IBM Institute for Business Value

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Restructuring costs rationally for long-term competitiveness in financial markets

In 2001, securities industry revenues dipped dramatically – the largest decline in 20 years – and spurred a similar drop in profit margins. In the near term, securities firms have tried to prop up margins by reducing capacity. However, long-term competitiveness depends on altering a company's cost structure permanently. Three strategic initiatives promise the type of far-reaching change that is required to rein in costs today … and position firms favorably for the next market upturn.

By Daniel Latimore, Ian Watson and Greg Robinson

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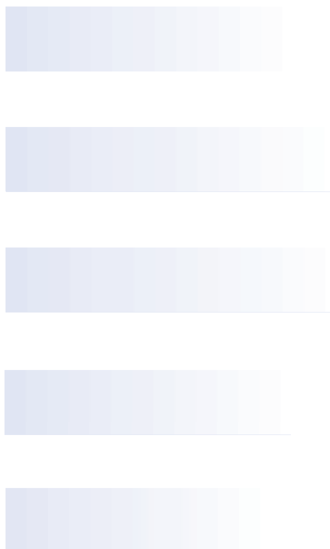


Introduction

For the securities industry, 2001 was the worst year in a generation. At New York Stock Exchange (NYSE) member firms, revenues fell by 20 percent, the largest drop in the last two decades.[1,2] Even during the last major revenue dip in 1990, revenues declined only 10 percent.[3]

But even before the recent revenue freefall, there were signs of trouble. Between 1996 and 2000, expense increases outpaced revenue growth by 10 basis points.[4] Pretax profit margins at top-tier firms declined even more severely than the rest of the industry – contracting by 50 percent between 2000 and 2001.[5] When revenue was growing 10 percent annually, rising costs seemed less ominous. However, with revenues deteriorating, the growing imbalance can no longer be ignored.

With top-line growth stalled, financial markets firms have only one avenue for increasing shareholder value in the near term: *reducing costs*. Scrutinizing budgets and trimming surplus capacity – although necessary – will not be enough to produce margins that satisfy anxious stockholders. In fact, research at the IBM Institute for Business Value indicates that top-tier firms may need to cut overall costs by as much as 16 percent simply to regain previous profit levels.

Eliminating excess capacity will not be enough

As they have done during past market downturns, securities firms initially responded to margin pressure by reducing headcount and cutting compensation. Between February 2001 and February 2002, Wall Street cut 43 000 jobs – the largest reduction in 25 years.[6] In 2001, investment-banking bonuses were slashed to half of their 2000 levels.[7] These reactions are not surprising because, on average, compensation comprises almost 60 percent of a securities firm's noninterest expense.[8]

Yet, not all cost-cutting measures carry equal weight. Cost-reduction strategies generally fall into one of two categories: type I strategies, which reduce costs by reducing capacity, or type II strategies, which drive savings by improving efficiency.

Besides the typical first-wave cost-cutting measures already mentioned (pay cuts and layoffs), type I strategies also include initiatives such as consolidating locations, exiting geographic markets and reducing the number of services or products offered. In contrast, type II cost-reduction strategies enable long-term efficiency gains by lowering the price of inputs (switching data providers, adopting open-source software or relocating specific operations offshore), streamlining operations (performing processes electronically or centralizing support functions) or reducing infrastructure costs (optimizing or outsourcing IT support). These two types of strategies can be further differentiated by their business impact (see Figure 1).

	Type I	Type II
Effect on revenue potential	Neutral to negative	Neutral to positive
Investment required	Minimal	Minimal to substantial
Time until impact	Short-term	Short- to long-term
Supports long-term, strategic goals	No	Yes
Execution risk	Low	Moderate

Figure 1. Cost-reduction strategies: type I versus type II.
Source: IBM Institute for Business Value.

But, the most important distinction between the two types of strategies is the difference in their impact once business picks up again. Although the payoff for reductions in capacity may be quick, it will not—in and of itself—return margins to their historical levels. Compounding the problem, type I initiatives can actually hamper a firm's ability to grow as the economy revives. In contrast, type II strategies require more upfront investment and take some time to implement, but they allow a company to make *permanent* changes to its cost structure — helping improve its financial position now and, perhaps more importantly, offering a source of competitive advantage as the market rebounds (see Figure 2).

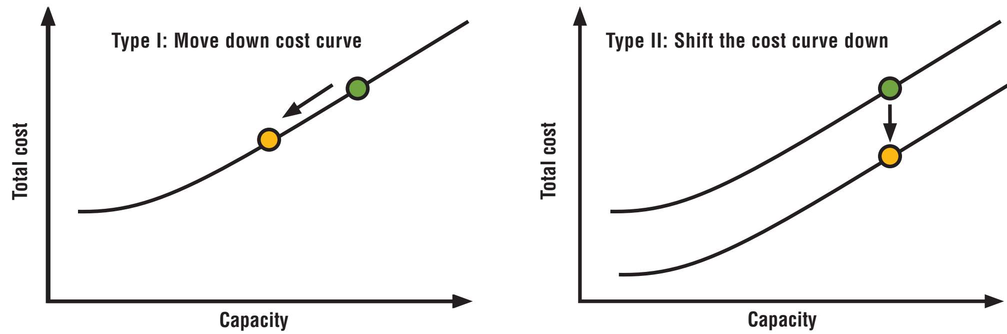


Figure 2. Type I strategies move a company *down the cost curve*; type II strategies shift the company's *cost curve down*.
Source: IBM Institute for Business Value.

Establishing an efficient cost structure: A competitive advantage
As financial markets firms contemplate more substantive cost-reduction measures that fundamentally alter their current cost structures, they will likely encounter a wide variety of type II improvement possibilities. The IBM Institute for Business Value recommends a closer look at three specific areas that show significant potential for long-term efficiency gains:

- *Straight-through processing (STP)*—By optimizing and automating processes related to the performance and confirmation of securities trades and other financial transactions, the IBM Institute for Business Value estimates that a company can eliminate 10 to 20 percent of its back-office expense.[9]
- *Information technology (IT) delivery optimization*—Inventorying IT infrastructure, identifying redundancies and redesigning the IT organization, processes and technology can lead to a 20- to 30-percent reduction in IT delivery costs without sacrificing flexibility or functionality.[10]
- *IT outsourcing*—Through the use of third-party vendors for development, management and maintenance of technology systems and personnel, firms can lower IT costs by as much as five percent and, more importantly, make a sizable portion of their fixed IT costs variable.[11]

Although initiatives in any one of these three areas would likely provide worthwhile gains, firms often uncover additional synergies by combining elements from multiple efforts into a comprehensive cost-optimization portfolio.

Straight-through processing: Start small; start now

The Securities Industry Association's (SIA) push to move the entire industry to a one-day settlement period (T+1) relies heavily on a comprehensive, inter-enterprise STP implementation. In fact, the T+1 initiative has made STP a standard part of the industry's vernacular and tightly linked STP and T+1 in most executive's minds. However, the urgency behind T+1 has waned. Succumbing to industry debate questioning the validity of the business case that it commissioned, the SIA is reevaluating the costs and benefits of moving to T+1.[12] Without regulatory backing, the SIA mandate – with its deadline already postponed to 2005 – has limited influence.

As the momentum behind T+1 slows, STP is dropping off the priority list at many firms. STP has become so intertwined with the now controversial T+1 initiative that businesses tend to ignore them both, overlooking the possibility of *selective* STP implementations – in individual processes versus end-to-end and with other financial products beyond equities.

Despite T+1's reliance on STP, they are not synonymous; STP pursued in individual operational areas by individual securities firms can yield significant returns, with or without the industry moving to T+1. Besides the cost-savings potential, STP can increase the overall transactional capacity of securities firms, helping handle periodic spikes in trading volume. Particularly attractive amidst today's highly volatile market, selective implementation of STP has the potential to reduce operational and settlement risk. By enabling STP in key areas, companies can reduce costs now, and at the same time, position themselves for a future end-to-end implementation. To identify the specific processes that would benefit the most from STP, firms should examine their back-office operations both vertically and horizontally (see Figure 3).

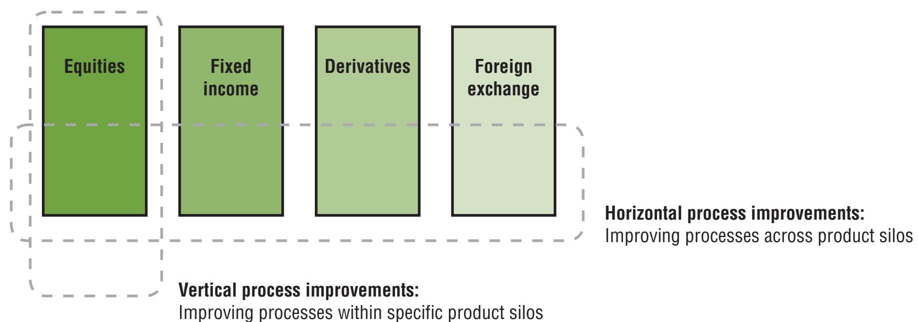


Figure 3. STP can take costs out of the back offices of securities firms in two ways.
Source: IBM Institute for Business Value.

Vertical process improvement

At many securities firms, cross-border equity trading is a prime opportunity for vertical process improvement through selective STP implementation. By its very nature, cross-border trading is significantly more complicated than domestic trading, with differences in currencies, transaction calculations, regulations and settlement periods.

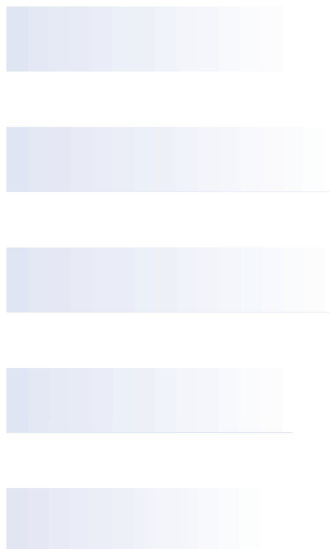
With complexity come consequences. The Global Straight Through Processing Association (GSTPA) estimates that 15 percent of all cross-border trades currently fail to settle on time.[13] Estimates from SWIFT are even higher; they suggest that on-time settlement failure affects 15 to 20 percent of all cross-border trades.[14] In addition, the one-day settlement lag between the foreign exchange and the equity transaction makes hedging risk difficult, particularly when one considers the significant amounts involved.

The average cross-border transaction weighs in at US$210 000.[15,16,17]

To make matters even more challenging, cross-border equity trading volumes are rising significantly. Dollar volumes in and out of the U.S. tripled between 1990 and 1995, from US$615 billion to US$1.7 trillion. Traveling a continually steeper growth curve, cross-border trades in 2000 totaled US$10.6 trillion, over six times the amount traded in 1995.[18]

As companies chart their response to these trends, they should consider the pivotal role that STP can play. By automating key processes and reducing the number of failed trades, STP can help companies lower the overall cost of cross-border trading and mitigate risk.

Equity trading—both domestic and international—represents only a portion of the overall STP opportunity; STP-enabled trading processes for other financial products can generate savings as well. Companies should look beyond the STP avenues popularized by T+1 and examine each line of business for potential STP efficiency gains.



Horizontal process improvement

Looking horizontally across a typical financial markets organization, collateral (securities and cash) and liquidity management stands out as a significant opportunity for gaining efficiency. The growth in the number of products offered and geographies served has led to a complex and inefficient collateral and liquidity management process. Firms often interact with a large number of correspondent banks, as well as numerous clearing and settlement providers. This complexity has made it increasingly difficult for organizations to have a transparent, near realtime view of collateral on a global basis.

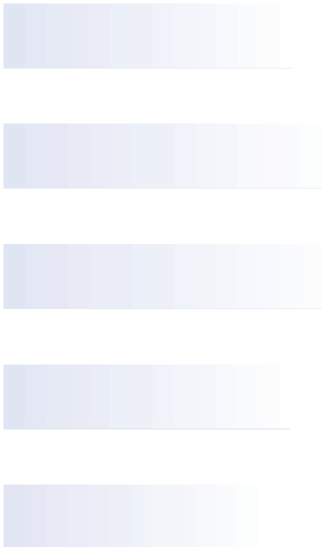
Lacking this view, financial markets firms are unable to optimize their asset utilization, and the cost of managing exceptions is high. The IBM Institute for Business Value estimates that the typical large investment bank could generate savings of US$1 to 2 million per day given a transparent and efficient approach to collateral and liquidity management. Connecting and automating collateral and liquidity management processes through an STP implementation can help firms achieve these significant cost savings.

IT delivery optimization: Decrease duplication

Throughout the last decade, several factors have reshaped IT delivery at financial markets firms. Industry consolidation and global expansion created a groundswell of industry mergers and acquisitions (M&A) – with the number of M&A transactions increasing 316 percent between 1990 and 1999.[19] With other synergy opportunities garnering corporate attention, IT integration often received short shrift. Newly formed organizations were frequently left with overlapping systems, excess computing capacity and inconsistent IT service levels.

1999 saw a record number of securities firm consolidations with 82 in the Pacific Rim, 113 in North America and 101 in Europe.[20]

During this same time period, many securities firms abandoned centralized IT functions in favor of business unit or geographic-based IT organizations, in hopes of gaining speed and flexibility. Unfortunately, decentralization also introduced significant overlap and underutilized capacity. As with prior decades, the 1990s brought advances in technology, pressuring firms to experiment with unproven technology simply to remain competitive. Caught up in the unprecedented growth of the late 1990s, firms spent more freely on IT, making investments that – in hindsight – seem risky and, in some cases, unnecessary. With unrelenting emphasis on top-line growth, controlling IT costs was not a priority.



Taken individually, each IT decision made in response to these industry pressures was undoubtedly sound … at the time. But, collectively, over the past ten years, these actions have led to bloated, inefficient IT delivery infrastructures, which now cost the securities industry 3 to 4 percent of its annual revenue.[21,22]

At most securities firms, IT infrastructure needs a major overhaul, not only to reduce costs but also to improve service levels and increase operational flexibility. The payback on improved efficiency can be substantial. The IBM Institute for Business Value estimates that a comprehensive IT delivery optimization strategy – implemented at a top-tier financial markets firm with an IT budget of US$1.5 billion – has the potential to reduce annual IT expense in the range of US$122 to 250 million.

Taking a holistic look at IT infrastructure involves careful consideration of three types of consolidation initiatives – shared services, hardware consolidation and application rationalization (see Figure 4).

Initiative	Goal	Target	Potential savings as a percent of IT spend*
Shared services	Consolidate similar IT functions across multiple business units to reduce costs and improve service	• Hardware • Software • Staff • Processes • Sites	4 to 6 percent
Hardware consolidation	Review and redistribute a firm's technology components to optimize operational capability and flexibility at the lowest possible cost	• Networks • Storage • Servers • Sites	4 to 10 percent
Application rationalization	Review and reduce a firm's application portfolio to better align applications with business objectives and lower costs while maintaining necessary functionality and flexibility	• Applications	4 to 7 percent

* Estimates based on IBM Business Innovation Services consultants' experience working with financial markets firms.

Figure 4. Three key infrastructure consolidation initiatives.
Source: IBM Institute for Business Value.

Shared services

When shifting IT toward shared services, firms should evaluate each function carefully to determine whether it is best delivered centrally or through individual business units. A shared services model is not an "all or nothing" proposition; finding the right balance between centralization and business unit autonomy is key. An important output of this evaluation is a business case that clearly delineates the expected returns and helps garner management approval and commitment.

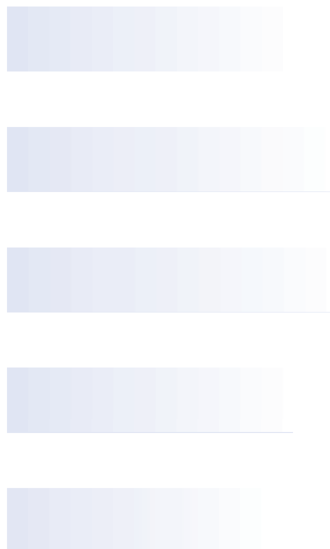
Naturally, business units may be apprehensive about losing influence and control as IT becomes more centralized. To gain their confidence, a shared services strategy should include provisions for governance to establish unambiguous decision-making processes, flexibility to meet the needs of a larger constituency and incentives to maintain responsiveness to the customer (business units).

Properly implemented, shared services encourage collaboration, reuse of intellectual capital and implementation of best practices across the company, which, in turn, can help increase innovation, raise quality levels and reduce cycle time. But, most importantly, shared services help businesses control costs. IT expenses – which were previously scattered and hidden in pockets throughout the organization – become more visible and easier to manage, allowing the business to allocate increasingly scarce resources to the enterprise's highest priorities.

Hardware consolidation

Besides eliminating hardware costs through consolidation, businesses can lower support costs as well. By shrinking the overall architectural base, IT departments have fewer systems to monitor on a daily basis, change becomes more manageable and the IT department's ability to introduce new business capabilities may improve.

Although hardware consolidation offers tremendous opportunity for cost savings, businesses should perform an in-depth analysis of user needs and expectations alongside the potential impact of any hardware restructuring, to avoid negatively affecting the company's long-term business strategy. When planning a hardware-consolidation initiative, it is also an opportune time to revisit business-continuity plans. Consolidation can make contingency plans less complex and reduce continuity-related risk.



Application rationalization

Rationalizing application investments involves careful scrutiny of a firm's entire application portfolio. To remain part of the optimal application portfolio, an application must pass through multiple filters – strategic, functional, technical and financial. Based on this analysis, applications are retired, replaced by or combined with other applications, restructured to reduce repair frequency or retained "as is." Reconciling the application portfolio can also help position the business for additional changes – such as implementing shared services or outsourcing application management.

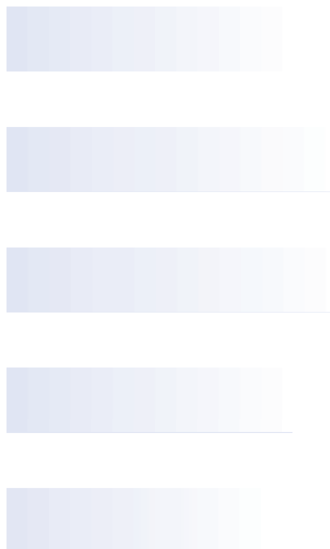
Changes to the portfolio are likely to face organizational resistance. The line between preferences and needs blurs quickly when business units face losing applications that they designed and built. The company must be prepared to address organizational challenges throughout the valuation and implementation stages. The magnitude of financial benefits from application rationalization varies widely based on a number of factors, such as size of portfolio, age of applications and degree of overlap. However, the greatest returns usually come from retiring applications or transferring application management to a third party.

IT outsourcing: Preserve financial flexibility

At financial services firms, IT budgets command a higher percentage of company revenue than at firms in almost any other sector. And, with the latest market downturn reminding securities firms just how cyclical the industry is, the idea of converting fixed IT costs into variable ones is particularly alluring. However, securities firms have been extremely reluctant to venture into outsourcing arrangements.

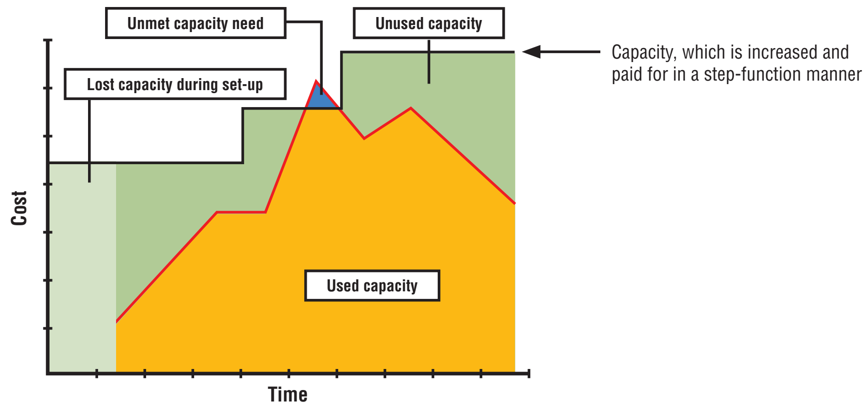
In 2000, outsourcing comprised only 8 percent of the IT expense within the securities industry — compared to 20 percent for insurance and 25 percent for banking.[23]

Securities firms have the same concerns as other companies that are considering outsourcing: deteriorating service levels, lower IT morale and loss of control. They are also nervous about prospective vendors' industry knowledge, track record and solvency. But, above all else, securities companies worry about risk. In the financial markets, penalties for operational failure are much higher than in other industries. Technology problems can escalate quickly in a realtime trading environment. With high transaction volumes and huge monetary amounts involved, one glitch can cost a securities firm tens – or even hundreds – of millions of dollars.

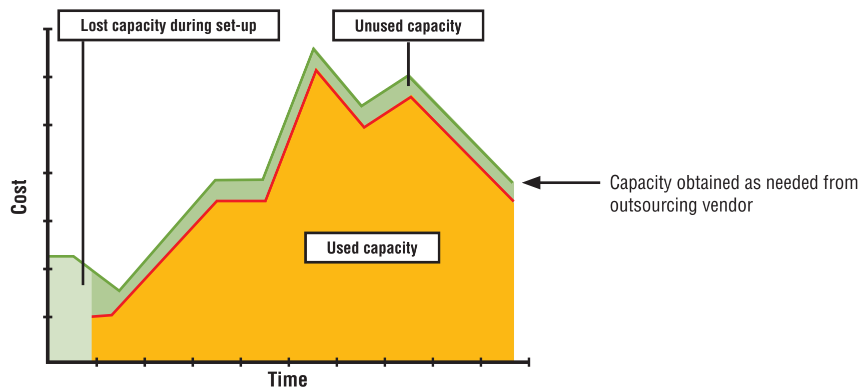


Yet, business pressures are intensifying, compelling the security industry to reconsider its views on IT outsourcing. Industry cycles continue to drive large swings in IT demand. Securities firms have difficulty increasing capacity precisely when needed, and – during troughs – overcapacity places a heavy burden on the corporate income statement. Competition is intensifying, requiring firms to deliver a solid financial performance quarter after quarter. All the while, remaining technically current is difficult – and expensive to sustain. In a world shaken by the events of the September 11 terrorist attacks, fear of catastrophic disasters is rampant, pushing firms to seek cost-effective methods for safeguarding the business and reducing risk.

In many ways, outsourcing helps insulate securities firms from the pummeling effect of these market pressures. Acquiring IT support on an incremental basis – paying only for the capacity needed at any given time – helps financial markets firms cost-effectively address oscillating levels of demand (see Figure 5). IT costs become variable, rising and falling with demand. Transferring assets to an outsourcing vendor can help businesses boost return on assets. Plus, with most outsourcing arrangements, business-continuity protection is built in. Firms can avoid large upfront capital investments to construct their own in-house disaster recovery capabilities – and the ongoing expense of maintaining them – plus, the outsourcing vendor assumes a portion of the risk.



Total lost and unused capacity paid for in this example is approximately 35 percent



Total lost and unused capacity paid for in this example is approximately 15 percent, a 20 percent reduction

Figure 5. Obtaining IT functionality on an as-needed basis allows firms to reduce lead times, upfront costs and unused capacity.
Source: IBM analysis

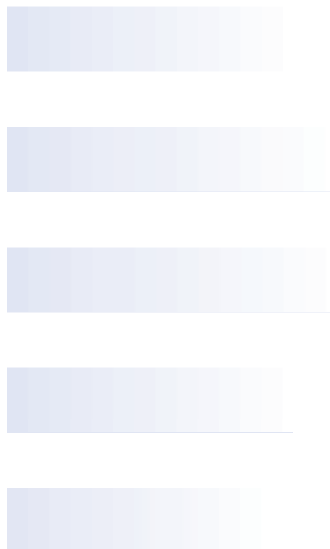
Implementing a type II strategy

Type II initiatives are more complex and difficult to implement than type I strategies. As companies execute these long-term strategies, they face three primary challenges:

- *In-depth oversight*—Strong leadership is required to successfully shepherd a type II initiative through approval, planning and implementation. Whether consolidating trading platforms across multiple lines of business or negotiating an outsourcing agreement, major initiatives need a champion—someone willing and able to take significant risk to achieve potentially significant results and someone tenacious enough to see the effort through to completion.

- *Funding*—Paying for a type II initiative may seem impossible, given the constrained fiscal environment. Upfront investments can be substantial, and payback periods are often longer than those of other initiatives. However, with careful planning, firms can create a self-funding portfolio of initiatives that uses savings from early—usually type I—initiatives to pay for subsequent efforts. To work around restrictive budgets in this manner, firms must withstand the short-term earnings pressure to let type I savings flow directly to the bottom line and, instead, invest some portion of those funds to develop a more competitive long-term position.

- *Organizational impact*—Implementation of type II strategies may require extensive organizational change. Because compromise may be necessary, businesses need to devise methods for overcoming territorial defensiveness and reducing organizational friction. Carefully outlined and effectively executed change management plans—which encompass every facet of change from restructuring the organization, to adjusting incentives, to introducing new systems and processes—are critical to success.



Assessing your efficiency

How much opportunity for improvement currently exists within your operations? Take a moment to reflect on your existing operations and identify areas worthy of a more in-depth investigation:

- What are the major expenses involved in the trading processes of each of your product groups?
- How much are broken trades costing your firm?
- What are the primary causes of trade settlement failures?
- Which areas within your trading process are manually intensive?
- What are the top three cost drivers within your IT delivery infrastructure?
- How complete is your understanding of the total cost of IT?
- Which IT areas have expanded considerably over the last few years due to M&A transactions and global expansion?
- What are the key similarities and differences in IT needs among your various lines of business?

It's time

Cost-cutting initiatives that required nominal investment and carried low execution risk have largely been tapped already, but, for many companies, these initiatives have failed to push margins back up to desired levels. To improve – or perhaps simply sustain – shareholder value, financial markets firms need to make substantial improvements to their cost structures.

Long-range initiatives, like the type II cost-reduction strategies outlined here, require time and money to implement – both of which are in short supply during a market downturn. Yet, during an upturn, operational efficiency initiatives are almost always suffocated by an overwhelming focus on growth. Simply stated, the optimum time to invest is when companies can least afford it.

Because the timing rarely seems appropriate, firms can easily ignore operational efficiency altogether, steadily falling behind competitive benchmarks until some type of crisis forces change. But, by investing regularly in type II initiatives, securities companies may be able to avoid drastic, catch-up attempts.

Although type I initiatives may provide temporary relief during financially challenging periods, they may eventually stifle a firm's ability to grow. Type II strategies, on the other hand, offer an important premium: they remain in effect long-term, helping position a firm for market leadership as the industry rebounds.

To learn more about type II strategies and their potential impact on your business, we invite you to contact us at *bva@us.ibm.com*. To browse other resources for business executives, we invite you to go to our Web site at

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The Financial Services Sector Team at the IBM Institute for Business Value created this executive brief based on their study entitled "Pulling the Cost Lever to Optimize Operations at Financial Markets Firms." To learn more about this study or discuss the potential impact of type II strategies on your business, please contact Dan Latimore at *dwlat@us.ibm.com*.

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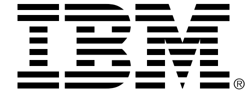

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