Capital Markets Industrialization 2.0

Finding a path to sustainable ROE performance

Industrialization 2.0:
Finding a path to sustainable ROE performance

The capital markets and investment banking (CMIB) industry is in a period of unusual strife. Internal cost pressures and external regulatory demands have created a unique tension that traditional transformation efforts (Industrialization 1.0) can no longer address. The need to pivot from marginal operational improvements to wholesale operating model shifts and dramatic increases in agility, requires a new set of tools and practices to achieve long term sustainable growth. As such, an innovative and more comprehensive approach to achieving sustainable cost efficiency, scale, and operating leverage is emerging: Industrialization 2.0 (IZ). IZ 2.0 is composed of five change levers allows CMIB firms to address the current tension and set themselves up for future success.

Current Environment

Core economic factors continue to create headwinds for revenue growth. Margins have collapsed as many CMIB product offerings have become commoditized. It is no secret that regulations constraining capital, liquidity, and leverage, along with limitations on the ability to take principal risk, have made meeting historical norms of capital return much more difficult. Moreover, regulatory and risk agendas continue to dominate change investments and make complex systems and processing environments even more complex.

These pressures continue to push financial performance to historic lows across the industry. Cost reduction initiatives have helped the CMIB firms keep front-office costs in line with revenues during this period. However, non-front-office expenses (largely in the operations, technology, compliance, and risk functions needed to manage post-trade processing) have essentially stayed flat while revenues have fallen over 25%[1].

It has become clear that traditional transformation efforts have been slow to deliver returns and/or unable to sustain initial gains:

- Divestiture of underperforming businesses
- Outsourcing and offshoring
- Automation to improve post-trade straight through processing
- Legacy systems convergence and/or elimination
- Process reengineering and simplification
- Organization convergence and pyramid rightsizing
- Headcount reductions

The industry is being forced to rethink its operational approach to address persistently weak financial performance.

[1] Tricumen Data

Borrowing heavily from other "industrialized" market sectors (e.g., manufacturing and supply chain), IZ 2.0 blends disruptive new capabilities with traditional reengineering approaches. This enables firms to deliver a more comprehensive transformation via five key levers (see Figure 1):

Figure 1

Cost Transformation Levers

Service Management	• Commercial process management • Service catalogs, SLAs/pre-requisites, performance metrics • New organizational roles, functional areas and principles
Cost Mutualisation	• Efficient "supply chain" to fulfill non-core functions • New managed services, utilities and FinTech • New entity development and safe transition
Lower Cost of Change	• Model-driven development, automated testing, agile development • New operating models and governance structures
Digital Client Interface	• Collaborative electronic experience for clients • Process transparency and self service capabilities • Developing Client portal and micro services
Bottom-up Transformation	• Business Intelligence, Cognitive and Robotics technologies • Continuous improvement and agile problem solving • Innovative reward programs & incentives, and new skills

Potential Outcomes

- Convert fixed cost to variable
- Shift transformation investment burden to suppliers
- Use industry-level cost efficiency to improve ROE
- Lower change investments and increasing change capacity
- Improve Client efficiency and enhance Client experience
- Maximize and sustain efficiency returns

The sections below will explore each of the five IZ 2.0 levers and how they can be implemented to realize substantial cost savings.

Service Management

While all CMIB firms have made herculean efforts to reduce their cost base, few undertook the investments needed to ensure that their new cost performance is sustainable. We find the lack of metrics to assess process performance to be particularly troubling. Without the ability to measure performance, process "drift" alone can eliminate hard-won reengineering gains in just a few years. Furthermore, the entropy created by rapidly changing systems and organizational constructs can both increase and accelerate that loss.

We now see many firms developing service catalogs for operations and other non-revenue areas. Much of this is being done to fulfill recovery and resolution planning needs and to create shared service centers, but the desire to better understand and measure cost drivers is an additional motivation. We believe that establishing service catalogs with clear service-level agreements (SLAs) and corresponding prerequisites are foundational to good service management discipline and sustainable cost performance.

We also see many firms investing in establishing activity-based costing capabilities that allow them to understand their costs at a process level and better allocate costs to revenue centers. Some firms are going a step further by developing an "economic architecture" to operationalize the activity-based costing model allowing them to:

- Combine output with transaction data to understand unit costing
- Enable analysis of the cost to serve targeted clients, markets, and products
- Integrate with service catalogs to issue line-item invoices to business areas

More ambitious firms are even investing in similar risk and service "architectures" to enable process-level comparisons of cost, risk, and service to more completely inform the trade-off decisions needed for profitability.

Finally, we see growing investments in establishing new process performance management functions and organizational structures, most notably:

- **Ready-to-transact** functions that establish SLAs for front-to-back processing and provide preventive controls by measuring and reporting adherence to prerequisites by client and business area
- **Activity monitoring** functions to track front-to-back process performance against SLAs, catch issues in or near real time, and promote continuous improvement

This additional transparency is helping to radically change the dynamic between revenue and cost centers. We see a robust trade-off dialogue developing that promises to be an anchor for sustainable cost performance and profitability. More specifically, we see new client, market, and product investments being made in tight collaboration between revenue and cost centers to ensure efficiencies and a positive return on investment.

We expect that banks that can make the appropriate investments in service management will enjoy a growing advantage against their peers over the next three to five years in both sustainable cost performance and profitability.

Lower Cost of Change

Perhaps the most vexing issue for banks today is that acute economic pressures are greatly limiting their ability to invest significantly in any transformation. For example, we find that 80% or more of CMIB firms' technology budgets are being used for mandatory work (regulatory, risk and required technology maintenance), leaving very little for discretionary or strategic spending.

At the same time, we recognize that the largest and least-controlled pool of costs lie, counterintuitively, in "change the bank" (CTB) functions, not in "run the bank" (RTB) functions. In fact, CTB costs in post-trade may now exceed RTB costs. If change control (e.g., regulatory and risk oversight) costs are considered as separate from RTB, then non-RTB costs dwarf RTB costs.

We find that the investments CMIB firms are making for transformation efforts are all directed at reducing RTB costs—that is, toward the smaller cost pool. Many banks are also experiencing difficulty in realizing expected cost efficiencies through these transformation investments. They find that any reduction in labor costs achieved in RTB are often canceled out by increased CTB costs due to corresponding increases in the complexity of the technology environment.

What is to be done? We believe that banks need to double down on efforts to lower their cost of change through key initiatives such as:

- Agile development
- Model-driven development
- Automated testing
- Project portfolio management
- Centralized change investment governance

Of these initiatives, model-driven development has the most disruptive potential.

Banks that can successfully reduce cost of change will find they have also achieved more rapid technology innovation and increased capacity to initiate change. This freed up capital can be used to address stagnant internal transformation agendas.

Cost Mutualization

Our analysis suggests that, based on CMIB firms' average performance the industry still needs to reduce operating expenses by an additional 10-15 percent to deliver "desirable" levels of return to the market. After enduring repeated cost cutting over the past few years this seems difficult for any bank to achieve organically, increasing the pressure to create new commercial and utility structures. These new structures allow for the effective mutualizing of costs related to post-trade processing, creating an efficient industry supply chain.

Many suppliers already exist and we believe that firms should prioritize fully utilizing these solutions. This requires a concerted effort to complete service adoption both within banks and client organizations. Banks, therefore, have a vested interest in proactively supporting suppliers and encouraging adoption by their clients.

Many new suppliers are emerging in multiple areas: managed services, utilities, fintech and so on. Each supplier brings a different mix of opportunities for operating expense and change investment cost mutualization. In the long run, however, we would expect mature supplier offerings to offer a very similar value proposition, differentiated only by their specialization in the process area they address.

Many more suppliers are expected to emerge in the near future as banks look to aggressively shed non-core functions. Much is at stake for the industry here: a rich supplier ecosystem could drastically reduce banks' operating expenses as well as attract independent investment to help cover the capital expenditure needed to drive a successful transformation.

In fairness, banks and their new suppliers will need to navigate many risks in restructuring the industry supply chain:

- Developing a new supplier
- Integrating the new supplier
- "Disconnecting" the transferring function from the current operating model
- Executing the function transfer
- Developing a "supply chain management" capability within the banks
- Sharing liability in the new relationship
- Preserving agility and low cost of change in the new supplier relationship

We expect a chaotic environment over the next couple of years as new suppliers emerge; many will likely fail in the attempt to establish themselves. However, in five or more years, we expect to see a sharply different supply chain for the industry.

Digital Client Interface

As if regulatory and cost pressures were not enough, CMIB firms are also contending with a shift in employee demographics and client behavior. Specifically, the growing presence of Millennials and post-Millennials in the industry workforce is challenging the "put your head down and get the job done no matter what" mentality that has served the industry well for so long. Falling compensation rates in the industry are partly to blame, but even aside from that, this new generation of managers and leaders who grew up in the Internet age are questioning the very fundamentals of how the industry works. Their dissatisfaction is driving up attrition, creating unprecedented recruiting challenges, and adding stress to a system that is already under siege.

The new generation of CMIB professionals is consistently shocked by how different their operational experience is in their work lives versus their personal lives. In their day-to-day lives, they are used to ordering online, interacting with web or mobile apps to communicate specific needs, tracking their purchases online, resolving issues through FAQs and live chat, and receiving their purchases at their doorstep. As employees, they are frustrated by the need to work with ancient and highly fractured applications, the incessant need to "reconcile" between disparate systems to get a simple view of status, the manual effort required to feed data from one technology environment into another to successfully process trades, and, in general, the experience of spending a large portion of their time serving as a "human logic gate."

Three basic trends, fueled by the availability of new digital technologies, are poised to fundamentally address how the industry works:

1. Digital transparency enabling low-touch service in post-trade interactions
2. Digital collaboration enabling high-touch service in advisory and pre-trade interactions
3. A seamless front-to-back digital experience for clients

On the client side, this new wave of managers and leaders are confounded by the age-old ritual of pitch books, the inability to leverage internet search to perform research and analytics, and the barriers to forging informal electronic networks with peers to make collaborative decisions. They want to be in the virtual kitchen, select the ingredients, pick the recipe, and bake the cake along with their colleagues, not just consume whatever is put in front of them. Further, they want to collaborate simultaneously on multiple transactions with multiple providers anytime, anywhere, and through the medium of their choice (mobile, web, phone, or in-person).

This new generation of professionals is also frustrated by the inability to track their CMIB transactions online, the lack of self-service tools to transmit their information, the incessant email and phone interactions needed to resolve issues, and the service provider's general inability to be efficient while remaining effectively invisible. Their desire is to begin and complete their transaction experience online through a single digital interface is driving many firms to start investing in a front-to-back digital client interface. A few are also using this technology refresh as an opportunity to both rethink the client experience and change the internal operating model for employees. We believe that these firms will be rewarded by finding a silver bullet that helps them at once improve client service, increase employee satisfaction, reduce operational costs, and virtually eliminate operational risk.

Bottom-up Transformation

Finally, we believe it is imperative to enable staff at all levels to participate in a transformation effort. Otherwise, an organization risks losing engagement among the Millennial and post-Millennial population, hindering the achievement of the transformation's goals and putting the transformation's sustainability at risk.

Firms that successfully engage their broader organization in transformation efforts can benefit from the development of a continuous improvement mindset that can pay handsome dividends over the long term. In fact, it is our belief that firms which invest aggressively to give their younger workforce the right tools, skills, and incentives to participate in continuous improvement are often rewarded by strong short-term efficiency gains.

Bottom-up transformation can be achieved very effectively through Kaizen–like process improvement tools and skills. Some more adventurous firms are also successfully investing in a suite of other capabilities such as:

- Business process management (BPM)
- Business decision management (BDM)
- Analytics design
- Business intelligence

In addition, firms that invest in capabilities like robotic process automation and cognitive technologies, and whose technology and business teams collaborate closely, can create a groundswell of efficiency that gives larger STP and replatforming initiatives room to run and succeed. It should be noted, however, that such capabilities should be implemented thoughtfully, as they inevitably demand the creation of new roles, responsibilities, and even organizational structures—as well as a change in the talent model that can start to blur the lines between the technology and business functions.

Conclusion

The current stress in the CMIB industry is pushing it to the brink of a radical transformation (Industrialization 2.0) that may:

- Help banks acquire service management discipline in line with their suppliers
- Give birth to a new and efficient supply chain
- Drastically lower the cost and increase the speed of change
- Reconfigure banking operating models for success in a commoditized future
- Reinvent the client interface
- Rebuild the employee value proposition

Through this process, we believe the industry will emerge leaner, more agile, and better able to achieve and sustain a competitive ROE.

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