The Networked Bank: Utility Concepts to Transform the Operating Model

By taking a utility approach to service delivery, banks can increase their cost-control initiatives across geographies and business divisions, advance new growth opportunities, standardize operations and improve the client experience.

Executive Summary

Industrialization helps banks cut operational costs, protect eroding margins and build a leaner, more standardized operating model for lowering risk and supporting revenue growth. While industrialization in the banking industry is not a new concept, it remains in the early stages. Yet the complexities arising from multiple, fragmented and redundant processes – often manually controlled – underscore the need for banks to focus on transforming their operating framework.

Industrialization impacts all areas of banking, including business development, regulatory compliance and operations. By nature, business operations are the most amenable to industrialization, followed by regulatory controls (when based on a robust operational foundation) and select client services activities. Back-office processes – including post-trade securities processing, cards processing, mortgages and trade finance – are also affected by industrialization.

One way to industrialize a bank is through the creation of a utility – or shared services – model that can be employed internally, or externally to support multiple banks. The utility approach helps ensure the most efficient use of resources, and helps keep costs under control. However, setting up this type of environment requires executive commitment at the highest level, combined with a strategy backed by a strong operating model and effective program governance. In this white paper, we will examine key considerations that a bank needs to address when setting up internal and external utilities.

Banking on Industrialization

Before we can understand the fundamentals of industrialization, it is important to know the forces that have led to its emergence in the banking industry. Although the industry has survived the financial meltdown, growth has been stymied by structural change, driven by risk management-related regulations.

Historically, the banking industry evolved primarily by piggybacking on rapid growth – an approach that often led to fragmented operating models. To address customer needs, banks regularly offered
Banks realize that profound changes are required if they are to sustain long-term growth – compelling them to explore how to architect new operating and business models to leverage their cost structure.

Given this backdrop, it is important to understand what an industrialized bank looks like. Conducting an activity in an “industrial way” implies being able to efficiently handle large volumes on a very large scale. Take a manufacturing company, for example. The company decomposes its production value chain, then recomposes it to make it possible for various functions to be supplied by the most efficient provider (either internally, or through a third party). The company then assembles the components needed to best fulfill customer demand.

Traditional industries have embraced industrialization to drive growth and profitability. A bank’s transactions, processes and information flow can be viewed in ways that resemble a manufacturer’s products, production lines and supply chains. Inspired by the latter, banks are embarking on a similar transformational approach – a significant shift from the 1990s and even the early 2000s, when banks’ mindset would never have considered this option.

### Lowering Margin Pressure Beyond Pure Cost-Savings Initiatives

![Profits-Before-Tax (USD bn) and Income-to-Assets Ratio (%) of Top 1000 Global Banks (by Assets), 2008-2012](image)

Source: Capgemini Analysis, 2013; The Banker Database, July 2013

Figure 1

Innovative financial products and, in the process, deployed tactical operating models and systems to be ready to take on new business. In the initial stages of this trend, due to high revenue growth, the return on equity (ROE) of these models justified the investments made, but also lessened the focus on efficiency and integration. With competition growing steadily over the last decade, the profitability associated with particular products or business lines eroded. Operating models stymied by poorly integrated systems and under-utilized resources were duplicated across business and/or product lines – resulting in even more margin pressure.

Overall, this situation led to the erosion of top-line growth, as well as the erosion/stagnation of bottom-line growth for some global banks. As shown in Figure 1, for major global banks, decline in some of the key performance metrics such as income-to-assets ratio over the last four years has rendered these institutions’ business models obsolete – necessitating the need for them to optimize their operating costs. Today, banks realize that profound changes are required if they are to sustain long-term growth – compelling them to

**Business Activities Ripe for Industrialization**

Industrialization in manufacturing succeeded because companies were able to pull apart specific business processes and outsource their operations – or even sell them. This allowed room for standardization, innovation and better quality. But processes in banking are not easily componentized. They are tightly integrated with the entire value chain, and come with added complexities, such as product- or geography-specific requirements. As banks seek to embrace industrialization, they need to assess, scope and identify processes, as well as look for key upside opportunities. Important questions institutions should ask include:

- Is the business process core (customer-facing/revenue generating) or non-core (operational/regulatory)?
- Is the process standardized and streamlined?
- Does the process offer sufficient scale in terms of volume?
- Can the process be easily automated?
Banks can generally segregate their overall operational activities (capital markets, wholesale banking, retail banking, etc.) into new business, taking into account regulatory needs and core business operations (see Figures 2 and 3). In this whitepaper, we will provide our broad perspective on the points below:

• Banking activities amenable for industrialization and further aligned according to the nature of the activity - client-focused, product-based or pure-play process.

• The suitability of different operating arrangements for various banking activities.

We have also included a brief overview on various operating frameworks.

Achieving Differentiation in the Front Office

Achieving differentiation in back-office areas is almost impossible. Plus, there is the growing

- Client Services
- Research Services

- Regulatory Reporting
- Records Verification (e.g. Client data)
- KYC Verification

- Clearing & Settlement
- Corporate Actions
- Reconciliation
- Payments Processing
- Reference/Master Data
- Collateral & Margin Mgmt.
- Asset Optimization
- Asset Servicing
- Compliance & Risk Mgmt.
- Credit Checks
- Loan onboarding
- Loan & Collateral Documents
- Lending & Deposits
- Tax Accounting
- Ledger Accounting
- Post Closure Audit (Lending)

Figure 2

Figure 3

• Can the process be independently operated or outsourced with minimal control, and without increasing operational risk?

• Does the process offer enough scope for cost reduction and/or revenue enhancement?

Operational Task Segmentation
need for banks to free up expertise and resources from operational tasks to re-focus on customer-facing activities and business execution. This situation is driving banks to concentrate on driving new business through innovative products and services that can create differentiation and fortify the brand.

As banks ride the industrialization wave, they concentrate on IT and operations standardization, especially in back-office areas, and address issues related to risk, controls and shrinking margins. Hence, institutions are adopting utilities/shared services models that provide a common platform for overseeing operations, technology and infrastructure - all in a standardized, simplified and cost-effective manner.

We believe that the following two models will emerge:

• **Collaboration among peers or tier 1 firms (T1).** These banks are at similar levels of maturity, and thus able to collaborate effectively in ways that are no longer possible internally (i.e., they have reached their efficiencies of scale).

• **Opportunities for improvement in tier 2/tier 3 firms (T2/T3).** These banks look to one another for assistance in deploying services and improving the efficiency of operations in order to scale and compete with tier 1 banks - something that was not previously achievable internally due to several factors (severe funding issues, insufficient transactional volume to reach scale efficiencies on their own, for example).

**Back to Basics: Utilities**

Utility models extend beyond traditional offshoring and cost-cutting techniques. They require a bank to religiously assess its business operations to find common features throughout the organization and across business divisions/geographic locations. So far, banks have been relatively slow to adopt the utility approach. However, to achieve the real benefits of industrialization, they will need to bundle processes on a large scale.

Below we explain how both internal and external utilities factor into this equation.

• **Internal utility:** An internal utility, also known as a shared services framework, is centralized - spanning lines of business, products and locations within a bank. It is supported by dedicated operations teams and common technology platforms. An internal utility would be well suited for large/global banks, universal banks, etc., in areas such as:

  » **Payments** across investment banking, asset and wealth management, and commercial banking.

  » **Reconciliations** covering investment banking, asset and wealth management, and commercial banking.

  » **Reference data** across investment banking, and asset and wealth management.

  » **Data management** for regulatory reporting.

• **External Utility:** An external utility services multiple banks. However, external utilities are complex to implement and manage as they require intense collaboration among participating banks for the business areas under consideration. However, they provide a step benefit in footprint reduction in cases where a bank is able to completely hand over an operational area and buy a managed service.

Both forms of the utility/shared services model can be set up by the banks themselves, or by partnering with third-party providers with the necessary infrastructure and expertise. Regardless of the model, the utility provider takes responsibility for performance, remaining compliant and delivering to market standards. This is unlike existing outsourcing models, where performance, regulatory compliance and functional updates remain the responsibility of the bank.

While the use of external utilities in the banking sector is rare, our analysis - based on the latest market trends and our experience in executing similar engagements with large banks - indicates that internal utilities are being rapidly embraced by banks, a trend set to accelerate in the future. The primary objective of both models is equivalent: increase processing volumes, reduce cost per transaction and promote better control.

Another characteristic of utilities is the selection of a pricing model. Historically, outsourcing deals followed a full-time equivalent (FTE)-based or input-based pricing model. With changing expectations, the transaction-based pricing model is being adopted for internal or externally sourced
services. (Transaction-based pricing refers to a model where payment to a vendor partner or vendor is based on the number of transactions they process). Here, the payment is directly linked to output as opposed to the FTE-based pricing model, where payment is linked to inputs (resource time and materials).

**Benefits to Banks**

The benefits of a utility-based model are more tangible than traditional outsourcing approaches. A utility-based model:

- Follows best practices in areas such as standardization, process excellence, productivity improvements and staffing consolidation, for example. These have an overall impact on economies and cost reduction. Our preliminary assessment indicates that banks can look forward to cost reductions in the range of 30%-40% by implementing utilities.

- Segregates core and non-core activities - allowing banks to spend more time on customer activities and improving client satisfaction.

- Allows the bank to quickly respond to market and customer needs through process and platform standardization, process excellence and productivity improvements, for example.

-Facilitates rationalization of the technology infrastructure by improving customization and enhancement possibilities - a benefit that would apply across all business divisions and locations. Having a single platform affords simplicity by reducing the number of interfacing applications, and lowering costs associated with managing the architecture, data feeds, etc.

**Challenges of Setting Up Utilities/Shared Services**

Setting up a utility is not a small task; the associated complexities, if not addressed adequately, can lead to a convoluted system landscape, a fragmented infrastructure, process inefficiencies and internal resistance - each of which can hamper implementation.

Although external utilities can potentially achieve the lowest cost per transaction, it is worth considering the following in terms of business risks:

- Data confidentiality.

- Ownership and recovery of sensitive/business-critical data if the utility provider is acquired or goes bankrupt.

- Reliability and availability of the utility if the provider closes its doors or stops investing in a backup service in-house, such as disaster recovery, which has a direct impact on the utility.

- Absence of a dedicated team for special processes.

- Resistance to change from teams across lines of business and geographies.

- Specific market practices, regulations or special processes that are handled differently from a utility perspective.

- Integrating with external trade utilities, such as DTCC, SWIFT, etc., which vary from bank to bank.

**Early Adopters**

Global investment banks and custodians have been among the first to adopt utility-based operating models.

- **Euroclear and Smartstream** have jointly created Central Data Utility (CDU). The CDU collects information from multiple original market sources and further processes the data so that the downstream firms accessing the data derive greater efficiencies and avoid reworking the data independently.

- **“Post Trade Plus,”** a platform launched by Citibank and UBS, provides a comprehensive post-trade solution to broker-dealers in the Asia Pacific region. The platform enables broker-dealers to focus on their core business, with UBS performing all middle-office functions and Citibank providing clearing and settlement, as well as custody services.

- **In mortgage and consumer lending,** utility models are known to exist in areas that facilitate decisions regarding granting consumer credit, and are provided as an industrialized service to lenders. Without this model, these lenders would have to rely on their own individual and sometimes sub-optimal efforts to cover all possible bases.
To facilitate payments tracking, quite a few banks are implementing shared database utilities that link the customer’s bank accounts to mobile numbers or e-mail addresses.

Some leading global banks have set up a shared services model for electronic invoice presentment and payment to facilitate end-to-end invoice processing and provide fully integrated accounts payable/receivable functionality.

Key decision criteria that can be used to determine the suitability of either utility operating model include regulatory requirements, differentiating operations vs. commodity, specific knowledge, control and risk.

Implementing a Target Operating Model

The operating model at the core of the utility, as well as its implementation, represent major decisions for any bank. We suggest seven generic steps (see Figure 5) for implementing the target operating model, which can be different for each bank depending on the maturity of back-office services and the institution’s appetite for change.

From Identification to Implementation

<table>
<thead>
<tr>
<th>Current state assessment &amp; identify opportunities for industrialization</th>
<th>Deep-dive analysis and develop business case</th>
<th>Operating model consideration and identify potential partner</th>
<th>Develop industrialization roadmap</th>
<th>Design services to be industrialized (Build Target operating model)</th>
<th>Transformation roadmap and detailed planning</th>
<th>Implement and Operate</th>
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<td>Change Management</td>
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Overview of the Transformation Steps

Transforming to a utility model involves several steps:

- **Assess the current state and identify opportunities for industrialization:** At this stage, banks should conduct a scope analysis and identify affected entities, services and employees. This provides a framework for change, and aligns the utility model with the wider organizational strategy.

- **Perform a deep-dive analysis of identified areas and develop the business case:** A sound business case can help ensure that all key stakeholders understand the rationale for transformation. Banks must justify the business case in terms of the cost implications, anticipated business impact and associated risks, and mitigation. At this stage, it is important to agree on the preferred operating model option.

- **Consider the operating model and identify a potential partner:** For a large-scale transformation (since we do not recommend an in-house option), banks must choose their partners. Key partner selection criteria are rigorous due diligence, executive management commitment, future funding options, and consensus on Service Level Agreements (SLAs) and commercials.

- **Develop an industrialization roadmap:** Banks should develop a chronological roadmap for moving given functions to shared services. At the end of this stage, institutions should be in a position to validate the outcome of the business case.

- **Design services to be industrialized (build target operating model):** Banks should work with their partners to design the target business architecture and operating model. Levers for the detailed design include guiding principles, process decomposition, ascertaining the right granularity for the current state, data-gathering and preparing a “to-be” state reference model. The “to be” state model should also provide a view of geographical/regional variations, map current business processes to the target state model, apply implementation constraints, and identify process and IT improvement initiatives.

- **Develop a transformation roadmap and detailed planning:** The bank should put in place a sound plan summarizing key steps for mobilizing and driving the utility model. Planning should be backed by rigorous progress monitoring.

- **Implement and operate:** At the final stage, when the utility model is up and running, the focus will shift from design and construction to support and transformation. The utility in its target state should support multiple areas across lines of business.

The underpinnings of this approach should encompass program management and change management:

- **Program management:** This is critical to ensuring that the implementation program runs smoothly, that the correct resources are in place, and that risks are managed and sustainability is built in. Banks must focus on the vision, with supporting milestones and responsibilities specified throughout the change. Otherwise, benefits can erode rapidly and, eventually, dissolve completely.

- **Change management:** Banks often face employee resistance, since setting up a utility model usually involves transforming the operations model, which has a significant impact on organizational structure, roles and responsibilities. The change management process should begin at the inception of the program and continue throughout the transformation process. The success of the transformation will be determined by how effectively employees are engaged, since they will be the ones ultimately responsible for delivering more value.

Realizing Tangible Benefits

Banks should adopt the following principles in order to realize the transformational benefits of services delivered by utilities:

Success of the transformation will be determined by how effectively employees are engaged, since they will be the ones ultimately responsible for delivering more value.
• Ensure that the right people are in place to manage the utility design and implementation.

• Build consistent and strong leadership - crucial to assuring that the utility is accepted and managers do not fall back on less efficient ways of functioning.

• Aim for the highest degree of standardization and automation to help maximize savings. (This warrants robust planning well before the model is created).

• Aim to re-engineer internal processes that have the greatest impact on business, and address the pain points of the current set-up.

• Work to develop strong and trusting relationships among collaborating groups, supported by proper governance arrangements.

• Devise risk-sharing agreements to manage the balance of risk and rewards.

The above factors can enable banks to overcome some of the challenges, especially the ones that are internal, and better position them to manage the stumbling blocks arising from external environments and service providers. Ultimately, the success of the operating model will be determined by the benefits achieved, not just in one, but in all of the key metrics described in Figure 6, below:

Metrics for Success

<table>
<thead>
<tr>
<th>Metric</th>
<th>Minimum Benefit</th>
<th>Preferred Benefit</th>
<th>Qualifying Criteria</th>
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<tbody>
<tr>
<td>Cost of Operations</td>
<td>Reduces.</td>
<td>Target cost benefits are achieved.</td>
<td>• Reduce costs by eliminating variable overheads.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Create capacity and scale.</td>
</tr>
<tr>
<td>Quality of Service</td>
<td>At par with the old model.</td>
<td>Increases.</td>
<td>• Enhance client experience and eliminate client pain points.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Increase client servicing (increased responsiveness, etc.).</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>At par with the old model.</td>
<td>Reduces.</td>
<td>• Provide for adequate audit controls.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Align with the evolving regulatory environment.</td>
</tr>
</tbody>
</table>

Figure 6

A Roadmap for Defining an Internal Utility Operating Model
Defining the Utility Operating Model: An Illustrative Approach

We recommend that banks create utilities with a transformation partner. In either an internal or external utility, a common approach applies in transforming to the operating model:

- Identify tasks that are common across the bank or other banks, and which can be standardized and simplified.
- Identify tasks that are common across the bank or other banks, and which can be standardized and simplified.
- The operating model will need to be supported by a common utility organization, governance, and reporting, and a standardized platform (see Figures 7, above and Figure 8, next page).

While the initial steps for defining the external utility operating model are the same as those for an internal utility, the final post-transformation stage is represented in Figure 8. Looking Forward

Internal utilities are receiving a good deal of attention as global investment banks implement
utility/shared services, especially in back-office functional areas. As with all emerging approaches, developing utility models can be challenging in the initial stages. However, if the utilities are implemented properly, they can trigger the next wave of performance improvements in IT service delivery and operations.

At the same time, growth-oriented banks and their senior management need to understand that utilities are more than a mere cost-reduction play for achieving process efficiencies. While cost savings are an initial allure, delivering services as a utility will eventually support key strategic objectives by adding new business capabilities and process improvements that drive growth and improve customer service.

Footnote
1 Industrialization as relevant to the banking world provides the framework to shorten time to market, improve the quality of services, reduce operational risks, improve cost position and free up expertise/resources from operational delivery to re-focus on client-facing advisory and business execution.

References

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**An External Utility’s Post-Transformation Stage**

![Diagram](image-url)
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