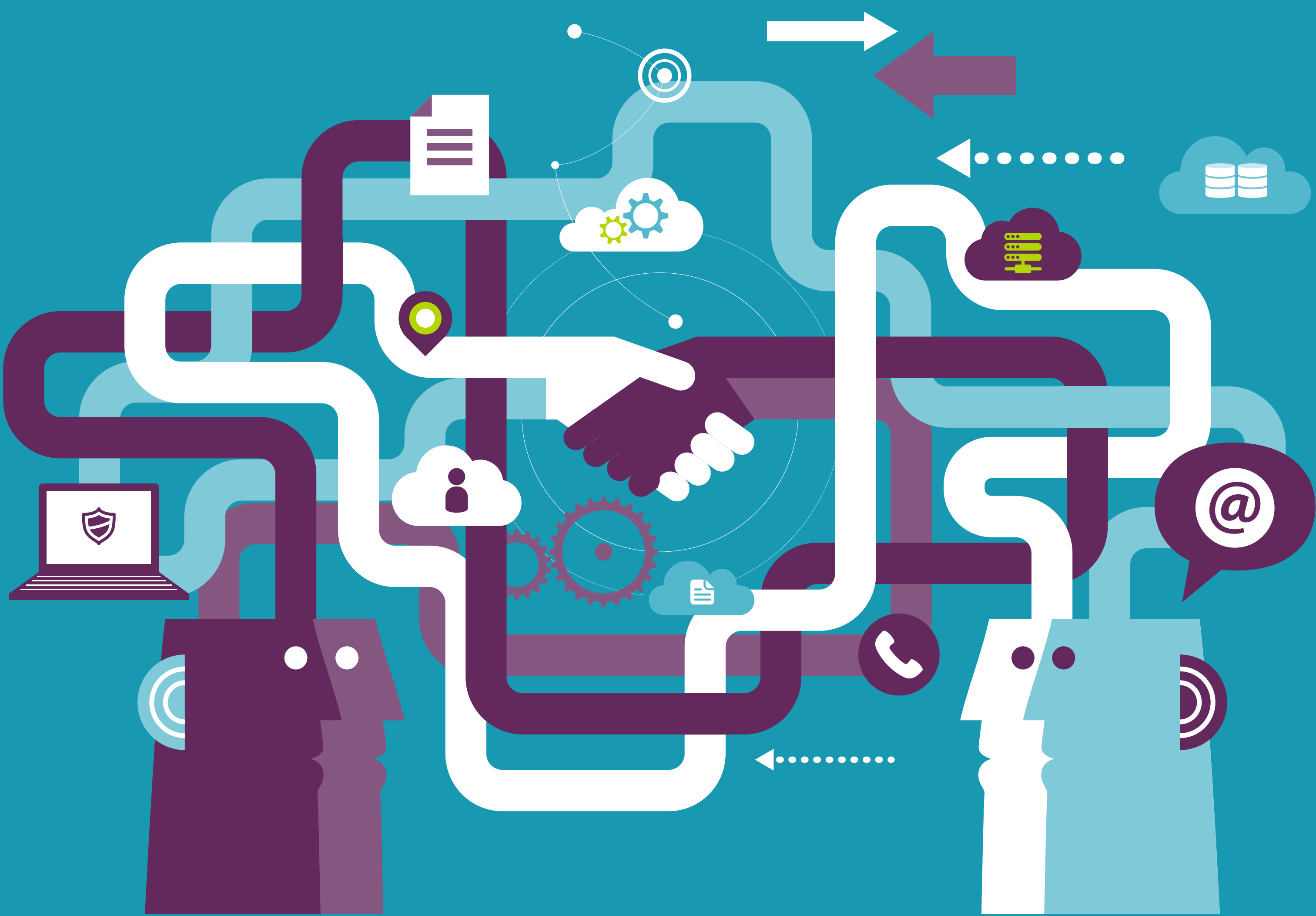
Financial Procurement in the age of disruption

Creating value within a climate of post-regulatory change



Riskcare

ATTITUDES AROUND BANK'S SPENDING ON PROFESSIONAL SERVICES HAVE CHANGED IN RECENT YEARS. JASON MCINTOSH EXAMINES HOW INTERNAL PROCUREMENT CAN UP ITS ROLE AS A VALUE CREATOR

Investment in staff, services and technology ballooned across the financial sector during the 1990s and early 2000s. For many years, booming revenues and high margins meant that technology and infrastructure costs could largely be ignored.

It is no surprise that since 2008 things have changed. The combined pressures of increased regulation, a low interest rate environment and technology disruption have challenged existing business models and forced a change in thinking.

The organisations Riskcare has worked with in the decade since have adopted a wide variety of approaches when it comes to this challenge. These strategies have also varied enormously in terms of their effectiveness in delivering long-term value.

THE BAD OLD DAYS

Before we discuss the approaches, perhaps it's worth recapping how we got to where we are now. Following de-regulation in the late 1980s, the financial sector started to boom. Margins were high, business plentiful and competition intense. Product lines were highly segmented with key individuals controlling client relationships and exercising significant control in each domain.

Since these so-called 'rainmakers' could move to another employer and take their business with them, they had huge negotiating power when it came to salaries and technology. This resulted in a proliferation of systems within each bank, inflated Front Office staff costs and a lack of internal cooperation.

Throughout the 1990s the banks continued to enjoy high levels of growth and consolidation – resulting in their becoming much larger and more complex organisations. Despite this, and the increasingly global and cross-asset nature of their operations, Front Office was still generally segmented by product line, with business heads exercising high levels of control.

Margins remained high and cost could be thought of on two levels; firstly the primary cost of doing business – namely cost of capital and Front Office – and secondly the cost of supporting infrastructure and technology. The priority was to win market at all costs, regardless of background expense. As a result, while some support functions were centralised or outsourced, front and middle office technology remained fragmented and suppliers enjoyed relatively little pressure on rates.

THE HANGOVER

This scenario was fine while the good times lasted, but following the crises of 1998 and 2000 worries about systemic risk resulted in an inevitable host of new regulatory requirements.

The majority of banks now had between 15 and 20 years of legacy technology and data – much of it specific to individual business lines and in some cases inherited from multiple organisations. Centralised functions also faced an uphill struggle when it came to trying to enforce standardised calculations across Front Office.

The result for many organisations was inefficiency and spiralling costs, as well as growing reliance on the services sector to help sort the mess out.

GETTING A GRIP

During the years following 2008, cost became more of a priority. New regulations raised capital requirements, while limiting proprietary activity and at the same time competition was driving margins down. Cost quickly became an issue in terms of sustaining both Front Office (capital and people) and a competitive technology platform.

The first step towards redressing this was to reduce unproductive uses of capital. Non-core business lines and geographies were closed down, capital strengthened and exposures reduced. Although while this helped shore up balance sheets there was still the challenge of how to recover margins.

It was becoming increasingly clear the boom days were not likely to return and the prospect of technology disruption was becoming progressively more likely. The obvious next step was to introduce a value agenda from the top down.

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EVOLVING A RESPONSE

For most banks this meant the introduction of comprehensive programmes of cost reduction – including trying to label costs at source (see: http://www.riskcare.com/insights/services/model-tco-reducing-waste-financial-analytics), eliminate waste and select only those projects satisfying the set hurdles in terms of expected return.

The other challenge was supplier cost and, unsurprisingly over the past few years, we've seen the banks trying to catch up with other industries in professionalising purchasing. As a result, there has been an evolution amongst both bank and suppliers – as both sides have adapted to a more structured buying process.

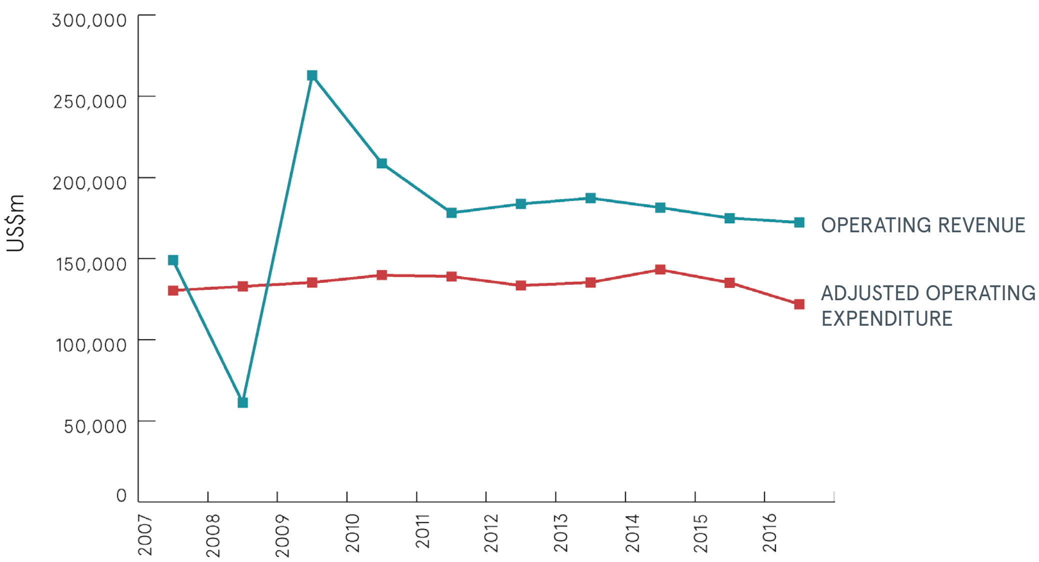
STEP BY STEP

Initially progress was slow (as can be seen in the chart below) and op-ex across the sector actually continued to increase up to 2014. While banks were keen to reduce expenditure during that period, they had to focus significant resources on complying with new regulations. Since 2015, however, the pace of new regulation has finally slowed and we are now seeing a net Opex reduction.

While this is great, there is undoubtedly still a high level of waste across the sector – particularly within 'full coverage' organisations where it has been estimated that over 80% of internal functions are duplicated.

We don't yet know whether this will force the industry to completely restructure. In the meantime, banks are naturally continuing to focus on eliminating overlaps, consolidating systems and outsourcing non-core functions.

GLOBAL BANKS COMBINED REVENUE VERSUS ADJUSTED OPERATING EXPENDITURE 2007-2015, SOURCE TRICUMEN



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ENTER PROCUREMENT

Once Procurement started to become a recognised function it was a natural progression for it to take a more central role when it came to professional services. While this was initially all about cost and volume, many organisations have since started to realise the benefits of a more nuanced and collaborative approach.

In the model below, financial professional services procurement is mapped against a maturity scale – where the top represents a mature style based on long-term value generation, and the bottom, a short-term cost-driven approach.

While entirely rates-based negotiation is useful to cut obvious waste and price gouging, it overlooks less obvious, but important, aspects of value generation – such as reliability, total cost and contribution towards wider programmes of work.

It is also important to note that moving up the scale isn't a substitute for robust negotiation – it just means that value is explored, discovered and exchanged across a wider range of dimensions. The supplier is then chosen depending on where value can be realised in a particular situation.

THE PROCUREMENT MATURITY LADDER

		STYLE	IMPACT
TRANSACTIONAL	VALUE DRIVEN	■ ACTIVE LEADERSHIP ■ PORTFOLIO APPROACH ■ SME DRIVEN ■ COLLABORATION/HIGH TRUST ■ RISK AND VALUE SHARING	■ + + ALIGNMENT OF GOALS ■ + + CREATIVE COLLABORATION ■ + + TRANSFORMATIVE VALUE CREATION
TRANSACTIONAL	SPEND TO SAVE	■ EARLY STAGE ■ CATEGORY DRIVEN ■ CONVERSATIONAL ■ INDEPENDENT MEASUREMENT OF SUCCESS ■ CO-ORDINATED APPROACH ■ MEDIUM TRUST	■ + LOWERED RISK AND OVERHEAD ■ + CONSISTENCY AND ACCOUNTABILITY ■ + INCREMENTAL BENEFITS OVER TIME ■ + CASH GENERATIVE MEDIUM TERM ■ + CREATES VALUE
PARTNERSHIP	BAD COP	■ PROCEDURAL/ADMINISTRATIVE ■ CHALLENGING/HOSTILE ■ INDEPENDENT ■ LATE STAGE	■ + WASTE REDUCING ■ - INFLEXIBLE AND SLOW ■ - CREATES OPPORTUNITY COST
PARTNERSHIP	THE CHOP	■ AFTER THE FACT ■ TRANSACTIONAL ■ PRESCRIPTIVE/FORMULAIC ■ IMPERSONAL ■ SHORT TERM	■ - VERY SHORT TERM ■ - NET VALUE DESTROYING

EACH PROCUREMENT STYLE COULD BE SAID TO BE THE REFLECTION OF THE CORRESPONDING INTERNAL ATTITUDE TO SPEND. AS THE INTERNAL MANAGEMENT STYLE AROUND INVESTMENT AND PRODUCTIVITY MATURES, SO TYPICALLY DOES THE WAY EXTERNAL SERVICES ARE BOUGHT:

THE CHOP

Level 1 is akin to the typical top-down approach we are all familiar with: Bob/Katy/X joins in a senior leadership position keen to make an impact and issues a bold instruction such as "cut 20% of costs" or "remove all external contractors". There is usually little guidance as to how this should be achieved and a lack of permission to exercise judgement or protect critical pieces of work.

As a result these initiatives typically fail to deliver savings due to unanticipated consequences and the ensuing costs. Often X then moves on, only for the whole process to repeat under the next person. The issue here is churn of management responsibilities and a failure to link immediate decisions to long-term value generation.

The external equivalent is for Procurement to act as gatekeeper, working to an arbitrary target such as "use only ten suppliers" or "all work must go to tender". While this is well motivated and effective in the short term, stipulations of this type also often lead to failure. Quality is overlooked, sponsors game the process and suppliers may mi-represent headline or actual cost. In the worst case scenario suppliers may withdraw in the face of unsustainable demands, leaving the buyer with limited choice.

BAD-COP

A slightly more effective approach is to co-ordinate spending at senior management level under a centralised budgeting process. Under this model costs are attributed against revenue lines and while there may be headline targets these are nuanced across different parts of the organisation.

In this case, Procurement is typically engaged early-on to manage supplier, to manage parts of the selection process and to conduct the end stages of negotiation. This can be effective in securing additional concessions, but can be frustrating to both sponsors and suppliers when negotiations have to be-reopened or when discussions become focused on day rates rather than total cost.

Procurement in this case usually consists of non-specialists and valuable time can be lost dealing with internal haggling and paperwork. In the worst case, a poor supplier is chosen despite the wishes and needs of the sponsor.

SPEND TO SAVE

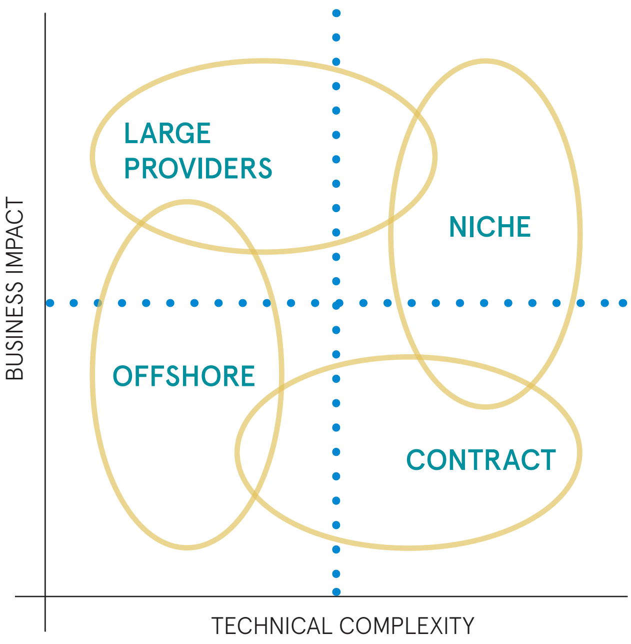
The next approach is to permit investment where it meets a target return on investment over a given time period. Higher investment may be permitted if it leads to savings or lowered opportunity cost down the road.

This represents a wiser approach to spending – cut where you can, but invest where you can see an attractive pay back in the future. Examples include prioritisation for capital saving, regulatory compliance programmes and system consolidation.

Cost saving initiatives fail where they are too ambitious, but rationalisation can be highly effective if delivered in manageable pieces. When executed well, each change delivers incremental benefits – enabling further rationalisation and creating a virtuous circle of improvement. The trick here is to do the homework and to measure which investments were truly effective. All too often our customers launch into large programmes of work that are based on patchy business justifications, with post-project evaluation overlooked in the rush to do 'work'.

Restructuring work often benefits from specialist external support and here Procurement can start to become involved up-front: introducing category differentiation, selecting appropriate supplier short-lists and starting to actively identify areas for niche versus bulk spend.

The challenge is for the buyer to understand the sensitivities and complexity of each programme and to correctly match suppliers to needs. Where a need lies on the left of the complexity divide, a volume and service level negotiation can safely be pursued. But anything to the right and top will benefit from a more nuanced approach.



SERVICES MARKET SEGMENTATION

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At this point Procurement can also introduce formal tools to measure quality and to assess individual work. In the case of software, this might mean using automated code evaluation tools such as BlueOptima and SonarQube, or metrics around the stability of the resulting platform.

In the case of analysis or advisory work, it might mean keeping close to the project, measuring sponsor satisfaction and participating in assessment against original savings objectives.

We see many organisations moving in this direction, but the trick most miss is to place sufficient SME skills within the buying function. Adopting this approach can release untapped value by more effectively identifying quality in the supplier roster and applying it where it can really add-value.

Yet this approach is limited in that it focuses on unit productivity and applies a rather formulaic approach to measuring individual contribution.

The next and final step is where the industry really has an opportunity to add value for the future – with a focus on trust, creativity and collaboration.

VALUE DRIVEN

At the upper end of the maturity scale we see a portfolio approach that is in line with best practice observed in other industries. The bank has a conscious and developed strategy for every spending category, and these are managed by both functional heads and spending category owners. This identifies best of breed both at category and sub-category level, with a dedicated value creation strategy for each.

Within professional services this means having separate strategies for sub-categories such as legal, financial and advisory consulting – reflecting scale, complexity and risk across each function. For each sub-category, a provider roster is assembled based on maximising value and a separate negotiating strategy is adopted for each.

Specialist category owners make a balanced judgement regarding risk/reward and are able to freely negotiate value exchanges with suppliers such as team mix, project duration and financial risk sharing. In the most advanced cases this extends to collaborating with suppliers to lower cost – for example, by working closely to provide information or by actively highlighting areas where service quality exceeds needs.

This approach requires the allocation of time for planning and classifying work, managing delivery risk and continuing to monitor success after the work is done. It also requires staffing Procurement with SME skills and placing it centre stage in negotiations.

Changing internal culture is, of course, never straightforward. It takes time and investment to bed-down. Yet ultimately evolution may not be a choice. As the sector adapts to increasing shareholder scrutiny and growing competition, change will need to be take place.

Those willing to give an SME-led approach a go can realise long-term benefits, reduce duplication, ensure objective decision-making and create real value from partnership and collaboration.

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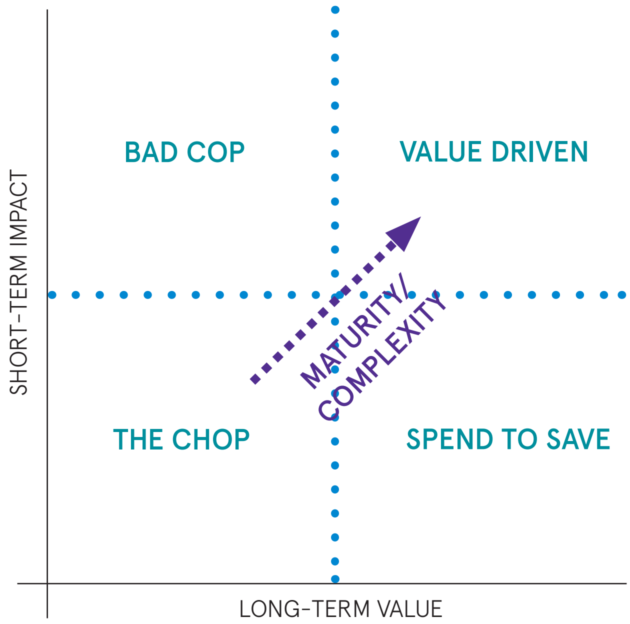

PROCUREMENT EVOLUTION

ABOUT RISKCARE

Riskcare is a financial services consultancy and outsourcing company with offices in London, New York and Sydney.

Over the past 23 years we have built up experience and knowledge that sets us apart in delivering advanced, complex and transformational change to the capital markets industry.

We service a broad range of clients, including investment banks, institutional investment companies, hedge funds, exchanges, commodities trading houses and insurance corporations.

LONDON

Karen Line

Tel: +44 (0)20 7614 3600
DDI: +44 (0)20 7614 3742
sales_eu@riskcare.com

25 Worship Street
London, EC2A 2DX

NEW YORK

Ian Rebello

Tel: +1 646 625 5415
DDI: +1 646 625 5422
sales_us@riskcare.com

1431 Broadway
New York, NY 10018

SYDNEY

Cindy Chan

DDI: +61 (0) 431 594 829
sales_apac@riskcare.com

Suite 121
377 Kent Street
Sydney NSW 2000

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