

Better operating models for financial institutions

Article at a glance

Financial institutions are under pressure to expand their business volumes while maintaining or reducing the cost of transactions.

Operations and IT executives in the financial industry typically respond by implementing discrete cost reduction or performance-enhancing measures, such as offshoring and lean techniques.

A more effective transformation will come if financial institutions redesign the operating model they apply to their processes from end to end, from customer interface to back-office transactions.

This article is part of a special section on improving operations in banking institutions. A related article, “Merging bank operations across borders,” takes a look at successful operating models in cross-border banking mergers.

Banks and brokerages frequently can reduce operating costs by adopting one or two performance-improvement measures. Bigger rewards await those that can conceptualize a broader redesign.

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Every operations and IT executive knows the dilemma: how to support rising business volumes without allowing costs to grow in parallel. Many have used a range of traditional levers—centralizing shared services, automating transactions, or tapping the global workforce—to reduce labor and transaction costs. Far fewer have taken the comprehensive approach of evaluating the entire operating model they apply to their core processes, with the aim of lowering unit costs while increasing quality and customer service.

By “operating model,” we mean the way people, technology, and processes interact to deliver a common objective, as well as where these resources are located and who owns them (exhibit). The term can be applied very broadly—to a finance function, to a pharmaceutical company, to a university. In financial organizations, it would include processes such as claims underwriting, trade execution, and settlement. In this article, we show how some financial institutions, by rethinking all the elements of an end-to-end process, are beginning to realize enormous benefits compared with others that focus on only one or two elements of the process—such as offshoring certain tasks without considering interactions with technology or potential process improvements.

Taking a bold approach

Leading financial firms have been prompted to take comprehensive measures by an unprecedented set of challenges to their profitability. First, in many markets in North America and Europe, the customer base is maturing while the pace of product innovation has slowed. At the same time, industry incumbents confront an array of new competitors pursuing the same customers they do but with fresh services and delivery methods.

Complicating matters are increasingly stringent regulatory regimes, which may be standardizing across international boundaries but appear unlikely to loosen anytime soon. Finally, customers of all shapes and sizes have grown more savvy and demanding, thanks in part to the rise of competition and greater transparency in product features and pricing. As these external pressures squeeze traditional financial organizations, the question of how to marry growth with stringent cost controls becomes ever more acute.

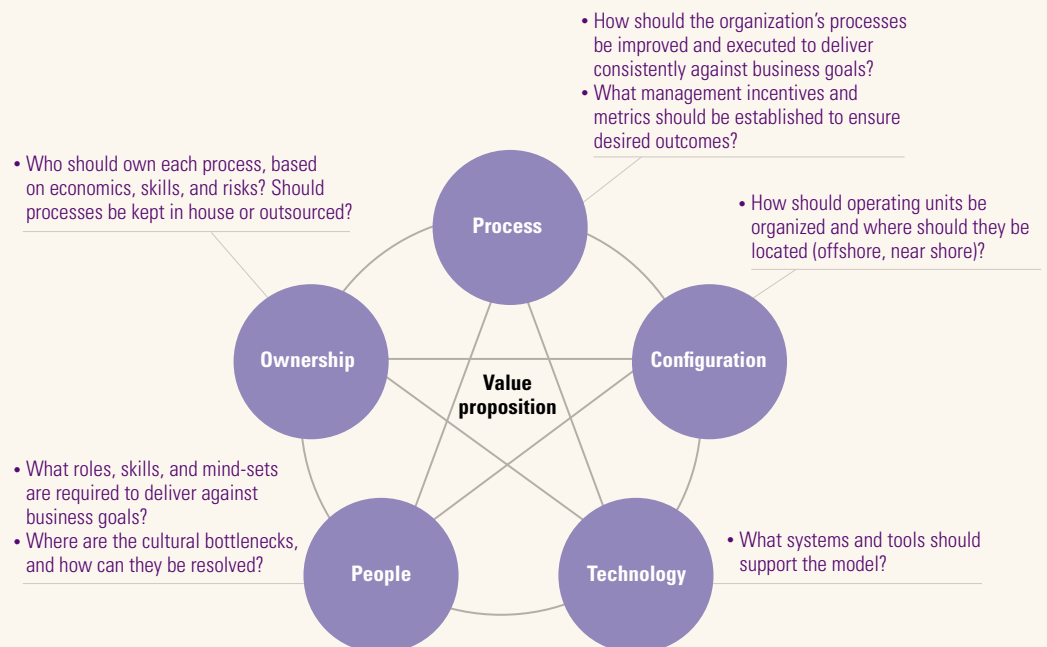
Fortunately, if some external trends are making life more difficult, others favor the changes these companies need to make.

1. *Global sourcing.* Foremost among these trends is the rising quality and accessibility of resources in low-cost locations, combined with inexpensive telecom bandwidth for managing operations remotely. Financial industries have led the way in tapping global labor markets to run their back-office operations, and now they can exploit their experience of coordinating these activities across remote locations to offshore even more advanced operations.
2. *Technology.* The financial sector is also ahead of others in adopting IT systems for the rapid and accurate capture of data, inexpensive information storage, and high processing capacity and performance, as well as the ability to share and process data across multiple locations.

Exhibit

Evaluating the operating model

A comprehensive approach can deliver lower unit costs at higher volumes while increasing quality.



3. *Process improvement.* A third enabling factor is the financial sector's adoption of process-improvement methodologies, including lean techniques and Six Sigma, that got their start in industrial settings but are now increasingly applied to service organizations. A core principle of these techniques is to change mind-sets by teaching employees how to improve a process constantly. Once trained, these employees can become effective internal change agents, spurring transformation across the organization.

Although a redesign of this scope is not easy, our work with several leading banks, securities firms, and insurance brokerages has clearly demonstrated its value. First, when senior managers focus on the process as an end-to-end chain, they are less likely to view the front end as more important than the back. This is important because applying changes to one part of the process inevitably affects others. Reviewing the entire chain of elements that make up a process uncovers opportunities for profitably scaling the business by freeing up capacity while maintaining or reducing unit costs. In addition, a comprehensive approach can drive focus: while managers often confront a variety of initiatives pulling them in different directions, a bold redesign can unify and clarify direction, leading to speedier execution and less internal squabbling.

Priorities of a redesign will differ from one financial industry to another. For one example, see "Rethinking wholesale-banking operations," on mckinseyquarterly.com.

Finally, by putting everything on the table at once, a broad redesign effort makes it more difficult for any unit leader to remain recalcitrant. At one insurer, for instance, candid conversations around redesign allowed senior-executive peers to challenge one another's sacred cows—a level of scrutiny that probably would not have happened if improvements had been tackled one division at a time. As a result, leaders were more willing to accept change in their programs, since the alternative was to appear obdurate while others cooperated.

Overall, the benefits of a comprehensive redesign outweigh the challenges. The proviso is that a transformation on such a scale must be embraced wholeheartedly and planned carefully if it is to get off the ground and create a substantial and lasting effect.

Undertaking the redesign

In applying the five elements of an operating model to end-to-end processes, banks must be careful to balance some ongoing fundamental operating requirements against the need to create capacity for new growth. Thus, they must continue to deliver a broad portfolio of products and services across a wide-ranging client base while managing the associated risks. Complicating the challenge are shortcomings common to many financial institutions' operations and IT organizations, including highly fragmented operations and technology platforms (sometimes the result of inadequate postmerger integration); inconsistent alignment around which capabilities are best shared and which should remain specific to a particular line of business; and a lack of firmwide standards in, for example, data, interfaces and functional performance.

Applying the operating model approach to an institution's end-to-end processes can help remove these barriers. A necessary first step is to design an operating architecture—a structure for all the processes and the way they are organized—aimed at creating

transparency, simplifying the value chain, ensuring accountability, and delivering on the key performance metrics that matter to customers. The central principles of such an architecture may include the separation of processes into those initiated by a customer, those that are necessary to support a product, and those that support the institution's needs. The architecture could also organize processes by relevant customer segment to deliver a package of integrated services to each group in a better way. The management of and accountability for each process also should be described and clarified up front.

Once this architecture is in place, the focus should turn to improving the institution's processes. As noted, each end-to-end process can be optimized by applying the operating model concept—that is, by considering the people, technology, process structure, ownership, and location and by determining the best ways to improve each combination. The selection and sequencing of specific improvement initiatives will differ from one process to another, as well as from one company to another. Common improvement levers include rationalizing the number and types of applications, consolidating operating and technology groups, calculating the right amount of outsourcing and offshoring, building more scalable platforms for operations and IT, and redesigning processes with a lean mindset. (For a more detailed example of operating model redesign, see sidebar, “Redesign in property and casualty insurance.”)

The sequencing of these improvements will depend on a range of factors—for example, the time required to set up a shared-services center, the speed at which the center can accommodate processes, and whether a process should be automated before or after the shift to a lower-cost location. Sequencing may also be affected by the prioritization of business initiatives or by regulatory constraints on the ability of business units to move rapidly on specific actions. All told, bank executives should anticipate a three- to five-year time horizon for a realistic redesign road map, with a strong emphasis on pilots in the early months. This approach may seem excessive, but making progress through narrowly scoped, poorly orchestrated efforts ultimately will require even more time and investment.

Getting it right

Successful redesigns align all five elements of an operating model in order to deliver value to customers by lowering costs, improving service, and generating appealing new products. Operational and technological enhancements should aim to achieve high productivity (measured in terms of the lowest cost per transaction) and high quality of service (measured, for example, by error reduction, the speedier delivery of new products and services, and consistency of service levels). Strong governance is required, often redrawing boundaries for control over organizational and geographic units and changing focus from annual budget-based management to the continuous monitoring and improvement of operational performance. Our work with leading financial firms identifies five key steps to ensure successful transformations.

Determine the right time to start

Redesigning an operating model requires broad organizational change to execute a transformational (rather than incremental) set of improvements. Companies that undertake such a program must be willing to commit significant time and resources to achieve

these ambitious goals. Those that do so tend to be responding to one or more serious business challenges.

1. *Ambitious growth objectives.* Many companies undertake the redesign of end-to-end processes as an essential component of achieving ambitious growth objectives. Often, this scale of growth cannot be realized profitably without significantly rethinking operations and technology in order to keep unit costs down.
2. *Competitive threats.* In some instances, a threat from new, more nimble entrants forces established players to rethink their operations and IT fundamentally to keep pace. When incremental changes are not enough to protect market share, a more comprehensive redesign will be required.

Redesign in property and casualty insurance

Jeffrey H. Chookaszian

A property and casualty insurer that focused on personal lines and small commercial segments had higher costs than its competitors. A weak postmerger integration effort had left it with multiple systems. Less than 30 percent of its application processing and underwriting was automated. In addition, the company had a record of slow processing for applications and claims, low satisfaction among customers and agents, and a limited ability to gain market share.

Facing these barriers, the organization decided to review its operating model with the aim of boosting its growth capacity without adding employees, strengthening its relationship with agents by dramatically improving service levels, and significantly reducing transaction costs. The company's redesign team spent three months diagnosing the existing model and designing a new one. Three initiatives in particular emerged as key to helping the company achieve its goals.

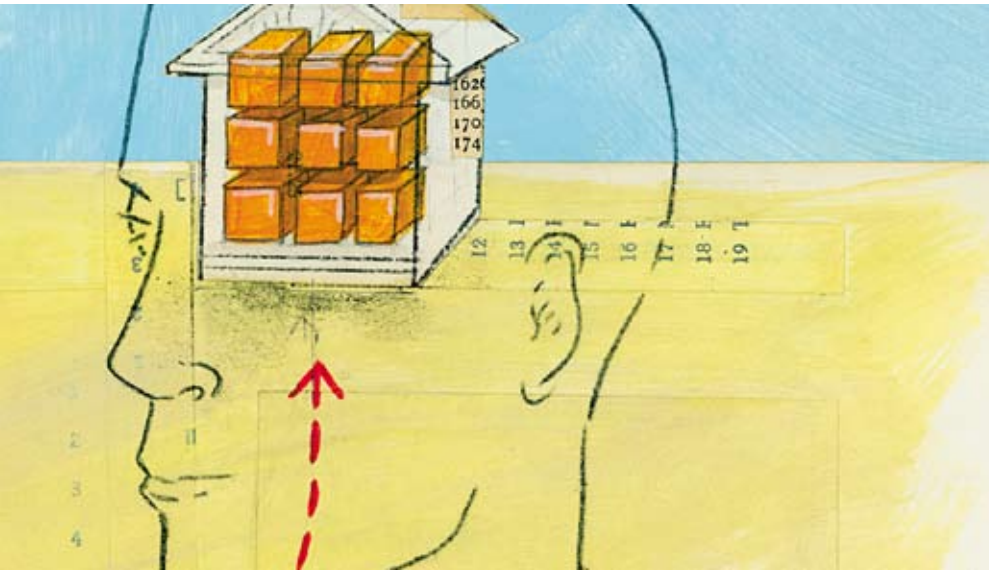
1. *Consolidation.* By combining lower-value underwriting activities in two large service centers, the insurer converted 20 full-service branches into a network of thin branches primarily focused on new-business underwriting for midsize and large agencies. Centralizing activities such as renewal preparation, small-account underwriting, and the processing of changes in coverage helped the organization to free up 20 percent of the underwriters' time to focus on building agency relationships and improving service responsiveness.

2. *Automation.* The insurer used rule-based expert systems to increase the percentage of applications that were underwritten automatically. The efficiency, quality, and consistency of underwriting decisions went up as a result. The company also improved its self-service capabilities for customers and agents by making common service tasks (such as billing inquiries and changes to policies) available online, thereby reducing transaction-processing costs by 20 to 30 percent at the same time.

3. *Process improvements.* The insurer focused on improving parts of the process that are critical to the buying decisions of customers and agencies. In particular, turnaround times shrank and responsiveness improved (as workloads were balanced across underwriters) and error rates fell, minimizing rework.

By taking a holistic look at the operating model, this carrier was able to build a platform for growth and refocus its business on the most valuable distribution partners, all while reducing costs.

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3. *Change in focus and positioning.* In other cases, companies may be launching new products or services, extending existing services, or entering new markets. Without a redesign, existing processes may not be able to cope with the additional demands.
4. *The complexity of the required change.* Companies sometimes find that applying only one or two improvement techniques doesn't go far enough: a more comprehensive program of change (redesigning the entire operating model) is required.

Define goals

Setting ambitious and transparent productivity and quality goals creates a sense of urgency and helps managers and staff to understand what is being asked of them. Some redesigns fail because they are launched without a clear view of how and where the operating model is to be applied and what results are expected. While general goals such as higher productivity or lower costs may be made explicit, details a level or two down—such as key metrics, with quantitative targets—are often left undefined too long into the process.

To avoid such pitfalls, operational targets (including productivity goals and quality levels) must be articulated at the start of the redesign. In banks, for example, metrics to measure these productivity goals include costs per transaction, credit applications per day per person, and approval times for products such as mortgages.

Set a clear vision based on end-to-end customer needs

Successful operating model redesigns begin with an understanding of customer needs and the current constraints on growth. Most companies have one organization facing inward to operations and another facing outward to customers, and for many years the front line and senior management have seen the back office as a second-tier partner. A common goal of operating model redesigns is to close the gap between the two parts of the organization and create an integrated view of processes that run from customer contacts back through operations.

Govern for the long term but maximize short-term impact

Some redesigns fail because of weak or ambiguous governance, yielding a series of pilots that fail to change the organization significantly. To demonstrate the value of the comprehensive approach to redesign, the implementation program should be designed to ensure early wins. These gains should then be used to showcase the program and broaden organizational support. At one international bank, for example, early successes were instrumental in converting a number of managers from skeptics into enthusiastic supporters.

Provide for a flexible migration path

Finally, successful transformation programs provide for flexibility as the organization learns. While the vision must be clear from the outset, most banks will launch early initiatives before the end-state operating model is fully fleshed out. This move is essential to gain quick wins in order to build momentum and deliver cost savings that can be reinvested in the program. By identifying unanticipated roadblocks, these early initiatives will also help managers plan the rest of the journey—for example, by spotlighting the need for new skills and people within the organization or the imperative to work with regulators to reduce the difficulty of operating across borders.

Every financial institution has its own culture, so each will have to manage change within bounds acceptable to its leadership. In most cases, it will have to look beyond its existing organization for new skills, hiring or retraining where necessary. In all cases, organizations must clearly articulate the need for broad change, build the momentum to get programs moving, and remain committed so that enthusiasm remains strong from conception to completion. **MoIT**

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