COST RESTRUCTURING PROGRAMS, THE BEST APPROACH FOR BANKS TO UNMASK HIDDEN EXPENSES TO FACE FUTURE MARKET REALITIES

Naleen Edirisinghe
Assistant General Manager - Retail & Business Banking, Pan Asia Bank PLC

Reducing interest rates, thin margins, strict regulatory requirements coupled with alarming marketing uncertainties such as the recent pawning crisis are prompting banks to rethink business strategies, operation models and cost structures. During the past, revenue growth driven by credit fuelled economic expansion was the key performance driver. Growing revenues masked the rising costs. Banks managed their performance with revenue growth and typically took action on cost only as a short term corrective measure or where the cost to income ratios drifted out of line with those of their peers. Focus has been on quick wins through multiple cycles of cost cutting and annual budget reductions. However, times have changed and banks have realized that cost restructuring is as equally important as remodelling their business structures.

Present market conditions and perception on costs

Following the recent dip in revenues and profitability due to the above reasons the banks are now realizing that their cost to income ratios is on the increase. The result has been an unprecedented focus on cutting costs. The measures have been- reduced salary increments, frozen or withheld bonuses, reduced spending on marketing, freezing of recruitments, supplier and contractor terms and prices rapidly negotiated etc. Banks need to ensure that such cost cutting measures do not inflict lasting damage on the business. They also need to make sure their cost related decisions position them to capitalize on improved market conditions.

Suppose Bank A consolidates multiple mortgage processing centers in an effort to quickly extract costs. Bank B, its competitor, also consolidates its processing centers and in addition reengineers its lending process and migrates them to a standard platform and enters in to a business process outsourcing arrangement for post closing functions, which enables a variable cost base. When a stronger market returns, Bank B's cost will remain in check, but Bank, As is likely to rise again. By balancing short and long term objectives, Bank B has achieved competitive advantage over its rival and is on the path to high performance.

At present the average cost to income ratio of banks in Sri Lanka is around 60%, however for larger banks it's around 50%. The CBSL's consolidation plan will pave the way for improved cost to income ratios of financial institutions through economies of scale. In this backdrop banks need to take a longer term strategic approach to cost restructuring. It is no longer enough to rebalance and keep a lid on costs through periodic and superficial cost cutting measures.

Leading banks realize the importance of taking out costs and investing the savings in strategic programs that will help them bring products to the market more quickly, interact with customers more effectively and gain competitive advantage.

As a part of its Basel II compliance efforts, a bank spent substantial amounts in the past two years building a new technology platform to track, measure and manage its credit risk exposure. The bank completed the project well within its allotted program budget. But instead of terminating the commitment at that point, it used the remaining funds budget plus an additional investment to develop better insight in to managing credit risk limits for its customers. As a result the bank is aiming to reduce the amount of risk capital on its balance sheet thereby decreasing its cost of capital and hoping to price its customers far more effectively. For a relatively small investment and by leveraging capabilities built for a compliance program, the bank is seeking to cut its cost of capital and potentially improve revenues on its balance sheets.

Cost restructuring - a key priority

Banks should now look at more comprehensive strategic cost restructuring programs with clear definition and tracking of benefits and an explicit targeting of more deeply entrenched cost categories with a longer term , but more enduring pay offs such as property , third party supplier spend and greater tax efficiency. In fact it is noted that cost restructuring initiatives have been one of top priorities in bank CEO's agendas in the recent past. Further the continued volatility and uncertainty in the market have taken a toll on CEO confidence about future business prospects. As a result reshaping and restructuring the cost base to reflect these changes has become a necessity.

Doing it right

To produce sustainable cost-restructuring measures, you must design and construct a program with the right characteristics:

- All available opportunities should be identified and given proper consideration. For this both subject matter and change expertise are essential.
- Financial discipline, stable cost management and a detailed understanding of the costs baseline are vital to identify, deliver and track cost reduction opportunities that affect the P & L.
- Ambition is necessary to tackle hard tasks such as restructuring the underlying cost base and third party spending when there are real opportunities rather than focusing on quick wins or visible costs.

- Vigilance is vital so that savings don't get lost in annual operating results but are rigorously tracked on a systematic basis and embedded in to cost centre budgets.
- Determination is crucial to change behavior in relation to cost management and control, embed reporting disciplines and push for continuous improvement.

Fresh thinking

It's easy to get stuck in a way of thinking about cost restructuring that results in opportunities being overlooked. To make progress, you need to challenge your assumptions about what is achievable through a cost restructuring exercise. Equally, quick wins can be more complicated than we think. Some examples;

- Redundancies are not the only way to reduce permanent staff cost re-examining reward models and pension provisions can also produce significant savings
- Contract staff are not a cost effective replacement and long term substitute for permanent staff – and they should be tightly managed as a flexible resource
- The best way to reduce procurement costs might not be by squeezing suppliers alone but by engaging with the sources of demand in the business to make better buying decisions
- Structured changes such as consolidation and outsourcing are not always straight forward – benefits must be weighed against potential tax liabilities, which can be considerable

Cost restructuring tips

- It's not about just cutting costs. It's about an uncompromising focus on value and having flexibility and agility to release capacity and redirect resources to growth areas.
- Focusing on operational costs only will not be sufficient. Areas such as front office costs, the cost of risk management failures and funding costs will have to be considered in new ways. For instance at a time of excess liquidity in the market, raising deposits aggressively will only increase your costs thus affecting the bottom line.
- It is not about placing items "on hold". Many organizations simply stop investing in new projects during difficult times thus letting go some golden opportunities
- Banks need to be vigilant about the entire cost items rather than a few individual el ements. It requires rigorous analysis of all the types of costs. There should be no sacred cows but all spending should be subject to review.
- Having good MIS and data about costs is critical
- A well organized end to end program is needed. Many banks have cost cutting stars or teams but lack an organization wide approach. Strong engagement of all stakeholders are required for cost cutting thinking.

Elements of cost

By material cost category –

People – Cost can account for up to 60% of overheads
Property – Property related costs are usually the second largest cost and represent the biggest procurement category
Third party- products and services provided by strategic and nonstrategic suppliers can be challenging to address
Direct & indirect taxes – represent a significant cost and are often considered non-addressable.

1. **By cost type and driver –**

   Direct Costs vs. Indirect Costs – It is imperative that as financial institutions both these costs are vigorously analyzed. As an example if a bank has excess liquidity and the industry demand for credit is low it is useless to attract deposits at higher market rates. In that scenario whatever the cost restructuring methods brought to tighten operational costs would be of no avail.

2. **By investment class –**

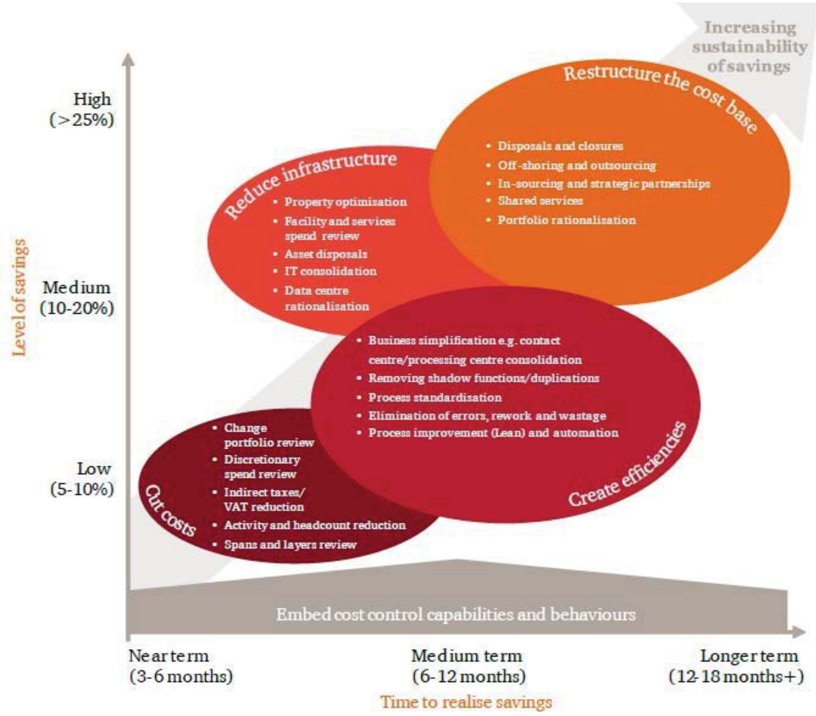
   Must spend category- Fixed overheads and infrastructure, mandatory regulation and compliance, Operations- keeping the lights on and core IT and data provision

   Should spend category- Operational improvements, head count and staffing levels, enhanced risks and compliance, preventive maintenance

   Could spend category- New propositions, new capabilities, service improvements, marketing and business developments

   It is obvious that strategic, innovative and business focused banks will use the could spend category whereas the others will remain at must and should spend categories.

A point of view on cost restructuring and the potential opportunity size of cost savings



Focus of Activities	Savings Levers	Opportunities
Restructure the cost base *'Do Different' (20%+ savings)*	Closures and Exits	• Closure or divestment of sub-scale lines of business, customer segments and/or product offerings.
	Strategic Sourcing	• Consolidate sourcing of activities and vendors, create shared services, outsource non-core processes and platforms, off-shoring, and core systems replacements.
Reduce infrastructure *'Do with less' (15-20% savings)*	IT Consolidation	• Consolidate IT platforms, hardware, infrastructure and data centres.
	Property Optimisation	• Review property demand to maximise space utilisation, identify asset disposal opportunities and reduce all property related spend via sourcing and vendor reviews.
Create efficiencies *'Do Better' (10-15% savings)*	Process Improvement	• End to end process improvement to reduce complexity, errors and rework and standardise around key processes, applying Lean and Straight Through Processing.
	Business Simplification	• Simplification and de-duplication of roles and activities; consolidation and rationalisation of similar functions and activities.
Cut costs *'Do Without' (5-10% savings)*	Activity and Headcount Reduction	• Review and challenge of team activities, workload capacity and line management structures and reporting lines leading to headcount reduction.
	Spend Reduction and Demand Management	• Demand challenge and discretionary spend reduction, and policy compliance – Reduce/eliminate discretionary spend – Reduce contractor spend – Re-negotiate vendor contracts

Source: Reshaping your cost base for today's market realities – PWC

Mere head count reduction will not achieve the new cost targets

1. A balanced approach with a blend of tactical and strategic cost initiatives that pro duce a range of savings over the near, medium and longer term is needed.
2. Many strategies will not pay back in a year or two. Many banks have inefficient structures as too many decisions are taken within a short term time horizon. Banks will need to look for large transformational cost restructuring in all parts of the business as margins are increasingly tested.
3. Building a sustainable competitive cost platform requires consistent investment, even in financial stress. This program should be funded through tactical short terms savings to fund medium to longer term savings.
4. Create breathing space by releasing immediate savings for more strategic initia tives such as IT or outsourcing.
5. These types of programs will be a significant test of leadership and organization al commitment. It demands dedicated focus and disciplined execution which must be owned and driven by the business.
6. Rather than repeating the same old cost cutting tactics banks will need to be more open to possibilities that may never have been considered or attempted before. How about granting credit facilities via online without any documents used on hard copies including security documents.
7. Strong leadership from the top of the organization is critical with constant follow up rather than an inaugural speech only after which everything is cascaded below.
8. Change is hard but an environment has to be created with positive behavior.

Approach to restructure costs

It is imperative that a team of experts from each unit sit together and do a brain storming session on all costs relevant to the bank irrespective whether they are direct or indirect and the team should be ideally led by the CFO as he is the numbers man who is conversant with the cost to income ratio. However, any cost restructuring process should be based on the following six key elements that high performance banks demonstrate efficiently:

1. Lean operational model – minimal management layers, clearly defined roles to eliminate duplication of activities
2. Rationalized product portfolio - rationalized product portfolio coupled with clear understanding of product profitability
3. Streamlined processes- broader use of image and work flow technology and strong culture of end to end process ownership and continuous improvement.
4. Effective customer experience- high levels of customer service with simple sales and service transactions and differentiated service based on customer profitability and future value
5. Simplified technical infrastructure- simplified IT architecture and supporting applications and aligning IT spending close to business strategy.

Thereafter the team should;

1. Arrive at a range of hypotheses based on your experience and subject matter expertise
2. Supplement by access to wide range of capabilities and benchmarks
3. Bring together a case of change, roadmap and early savings

On your way you will find hundreds of cost restructuring initiatives to craft a new way of thinking about savings. Do not think about cost cutting but think of cost saving. Based on above hypotheses which were arrived with your own expertise or if your bank is unable to do so even by an outside expert, to deliver a cost restructuring program that covers the entire organization- from third party spend, contract reviews, tax reviews to process re-engineering, infrastructure optimization, shared services, outsourcing, off shoring, portfolio rationalization and divestments. In fact there are a few expert companies who will handle this function for you, however in the long run I am sure like the retail banking unit or the corporate banking unit there will be a specialized cost saving unit in all banks due to its importance to the bottom line.

Based on your priorities validate the hypothesis and quantify the size of opportunities. After rapid but thorough analysis, develop detailed executable initiatives, backed by solid data and showing clear benefits.

Program execution & delivery

By the above exercise immediate potential savings could be identified, but it's a far sighted approach. Both tactical and strategic cost restructuring initiatives should be targeted that produce a range of savings over the near term (3 to 6 months) , medium term (6 to 12 months) and longer term (12 to 18 months) . This balanced approach would raise prospects of releasing immediate cash savings to fund long term programs such as IT and outsourcing arrangements.

These opportunities can be integrated into a robust cost program that focuses on multiple cycles of delivery. Some initiatives can be planned while others are being implemented. This strategy means that benefits can be released in waves, helping to drive and energize the entire program. In addition these waves create the time and funding to create robust business cases for strategic cost restructuring opportunities, which require time, resources and budget before implementation decisions are signed off.

Cost saving opportunities

Based on studies it is learnt that the greatest potential of savings are typically property, third party spend, staff cost and tax charges. However, as enumerated above please do not ignore the direct costs such as interest expenses which are usually handled by the Treasury which also needs to be rationally analyzed.

Property related costs are usually the largest procurement category, while third party spends on products and services, potentially involving thousands of external vendors, can be challenging to address. People including permanent and temporary staff costs can account for up to 60% of total overheads and tax represents a significant portion of costs and is often considered difficult to tackle. However, it is noted most banks are now having tax consultants to get the maximum tax benefits available which the professional bankers would not be aware of.

Permanent staff costs

Cost restructuring programs are commonly associated with head count. Ideally the organization structure should be re-visited so that duplication of work does not arise especially at the top level so that proper re-designations are made and additional duties are assigned. Redundancies aren't the only way to reduce staff costs. There are plenty of opportunities for savings across staff rewards and benefits, including pensions. There are also opportunities to improve the efficiency and effectiveness of HR.

Staff turnover is a cost as every time an employee leaves you have to recruit a new person and groom him to be a good worker. To reduce staff turnover you must compensate your staff with reasonable wages and benefits in line with the market. Employee's payee tax structures also need to be looked at in order to ensure that they receive a reasonable take home remuneration.

Banks also could look at other rewards such as appreciation letters, recognition in forums rather than just looking at monitory rewards.

Temporary staff costs

Banks assume that outsource staff are a cost effective substitute for permanent staff. But outsource staff are temporary staff and should only be a short term solution to fill skill gaps. They are not good long term value for money and are not a viable alternative for recruitment.

Approach to reduce temporary staff costs should start with a comprehensive, systematic check of all contracts including duration, day rates etc. You may challenge business owners to justify temporary roles. Dramatic savings on temporary staff costs are possible by negotiating and re-negotiating with suppliers.

Third party costs

Traditionally, cost restructuring in procurement have come from aggregating local spend, reducing unit cost and squeezing suppliers. Segmenting suppliers still has a role in comptetive markets for commoditized spend. But for strategic suppliers this approach won't work-suppliers walk away and the stability of your supply chain will be undermined.

Working more closely with the rest of the business means budgets can be specified at an early stage, rather than retrospectively, to support an agreed savings plan. That gives Finance the ability to challenge unplanned spend and boost the credibility of the procurement function to make recommendations. Equally by integrating reporting lines for procurement and finance, supply can be made secure and sustainable and the impact of procurement is enhanced.

Changing from a predominantly supply focused procurement strategy to one that puts greater emphasis on collaboration with the business will bring in more cost savings.

Property

Property related costs are normally the second largest overhead for a bank. Branch rent, electricity, water, security are some of the costs which are traditionally checked for cost cutting methods. However, other than branch rent which has to be negotiated by the head office the other costs under this should be monitored by the branch managers who have the accessibility to monitor same. Further, they should be interested in their own profits rather than head office.

Despite that a centrally monitored mechanism should be in place to identify red flags relevant to any high cost items of the P& L of any branch, failing which malpractices would occur without being noticed.

Tax

Income tax and financial VAT is a massive percentage of over 50% of PBT and represents over 40% of spend and needs focus for cost reduction efforts.

Banks should ideally obtain services of a tax consultant so that tax benefits could be obtained as per tax regulations which are vital. An example is the LSE asset portfolio which has VAT benefits. Further it is imperative to ensure that no taxes are overlooked which will result in penalties etc.

Conclusion

Banks have traditionally used revenue as the primary element in incentive pay for the front office and cost as the primary element for people in the back office. In response, the back office has focused on costs but has limited room for man oeuvre as their front office partners seek revenue, seemingly at any price and continue to have the highest expectations in terms of service levels and flexibility. As a result senior management's focus on the bottomline can create conflict between front and back offices.

Banks should continue to assess the changes needed to make organizational structure, skill sets and business culture to make the transformation to a total cost management approach. Gaining the buy in from the business to make sure the implementation is swift and effective is the most important aspect in this.

To achieve long term sustainable cost restructuring rather than repeating the same cost cutting tactics, you need to be open to possibilities you haven't ever considered or attempted, challenge the status quo and existing assumptions and overcome organizational inertia and resistance to change.

Change is hard, but is essential for progress!

References

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PWC, Reshaping your cost base for today's market realities