Optimising Operating Efficiency: A Competitive Necessity

Financial institutions face pressure from increased regulation and the need to control costs, which together add up to a significant challenge to existing business models. Firms are therefore refocusing efforts to optimise capital and operational efficiency and to make sure the cost of doing business is justified by returns.

At a time of economic uncertainty, fragile financial markets, regulatory reform and a requirement to manage costs, banks and other financial institutions are looking for ways of maintaining their profitability. Their task is straightforward: they must boost sales revenues and reduce costs if they are to survive, and ideally thrive.

For most firms, there is a need to focus on the second part of that task, controlling costs and improving operations. Optimising operating efficiency has become a competitive necessity, especially today when revenue-generating opportunities are sub-optimal.

In the past five years, financial services have been subject to perhaps the greatest regulatory upheaval of all time. Initiated by the G20 leaders at their summit in Pittsburgh in 2009, developed by international bodies like the Financial Stability Board and the Basel Committee on Banking Supervision, and then implemented at the national level, a raft of financial regulation has been put in place to protect customers and investors and ensure the stability of the financial system.

Of all types of financial institution, banks have been the most affected. But they have accepted the need for more regulation, not only because of the benefits it brings to wider society, but because of the benefits it brings to banks too. Having to act more prudently and manage risks better will make for more solid, more sustainable institutions.

Operating efficiency

With these economic shifts, financial market changes and tighter regulation, optimising operating efficiency has become a competitive requirement. There are two strategic dimensions to 'operating efficiency'. The first centres on how financial institutions use capital effectively, something that Basel III for banks and investment firms has brought into sharp relief. The second is 'operational efficiency', which is about the need for organisations to review and overhaul their intricate internal structure and processes.

For HSBC, both dimensions are a strategic priority. For example, when it decided to streamline its operations in May 2011 it set itself a target of annualised sustainable cost savings of \$3.5bn by the end of 2013. It has already exceeded this target, achieving \$4.1bn so far. It has done this by redesigning its systems and using them more efficiently. In turn this has created surplus capacity to grow the business and serve clients more effectively.

There are also efficiencies to be gained by firms collaborating more, to combine utilities and share services in non-competitive areas. Such co-operation can create major economies of scale, operational efficiencies, cost savings and higher standards for the benefit of all. An example of this is HSBC's participation, in partnership with business process management company Genpact and financial information services company Markit and several other banks, to help design a client onboarding solution.

HSBC

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The solution, announced in September, will provide banks, asset managers and other firms with all the services and processes they need for taking on new clients. Operating to HSBC's Global Standards on conduct and compliance, it will deliver real value and consistency to users by ensuring they comply with all their regulatory know-your-customer (KYC) requirements.

Managing technology

Some of the biggest savings are to be made by integrating and modernising technology. Where banks have grown by acquisition, maintaining disparate IT systems can be particularly expensive. It is important, therefore, that they are integrated as quickly as possible. Banks that are disciplined and integrate their systems early on do well. Those that are less disciplined and continue to rely on legacy technology face problems.

Of course, the pace of technological change is also creating huge opportunities for banks. It is allowing them to reduce costs structurally by embracing trends such as commoditised hardware, open source software and cloud computing, especially public cloud.

Outsourcing services

An important way of improving operational efficiency is to outsource processes to a third party – an outsourced service provider – that specialises in those processes and handles them on such a scale as to generate major cost efficiencies.

HSBC Securities Services (HSS) is a provider of outsourced post-trade securities transactions processing to asset managers, pension funds, insurance companies, banks, broker-dealers, sovereign wealth funds (SWF) and companies around the world.

Broker-dealers have, by and large, continued to keep these processes in house, but that is beginning to change. "2012 was a tricky year for most broker-dealers because their income is commission based, and transaction revenues were lower last year," says Cian Burke, Head of Prime Services, HSBC, and Co-Head of HSBC Securities Services. "Their revenues are shrinking and their costs are fixed and high. Most of these businesses run at cost-income ratios of 70-80%."

"We are now, therefore, having conversations with broker-dealers about the benefits of outsourcing their post-trade processing to us. They already clear and settle through our network, so we are talking to them about how they might move up the value chain and outsource their back or middle office."

This would allow broker-dealers to focus on their core competencies and convert their fixed operational costs to a variable cost. That would give them more certainty on their profitability, as their variable income would be matched to their variable costs.

Outsourcing helps broker-dealers redefine their operating models as well as reduce costs. Even the larger ones that do not outsource because they have scale in their processing will be forced to redefine their processes to compete at a time when margins are compressing.

Outsourcing – issues to consider

Whatever type of organisation you are – broker-dealer, asset manager, pension fund, SWF – you need to monitor your outsourcing partner closely. Tight service level agreements, allied with regular site visits, are imperative.

What regulators think about an outsourcing arrangement is also important. They have an interest in what regulated firms outsource. One of their main concerns is to ensure the security of customer data, especially when it is transferred between organisations.

Deciding what is not a core competency so it can be outsourced is not always a straightforward task. In addition, there is often internal resistance by staff, who may be worried about their jobs.

Benchmarking one's capabilities against industry standards will highlight where one's weaknesses and strengths lie. To address a particular operation's weaknesses you then have a choice: either improve it and keep it in-house, or outsource it.

However, an outsourcing decision should be based less on what a firm is good or bad at, and more on what is core and non-core. As Mr Burke says: "Asset managers are good at all aspects of managing money, whether it is investing or carrying out post-trade processing. But processing is not their core business, which is why they tend to outsource it to a firm that can do it as well, or even better, and at a lower cost."

Reviewing the operating model

The single biggest factor a firm needs to think about, therefore, when optimising its operational efficiency is its operating model. Achieving efficiencies is not just about generating cost savings at the margins, it is about reassessing the operating model to bring about a fundamental change in the way a firm operates.

The firm needs to examine what is core to its competencies and capabilities and create an end-to-end operating model. It can then lift out the non-core elements of that model and place them with an outsourced service provider that has the scale and expertise to perform them more efficiently. Taking that approach will enable a firm to bring about a major reduction in its underlying cost base.