Banking support function costs

How they are trending and what banks can do to control them

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Banking support function costs

A decade on from the credit crisis, the world's major banks are still struggling to bring costs under control. Having gone through multiple cost reduction programmes post-2008, firms are under continued shareholder pressure to increase return on tangible equity.

With revenues under pressure from a flatter yield curve and an uncertain outlook in many business areas, cutting group function costs remains key to improving ROTE. Here we look at how function costs are trending and assess the measures with the greatest potential to transform costs long term.

Key trends

Despite extensive cost-cutting, group function costs in banks have not fallen at the same rate as revenues and frontline costs.

Banks are turning to a range of levers to extract savings.

Locating roles and processes to lower-cost locations is proving effective compared to the investment it involves.

Investing in automation and other technology is more expensive in the short term but can position firms for greater profitability in the long term.

A cost strategy that can improve operational efficiency and also strengthen a bank's ability to respond to future market needs is now essential.

In an uncertain and low-rate environment, banks need an infrastructure that can scale up and down in line with revenues – and technology is key to achieving this.

Despite action, costs are still rising proportionately

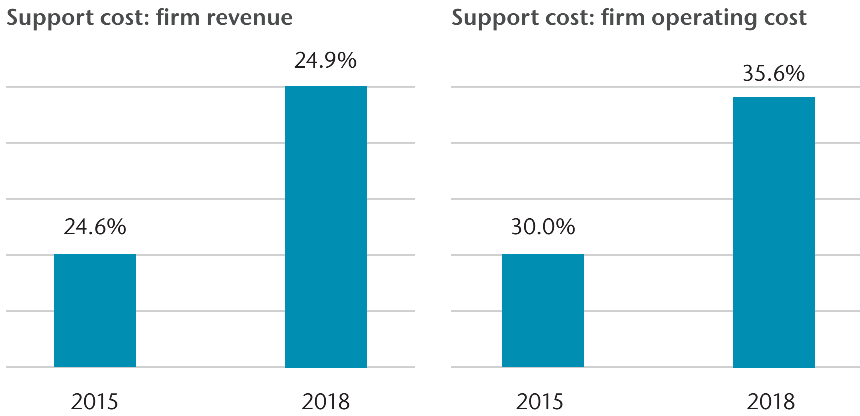
Over the past decade, major banks have invested extensively to reduce costs. Since 2015 alone, firms on average have spent 35% of their total budget on restructuring their bank spend.

This has included both regulatory programmes in response to Basel III, Dodd Frank and other post-global financial crisis regulation and discretionary investment on growth initiatives, digitisation, upgrading platforms and technology and process improvement.

Yet despite expense and headcount reduction, group function costs have not fallen at the same pace as revenues and frontline costs.

Consequently, as a proportion of revenue, support function costs have increased marginally while as a proportion of total operating costs they have increased significantly from 30% to 35.6% – see Diagram 1 below.

Diagram 1: Functional costs as a ratio of revenue and operating costs



Source: Aon

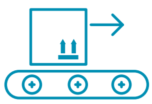
What measures are banks taking to extract savings?

Across the global industry, firms are deploying a range of levers to drive cost savings across their organisation. Below we identify the six most prevalent activities.

1. Location strategy

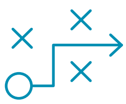
Firms are looking to lower-cost locations for a range of business functions, from anti-money laundering operations to IT services. On average, firms have moved 3% of their workforce to lower-cost locations since 2015.

2. Automation



Banks are looking to technology and automation to drive efficiency and effectiveness gains in areas such as report production, anti-money laundering processes and client service operations.

3. Realignment

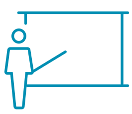


We have started to see support functions move from being wholly centralised to being aligned to specific business lines to drive greater cost accountability, transparency and cost management discipline.

4. Talent management

Firms are realising that returns on investment can be improved by focusing on retraining existing talent rather than incurring significant restructuring/severance costs and a premium to hire into new roles.

5. Standardisation



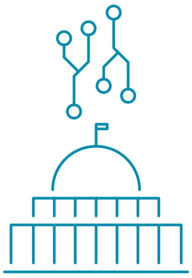
More roles are being moved to shared service centres to standardise them and realise greater economies of scale. Staff grade pyramids are being assessed to ensure the appropriate mix of senior versus junior grade.

6. External spend

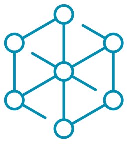
Since 2015, non-compensation spend, consulting and contractor spend has reduced 11% on a per capita basis. Banks are putting more pressure on vendor pricing and renegotiating contracts more aggressively.

Is location strategy or automation proving more effective as a cost reduction strategy?

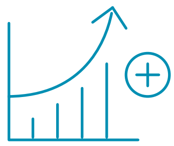
To reduce cost, banks have been focusing on location strategy or automaton and technology as their primary levers to extract savings.



In terms of functional costs, there is not a clear difference in cost efficiency (as a percentage of revenue) between those firms that have primarily invested in technology and automation versus those that have focused a location strategy.



Because they are (generally) less complex and costly to execute, location strategy programmes are yielding higher returns on investment in cost savings than automation.



Typically, technology-led business cases achieve $1 in run-rate savings for every $3-$5 invested. For relocation business cases, the ratio is $1-1.5 invested for every $1 of run rate savings.

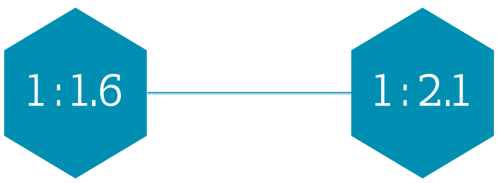
But a primary focus on technology appears to offer greater long-term benefits

1. Technology is leading to more efficient use of headcount:

Our data show that firms that have invested less in technology have more of their functional headcount (up to 60%) assigned to activities that have high potential for automation, such as report production and anti-money laundering processes, whereas highly tech-focused firms have as little as 30% of headcount assigned to these same activities.

This is best illustrated by the headcount coverage ratio, which measures the ratio of heads in the support functions to the total number of firmwide heads – see Diagram 2 below.

Diagram 2: Support function: total headcount coverage ratio



Low degree of automation

High degree of automation

Source: Aon

2. Tech investment is leading to stronger revenue growth...

Judicious investment in technology is likely to lead to stronger revenue growth. New digital channels and technology-enabled infrastructure can position firms for stronger top-line revenue growth (alongside other market and firm-specific factors). Areas including Transaction Banking, Payments and Prime Services, which are all reliant on strong technology platforms, have performed well in recent years (Prime Services revenues grew by 30% between 2013 and 2018, for example) and are likely to continue to do so.

3. ...and positioning firms for greater profitability

Those firms that have already invested in technology and greater automation are creating more capacity for growth and profitability in their banking infrastructure. At the same time, they still have scope to use a relocation strategy to further reduce costs. By contrast, those firms that have yet to implement automation and digitisation to reduce costs will face a tougher challenge to yield sufficient savings in return for their technology investment – yet risk falling behind if they delay investing in automation much longer.

Here are six questions that banks need to be asking to strike the right balance between cost control and future strategic investment

1. Where can technology spend have the most impact on our savings and future growth?

As we've seen, automation and other efficiency-driving technology doesn't come cheap. But with up to 60% of support function roles offering high potential for automation, the long-term cost saving potential cannot be ignored. Banks need to take time to assess in which areas of their business technology investment can deliver the both greatest cost savings and support the overall growth strategy of the firm. To take an obvious example, increasing online functionality for clients and customers can reduce the cost of transacting while also addressing a growing appetite for self-service banking.

2. Is our infrastructure scalable to our revenues?

The reason why banks often haven't seen their support function cost-to-income ratio fall is because they don't have an infrastructure that can scale up or down in line with revenues. In particular, banks may want to explore how technology can help scale down their support function costs during periods of declining revenues – but still deliver the capacity to cope as activity picks up.

3. Are we leveraging locations in the optimal way?

The differential in headcount deployed to low-cost locations can vary by as much as 25% from one bank to another. But before adopting a location strategy, firms need to consider carefully the extent to which a process or role can be automated right now. After all, it is likely to be more costly in the long term to move roles/processes to another location and then automate them at a later date.

4. Which operating model is optimal for our firm?

A greater degree of accountability, transparency and management discipline over support function costs can be driven by shifting some areas of support from 'Group' into individual lines of business. Firms need to consider whether a highly centralised model for support functions, a highly business-aligned model, or hybrid of the two is best for their organisation.

5. How can we improve return on equity while investing in the longer-term growth of our business?

Focusing solely on cutting costs fails to safeguard a bank's future potential for growth. A strategy that can improve operational efficiency but also strengthen a bank's ability to respond to future market needs is key.

6. Are we making the most of our existing talent to unlock greater returns?

The average cost of replacing a role can be up to 1.5 times the total compensation package of an individual once exit costs, hiring, training and salary premiums are factored in. Firms may want to make use of digital assessment capabilities to determine how the firm's existing headcount can be most effectively deployed.

Conclusion

As banks continue to seek to optimise their support function costs in the face of persistent revenue pressures, it's important to keep sight of the business's needs in the longer term as well as its return on equity in the short term.

For more information

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