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Banks Are Passing the Buck in Cost Cutting

Misaligned incentives still reign in the banking industry, turning cost cutting into a hot potato passed around divisions.

As we wrote in our **last piece**, there is a certain mindset in the banking industry that still runs contrary to value creation. We promised a follow-up on how value is destroyed in relation to disposals and acquisitions. But before that, we want to dive deeper into how banks currently conduct cost cutting, which will provide a decent backdrop for exploring how value is lost in disposals and acquisitions.

Large financial institutions are typically divided into front office and service providers. Front office consists of functions such as retail banking, corporate banking and global markets. Service providers are numerous and typically include departments such as human resources, IT, operations, control, legal, compliance, risk and audit, to name a few.

The front office functions run their own P&L but the service providers do not. So when HR works with a business unit, it incurs costs and allocates them to the product line. Because of this process, the product division typically incurs more than 60 percent of its overall costs through internal allocations from service providers and less than 40 percent through direct costs (or costs which it can influence directly) such as headcount, floor space, computers and external consultants. The exact split varies from location to location, and department to department.

Cut or challenge

When the CEO and the board decide to embark on a cost reduction, targets are typically set by the board at the product level where the organisational profitability resides. Managers in the product divisions have three main areas where they can cut costs: 1) the internal direct costs in their divisions incurred by their staff and their direct expenses such as salaries, benefits, travel and entertainment; 2) the external direct costs in their divisions incurred through third parties such as vendors or market data providers; and 3) and, by far the largest bulk, the indirect costs allocated to them through service providers. The largest of these indirect cost allocations is no doubt from IT and operations but given the increase in regulatory requirements, service providers such as finance, compliance, legal and risk have gained substantially in importance and hence in costs. In fact, during the last 20 years, large financial institutions actually have seen their direct front office costs drop while overall costs increased – a reflection of the increasing complexity of the control functions and service providers.

Product divisions very quickly learn that cost reduction initiatives in the first two areas are highly undesirable and hard to achieve. They reduce front office staff motivation, and frequently require an upfront cost investment to redesign a process. Cost reduction initiatives could result in lower quality product offerings to their clients and hence perhaps long-term negative repercussions to their business.

Take a division such as retail banking. Front-office cost reduction in the first category – internal direct costs – can be achieved through branch closure or staff reductions in the remaining branches. The former having a negative impact on long-term client coverage, the latter on overall client services and both on front-office staff morale. A cost reduction in the second category – external direct costs – can be achieved through renegotiation with and/or cancellation of business consultants supporting the division or reduction of available data terminals such as Reuters and Bloomberg terminals. Both have a negative impact on client services.

The most desirable area to look at is the third area – the allocated costs from service providers. Here two general options open up to the division. Either tackle the overall costs of the service provider or challenge how much has been allocated to the product line. The former is difficult as it typically results in a fierce discussion between the front office and the service provider about who is responsible for deciding on the appropriate level of resourcing of the service providers. Naturally, the service provider will have an information advantage of its own cost base and tends to block most front-office suggestions for cost reductions in their areas of expertise. This is extremely tricky in control areas which monitor the legal and regulatory behaviour of the front office such as compliance, audit or finance. Here the business division faces a conflict of interest. On the one side, it wants these functions to be cost effective but, at the same time, it does not want to be perceived as wanting to reduce the oversight of its division. So the front office tends to find that the easiest and most effective way to reduce their respective costs is by challenging and making changes to the highly complex cost allocation matrix, i.e. the percentile cost allocation it receives.

Squeezing the sausage

Naturally, the overall costs for the firm are not reduced at all in these battles but are merely shifted from one area to another without creating any additional value to the organisation. This is akin to squeezing a sausage on one end just to shift some of the meat to the other. The size of the sausage (i.e. costs) remains exactly the same. Given that the cost allocation keys are such a crucial factor in the overall divisional costs – each division is well advised in this process to appoint cost experts to analyse the key cost allocation factors to arm themselves with the best arguments to change the relevant cost allocation keys. The divisions are facing a typical **prisoners' dilemma** with the overall result being a "cost allocation expertise" arms race. So the net result of these cost reduction programmes is frequently additional costs within divisions. This can be seen by the mushrooming in the last decade of functions such as Business Managers, Chief Operating Officers within divisions, numerous locations and ever-increasing support staff.

The discussion about cost allocation is far removed from value or value creation and yet financial institutions are investing good time and effort in the misplaced hope that somehow squeezing that sausage will make it smaller.

Cutting the sausage

Fixing this state of affairs is easier said than done, but it starts with a culture change on two fronts. First, by focusing on cost allocations, the product lines essentially get out of looking for ways to create value in their front office functions and asking whether their service providers could be giving more value. The management should have front offices focus on optimising their business to minimise costs, as opposed to challenging internal cost allocations.

Second, a mindset shift is also necessary among the service providers. With no P&L responsibility, there is no incentive to run operations in a cost efficient way, because work can be allocated to the product lines. Costs in the financial industry have gone up over the years despite optimising front office functions due to increased compliance and regulatory costs. , Therefore, financial institutions will have to find more ways of optimising their front offices and squeezing more value from their external providers. Otherwise, the squeezing of the sausage is likely to continue.

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