New cost imperatives in banking

Gaining greater efficiency

May 2021

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> Cost optimisation should not be seen as restricting activity or innovation, but rather as a commitment to continuous improvement. A continual asking of how things can be done better and more efficiently. This requires a shift in mindset in most organisations.

— **Judd Caplain**
Global Head of Financial Services Partner
KPMG in the US

Cost optimisation has been high on the agenda for most banks for many years. It is an ongoing process that must flex and evolve over time, as market conditions, customer requirements and stakeholder expectations change: it is indeed a journey that is never 'done'.

By definition, cost transformation is a difficult journey. After all, many cost inefficiencies are systemic and stem from the bank's complexity and legacy. In addition, as banks grow and evolve, it is often easier to add new costs rather than remove existing ones.

In the wake of the COVID-19 pandemic, the cost agenda has been elevated to a new level of importance. A clear majority of banks are looking to intensify and accelerate their cost transformation programs, in many cases significantly. This urgency derives from the downturn in bank profitability globally.

In the current environment, banks around the world typically will need to reduce their cost-income ratio by 10 percentage points or more. They need to reinvent their operating model and harness the agility, resilience and digital transformation they mobilised in their initial pandemic responses to lock in sustainable cost optimisation.

An important focus of the cost strategy should be its customer impact. A smart approach to cost reduction is to target activities that do not add customer value and to simplify and streamline existing activities and processes.

Those banks that are bold and successful in their cost transformation programs will be strongly positioned for success. But those that are inconsistent or lose their focus will be competitively disadvantaged.

Given the importance and urgency of the cost agenda, KPMG International commissioned comprehensive research among senior banking executives around the world to gain first-hand insights into actions and priorities on the ground.

This report demonstrates that banks worldwide urgently need to develop focused, 'smart' cost transformation strategies and observe the lessons from the past to ensure successful implementation and benefits realisation. Success depends on having a clear and consistent top-down direction, and a strong cost culture.

We explore this in depth through this report and hope it will shine a powerful light on this most critical of areas for the banking industry.

Chris Monaghan
Partner, Financial Services Advisory – Banking Model Transformation
KPMG in the UK
E: chris.monaghan@kpmg.co.uk

Adrian Harkin
Global co-lead, Banking Cost Optimisation
KPMG in the UK
E: adrian.harkin@kpmg.co.uk

Key findings at a glance

In late 2020 KPMG International commissioned research of more than 200 executives from some of the worlds largest banks to understand how their cost transformation priorities are changing in response to the COVID-19 pandemic. Our research explored drivers and enablers for successful cost transformation projects; the future target operating model (TOM) and associated cost structures and how priorities are likely to change in a post COVID-19 environment.

New thinking for cost efficiency emerges

Top 2 issues for banks to address post COVID-19

21%
revenue loss

20%
cost management

As a result,

61%
said cost reduction increased in strategic priority

59%
said digitisation is the most important cost lever

Banks double down on cost management

83%
are refocusing their cost optimisation efforts

85%
are accelerating them

Cost reduction targets increase

61%
have increased their targets by up to 10%

19%
increased their target by more than 10%

Yet, significant savings are pushed to the mid-term

66%
set a cost savings target of more than 10% of the cost base over the next 3 years

15%
will look to take more than 10% of the cost base over the next 12 months

To address the challenge

28%
of banks are targeting radical change in their operating model over the next 3 years

Most essential enablers to achieve greater efficiency

91%
committed leadership

89%
culture

89%
accountability

Yet, just

58%
rate their culture highly for supporting cost optimisation objectives. **More needs to be done**.

Source: Banking cost transformation survey, KPMG International.

Evolving cost priorities and COVID-19

As a result of COVID-19, the cost agenda has been significantly elevated by banks:

Costs have increased as a priority

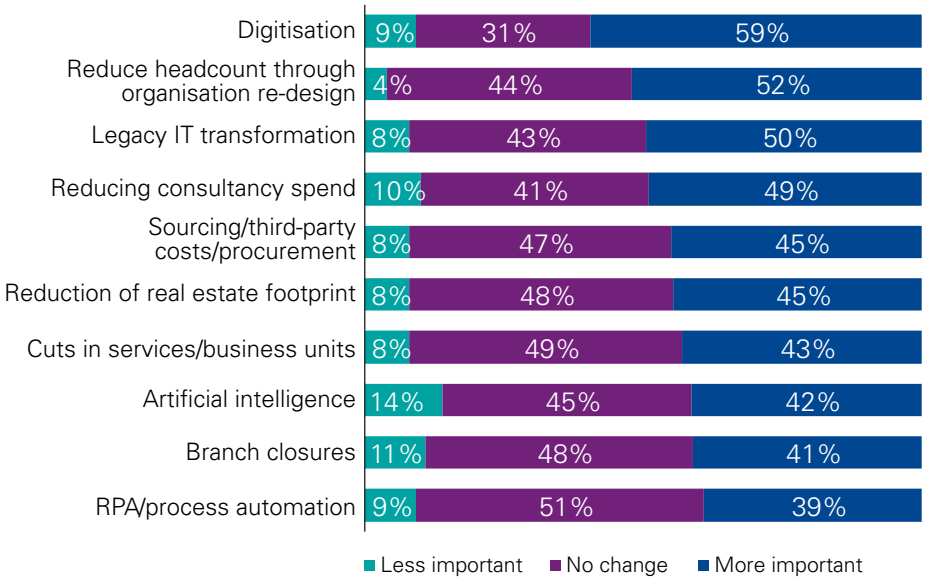
Cost efforts have been refocused and accelerated

Targets have increased (albeit mostly in the medium term)

The cost reduction agenda has gained importance and substance, globally.

The areas that are seen to have become more important to aid cost reduction post COVID-19 are digitisation (59 percent), reducing headcount (52 percent) and legacy IT transformation (50 percent).

Areas of cost reduction and their importance in helping to achieve cost reduction targets over the next 12 months



These are critically important areas — and have been the focus of banks' cost optimisation efforts already.

Digitisation is a pervasive priority across the banking industry and lies at the heart of the modern banking operating model.

We see the biggest gains are to be made in process automation and end to-end digitisation in the middle- and back-office, where there often remains a high reliance on inefficient manual processes. This also provides a route to headcount optimisation by reducing labor-intensive paper-based processes freeing up staff to focus on more client-centric tasks. It is a hallmark of the digitally enabled organisations that banks are seeking to create as they replace and modernise their legacy IT platforms. KPMG's Connected Banking model provides a blueprint of a customer-centric approach to digital transformation that aligns front-, middle- and back-offices and can be a powerful driver of cost optimisation.

At the front end, one of the effects of COVID-19 has been to significantly accelerate customer migration to digital channels. Increasingly, customers are comfortable and prefer to conduct banking and manage their money themselves, at their own convenience. This can not only improve the customer experience, but also lower costs in the medium and long term.

In our view channel digitisation should be considered primarily in the context of customer needs. From a cost perspective it is often less effective than some other levers. Reducing physical channel costs remains challenging in large part due to fixed costs. There is also the persistence of residual activity despite digital uptake. Furthermore, banks have an ongoing responsibility towards vulnerable customers to continue to offer access through traditional physical channels and services.

Additionally, we should recognise that there are new costs that are non-discretionary. Banks have no choice in adding activities that are required from a customer (e.g. product innovation), a regulatory or a societal (ESG) perspective.

> You won't be able to reduce your branch footprint at the same rate that customers are adopting digital channels as some customers will still require face-to-face sales and service options. Don't overestimate the cost benefits of customer migration to digital channels.

— **Hessel Verbeek**
Global Cost Transformation Co Lead
KPMG Australia

Taking the lessons of the past to overcome barriers to success

“Some people believe you can’t be cost-conscious and customer-centric at the same time. I disagree. If you’re laser-focused on what the customer really wants, you will naturally shed costs.”

— **Karen Parkes**
Partner
KPMG Australia

Business silos continue to create cost silos within some of the banks, limiting understanding of actual cost of ownership and potential optimisation efforts. Costs should be measured across lines of business, channels and front to back-office functions to develop a true understanding of total costs. This is critical to achieving sustainable and material cost optimisation.

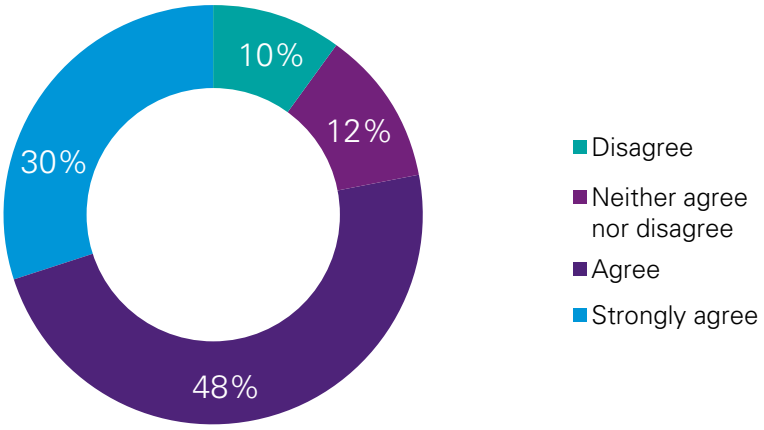
— **Tapasvi Narula**
Global Cost Transformation Co Lead
KPMG in Canada

While banks are raising the cost efficiency bar, they recognise that historically they haven't been as successful in meeting their own targets.

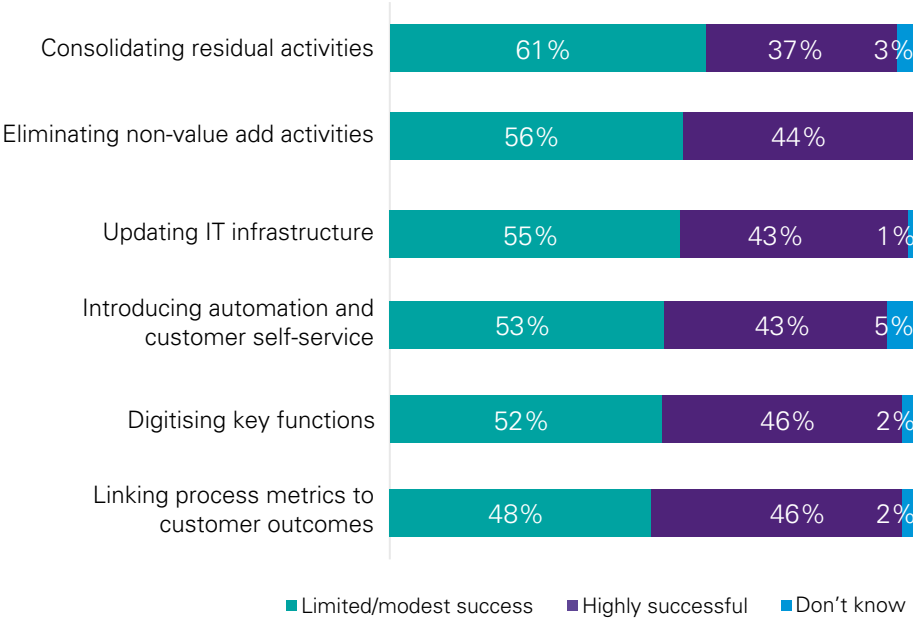
Cost initiatives are nothing new in banking with some banks spending between 15–20 percent of their cost base on transformation and change delivery. So, what do past programs show us about the task ahead?

A mixed picture emerges. Our research indicates the majority of banks — 78 percent, feel their cost optimisation programs in the last three years have delivered the expected returns. However, at a more granular level, most banks report 'modest' or 'limited' success in specific areas such as digitising key functions, linking process metrics to customer outcomes and eliminating non-value add activities.

Respondents that felt in the last 3 years cost reduction initiatives have delivered expected returns



How successful has your organisation's current cost optimisation strategy been in achieving the below outcomes?



This qualified view of success should be no surprise. As a recent report from KPMG in the US observes, organisations change over time. They become more complex through organic growth, acquisitions, economic fluctuations, new regulatory requirements, business model changes, and various other internal and external factors.

Banks should be clear about the main barriers to successful and sustainable cost reduction — so that they can take effective steps to address roadblocks and improve the results being achieved. Our research finds that banks identify a number of key obstacles that commonly hold them back.

It is clear that the barriers are numerous, complex and often inter-linked. In KPMG's view, the survey highlights the critical success factors for cost transformation including an understanding and prioritisation of the key cost levers, a clear view of the TOM to deliver the cost benefits and a strong 'cost culture' within the bank.

Percentage of banks that felt the following were the key obstacles they faced:

87%	sheer length of cost initiatives/the time (and stamina) needed
84%	competing management agenda's
83%	management turnover impeding on multi-year programs
81%	management prioritising 'easy' costs over systemic problem areas
81%	lack of accountability
81%	executive focus on revenue growth rather than cost reduction
77%	varied management interpretation of cost reduction strategy

Success factors:

1. **Setting a focused cost agenda**
2. **Rethinking the TOM to maximise benefits**
3. **Recognising the importance of cost culture and enablers**

1. Setting a focused cost agenda

In our experience, to be successful banks need to focus on a number of key programs rather than a multiplicity of small micro initiatives to reduce costs.

These programs can be grouped into 12 underlying cost transformation levers, approached through the lenses of strategy, simplicity and engineering. Which levers a bank prioritises and when will depend on a number of factors:

— current (cost) performance against benchmarks and targets

— cost reduction target and investment in cost reduction

— speed to achieving cost reduction

— potential risks associated with each lever pulled.

The combination of a clear program organized around the 12 levers, with the focus that the three lenses bring, means that significant results can be achieved — unlocking considerable cost reductions in relatively short time frames, as described in the indicative chart below:

Across all the levers, we believe that activity should be viewed through three key lenses:

Strategy — Defining the long-term vision and plan for the bank, pulling together multiple executive agenda items into one integrated approach.

Simplicity — Ensuring there is transparency and accountability, strong governance, operational and focused executive leadership, and one primary axis through which it operates. We observe that banks with highly simplified models have a significant cost advantage.

Engineering — The underlying designs adopted across different components and functions within the bank.

Levers of cost transformation

Macro cost lens	Cost reduction lever	Opportunities	% Cost saving (from total costs)	Speed to cash	Cost per $ saved	Risk
1.Strategy	1.1 Geographies, markets, products	Reduce presence in low performing customer segments and product areas	To be determined	Slow	To be determined	
	1.2 Operating model & balance sheet	Reduce the cost of funding by optimising the balance sheet				
2.Simplicity	2.1 Organizational model	Reduce organisational complexity, including reporting, decision-making and governance structures	Medium	Fast	Low	
	2.2 Transformation optimisation	Create a core organisational capability around transformation				
	2.3 Cost management focus	Drive a cost focus through strategy and accountability				
3.Engineering	3.1 Digitisation & operational efficiency	Digitise work from front to back office and drive enterprise-wide automation	High	Medium	High	
	3.2 Channel optimisation	Digital shift with interventions to drive behavioral change				
	3.3 Organisation design & people	Drive the simplification of the organisational design throughout the bank, focus on spans and layers and realignment of pay and rewards	Modest	Fast	Medium	
	3.4 Technology optimisation	Accelerate the migration of critical environments to the cloud, decommissioning of the obsolete applications and removal of data centers	Modest	Medium	Medium	
	3.5 Property optimisation	Rationalisation of operations between head offices and regions, adjustment of seat to desk ratio to 2.5:1	Modest	Slow	To be determined	
	3.6 Sourcing & super management	Drive third-party spend down through challenge of integrated supply and demand	Modest	Fast	Low	
	3.7 Tax & Legal optimisation	Optimisation of tax and legal structures	Modest	Medium	Low	

% Cost savings: Modest (<5%), Medium (5–10%), High (>10%)
Speed to cash: Fast (<12 months), Medium (12–24 months) Slow (>24 months)
Cost per $ saved: Low (<$0.50), Medium ($0.50–1.00), High (>$1.00)

Source: KPMG International, 2021.

An effective approach to using the cost transformation levers is for the bank to take an 'outside-in' view of its business, using internal and external data analysis. This will enable the bank to:

1. Develop a number of strong hypotheses about which levers will provide the most impact based on an in-depth knowledge of how the business operates and performs.
2. Estimate the cost reduction potential for each of the levers and hypotheses based on external and internal experience, including benchmark data.
3. Prioritise which cost transformation opportunities to take forward for further analysis and validation.
4. Detail how the prioritised levers could be applied within the bank based on bottom-up internal analysis.
5. Develop the business cases for your cost transformation initiatives.

With the current availability of internal bank data and industry benchmark data in combination with the increased use of contemporary analytical tools, analysing and prioritising the cost transformation levers can be done relatively easily and yield rich insights. KPMG is using advanced data analytics as an accelerator to help banks identify quickly where to focus their cost transformation efforts. In this context it is important to note that the majority of survey respondents acknowledge the importance of their data and analytics capabilities for their bank's future success (even more so for the banks that anticipate more radical change in their operating model).

It is pertinent to call out transformation optimisation (lever 2.2) in the context of the increased risk and regulatory transformation requirements that banks globally continue to experience. As the expenditure on risk and regulatory transformation is currently very significant (in some countries, the majority of transformation spend is having to be directed to this area), achieving greater efficiency here can be a very powerful cost lever. Therefore solutions like different operating models (including alternative sourcing options and industry solutions) and partnering with regtech providers should be considered. In KPMG's experience, more cost efficient approaches to risk and regulatory transformation can be an important lever for cost transformation.

A solid understanding of current business operations, coupled with an in-depth understanding of variables such as timing, risk, downstream dependencies, prioritisation, customer impact, and projected effect, will help prioritise implementation initiatives. Most important, a holistic cost and waste reduction strategy will help drive targeted impacts while maintaining a strong customer experience.

2. Rethinking the TOM to maximise benefits

While 82 percent of banks say they have clearly defined cost objectives; fewer have translated that into a clear cost strategy (77 percent) or a fully mapped TOM (72 percent). The importance of the latter is evident, as with 91 percent of banks who said their past cost reduction initiatives were successful also saying they have a fully mapped TOM. It is imperative that banks' cost strategies include a clear view on the TOM that will deliver the benefits. Further, cost optimisation goals should be adjusted based on a deep understanding of the operating model, for example a 10 percent cost reduction could be considered aggressive in one area of a bank (e.g. loan application processing which has already been automated), while a 20 percent optimisation may be considered conservative (e.g. systems licensing and servicing related to a large book of legacy products that are no longer being sold).

An important principle is that TOMs should seek to drive increased simplicity of the bank. The complexity of the operating models of most banks imposes a major performance penalty in terms of costs, risks, and strategic agility.

Is radical change on the horizon?

In the wake of COVID-19, more than a quarter of banks (28 percent) are anticipating radical change to completely rethink their TOM — and this rises to 36 percent of the largest banks. Regionally, banks in Asia-Pacific are most likely to be contemplating it (36 percent), somewhat ahead of banks in Europe and the Americas (28 percent and 23 percent respectively).

A clear example of an operating model change that delivers greater simplicity and cost efficiency is the integration of channel management between branch networks and virtual channels such as contact centres and digital. Breaking down the channel siloes to create a single, integrated distribution function

> "Banks are starting to look hard at what activities give them competitive advantage and differentiation. If someone else can do a better job on the bank's behalf — then collaborative utility approaches are very attractive."
>
> — **John Armstrong**
> Head of Financial Services
> KPMG in Canada

has many benefits beyond cost reduction. KPMG sees this trend towards integrated distribution operating models being accelerated as a result of COVID-19, as contact centre activity is more dispersed and also takes place from branches and from home.

Another operating model example is to 'hollow out' the core, and to slim down the organisation and its processes. One of the most effective ways of hollowing out is through partnering. For example, to create a digital mortgage proposition, this would involve partnering with a digital mortgage originator rather than digitising the legacy paper-based mortgage business.

For many, radical change may consist of ceasing certain in-house operations and finding platform or utility solutions in their place. Payment switching is an example of this — many banks still have their own payment switches however, they could put their payment volumes through a utility processor instead.

Utility models can be expected to increasingly be adopted, with 80 percent of banks saying they will play a more important role in their operating model.

These could apply across a wide range of activities — cheque processing, the movement of cash and stocking of automated teller machines (ATMs), anti-money laundering (AML), and know-your-client (KYC), due diligence. Managed services for areas such as remediation or collections are also likely to grow. In the past, utility solutions have proven hard to make work on a sustained collaborative basis. There is greater momentum behind them now.

3. Recognising the importance of cost culture and enablers

In our research, the most important 'soft' enablers are seen to be a strong cost culture, the ability to commit time and resources long-term, executive accountability, and cost reduction key performance indicators (KPIs).

However, only 58 percent of banks rated themselves highly on having a strong cost culture (although, significantly, this rose to 72 percent among those banks whose past initiatives had delivered the expected returns).

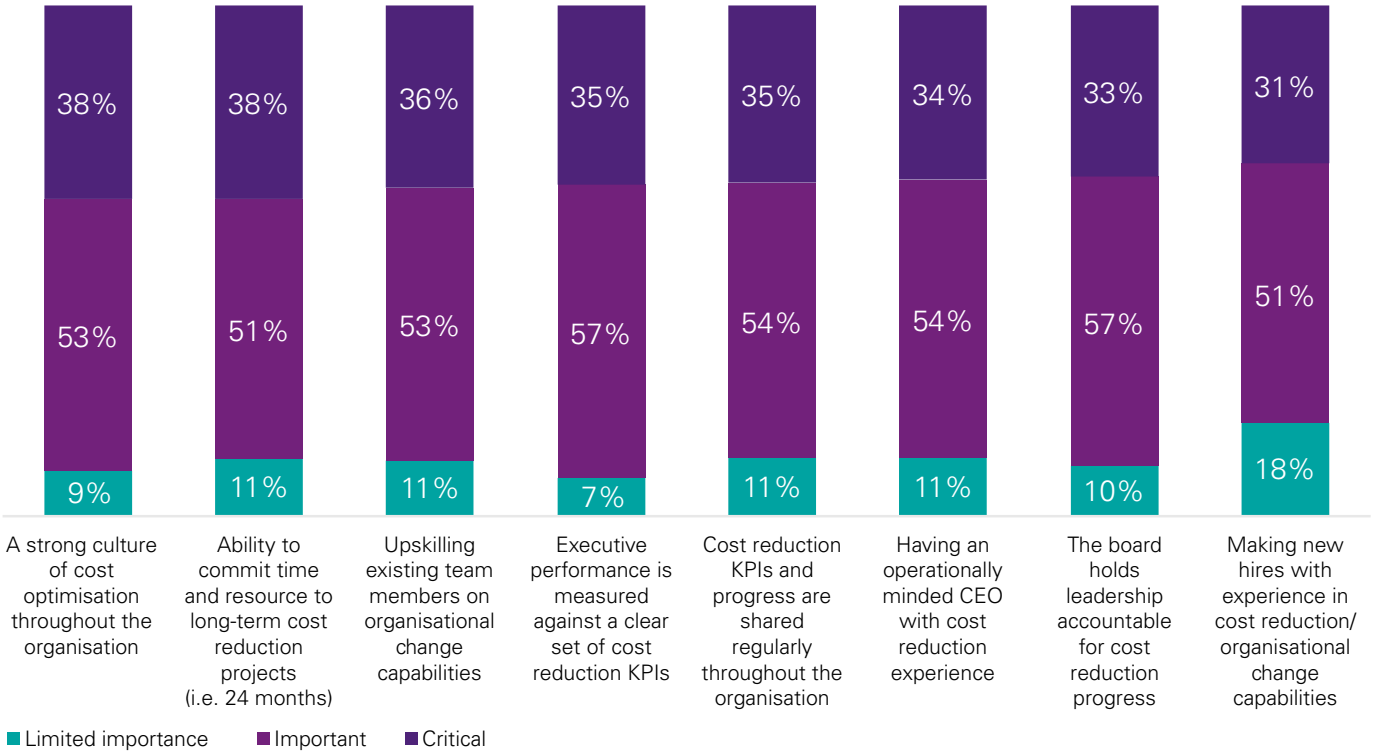
Creating the right culture

How can a strong culture be created? Quite simply, it must begin at the top. The natural owner is the group CFO and wider finance function — with very clear CEO sponsorship. This CEO support is crucial if the CFO and team are to have the imprimatur needed across the business. There must be buy-in right across the C-suite, with each member committed to driving cost optimisation in their domains and taking accountability for progress.

Ninety percent of respondents say it is important or critically important that the Board holds leadership accountable for cost reduction progress; while 91 percent say a strong culture of cost optimisation throughout the organisation is key.

Executives and senior management across the enterprise must be fully brought into the cost effort — and in practical terms, this means ensuring that cost performance is one of the metrics in their personal compensation and reward. But, more than this, it's vital that different individuals' incentives don't conflict or work against each other. For example,

Importance of the following attributes in achieving sustainable cost reduction within the bank over the next 12 months



product and channel owners shouldn't be singularly incentivised to pursue growth through expensive channels if more efficient alternatives are available. The incentives involved should all point the same way.

Shifting to a continuous improvement mindset

Another important factor is that cost optimisation should not be seen in a negative light as something that restricts activity, innovation and the customer focus. In contrast, it should be seen as part of a commitment to continuous improvement, a continual asking of how things can be done better and more efficiently. It should also be viewed as a constant lens on the customer — focusing on what really matters to them and how delivery can be made more efficient.

Banks need to make performance improvement a continuous effort, rather than relying on periodic, ad-hoc activities. They should focus on constantly evolving their initiatives as part of an overall and 'live' cost strategy.

Measurement matters

Among other enablers, one area where banks rated themselves relatively weak was on KPIs. Only 56 percent of banks said they were effective or very effective at sharing cost reduction KPIs and progress regularly throughout the organisation. Indeed, this fell to just 47 percent among the largest banks. However, there is a widespread recognition that monitoring, and measurement are critically important.

Getting this aspect right is key because effective reporting can be a lever in strengthening the over-arching cost culture. If stakeholders can see the progress that is being made, this motivates and encourages them to maintain the momentum being built. If progress is faltering, seeing this in black and white may give them the impetus they need to redouble their efforts. It is clear, reporting makes cost transformation feel 'real' and therefore embeds it in the organisational culture.

"Too often there are competing agendas. Everyone needs to be incentivised to pull in the same direction."

— **Owen Lewis**
Partner
KPMG in Ireland

Moving forward

The current environment requires most banks globally to transform their operating models and move their cost bases onto a sustainable lower footing. Those banks that don't move fast or boldly enough are likely to find themselves unable to compete on price, value and delivery with their leaner and more efficient rivals, hemorrhaging market share.

Cost transformation is not new. It has been a focus for banks worldwide, however, few have been able to achieve the full benefits of past efforts. As a result, cost levels stubbornly remain above where they should be.

This survey has looked into banking cost transformation, the barriers from the past and success factors going forward. Whatever the market position of an individual bank, certain key principles for effective cost transformation will hold true:

— clear, well-defined and understood objectives

— inclusion of 'smart' cost transformation as a permanent feature in the bank's strategy

— rigorously prioritised cost take-out areas

— a fully formed architecture for the transformed TOM

— a strong cost culture supported by enablers such as aligned KPIs

— fortitude and commitment by the bank's senior leaders to stay the course.

At KPMG, our experience working with banks around the world on cost optimisation initiatives has shown us just how much is possible, and provided us with practical insight to address challenges.

With COVID-19 having highlighted the cost imperative for banks globally, they have it in their hands to go further still and create a new blueprint for the future.

Contacts

Chris Monaghan
Partner, Financial Services Advisory – Banking Model Transformation
KPMG in the UK
E: chris.monaghan@kpmg.co.uk

Adrian Harkin
Global co-lead, Banking Cost Optimisation
KPMG in the UK
E: adrian.harkin@kpmg.co.uk

kpmg.com/uk

home.kpmg/socialmedia

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