Booz | Allen | Hamilton

Process Utilities

Economies of Scale for Efficiency and Growth in Financial Services

Economist Intelligence Unit

The Economist

TABLE OF CONTENTS

Produced in cooperation with the Economist Intelligence Unit

Process Utilities

Economies of Scale for Efficiency and Growth in Financial Services

Consolidation in the financial-services sector has given many banks the chance to achieve extraordinary economies of scale in back-office processes. Such improvements can cut costs dramatically, reduce risk, increase processing speed, and minimize errors, as well as enhance customer service. Econometric studies from the Federal Reserve Bank of Boston,[1] the Bank of Canada,[2] and the European Investment Bank[3] all underscore the potential to increase scale in the industry—but not all banks have realized this potential.

Decentralized organizational structures often make it politically difficult to standardize common processes and realize efficiencies, while varying regulatory regimes in different areas may constrain where processes take place and how they are structured. As a result, major efficiency programs in the U.S. banking industry implemented from 2002 through 2006 have not paid off as expected, and costs have continued to grow more quickly than revenue in most of the industry.

Companies that are unable to control their costs may face serious consequences: Profit margins of U.S. financial-services companies have declined recently, and equity investors may penalize banks that have growth in costs that matches or exceeds increases in revenues. Boards and senior management teams can develop a comprehensive strategy to manage costs and promote efficiency before these penalties are incurred.

These issues were the focus of an Economist Intelligence Unit (EIU) survey, sponsored by Booz Allen Hamilton, about cost-management strategies for financial services that was conducted in the summer of 2007. About one-third of the 499 respondents were C-level executives; another 25 percent were heads of a business line. (For more information, see “About the Survey,” page 2).

In particular, the survey focused on an emerging model of efficiency enhancement and cost reduction known as process utilities. Organizations that want to build process utilities must look across business lines, functional silos, and geographic divides to identify those processes that could and should be shared across boundaries to achieve greater scale, improve consistency in execution, and lower costs. Unlike many previous cost-cutting efforts that have focused primarily on corporate support functions like finance, accounting, human resources, and procurement, a focus on process utilities requires institutions to examine opportunities to aggregate similar activities that are core to the delivery of products, services, and revenue—for instance, checking or mortgage activities for retail banks, or trade execution for investment banks. Further, by adopting process utilities, firms have the opportunity to more systematically share

[1] J. Christina Wang, “Productivity and Economies of Scale in the Production of Bank Service Value Added,” Research Department, Federal Reserve Bank of Boston, September 2003.
[2] Jason Allen and Ying Liu, “Efficiency and Economies of Scale of Large Canadian Banks,” Bank of Canada Working Paper No. 2005-13, May 2005.
[3] Paul Schure and Rien Wagenvoort, “Economies of Scale and Efficiency in European Banking: New Evidence,” European Investment Bank, 1999.

best practices, promote a more consistent customer experience, and maximize cross-selling opportunities, driving higher customer satisfaction and improved opportunities for growth.

This report presents the key findings of the EIU/ Booz Allen survey. In addition, it illustrates the findings with three case studies describing how National Australia Bank, Den Danske Bank, and Deutsche Bank took steps to boost revenue and manage costs and efficiency.

Getting Costs Under Control

The pursuit of top-line revenue growth remains the predominant strategic priority at most financial institutions (see Exhibit 1). But the second slot in terms of strategic priorities is occupied by cost reduction and efficiency improvement, with improving the customer experience in third place.

Exhibit 1
Financial Institutions' Strategic Priorities

	Rank in Terms of Strategic Priorities	
	1	2
Top-line Revenue Growth	59%	17%
Cost Reduction/Efficiency Improvement	15%	34%
Improving Customer Experience	17%	24%

Note: The percentage represents the proportion of executives assigning the goal a 1 (very critical) or a 2 (critical), part of a five-point scale from "very critical" to "not at all critical."
Sources: Economist Intelligence Unit; Booz Allen Hamilton

The simultaneous pursuit of revenue growth and cost reduction and efficiency enhancement is common at financial institutions. Den Danske Bank CFO Tonny Thierry Andersen explains, "While we have been pursuing top-line revenue growth through acquisitions, this is a complement to a strategy based on growing scale to reduce our cost of doing business."

About the Survey

In July 2007, the Economist Intelligence Unit conducted a global survey, sponsored by Booz Allen Hamilton, of 499 financial-services professionals on the subject of process utilities.

- One-third of the respondents represented retail or universal banks. An additional one-third of respondents worked in wealth management (13 percent), investment banking (13 percent), or corporate banking (10 percent).
- The executives surveyed held senior positions in their organizations. About a third were C-level executives; 12 percent were CEOs. About a quarter were heads of business lines or VPs. The rest were managers, department heads, or other professionals.
- The survey was global, with about one-third of the respondents based in Europe, one-third in the Asia/ Pacific region, one-fifth in North America, and the rest in emerging markets.
- Although about a third of the respondents came from small banks (assets less than US$10 billion), larger banks were also well represented. About one-fifth had assets of more than US$500 billion. Respondents' banks had average assets of approximately US$240 billion.
- Approximately 60 percent of the respondents worked in finance and risk, and one quarter had responsibilities in the strategy and business development areas. Fourteen percent had operational responsibilities. (Respondents could choose more than one function.)

Yet there are still banks, albeit a small percentage, that don't pursue this opportunity. Six percent of respondents, representing 30 institutions, said that their bank had not initiated efforts in cost reduction or efficiency improvement in the last three years and was not likely to do so in the next three years. National Australia Bank Deputy CEO Michael Ullmer points out that for too many financial institutions, "cost containment represents a very significant opportunity which does not always receive the level of strategic focus it should."

Ullmer contrasts the management mind-set at many financial-services institutions with that of manufacturers facing fierce competition from companies in China or India. Manufacturers, he points out, are intensively focused on managing their cost base. They are challenging themselves not merely to slow the growth of costs, but to reduce them by 5 to 10 percent. For manufacturers, controlling costs isn't merely a question of profitability or even of incremental improvement. "It's a question of survival," says Ullmer (see "National Australia Bank: Accountability Cuts Costs, Enhances Service," page 4).

In the world of financial institutions, "we place our focus on net interest margins, on capital management, on our risk profile, on bad and doubtful debts," says Ullmer. It's not that costs are ignored, he explains, but rather that senior management "sees none of the depth and richness of the dynamics within their cost base." Consequently, says Ullmer, "there's a prize to be had by those financial institutions that can view their costs of production in the same way as a manufacturing company or that can manage their cost with the same skill and effectiveness they bring to net interest margins or the balance sheet."

Benchmarking Traditional Cost-Cutting Initiatives

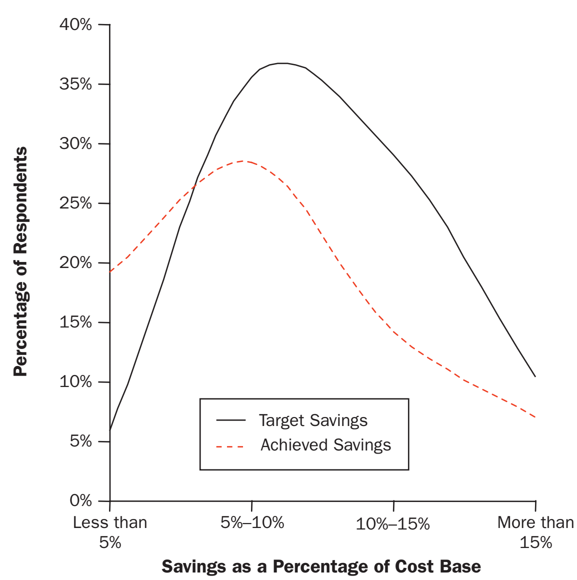
Cost management represents an opportunity, and most executives at financial institutions are at least attempting to capitalize on it, using traditional methods such as business process reengineering, outsourcing, and shared services, among others. More than half of the survey respondents (52 percent) said their organizations have conducted a significant cost reduction or efficiency-improvement exercise within the past three years. Another 20 percent said they will start such an initiative within the next three years, and 18 percent said such a move is under consideration.

The survey also examined the success rate of initiatives that have already been implemented or are in the process of being implemented. A significant number of banks have fallen or are falling short of their objectives. Small cost reductions—less than 5 percent of the cost base—appear to be easily achievable (see Exhibit 2).

Sixty-seven percent of respondents were able to reach that level of savings, although in some cases their target might have been higher. But only those who aimed low hit their targets. Those banks that aimed to save more were less likely to be successful: Of the 334 banks that tried to achieve savings of

continued on page 6

Exhibit 2
Targeted and Achieved Savings at Financial Institutions



Sources: Economist Intelligence Unit; Booz Allen Hamilton

National Australia Bank: Accountability Cuts Costs, Enhances Service

National Australia Bank (NAB) Deputy CEO Michael Ullmer knows a thing or two about cost management. The bank was on a rocky road in 2004, when losses due to unauthorized foreign exchange trading and skirmishes with regulators hurt the bank's performance. Subsequently, the company sold off two of its operating units, National Irish Bank and Northern Bank, to Den Danske Bank.

But today the bank is much better positioned. Ullmer says that this is largely because of the bank's strategic decision to focus on the management of costs, among other issues.

NAB's cost position now is very different than it was in 2004, when costs were growing in excess of 10 percent per year. Since then, on a cost base of A$7 billion (US$6.35 billion), "the annual rate of cost growth has been 2 percent or even a bit less," says Ullmer. The transformation came about when the bank's senior management recognized that getting control of costs was critical. Today, he explains, cost management remains "one of our core strategic initiatives."

Accountability Cuts Costs

The means to achieving this success, says Ullmer, "is through a business model of accountability." The bank's management model has contributed significantly to the slowdown in cost growth. NAB has four primary divisions: Three retail and middle-market-focused divisions are organized according to geography—one each for Australia, New Zealand, and the U.K. The fourth division is the global NAB Capital Group, which focuses on institutional and wholesale customers and markets.

As Ullmer explains, "For each of these businesses, we set high-level targets for return on equity and bottom-line growth." In addition, the divisions are given targets for customer and employee satisfaction, as well as risk limits. But otherwise, he says, "they're given very significant authority and accountability to run their businesses." They are "free to make decisions about their costs and their investments," says Ullmer. "It's in their hands how they meet the needs of their customers and employees while accomplishing their financial goals."

The impact of this responsibility is very powerful. Adds Ullmer, "The divisions take ownership of their business, and they present plans to us that they agree are realistic and deliverable." With responsibility for costs, revenues, and customer and employee satisfaction, "they're in a position to make balanced decisions and then stay on top of things to ensure they deliver on their commitments."

Ullmer says that the big difference between the periods 2000–04 and 2005–07 is that "we've put power back into the line, and now the line is responding." For example, the divisions have taken steps to streamline levels of management across their businesses. In addition, he says, "there's extensive use of Six Sigma and lean techniques." Several of the divisions are also launching pilot programs to offshore noncore processes.

These actions have not only reduced cost growth but have also "improved productivity, shortened service intervals, reduced risk, and improved customer and employee satisfaction." Accountability and a focus on costs, says Ullmer, are "proving very effective."

National Australia Bank: Accountability Cuts Costs, Enhances Service (continued)

Sustainability

Although cost management is vital, Ullmer insists that companies need to avoid falling into the trap of having a short-term focus. He explains that this is why accountability for longer-term performance as well as customer and employee satisfaction is critical.

Customer and employee satisfaction in particular, says Ullmer, can serve as early warning systems as to whether or not institutions are making the right decisions or investing in the right areas. Customer indices, he says, "will tell you whether or not you are performing adequately in the provision of service." Similarly, employee indices "will give you an idea of whether or not you are investing adequately in the business and making the right decisions."

Listening to its own advice, NAB has been investing approximately A$800 million to A$900 million (US$736 million to US$828 million) per year on a variety of new projects. For example, the bank recently consolidated its formerly separate back-office processes in the United Kingdom into a single operating system, significantly enhancing teller operations. Although it has reduced the total number of branches, the company is simultaneously refurbishing many locations. For example, in the U.K., it rolled out 36 newly designed locations. Described as integrated financial solution centers, these locations target middle-market and top retail customers. In tandem, NAB recently hired more than 600 "front-line, higher-value-added, customer-service-focused" bankers from competing institutions.

Cost-cutting initiatives are at times mandatory. For example, in 2005, declining performance forced the bank to close a quarter of the U.K. branch network and shave 20 percent of the workforce. But during this time, says Ullmer, by being open with employees and following through on promises to shore up the bank's competitive capabilities, commitment and satisfaction among remaining employees actually increased.

"The employees knew what had to be done," says Ullmer. "So when management articulated a clear strategy and then demonstrated its commitment to reengineer the business, our staff was able to get behind the initiatives." The fact is, he says, "we've been able to use cost savings to fund very significant improvements for our workforce and our customers." So not only are customers happier, "but we're striking a bargain with our employees. We're saying we will continue to reinvest in the business and put the resources where it will help our staff do more for our customers."

In this way, says Ullmer, "cost savings translate into better service for our customers and into higher employee morale and satisfaction." That, he says, "creates sustainability. That's our vision, and it's a vision that's understood throughout the group."

The Next Step

Banks that achieve ongoing low rates of cost increases without compromising customer satisfaction or employee commitment can create a powerful springboard for the future. Ullmer maintains that NAB is extremely well positioned today for an era of sustainable revenue and profit growth.

As for the next steps, he explains, "We're looking to evaluate what we can do at the group level to deliver shared infrastructure that can go across all of our businesses. What are the savings to be had from that? What efficiencies, flexibility, and scalability can we create by viewing operations from an overall perspective?" He acknowledges that questions such as these lead to an interest in new techniques such as process utilities, noting, "We're open to all good ideas."

5 percent or more, 35 percent failed to reach their goals. The average shortfall in savings was about 9 percentage points.

Avoiding the Pitfalls

One way to reduce the risk of falling short in a cost or efficiency initiative is to identify the challenges in advance. The survey revealed that the challenges that executives feel are the most significant tend to be those that increase complexity, making it more difficult for a bank to nimbly meet customers' needs or to operate in a cost-efficient manner. Some of the challenges are structural, such as an inflexible IT environment (cited as a challenge by 33 percent of respondents), multiple data repositories (21 percent), and fragmented technology (21 percent). Others are organizational, such as cultural challenges (26 percent) and business silos (22 percent). Still others relate to market or other external forces: variation in customer needs (29 percent), burdensome regulatory/compliance frameworks (25 percent), and multiple channels (21 percent).

Similarly, the survey asked respondents to think specifically in terms of cost reduction or efficiency-improvement initiatives that fell significantly short of expectations. The respondents cited a number of factors that accounted for those shortfalls*:

- Failure to align objectives to broader business goals (36 percent)
- Failure to adequately define objectives (32 percent)
- Failure to provide incentives (32 percent)
- Failure to obtain buy-in from key process owners (30 percent)
- Failures in communication/education (29 percent)
- Inadequate/inflexible technology (27 percent)
- Lack of senior management support/buy-in (23 percent).

Accessing the Tools

On the other side of the equation, the survey asked about the most valuable techniques for reducing costs or improving efficiency. Those mentioned most frequently were*:

- Business process reengineering (61 percent)
- Outsourcing (45 percent)
- Shared services (35 percent)
- Procurement/sourcing strategies (28 percent)
- Consolidation (26 percent)
- Lean techniques (25 percent)
- Six Sigma (18 percent)
- Offshoring (16 percent).

Ullmer of National Australia Bank (NAB) offers some good examples of these techniques. "Our approach is to do small pilots so that we learn as we go forward, in a low-risk way," he says.

For example, one of the company's operating units began "doing a portion of its accounts payable with a provider in Bangalore, India," Ullmer explains. During the first three months, NAB watched compliance with service-level agreements very closely. It became clear, says Ullmer, "that not only were they exceeding our expectations on the cost side of things, but the quality was just remarkable." In fact, "they were right on" in regard to every metric that the bank examined, from processing speed to detection of duplicate payments.

Upon a visit to his provider's operations, Ullmer was especially impressed by the caliber of the personnel. Virtually everyone at the facility "had a university qualification," he explains, "and they were all very professional." Consequently, NAB has decided to expand its use of offshoring into additional areas of operations, including credit card processing.

Of course, offshoring can be a sensitive area, particularly for employee relations. But here, says Ullmer, "we've been careful to work closely with our unions to make sure they understand the reasons we have to do this. Remaining competitive is critical, and the unions understand this."

* Respondents could pick more than one answer and therefore the answers add up to more than 100%.

Six Sigma training has been another NAB initiative. "We view this as a means of improving processes and lowering costs without sacrificing the quality of the process in any way," says Ullmer. Consequently, his institution encourages employees to obtain training in Six Sigma techniques. Currently, says Ullmer, the bank boasts more than 1,300 executives trained in Six Sigma.

The Emergence of Process Utilities

Process utilities go beyond traditional cost-cutting and efficiency-improvement techniques. They require a financial institution to more systematically analyze processes in search of features common throughout the whole organization or across geographic regions. The degree to which processes can be consolidated, optimized, and standardized determines their potential to become process utilities. For example, Den Danske Bank's standardized credit analysis model is a basic process utility (see "Den Danske Bank: The Pursuit of Scale," page 8).

Less than one-fifth (16 percent) of the executives surveyed said they were very familiar with the concept of process utilities. About half (54 percent) said they were somewhat familiar, and just under one-third (30 percent) said they were not at all familiar with the concept.

But as the research also shows, process utilities are a necessary evolutionary step in cutting costs and increasing efficiency. They represent the next stage of commonly deployed practices, such as shared services, outsourcing, and offshoring, taken to their logical conclusion and to an even greater degree of efficiency.

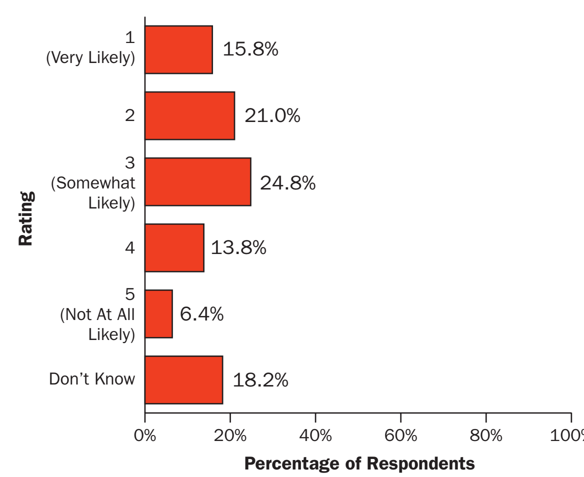
Martin Slumbers is the global head of investment banking operations for DB Operations International and Deutsche Bank's COO Organisation. According to Slumbers, Deutsche Bank views the concept of process utilities "as the means toward taking cost management to an entirely new level."

Even though executives are not yet intimately familiar with process utilities, they are climbing the learning curve at a rapid pace. For example, asked to rate their likelihood of applying the concept across their business lines using a scale from 1 (very likely) to 5 (not at all likely), 37 percent said they are very likely or likely, with an additional 25 percent saying they are somewhat likely to adopt process utilities (see Exhibit 3).

The survey also asked those participants whose organizations have already implemented (or are likely to implement) process utilities how important the practice is to their cost reduction goals. Nearly a third of executives described process utilities as having been very important (8 percent) or important (21 percent) over the past three years. However, when looking forward to the next three years, these figures rise dramatically. In terms of their relevance to future cost-cutting objectives, 64 percent of executives said they believe process utilities will be very important (25 percent) or important (39 percent).

Like other banks interviewed for this report, Deutsche Bank is no stranger to the pursuit of reduced costs and increased efficiency. Slumbers recalls that in

Exhibit 3
Likelihood of Implementing Process Utility Initiatives



Sources: Economist Intelligence Unit; Booz Allen Hamilton

Den Danske Bank: The Pursuit of Scale

With standardized processes at nearly every turn, Den Danske Bank is well on its way to a scale-based approach that makes intensive use of process utilities.

Many Brands

Den Danske has been Norway's largest bank for well over a decade. According to Tonny Thierry Andersen, CFO and member of the executive board, over the past three to four years, the group has been pursuing revenue growth from international retail banking operations. The result is a diversified financial-services company serving nearly 5 million retail customers in eight countries.

The company operates under many names. For example, in Denmark, the company is known as Danske Bank, but it also has an insurance subsidiary known as Danica. In Norway, it's called Fokus Bank. In Northern Ireland, customers know the institution as Northern Bank, and in the Republic of Ireland, the name is National Irish Bank. Both of these units were acquired from National Australia Bank in 2005. In mid-2007, the company added another major brand when it acquired Sampo Bank. The firm will continue to conduct business under this name in Finland and the Baltic States.

One Set of Processes

Along with pursuing growth through acquisition, a core component of the group's vision is cost containment. As Andersen explains, "Our strategy is to add scale to the business." Taking advantage of scale, he says, "requires standardization of processes."

Andersen says that the most distinctive element of the group's operations is the commitment to a single technology platform. "No matter where you go in our group, you will see the same systems," he explains. This applies both to customer-facing applications like the ATM network and to internal systems that serve functions such as finance, accounting, communications, or human resources.

Essentially, says Andersen, "the two pillars of our strategy are a commitment to many brands as well as a commitment to standardization and scale. In every instance where we acquire a new bank," he explains, "one of the first things we do is replace the existing IT platform with our own." Process utilities are a way to offer such standardization where possible, while preserving flexibility on the customer-facing side to allow for multiple brands.

Den Danske strives for standardization of not only systems but also management processes. For example, says Andersen, "We explain to our local CFOs that we want their internal reporting, no matter where they are in the group, to appear the same as anywhere else. The same procedures and the same key performance indicators are in place no matter where you are in the company." Such robust metrics are a key enabler of successful standardization and are a strong basis for the implementation of process utilities.

2001, "business performance was not at all what it should have been." In response, the group began an intensive look at its cost structure, among other initiatives. By 2005, Slumbers says, the company "had made great strides" by, for example, outsourcing some IT application development and other, similar tasks.

Still, he says, "We started thinking, Have we done enough?" Certainly, incremental outsourcing or offshoring can pay dividends. But given the likely business pressures and the competitive landscape of the next five years, Deutsche Bank needed "a way to evolve the management of costs into the next state. We wanted to create something that could generate significant competitive advantage not just in terms of costs but also in terms of best practices across a wide range of processes." One possible answer, says Slumbers, is the aggressive pursuit of process utilities. In mid-2005, he began exploring the concept with key executives.

"Banks—and Deutsche Bank is no exception—tend to organize themselves in silos," he explains; they typically adopt a model organized by business unit, product, or geography. Regardless of the structure chosen, Slumbers says, "it winds up creating silos. Whether it's foreign exchange or fixed-income bonds or whatever, the silos are everywhere."

However, silos may have similar activities. The promise of process utilities, Slumbers explains, "is that you look across all of these silos horizontally, find the common activities, then consolidate within processes that allow you to create economies of scale." For a large institution such as Deutsche Bank, "the opportunities are enormous."

Analysis: Which Banks Will Implement Process Utilities?

To find out which banks are most likely to implement business process utilities, we tabulated survey results by the responses to the following question: How likely is it that your organization will be applying the concept of business process utilities across its business lines? Respondents placed their banks in one of six categories: very likely, likely, neither, unlikely, very unlikely, and don't know. Analysis of the responses shows that the best indicators of whether an institution will implement process utilities are:

Familiarity with process utilities. The more familiar an organization is with the concept of process utilities, the more likely it is to implement them. Of those survey respondents who said that they were somewhat or very familiar with the concept, 84 percent said that they are either likely or very likely to apply it across their business lines.

Size of institution. The largest institutions were the most likely to say that they plan to implement process utilities. Of those banks with more than US$1 trillion in assets, 26 percent said that they are very likely to implement process utilities; for banks with less than US$50 million in assets, the number dropped to 14 percent.

Commitment to reducing costs. More than half of the total respondents reported that their bank is initiating a cost reduction and efficiency-improvement effort, or planning such an effort in the next three years. Of these, nearly half (47 percent) reported that it is either likely or very likely that their institutions will apply process utilities.

Experience in developing and improving business processes. Banks that either have developed or plan to develop business processes—such as IT application development, billing and account statements, account opening, payments, collections, deposit processing, credit/underwriting, and loan processing—are good candidates for implementing process utilities. About two-thirds of banks with business process experience in any of these areas said that they are likely or very likely to implement process utilities. Meanwhile, 43 percent of those who said they consider business process reengineering as critical for reducing costs or driving improved efficiency are either likely or very likely to apply process utilities, compared with 32 percent of those who did not report business process reengineering as critical.

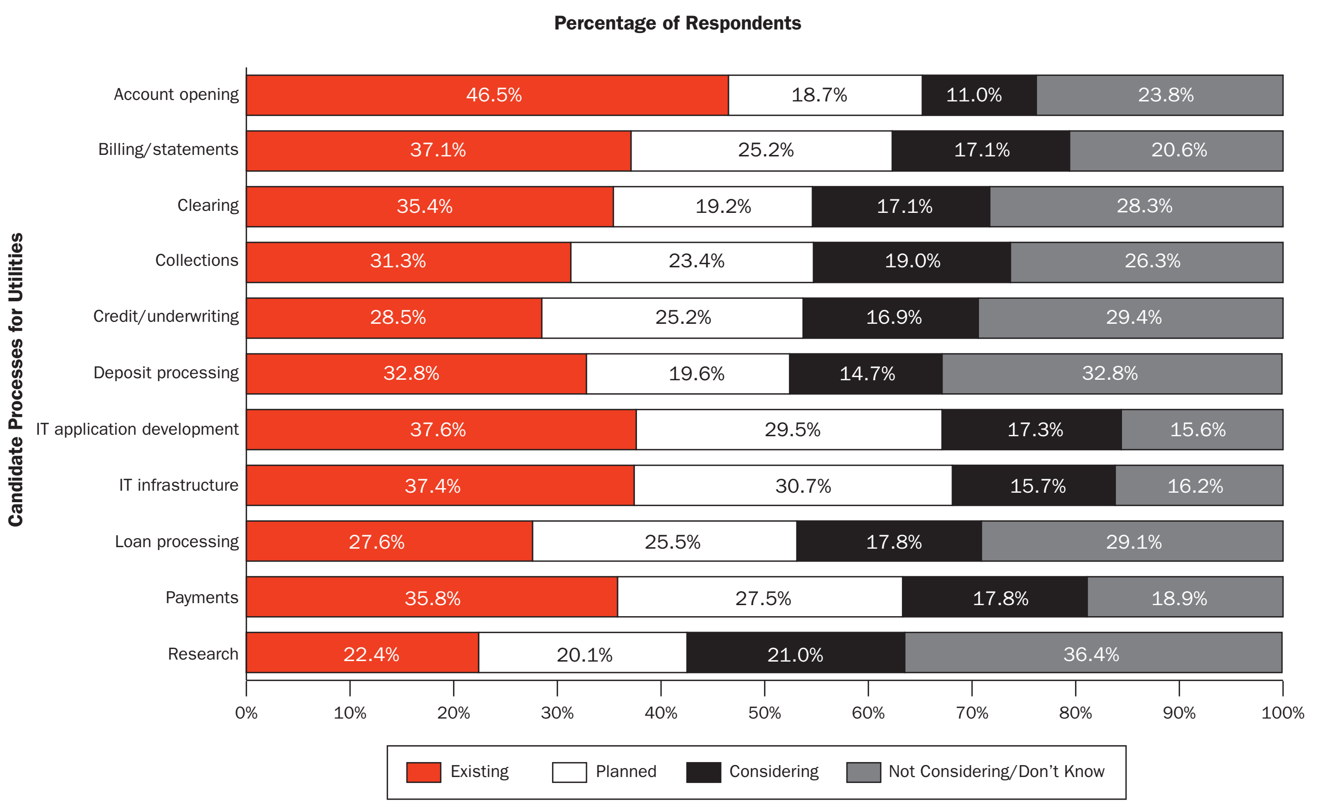
How process costs are charged back to business units. Banks are roughly twice as likely to favor process utilities when they base the price of processing on transaction volume, as opposed to determining fees by negotiation or allocation. Introducing a market mechanism provides an ongoing balance of supply and demand and ensures that process utility owners are competitive in both price and quality of service delivered. Further, it drives business unit buyers to be more thoughtful about their actual level of demand, making them more likely to focus on costs and make certain that processes are efficient.

Sector within financial services. Survey participants were grouped into 11 sectors, then were asked how likely they would be to use process utilities. The responses of the credit card company executives stand out from the rest: Half are very likely and a quarter are likely to apply process utilities. Diversified banking institutions are also rather positive, with 46 percent reporting they are either likely or very likely to apply process utilities.

Analysis: Which Processes and When?

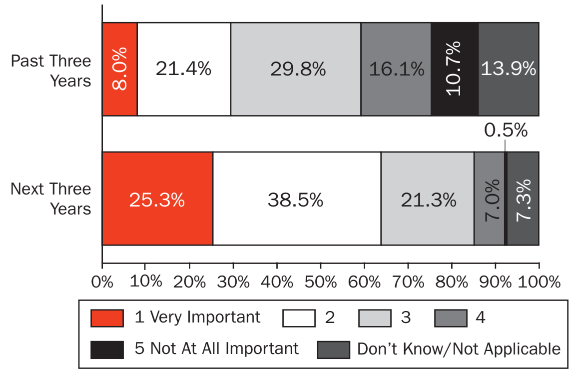
To understand which processes are likely candidates for inclusion in a program of process utilities, executives with live or likely initiatives were asked which processes were in production, in development, under consideration, or not under consideration/not sure. As expected, the processes most often chosen were those common to a wide range of business units, such as account opening, IT application development, and billing statements (see Exhibit 4).

Exhibit 4
Business Processes Most Likely to Be Included in Process Utilities



Sources: Economist Intelligence Unit; Booz Allen Hamilton

Exhibit 5
Importance of Process Utilities



Note: This question was asked only of participants who said their organization already pursues process utilities or is likely to pursue them in the next three years.
Sources: Economist Intelligence Unit; Booz Allen Hamilton

In terms of the specific time frames, 9 percent of survey respondents have already implemented process utilities, and 26 percent are in the process of doing so. Of the remaining respondents, those who had a firm time line for deployment were split between implementing process utilities in the next year (13 percent), the next one to two years (15 percent), and the next three years (14 percent).

Clearly, the concept of process utilities is beginning to command attention. Meanwhile, among organizations that have already deployed the strategy, its importance is on the rise (see Exhibit 5).

The Challenges and Benefits of Process Utilities

Companies implementing process utilities do so to realize a host of benefits. The benefits, ranked by the frequency with which they were cited, are*:

- Improved economies of scale (55 percent)
- Reduced complexity (47 percent)
- Greater consistency (37 percent)
- Increased customer satisfaction (37 percent)
- Faster speed to market (26 percent)
- Scalability (21 percent)
- Greater standardization/leveraging of industry best practices (18 percent).

Those who said their companies will not implement process utilities cited the following reasons*:

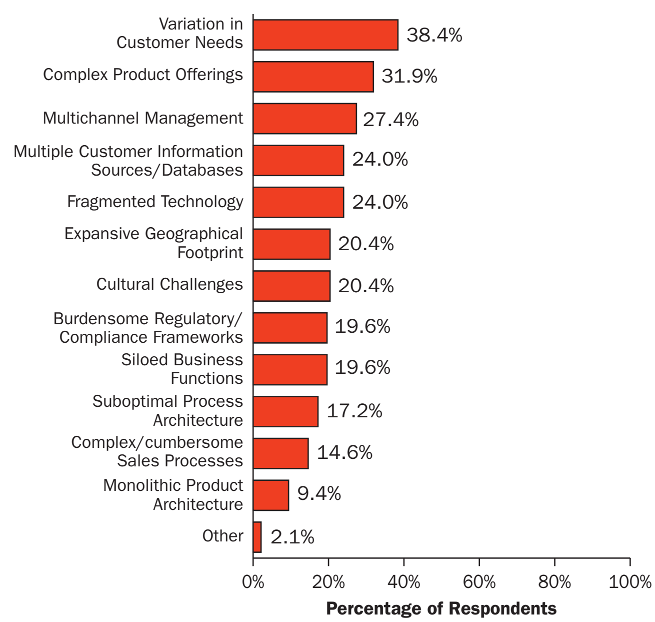
- Difficulty of implementation (29 percent)
- Resistance to standardization (27 percent)
- Uncertain/unproven payback (26 percent)
- Difficulty in establishing accountability for business results (18 percent)
- Resistance to consolidation (16 percent)
- Power struggles over ownership of process (15 percent)
- Cost control is not a critical strategy (15 percent)
- Potential service disruption (15 percent)
- Difficulty in establishing service-level agreements (15 percent).

In a closely related question, executives were asked what they believe would be the most difficult challenges in building process utilities (see Exhibit 6). The responses include*:

- Variation in customer needs (38 percent)
- Complex product offerings (32 percent)

continued on page 14

Exhibit 6
Most Difficult Challenges in Implementing Process Utilities



Note: This question was asked only of participants who said their organization already pursues process utilities or is likely to pursue them in the next three years.
Sources: Economist Intelligence Unit; Booz Allen Hamilton

* Respondents could pick more than one answer and therefore the answers add up to more than 100%.

Deutsche Bank: Process Utilities for Scalability, Durability, and Flexibility

According to Martin Slumbers, global head of investment banking operations for DB Operations International and Deutsche Bank's COO Organisation, process utilities represent "the next evolution, the next generation in operations management."

As Slumbers explains, the bank's implementation of the concept is taking place along two dimensions. First, the bank is unifying common processes—for instance, reconciliations, derivatives documentation, and some securities processing—"to harness scale, capability, and flexibility."

Second, the group is adding an element of structured round-the-clock processing using an "offshore/onshore/near-shore" model. With processing centers in India, England, and the United States, the model "meets the needs of clients 24 hours a day," says Slumbers. Meanwhile, it also "manages multiple common risk factors and process load-bearing needs for the bank." Overall, says Slumbers, the bank can now manage its processes "seamlessly, globally, and continuously."

A Fundamental Change

A big part of all this—and probably the most significant challenge, according to Slumbers—is migrating the group's business managers toward a new form of relationship with their process provider. In the past, Slumbers says, managers began to think of their outsourcing providers as part of their own extended business family. "They view [the providers] as 'their people' in India, and if you ask [managers] to give it back, it's as if you're asking them to give up their arm."

Any relationship with a captive process utilities provider would be decidedly less personal. Specifically, says Slumbers, such relationships tend to incorporate agreements "that specify ongoing cost reductions" year on year.

The situation is further complicated by the number of outsourcing arrangements that are already in place. In the past, says Slumbers, "we encouraged a great deal of outsourcing and offshoring." If, for example, a manager needed to reduce costs, "he would migrate a number of positions to an outsourcer."

Consequently, the bank has multiple arrangements in place, with many contracts lasting from three to seven years. Although each agreement made sense at the time it was executed, in the new era of process utilities, the contracts "are inhibiting efficiency and savings," says Slumbers. So now, he explains, "we'll be gradually unwinding these relationships."

The Importance of Documentation

Another key challenge in creating globally standardized process utilities, says Slumbers, "is creating a methodology, both for documentation and for implementation."

When a process is moved offshore and shuttled among three processing locations around the clock, "the details become very important," he says.

Deutsche Bank: Process Utilities for Scalability, Durability, and Flexibility (continued)

Contrast the situation "to where you are running a process strictly in the U.K. or the U.S.," he suggests. "There you have people with great experience who've done the process for years. There's institutional knowledge." So when operations are moved to a process utilities model, "you have to clearly document what has to be done, when, why, and how."

Today, says Slumbers, "our operating model is all about standardizing and industrializing our processes." The goal, he says, is to "reengineer and standardize so we are continually moving more and more activity into a lower-cost, more automated mode of operation." That means that even amid growth, rising transaction volumes, competition, and margin compression, the scalability, flexibility, and incessant cost optimization/reduction inherent in a process utilities focus "will keep the bank ahead of the pack."

Though process utilities do tend to standardize processes, Slumbers is quick to point out that there is still room for flexibility. The distinction, he says, "is that the customization needs to reside within the process itself and not in any way within an individual or manager." As Slumbers explains, "Flexibility can be built into the system, into the process. In no way does this have to become a puritanical 'you do it this way and no other' approach. Standardization and customization have to go hand in hand in a sort of balancing act. What you do not want is to wind up with a Model T: 'You can have this in any color, so long as it's black.' We want industrialization, but at the same time, we're not asking businesses to go backward."

Start Slow, Finish Strong

Getting started on the road to process utilities required a "go slow" approach. As Slumbers recalls, "We spent about six months building the overall business case, socializing the idea within the organization, and generally making sure that people at senior levels were comfortable with the idea." It was also important, he says, "to get people thinking that this wasn't just a cost play. This is a completely new operating model: building capacity, scale, and flexibility, and gaining greater insight and control of processes at remarkably low costs per transaction."

By January 2006, Deutsche Bank was out of the gate and running with "a low-end reconciliations process," says Slumbers. Though a carefully conceived and relatively low-risk play, he recalls, "I still wasn't ready to declare things a success until the end of the third quarter."

Today, however, the group is "very comfortable" with the approach and is substantially increasing the rate at which it implements new processes. For example, today a captive operation covers not only the reconciliations process but also derivatives documentation, cash management, trade finance, and some securities processing (fixed income and equity).

Slumbers believes Deutsche Bank is on to a next-generation financial-services operations model that will enhance profitability and competitiveness for many years into the future. The operation is "scalable, durable, and flexible," he explains. "What we are doing is ensuring that our operating costs, our cost per trade, will be very competitive, if not industry leading." That, says Slumbers, "is good for our shareholders and good for our customers."

- Multichannel management (27 percent)
- Multiple customer information sources/databases (24 percent).

The survey also asked executives what savings, actual or anticipated, accrue from the practice. Overall, 13 percent of these executives said process utilities will yield savings of more than 15 percent of the total relevant cost base, while 16 percent anticipated savings of 11 to 15 percent. About a third (30 percent) anticipated savings in the 6 to 10 percent range, and a quarter said they believe their initiatives will generate savings of 1 to 5 percent.

These executives were also asked how they currently bill or plan to bill internal customers for services rendered by a process utility. Here the findings show a broad range of views and practices:

- By allocation (32 percent)
- By transaction volume (27 percent)
- Not sure/don't know (25 percent)
- By negotiation (16 percent).

Finally, the survey asked who currently has responsibility for the performance of process utilities (or is likely to have it when the practice is implemented). The most frequently cited arrangement gives the reins to the COO (29 percent). But other likely executives include the CEO (20 percent), the head of operations (17 percent), and the CFO (10 percent).

Conclusion

Revenue growth has been and remains the highest strategic priority of financial-services firms. But the importance of managing costs and improving efficiency cannot be overstated. Investors are likely to penalize companies that fail to achieve scale, allowing growth in costs to outpace growth in revenue.

Financial-services companies are pursuing a broad range of cost-control initiatives, including traditional business process engineering, outsourcing, lean techniques, Six Sigma, and offshoring. Process utilities can leverage these techniques by looking across historical divides between business units, geographies, and functions to identify new opportunities for increasing returns to scale.

As with all new and emerging approaches, building a process utility for the first time can be difficult. Executives from banks that have already pursued process utilities say the concept is new enough to require a period of discussing the idea and providing information to ensure that both senior management and line managers are comfortable with it.

Furthermore, growth-oriented executives need to understand that process utilities are more than a cost play. Their potential benefits include increasing flexibility, promoting access to best practices, encouraging the design of more flexible or efficient processes, and providing greater insight into and control over processes. That leads to better execution throughout the company. Process utilities can make operations more consistent, which will bring about not only greater speed and better customer service but also lower risk. In doing so, process utilities support all of a financial institution's top priorities for growth, costs, and improving the customer experience.

Analysis: Process Utilities Winners and Losers

Not every bank benefits from process utilities, and different types of banks face different implementation challenges. Large banks, which can leverage economies of scale, have more potential to reduce costs than do small banks. Organizations with decentralized back-office operations can face severe challenges in building utilities (though they may ultimately benefit more from them).

To find out which banks have made the most progress, we used clustering techniques to classify survey respondents by attitudes toward process utilities. (Clustering is the process of organizing data into groups whose members are similar in some way.) This process yielded four bank "personalities":

- Rich and Rewarded
- Trying and Failing
- Little Laggards
- The Faceless Crowd

Cluster 1: Rich and Rewarded

With 180 banks, Cluster 1 is the second-largest group. These banks represent the true believers in business process utilities, and they are reaping the benefits. Ninety percent are very or somewhat familiar with the concept of process utilities. About two-thirds are either implementing them now or have already implemented them.

This group shares the lead with Cluster 2 (Trying and Failing) both in establishing a baseline level of savings or efficiency and in reporting the highest level of savings that could be achieved in business processes through process utilities. However, the Rich and Rewarded cluster is highest in actually achieving savings or efficiency.

Rich and Rewarded banks are most likely to report that they are in the lowest 20 percent in terms of cost-to-income ratio. Publicly available financial data confirms that half of these banks were in the top 40 percent in terms of efficiency ratio in 2006.

Cluster 2: Trying and Failing

Cluster 2 is a small group of 49 large banks—more than one quarter have more than US$1 trillion in assets—that are working hard on efficiency. This cluster contains the largest proportion of banks to have initiated major cost reduction or efficiency-improvement strategies in the past three years. Not surprisingly, these banks are also addressing the largest cost base in these initiatives (39 percent are targeting a cost reduction of more than US$1 billion). As noted above, this cluster shares the lead with the Rich and Rewarded group in terms of establishing a baseline level of savings or efficiency.

Analysis: Process Utilities Winners and Losers (continued)

However, success has been elusive. This group contains the smallest proportion (8 percent) of banks reporting that they belong to the top 20 percent for cost-to-income ratio, and their negative self-assessment is accurate. According to public financial data, only 8 percent were in the top 40 percent in terms of efficiency ratio in 2006. Furthermore, only 7 percent of this group were in the top 40 percent of revenue growth for 2006.

More than half of the Trying and Failing respondents are based in Western Europe, a notoriously high-cost and complex business environment. Despite progress in moving toward a single financial-services market, banks in the European Union remain organizationally more complex than those in North America. This may make it more difficult to reduce costs.

Cluster 3: Little Laggards

This small cluster of 55 banks contains mostly smaller banks—half have less than US$10 billion in assets—that generally do not understand process utilities and are not implementing them. Eighty-seven percent of the Little Laggards are unfamiliar with the concept of process utilities, and 69 percent are unlikely to pursue them. Furthermore, 44 percent of respondents from these banks do not know how they would charge internal customers for process utility work.

More than a third of these banks have failed to establish a target level of savings or efficiency improvement, and many have little interest in cost reduction initiatives. Those that have tried to reduce costs have addressed only a small cost base (64 percent targeted less than US$250 million in their initiatives).

The Little Laggards and Cluster 4 (The Faceless Crowd) share several characteristics. They contain the smallest proportion of banks reporting that they have initiated a major cost reduction or efficiency-improvement strategy in the past three years. Where there is an initiative in place, they are most likely to report that it is too soon to tell whether it will be effective. Both clusters report the smallest cost base to be addressed by the initiative.

Cluster 4: The Faceless Crowd

The largest cluster of 216 relatively small banks has the fewest distinguishing characteristics of the four clusters. They don't appear to be overly concerned about costs. Along with the Little Laggards group, this group has a small proportion of banks that have initiated a major cost reduction or efficiency-improvement initiative in the past three years. Where programs are in place, these respondents are most likely to say that programs are not yet complete and the ultimate savings are unknown.

What Booz Allen Brings

Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 90 years. Providing consulting services in strategy, operations, organization and change, and information technology, Booz Allen is the one firm that helps clients solve their toughest problems, working by their side to help them achieve their missions. Booz Allen is committed to delivering results that endure.

With 19,000 employees on six continents, the firm generates annual sales of $4 billion. Booz Allen has been recognized as a consultant and an employer of choice. In 2007, for the third consecutive year, *Fortune* magazine named Booz Allen one of "The 100 Best Companies to Work For," and for the past eight years, *Working Mother* has ranked the firm among its "100 Best Companies for Working Mothers."

To learn more about the firm, visit the Booz Allen Web site at www.boozallen.com. To learn more about the best ideas in business, visit www.strategy-business.com, the Web site for *strategy+business*, a quarterly journal sponsored by Booz Allen.

Contact Information:

CLEVELAND

J. Scott Cade
Principal
216-696-1738
cade_scott@bah.com

NEW YORK

Tim Hoying
Vice President
212-551-6490
hoying_tim@bah.com

Booz | Allen | Hamilton

Worldwide Offices

Asia Australia New Zealand

Bangkok
Beijing
Brisbane
Canberra
Hong Kong
Melbourne
Seoul*
Shanghai
Sydney
Tokyo
Wellington

Europe

Amsterdam
Berlin
Copenhagen
Dublin
Düsseldorf
Frankfurt
Helsinki
Istanbul*
London
Madrid
Milan
Moscow
Munich
Oslo
Paris
Rome
Stockholm
Vienna
Warsaw
Zurich

North America

Aberdeen, MD
Annapolis Junction, MD
Arlington, VA
Atlanta
Boston
Chantilly, VA
Charleston, SC
Chicago
Cleveland
Colorado Springs
Dallas
Dayton, OH
Detroit
Eatontown, NJ
Falls Church, VA
Herndon, VA
Honolulu
Houston
Huntsville, AL
Leavenworth, KS
Lexington Park, MD
Linthicum, MD
Los Angeles
McLean, VA
Newark
New York City
Norfolk, VA
O'Fallon, IL
Omaha
Parsippany, NJ
Pensacola, FL
Philadelphia
Rockville, MD
Rome, NY
Salt Lake City
San Antonio
San Diego
San Francisco
Stafford, VA
Tampa, FL
Washington, D.C.

Latin America

Bogotá
Buenos Aires
Caracas
Mexico City
Rio de Janeiro
Santiago
São Paulo

Middle East

Abu Dhabi
Beirut
Cairo
Dubai
Riyadh

* An associated firm

The most recent list of our office addresses and telephone numbers can be found by clicking the Worldwide Offices link under About Booz Allen on www.bozallen.com.

3/08 PRINTED IN USA