IBM Business Consulting Services
May 2004

From banks to banking II

The journey has begun

deeper

Executive brief

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About this paper

This document builds on the existing IBM thought leadership 'From banks to banking', published in May 2003. In this previous work, we described the challenges banks faced in the first decade of the 21st century. We focused on the component-based business model (CBM) approach and how this enables banks to tackle complexity in their operations. We stated that the banks that take the lead in transforming to a component-based business model will gain significant competitive advantage in terms of their overall performance and their customers' experience. This point of view is now becoming a practical reality. IBM has been working with some of the world's leading banks to deliver the vision and implement transformation journeys that will lead them to a componentised operating model.

In this paper we describe how three banks have embarked on a journey that will revolutionise their operating models and lead to a step change in performance that will place them ahead of their competition. By adopting the CBM approach, the three organisations have developed innovative target operational models to help them achieve key strategic objectives.

Case study 1 outlines how a leading international bank has developed a target CBM that helped to identify an overall cost reduction of more than 20% of base costs. This bank is currently implementing identified initiatives that could bring its cost income ratio below 45%.

Case study 2 describes how a leading European bank is aiming to significantly expand its customer base and double its shareholder value in three years. This bank has developed a CBM that will help deliver high revenue and shareholder value targets, while significantly reducing its cost income ratio.

Case study 3 shows how a leading European bank with retail, business banking and wholesale banking operations, has developed an operational strategy that is helping them to achieve world leading product manufacturing and processing capabilities. Through a CBM approach, the bank is leveraging its economies of scale and maximising collaboration between business units. This bank will see significant increases in revenue while its cost income ratio is expected to drop from 60% to 45% in three years.

What these banks have in common is that they understand the target operational model that best reflects their overall strategic objectives. They have all identified the key components in their business and are actively developing and implementing a roadmap for transformation that will keep them ahead of the competition and enable them to achieve a dynamic, on demand business model.

From banks to banking

Today, most banks largely operate with a vertically integrated business structure where distribution occurs mainly by product silo and operations are biased toward internally manufactured products. Within this structure, making material reductions in the cost base is difficult and customers generally see very little or no differentiation amongst banks. Given their financial challenges, banks cannot now afford to have capabilities duplicated across product silos, with each product operating its own processes, systems and product-specific channels. Although they offer increased efficiency, vertically integrated supply chains limit customer choice – leaving firms with an undifferentiated value proposition and lower overall customer wallet share.

As a result of the economic challenges of the last few years, banks are moving away from the confines of their historical business structures. However, with value continuously shifting to different parts of the value chain, many banks are struggling, unsure which areas of their business matter most and how they should structure their businesses to deliver their corporate strategies.

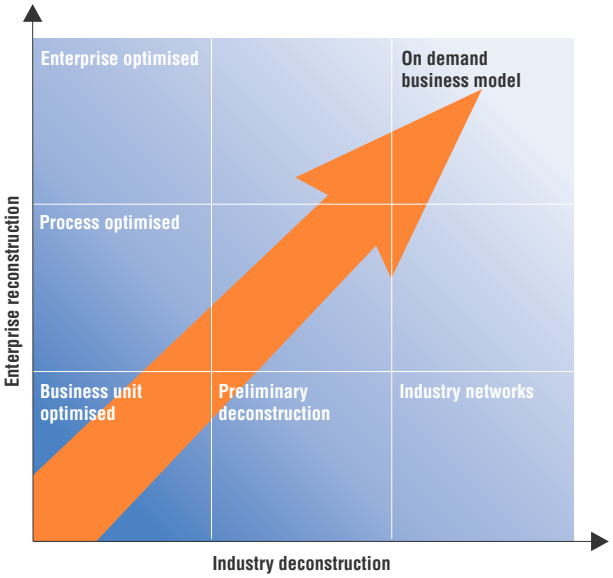
Banks have already begun the process of deconstructing their businesses. The growth in horizontal process outsourcing is just the first step. Over the years, the industry will witness strong growth in the outsourcing of vertical business processes.

Two trends are shaping how financial institutions will structure. See figure 1. At an industry level, there is a trend towards industry 'deconstruction', i.e. a move away from monolithic organisations that undertake every activity in the value chain towards 'networked' models where a number of institutions, both financial and non-financial (e.g. technology, communications) combine to deliver the overall offer to the customer.

Secondly, some organisations are actively moving from decentralised models, where each business operation is a silo to 'enterprise optimised' models where work is centralised across all segments, brands and propositions to drive out efficiencies and build competence.

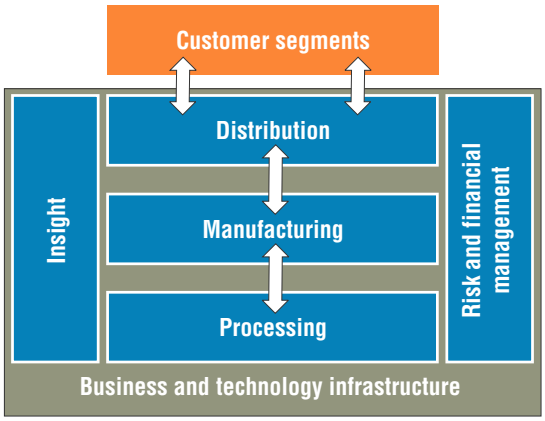
IBM's perspective is that where these trends come together, on demand becomes real. These trends will lead to the emergence of very responsive, focused and resilient models that concentrate in-house activity on the core components and operate at the centre of a network of organisations to deliver customer and shareholder value.

Figure 1: Paths of progression moving banks toward on demand



In response to these trends, banks will adopt component-based structures where the business is divided into autonomous yet interdependent parts that can be optimised individually to produce greater value for the whole business. Horizontal competencies will form the basis of these models, shown in figure 2 for a typical retail bank.

Figure 2: The horizontal competencies that form the basis of the component-based model



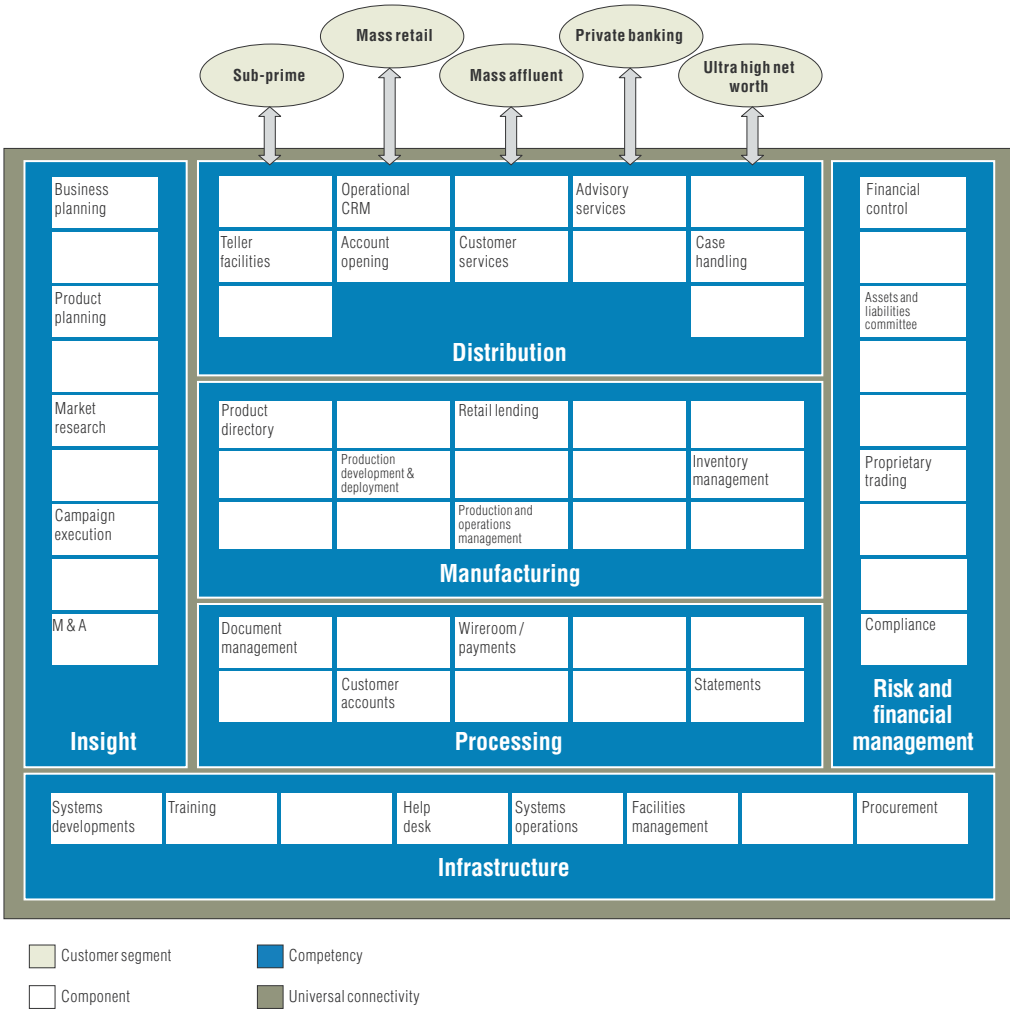
These horizontal competencies – composed of interlinked components – provide the general operational framework as opposed to traditional product oriented structure. Distribution is tuned to targeted customer segments, offering a variety of products through customer-centric channels. These are all focused on increasing customer loyalty and share of wallet. Reuse of manufacturing capabilities increases, and processing operations achieves enterprise wide scale economies.

Leaders are looking to monetise best-of-breed components. Many are looking to form new partnerships and industry consortia to perform certain functions on behalf of others in the marketplace.

These layers will form the organisational units in which the components will be grouped. This trend is already self-evident with many banking organisations already having taken this first step. As a result these banks are changing their operating models to be more 'customer centric'.

Within these layers we will see banks sub-divide their activities into components and this building block approach will enable enterprises to respond rapidly to change, reconfiguring as required.

Figure 3: Examples of typical components within a standard retail bank



The concept of componentising is a concept that other industries, particularly manufacturing, have adopted to deal with complexity and it is only logical that financial services will follow suit. It is important to recognise that it is only now that this strategy can be adopted effectively in the financial sector. Technology is the enabler for componentisation to happen. Technology is now moving at a sufficient pace to support the requisite connectivity and emergence of standards that will underpin the model.

As the industry moves to these networked models, banks will not purely focus on distribution, processing or product manufacturing but will use a combination of these to address different customer segments, products and geographies.

What is a component?

A component is a group of cohesive business activities supported by the appropriate information systems, processes, organisational structure and performance measures. Each component serves a unique purpose and collaborates with other enterprise components, using common messaging standards, information systems and service agreements. The average bank comprises 60-90 components.

This paper provides examples of banks that have embarked on their own unique on demand journey and are already realising sustainable economic value, by componentising their operating models.

Case study one

Delivering a cost-effective platform for growth

This case study demonstrates how one organisation has taken the first steps in their journey to on demand. By putting in place the basics of the component-based business model this bank is already realising very significant benefits.

Bank's strategic imperatives:

- **Priority one:** Reduce overall operating costs and invest in revenue generation
- **Priority two:** Improve ability to innovate
- **Priority three:** Enhance quality.

Institution profile

This major international bank offers a full service portfolio of financial products and boasts operations across multiple geographies. The group also operates a European subsidiary with a handful of recognised brands. In Europe, the bank employs more than 10,000 people and has around 5% market share for all of its core products. Although profitable, the group's European operation's cost income ratio is static at around 5% to 10% higher than the bank's leading competitors

Out of a total cost of over US$1 billion, the group calculated it could reduce costs by US$120 million.

The challenge

As a mid-tier player in the major international markets, the bank has experienced difficulty achieving the efficiency levels of larger competitors. Competitors have become more aggressive in the bank's key markets, and as a result it has started to lose market share. To compete effectively, the bank needed to become much more innovative around its product set and much more effective at attracting and retaining customers.

However, at the heart of the group's European expansion challenge was the fact that the bank's operating model was siloed, from a product perspective and also from a brand perspective because it had not sufficiently integrated its acquisitions. By keeping these operations as separate entities, the group had created a very complex operating model with large amounts of manual effort and duplication supported by multiple, heterogeneous technology platforms. This made any change programmes difficult and expensive to implement because initiatives would need to be applied across multiple channels, brands, operations and applications. There were many overlaps between the customer-facing, retail, operational, functional and product processes of each bank. The branch was still the focal point of customer operations. This also meant that launching new products and managing customers were very resource intensive processes.

The approach

IBM and the bank worked together to create a new 'target' operating model. As a first step to achieving focus and driving out inefficiencies the bank defined three layers of activity: distribution, manufacturing and processing and enterprise functions

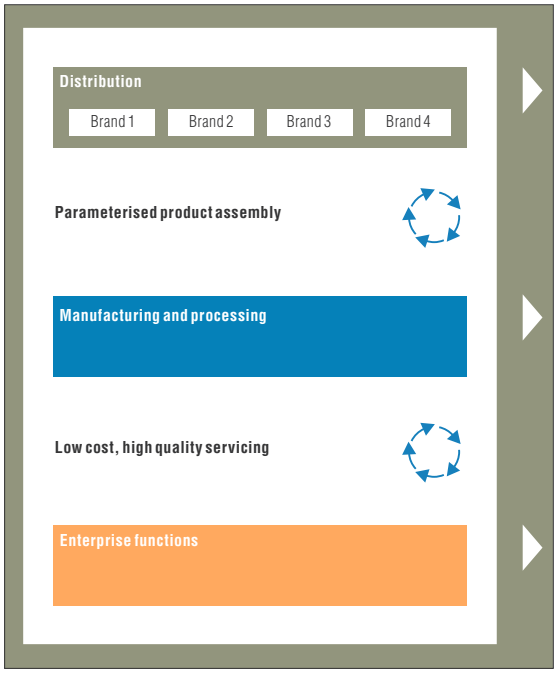
- **Distribution.** In this model, each brand is responsible for tailoring the customer offer, managing the customer relationship and maximising profitability at a segment level for its customers. The benefit of this is that distribution continues to be based on brands, while products can still be customised within set parameters. This means the bank can focus on sales and customer relationship management through a single set of channels that are independently branded.

The CBM approach also helped the bank to identify revenue opportunities.

- **Manufacturing and operations.** A highly efficient single function with a standard set of unified products and processes and clearly defined components. This is a virtual model that enables the group to move work between low cost processing centres and deploy best practice manufacturing techniques to drive continuous improvement. Transformational strategies have been defined for each component in manufacturing and processing that will encompass a broad sourcing strategy and wider collaborations. The European brands will now benefit from a single, mass manufacturing function.

- **Enterprise functions.** These shared service centres operate across the group's European operations and deliver low cost corporate functions, such as HR and IT, to pre-agreed service levels.

Figure 4: Operating model layers established by the bank



Each brand is responsible for tailoring the customer offer, within parameters, for its customers, managing the customer relationships and maximising profitability from its customer base.

A highly efficient single manufacturing function, with a single product set and single set of processes. Ultimately, a virtual model, moving work between low cost processing centres and deploying best practice manufacturing techniques (e.g. six sigma) to drive continuous improvement.

Enterprise shared services, responsible for delivering low cost corporate functions to given service levels.

Key insights and conclusions

By applying the principles of the component-based business model (CBM), the group will transform its operations and move towards a new 'target' operating model. They will achieve their objective – to integrate the different franchises at appropriate business and technical levels and build 'one bank'.

The bank will be able to simplify its operating model, thereby achieving cost reduction, funding investment in growth and implementing an operating model that will underpin the groups' ambition going forward. This simplification will enable the institution to exploit its unique strengths in Europe to achieve a delivery platform for competitive differentiation and advantage.

The financial benefits of applying the CBM approach became very compelling for this banking group. Out of a total cost base of over US$1 billion, the group calculated it could reduce costs by US$120 million per year. At least another US$55 million reduction would be possible by sourcing some of its processing work overseas. By embracing all of these initiatives, the bank could reduce the organisation's total cost income ratio from 51% to 43%.

CBM provides a liberating view of the way to organise retail banking.

The primary insights were:

- Restructuring the operating model has been the key to unlocking financial and human resource in the organisation.
- Material adjustments to the cost base require an enterprise-wide re-evaluation of the operating model.
- Componentising provides the only way to tackle complexity, and highlights the full spectrum of strategic solutions.
- The CBM provided a practical, action-oriented approach that enables buy-in at all levels because it is straightforward and based on rock-solid experience and assumptions.

Realising these goals is made easier through the delivery of a simplified target operating model as defined by the CBM approach. It means that the bank can adapt to changing customer behaviours, market trends and regulatory change more rapidly and cost effectively. Furthermore, the bank has identified the components where it needs to establish its own capabilities, such as new centralised, automated processing centres and where they should outsource or co-source.

With the CBM approach, this international bank is now implementing a dynamic European platform for bank and brand differentiation, standardisation, cost optimisation and maximised efficiency. As the bank itself put it: "CBM provides a liberating view of the way to organise retail banking".

Case study two

Harnessing the thin-bank model for expansion

This bank has embarked on a journey of rapid expansion in different geographies. To enable such an expansion it deconstructed its operating model to focus on sales and distribution, and outsourcing of its manufacturing, processing and support functions.

Bank's strategic imperatives:

- **Priority one:** Double shareholder value by 2005/6
- **Priority two:** Transform a people-heavy operating model to achieve scale
- **Priority three:** Expand internationally using a 'thin' operating model to minimise capital investment cost and risk.

Institution profile

A very successful and innovative brand, seeking to differentiate itself by developing propositions that revolutionise the banking industry, this European retail bank has grown rapidly to millions of customers. The bank now offers a range of innovative financial products and services that includes deposit products, credit cards, personal loans and investments.

The challenge

Like many successful organisations, the bank could barely keep up with the pace of growth. Customers moved in droves as a result of focused marketing and customer propositions. As a result, the bank's basic operating model required constant investment. Many back office and call centre processes were still very people intensive and growth required sustained investment in fixed costs, particularly property and people. The constant drive to innovate made the bank's operating model too complex and the bank continued to function as if in start-up mode.

With a high cost income ratio, the financial burdens of its own rapid expansion were only too evident. The bank wanted to apply some of the learning from this experience to transform its operating model and to deliver an ambitious target of doubling shareholder value. This target would require the enablement of further domestic growth as well as a more successful model for international expansion. In short, the bank wanted to become a thin-bank – to explore a different operating model that would enable them to leverage partners and/or other sourcing options to gain variability and scale.

The approach

IBM Business Consulting Services helped the bank's executives to understand the implications of delivering the shareholder value target and demonstrated how an on demand approach to its business model could create the variability and agility required. IBM was engaged to develop a new target business model exploring scalability and sourcing options.

The CBM approach provided this institution with a clear framework for transformation and sourcing around a 'thin-bank model'.

Very rapidly, IBM built a component view of the bank's business and used it as a framework to evaluate what was a 'core' and 'non core' competency for the bank.

The bank wanted to know which business components they should retain because they provided the bank with differentiation and which components could be options for management by external partners.

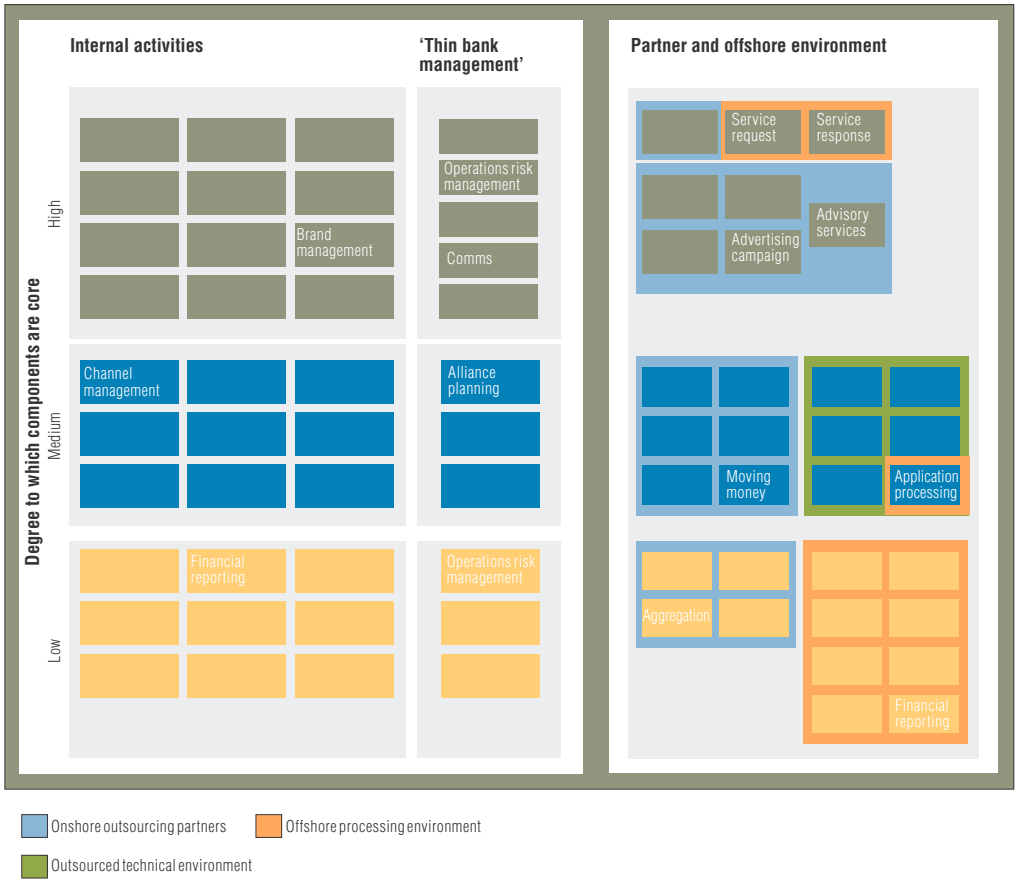
By scoring each component against its ability to deliver key elements of the bank's strategy, IBM very rapidly built a model that showed the relative importance of each component in terms of its potential to deliver shareholder value and enhance customer experience. Components that were particularly capital intensive or difficult to scale were also identified and analysed.

The analysis very quickly drove fresh thinking amongst the executive team, challenging many of their initial assumptions about which components could be called 'core' to their business. The cost and full time employees consumption of each component was also calculated enabling the team to focus its analysis on capital intensive, people intensive and non scalable areas of the business.

IBM mapped out and assessed the component model to the banks existing organisation and technology, reviewing existing capabilities against leading companies in order to identify opportunities. A new target operating model for the client was developed that clearly identified a broader set of components that could be sourced from partners but also recognised that the journey would require the development of new capabilities to better manage, control and operate a 'thinner' model. See figure 5.

Cost analysis showed the potential to reduce operating costs by over 20%, which together with their planned growth reduced the cost income ratio to the target 30-35% range by 2006. A number of business initiatives were developed and the current technology architecture was mapped to these to identify how to deliver the enabling technology. The bank has identified one component as a pilot and has accelerated detailed business case work and negotiation with suppliers to start the journey towards on demand delivery. In parallel it intends to develop more detailed business cases and plans for the priority initiatives identified in other components.

Figure 5: The target component model included a clear outline of the bank's sourcing strategy



Key insights and conclusions

This engagement provided the bank with a clear framework for transformation and sourcing strategies for each component and the financial implications of re-engineering the domestic model around a thin-bank model.

The primary insights were:

- The CBM approach in conjunction with deep industry and component expertise facilitates very rapid diagnosis of the opportunity and allows a coherent view of the target model to be constructed. The IBM team were able to quantify the financial benefits of the target and model the impact on cost income performance.
- Analysis of core and non core components can challenge pre-held management assumptions.
- A 'thinner model' also required clear thinking on which competencies needed to be retained and developed internally to manage and control the partner components.

The component and cost analysis approach has been applied beyond the original scope of the engagement, providing a significant contribution to the bank's current strategic work.

Case study three

Becoming a manufacturing centre of excellence

This bank is moving its operating model to a rationalised model in terms of processes, applications and infrastructure. The bank has adopted a CBM approach to design and implement its transformation programme with a key focus on achieving best of breed capabilities in core banking and product manufacturing components.

Bank's strategic imperatives:

- **Priority one:** Inorganic growth – achieve significant income growth through acquisition. Build scale through efficient post-merger integration.
- **Priority two:** Organic growth – achieve significant income growth through customer focus, retention and cross-selling.
- **Priority three:** Productivity and efficiency – achieve world class manufacturing and processing capability for core activities. Use world class suppliers for non-core activities.

Institution profile

This major European bank employs more than 30,000 people and is internationally active. It operates retail, business and wholesale banking businesses. In 2003, it achieved group profits of almost US$2 billion. It is also one of only a handful of players in its home market.

The challenge

The bank faced a difficult challenge to realise process, application and infrastructure synergies. The root cause of many of the bank's challenges lay in the complexity of its operations. This was in a large part because of the siloed business model and underlying multiple technical platforms that had resulted from a number of acquisitions.

Compared to its peers, this banking group was burdened with a relatively high fixed cost base and as a result, the institution was exposed to fluctuations in revenue. Cost and revenue sensitivity analysis showed that if revenues fell by 8%, profitability could fall by as much as 20% because a significant proportion of the cost base was fixed cost.

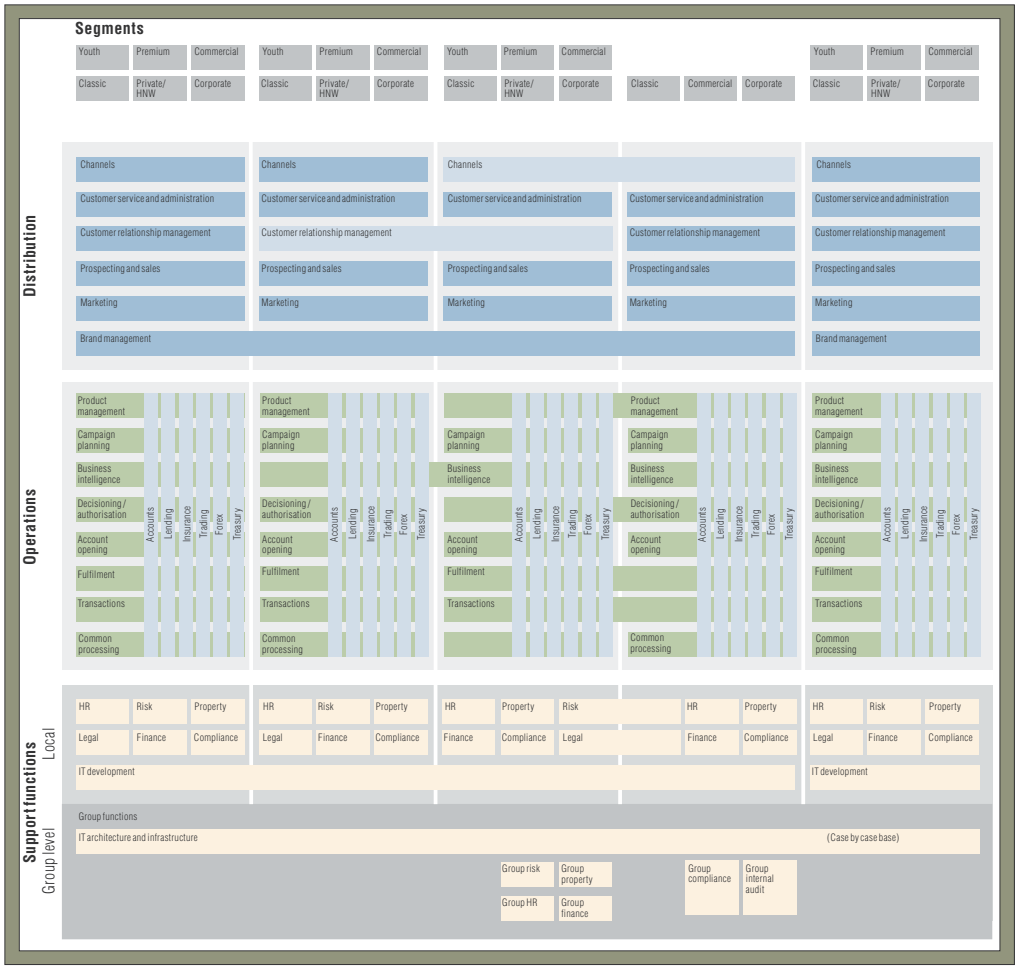
The CEO of the bank declared that his objective was to maximise the bank's revenue and cost opportunities by achieving scale and working as 'one bank'.

The approach

The bank required a dynamic business model that would enable them to:

- Be focused on their core and non-core operations
- Be responsive to changes in customer needs and market trends
- Be resilient in the face of an increase in the number of customers and operational complexity
- Be variable in keeping with peaks and troughs in business demand.

Figure 6: A component view of the current business model showed a high level of duplication



A component view of the business revealed a very significant degree of duplication in infrastructure, processing, manufacturing and distribution (see figure 6). The cost breakdown in product manufacturing and processing showed that more than 40% of the costs were in account opening and maintenance, two highly duplicated activities.

IBM Business Consulting Services worked with the bank to define key business and IT capabilities that were needed to deliver a target operational model that supports the overall business strategy. These capabilities included at the highest level the principle of a single integration platform with strong migration capabilities. This would enable the bank to effectively pursue its acquisition strategy in addition to maximising its economies of scale. Critical components were analysed and decisions were made on component strategy (see figures 7 and 8).

Figure 7: Core / non-core component assessment

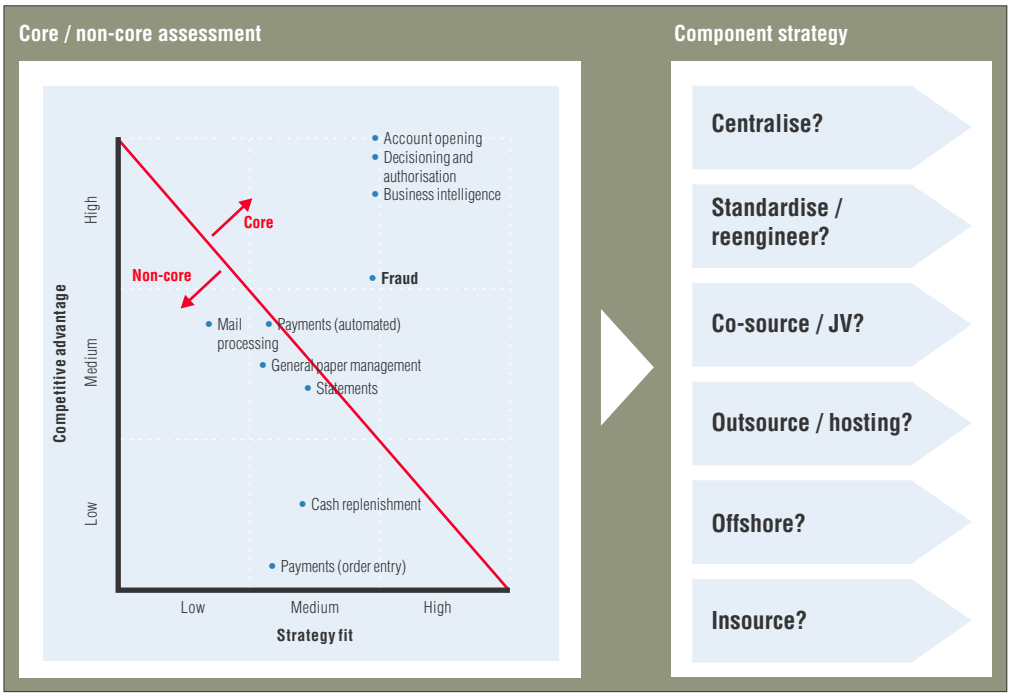
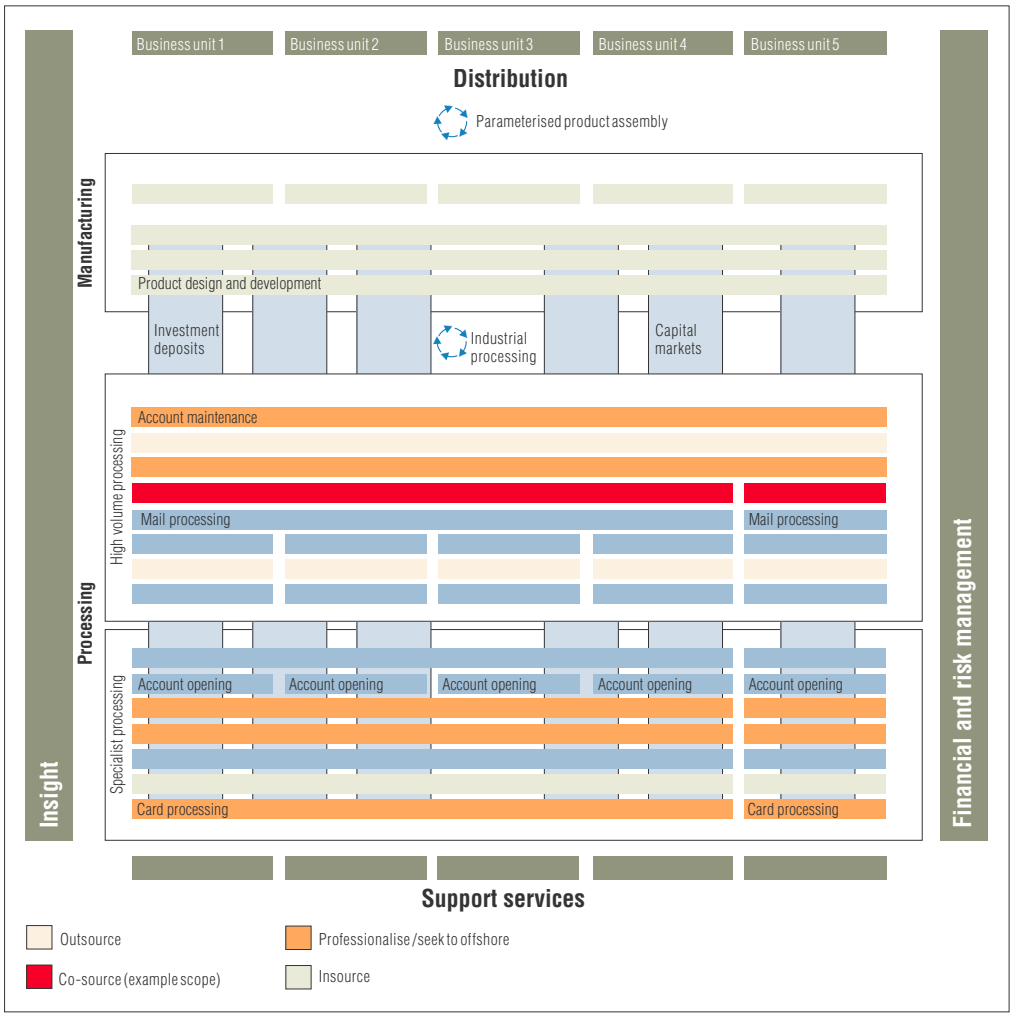


Figure 8: High level target component model



The bank also required one single, industrialised platform for product manufacturing. Underpinning this would be a single technical platform or core banking application that would replace the different business applications, platforms and legacy systems. In practical terms, the operating model would be componentised across different product silos to maximise synergies. For example, the current account opening component in terms of staff, process, applications and infrastructure would be standardised across all product sets and franchises.

While cost was not the major driver for this particular strategic CBM initiative, IBM identified that out of a total annual operational and IT cost base of US$1.8 billion there would be up to US$350 million a year in initial benefits. This would represent a cost income ratio of 45% bringing this bank in line with best-of-breed competitors.

The bank recognises that the target operating model will be a key enabler to their business strategy.

The bank identified 12 key initiatives that would be fundamental to its own roadmap and achievement of the target operating model. The bank is currently working with IBM to pilot a number of these initiatives to deliver early benefits and build momentum for its transformation

Key insights and conclusions

The total benefits from the target model achieved will lead to a step change in overall performance in terms of cost, income and customer experience. This will enable the bank to be best-of-breed in several areas where they are currently lagging behind the competition.

The primary insights were:

- CBM provided a framework that enabled the bank's IT and business to effectively communicate and work together to build the target operational model.
- The CBM approach helped the bank to better understand the level of complexity and duplication in terms of people, processes and technology.
- As a result of the more realistic view of cost and duplication, the bank was able to prioritise and agree initiatives within a short period of time.
- The CBM approach enabled the IT team to be more proactive in terms of developing the target model and identifying IT driven opportunities.

The future of on demand in banking – what next?

Over the past two years the tough economic climate has forced many banks to embark on cost reduction programmes. These cost reduction efforts often focused on tactical projects or process optimisation initiatives.

In large enterprises, process optimisation initiatives have failed fully to address complexity and duplication. For example, in most retail banks, components such as account opening or payments remain highly duplicated in terms of people, processes and technology. Process optimisation has generally focused on vertical integration and often within single products or business units.

To achieve a step change in performance, today's highly complex banking operating models must be simplified. Moving from process transformation to enterprise transformation will unlock significant benefits for banks. The case studies outlined in this paper demonstrate that this is becoming a reality. That reality is as we predicted in our May 2003 paper 'From banks to banking'. We now expect the pace of change towards an on demand world to quicken.

Our expectation is that leading banks will continue on their journey to on demand. They will construct their component-based operating models developing strong capabilities around the key attributes of an on demand business – responsiveness, resilience, focus and variable cost – to be able to compete in a volatile business environment.

Key actions that leaders on the next phase of the journey will take are:

- Organisational alignment to the component model – performance frameworks and roles and responsibilities
- Assessment of economic value of the components in the operating models to understand and measure their contribution to shareholder value
- Seek out, or drive the emergence of new sectors and offerings to shed non-core activity and focus resources on core components. In this way leaders will force the pace of industry deconstruction. Growth will not just be in traditional horizontal business process outsourcing but will include vertical process outsourcing such as mortgage and payments operations
- Further collaboration to gain industrial-grade efficiencies
- Rationalise application portfolios in line with their operating models and start to broadcast how there is a clear link from corporate strategy through to technology
- Pilot on demand solutions in components that make sense as 'first movers'. There will be an increase in the number of alliances between banks and technology vendors to explore and determine best practice on demand models which will be communicated via bold press announcements. In today's market several leading software and hardware providers are deploying or considering variable pricing structures to support on demand operating environments.
- Build out from pilots to move on demand activity further back in the value chain in order to capture greater value. This has started in niche / ripe areas but is already gaining momentum. IBM expects the emergence of much broader and more encompassing on-demand initiatives as the trend takes shape.

As this paper demonstrates, on demand is a reality in the banking industry. The first iteration of this for the industry is the component-based business model which lays the foundation for true on demand. We have demonstrated real-life examples of how organisations are evolving in this direction. As this journey continues, we will bring forward further papers to document and predict how financial services will move to an on demand world. We will be able to do this because IBM will continue to drive the pace of change to deliver the benefits to its clients.

Our belief and current experience is that most of our clients are keenly following the current developments and are engaging with IBM to initiate action.

For those financial institutions that have not yet got on board, it is not too late. It is time to embrace the emergence of the next wave of change which will take them through the first decade of the 21st century.

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