, banks will have no choice but to industrialize their operations to combine low costs with high flexibility.

To maintain competitiveness over the long term, banks need to move progressively from a substantially fixed-cost base to a more variable-cost base. This provides the organization with the flexibility to “dial up” or “dial down” both cost and capacity in line with market conditions and strategic goals. Many banks are already embracing this strategy through the selective use of alliances and outsourcing.

Accenture recently worked with a leading international bank to consolidate, standardize and ultimately transition parts of its value chain to lower-cost, off-shore locations. The new model generated operating cost savings of up to 60 percent and provided the bank with the ability to scale up volumes rapidly at a low unit processing cost.
Getting Started

In today’s uncertain and fast-changing environment, a strategic cost-transformation project must proceed quickly. Using pre-built diagnostic tools and assets can shorten the start-up phase, thereby enabling rapid identification of cost reduction opportunities and quantification of the potential benefits to be gained.

While the journey will be different at each bank, the initiative should be carefully planned and encompass the entire organization. Execution may well be challenging, in light of the scale of change required and the scrutiny by investors, regulators and the media.

Working with a wide range of bank clients on these programs, Accenture has observed four common challenges (Figure 4, left side) and five keys to successful implementation (Figure 4, right side).

Figure 4: Cost reduction projects: challenges and keys to success

<table>
<thead>
<tr>
<th>Execution Challenges</th>
<th>Prerequisites for Success</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Breaking down silos between business units</td>
<td>• Absolute executive buy-in of clear financial objectives and operating model</td>
</tr>
<tr>
<td>• Management culture and attitudes (we’ve tried it before and it didn’t work)</td>
<td>• An incontestable fact base and cost baseline</td>
</tr>
<tr>
<td>• Executing at speed while not disrupting business-as-usual activity</td>
<td>• Ongoing transparency and reporting of cost and benefits linked to financial plans</td>
</tr>
<tr>
<td>• Freeing up sufficient investment capital to tackle structural cost reduction initiatives that have a longer payback</td>
<td>• Clear alignment with existing investment portfolio</td>
</tr>
<tr>
<td></td>
<td>• Robust program structure and design authority</td>
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</table>
Collaborating with Accenture

Accenture has breadth of vision, deep bank industry experience and a wide range of tools to help clients drive their cost transformation initiatives. We can:

1. Rapidly identify major cost reduction opportunities.

Collaborating closely with a bank’s senior management to ensure executive buy-in, Accenture can typically complete an initial diagnosis of potential opportunities within six to eight weeks. By analyzing products, staff, customers, process, technology and sourcing, our diagnostics enable us to take a holistic view of cost reduction for optimal identification and removal of cost.

For example:

- Can the number of product families be reduced? Can the efficiency of the product development pipeline be improved through Six Sigma?
- Are employee roles aligned to business needs? Are performance and compensation aligned? Is labor sourced from low-cost locations?
- Can low-value customers be redirected to cheaper service channels? Can product promotions be more effective?
- Can processes be automated, reengineered, centralized, simplified and/or outsourced?
- Can IT enhancement and maintenance expenses be decreased and service levels reduced?
- Is the procurement strategy aligned to the overall business strategy? Are supplier relationships optimized?

This initial phase is brief because we have a proven methodology for creating a transparent cost baseline, a standard hypothesis based upon our experience and insight, and benchmark-driven diagnostic tools.

As Figure 5 indicates, the methodology consists of three steps. The first is a diagnostic that validates and identifies areas of opportunity, and maps them to the current operating model. The result of this diagnostic is a “heat map” and initial hypotheses for addressing costs. Next is the solution stage, where the high-level cost/benefits outcome and approach for each initiative are quantified, enabling the creation of a prioritized list of cost-reduction options complete with business cases. The third step is creation of the road map. The cost/benefit outcome and approach for each initiative are finalized and sequenced into an implementation road map with a balanced portfolio of short- medium- and long-term cost-reduction opportunities to sustain the cost transformation journey.

Figure 5: Accenture’s cost reduction analysis approach
2. Accelerate benefits delivery.
We have the experience to shape a holistic program of change that delivers quick savings to a bank's bottom line, while at the same time, ensures that the savings are appropriately invested in longer-term structural cost reduction. Accenture has a range of assets and capabilities that can be used to accelerate benefits delivery, including:

- **Global Delivery Network:**
  With more than 60,000 professionals, Accenture's global delivery network is the world's largest for outsourcing of IT application development and maintenance, and IT infrastructure.

- **Customer Contact Services:**
  Accenture's virtual global network of 23 centers manages more than 14,000 customer contact agents and services 20 million customers—helping deliver savings up to 35 percent.

- **Credit Services:**
  Transforms credit operations to improve processing of consumer loans, leasing, loan origination, servicing, securitization and collections—targeting a reduction in excess of 30 percent in overall operating costs within the credit lending process.

- **Human Resources Services:**
  Approximately 3,000 professionals provide HR services to more than 50 clients and their roughly 1.5 million employees—achieving cost reductions of 20-40 percent and staff effectiveness improvements.

Procurement is a particularly ripe area to achieve quick savings that can, in turn, become the funding mechanism for longer-term transformation efforts. Purchase spend is typically 20 percent of revenues for the banking industry. Although many banks have undertaken procurement initiatives, few have been able to create sustainable cost differentiation. In 2006-07, banks typically saved 4 percent in purchase spend through their procurement initiatives, compared to global best practice examples of 15 to 20 percent in other industries.

Accenture has worked successfully with leading global banking clients to deliver significant cost reduction in procurement. Typically, we have helped them achieve upwards of 15 to 20 percent in savings through a combination of strategic sourcing, improved procurement practices, and effective demand management. Accenture's procurement practice, unparalleled in its depth and breadth, is engaged in more than 1,000 procurement projects in 48 countries.

We also work with more than 350 clients on transformational sourcing programs; our 7,000 professionals source over $19 billion annually.

3. Assure certainty of outcome.
We stand behind our work by structuring risk-reward sharing arrangements and taking responsibility for outcomes where appropriate. Our global assets and capabilities also allow banks to “switch on” multi-client utilities to accelerate the benefits realized from their initiatives.
Looking Ahead

Banks are at a crossroads. They must continue to decrease costs and grow revenues in highly uncertain economic times. The actions they take now to optimize their cost base and enhance their capacity to respond quickly and effectively to market change will shape their ability to achieve high performance in the future.

Shaving costs through tactical efficiencies may be a winning short-term strategy, but beating the competition long term requires structural change. A good example is the tendency for banks to be satisfied with physical consolidation of operations—a temporary palliative which is rarely sufficient to address structural fixed costs. Historically, costs start to rise once volumes recover because the underlying unit cost drivers have not gone away. Similarly, with a short-term focus on purchase spend, the savings typically evaporate when growth returns and procurement discipline once again becomes lax.

In Accenture’s view, banking industry winners will be simplified organizations, with varied sourcing models, increased automation and customer service targeted to profitability. As they become more efficient, these banks will increase market share, leading in turn to improved shareholder returns.

However, even the winners will not be able to relax. Achieving high performance as a low-cost, agile bank will require ongoing vigilance, not just a single change effort. Going forward, banks must continually revisit cost governance and instill a culture focused on cost management, underpinned by clearly defined metrics to measure progress.

Case Study: Improve Procurement Operations while Reducing Cost

A leading global investment bank identified procurement as a key area for simplification, standardization and improvement. With approximately 4 million procurement transactions spread across nearly 200 different business areas each year, the bank wanted to gain greater control over its annual spend, streamline and leverage its vendors more effectively, generate more usable management information to drive better decision-making and establish an end-to-end purchasing management process supported by leading-edge technologies.

The bank worked with Accenture in a transformational procurement outsourcing initiative, covering source-to-pay business processes, people, a new technology platform and supporting infrastructure. Accenture was selected by the bank because it demonstrated a commitment to building a significant outsourcing business in procurement, collaborative approach to working with clients and proven record of combining business and IT expertise, strategy and execution to achieve high performance. Accenture helped the bank develop and implement a comprehensive procurement solution, leveraging Accenture’s global delivery center network in Slovakia, India and China, as well as its relationship with SAP.

Accenture provided high-quality service by using a standardized, scalable and low-cost utility procurement platform, enabled by state-of-the-art systems, tools and processes. The bank and Accenture have exceeded business case targets for a seven-year deal within just four years and delivered 15 percent savings in 2007 on vendor spend of $6 billion.
About Accenture

Accenture is a global management consulting, technology services and outsourcing company. Combining unparalleled experience, comprehensive capabilities across all industries and business functions, and extensive research on the world’s most successful companies, Accenture collaborates with clients to help them become high-performance businesses and governments. With more than 180,000 people in 49 countries, the company generated net revenues of US$19.70 billion for the fiscal year ended Aug. 31, 2007. Its home page is www.accenture.com.