Banking 2020:
Future operating models

Banking Matters | Hot Topic

Is it time for a radical rethink?

The financial services industry of today is subject to a multitude of forces that are only accelerating the pace of change in the sector. Organisations need to be clear about their source of differential advantage, and ensure their operating model is focused on developing and maintaining the capabilities required to succeed. Large universal banks will need to take stock and rethink their operating model for the future.

Facing forces of disruption

Financial Services (FS) players in Australia are caught in a brutal race. Regardless of their individual strategy or sector, they are all desperately trying to win at the same fundamental customer-centric game: leveraging open digital technology, 'agile' work practices and partnered ecosystems to deliver all the things their customers demand, such as a better customer experience, deeper insights and more relevant service propositions. They are trying to meet these rising customer expectations through value chains that remain vertically integrated, within an environment characterised by margin contraction and leaner cost structures.

At the same time, as described in our recent report The Future of Banking in Australia, the industry is being disrupted by powerful forces, including:

- concentrating value pools – as income inequality grows, populations age and urbanise, and small business pivots to service sectors
- increasingly heterogeneous consumer behaviour – more likely to be 'in the moment' and oriented to experiences with a far wider trust network
- a digital revolution where technology continues to unhinge itself from a half century of legacy systems, becoming open, networked, real-time and increasingly independent of and agnostic to infrastructure ownership
- interventionist and costly regulation – striking down conventional competitive barriers through identity, switching and capital/pricing models
- macroeconomic fragility – low rates, rising debt and increased capital requirements are challenging a value-creation model that has been sustained for two decades by asset growth, credit quality and leverage.

While each of these forces is significant on its own, together they represent a profound challenge to the traditional, integrated universal FS models most common in Australia.

Markets around the world face the same challenges and, in many cases, conditions are even more difficult for the industry abroad than here in Australia. As a result, many foreign players have been forced to be bolder in experimenting with business and operating models that are far more definitive in the customer arenas served and/or how they win.

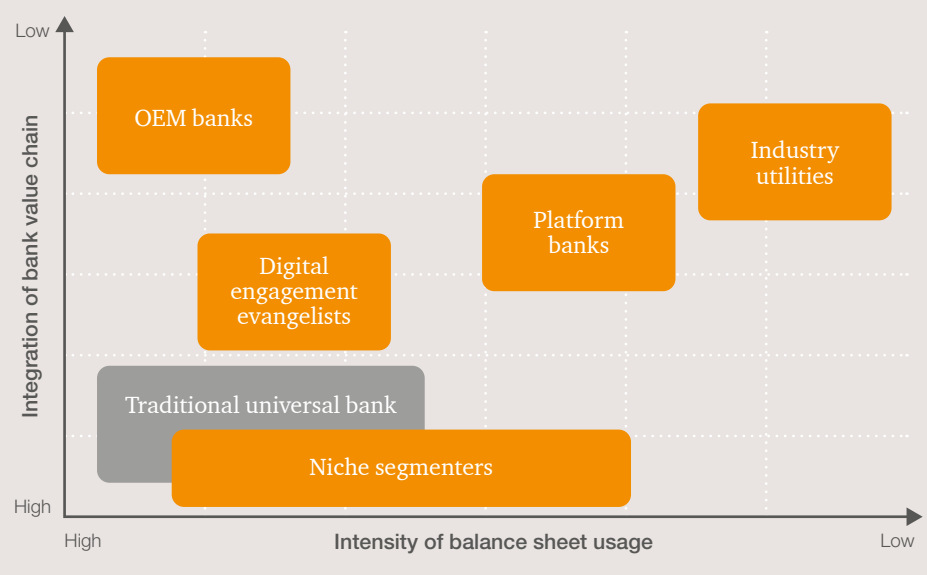
Five fundamental models

What succeeds abroad will soon come here. We have identified five business models for the industry we think every FS executive should understand (see figure to the right). Each model represents a radically different option for vertical integration and balance sheet intensity. Some are evolutions of what we have today, while others are so different that it could be argued they no longer represent what we would call a 'bank'. But each model has its place in a dynamic FS ecosystem, and offers lessons for incumbents seeking to choose their destiny.

Niche segmenters place a premium on specialisation. They seek to compete against universals by cutting through the noise – targeting defined customers with clear propositions and aligned operating models configured for a very specific set of customer needs. In The Future of Banking in Australia we described this as being 'simpler, smaller and more deeply connected'. We cited the examples of First Republic, East West and Rabobank, who have all built significant banking and wealth businesses by targeting clear and specific customer segments. They tend to be vertically integrated and while some are more selective about how they use their balance sheet, in general they manufacture product like a traditional bank.

Digital engagement evangelists are pushing the boundaries of what a 'digital' bank can be. They are removing structural costs associated with geographically proximate relationships, and leveraging the digital capabilities of the medium to provide greater personalisation to target groups of customers. They are also more selective than traditional banks in deciding what they do themselves, and how they source best-of-breed solutions for everything else. mBank, a wholly internet-based bank in Poland, is one of the earliest examples of this approach.

Examples of innovative ways to play



Platform banks are building a business proposition around the unprecedented rate of change in FS technology. The heart of information architecture is moving to what we call the 'digital core': a cloud-based collection of data, workflow, business rules, enterprise content and services. It will be the heart, soul and brains of the future FS company, providing a platform for customers to configure and engage with the services they want. Platform banks are agnostic to manufacturer's products, so long as they are consistent with the bank's compliance obligations and brand promise. Accordingly, their balance sheets will be lighter and value chains thinner. Fidor is perhaps the best example to date; however, the technology will unlikely be the source of enduring advantage as global players like Salesforce enter this domain.

OEM banks[1] have relinquished ownership of distribution, choosing to manufacture best-in-class products and services that are easily configured by others. It may seem counter-intuitive in an era of customer-centricity but in fact the majority of mortgages now pass through an intermediary, while some life insurance and retirement income players have already shifted to an OEM model.

OEM banks, like Cross River Bank in the US, are using their lending manufacturing capabilities to become a partner of choice for P2P marketplaces and other FinTechs rapidly building scale and lowering unit cost to develop compelling, customer-focused products.

Industry utilities are responding to needs of industry players who seek to remain agile while facing increasingly complex regulatory compliance requirements. Equally, utilities are realising value beyond the reach of any individual player by leveraging network effects and comprehensive data in areas like KYC/AML, fraud prevention, cyber security, IT, payments, fulfilment and even customer service. In countries such as Switzerland and China, utilities like Avaloq have grown to become such a material (and essential) part of the FS backbone that banks are free to focus on distinct sources of customer differentiation.

[1] *OEM is a term that comes from the automotive industry that means Original Equipment Manufacturers who manufacture the core product though may have limited or no involvement in distribution.*

Time for a radical business model rethink in Australia

In Australia, the financial system remains robust and uniquely concentrated with large universal models. Arguably our market depth precludes highly specialised, scaled plays. Today's models are centred on end-to-end value chain participation and asset ownership. However, the emergence of new executive titles and urgent mandates (e.g. CCOs, CDOs, CDAOs, etc.,) is perhaps evidence of the complexity in responding to a rapidly evolving environment.

In such an environment, incumbents need to rethink business models.

The first thing they need to do is revisit fundamental strategic choices about where and how they win. The examples from around the world show that each strategic choice emphasises fundamentally different capabilities, which collectively become the foundation for operating model design (what we call 'capability systems').

Put simply, a capability system answers the question 'What will we do better than anyone else to earn the next dollar of our customers' business?'

Align operating and business models

Once the choice of business model is made, a bank needs to align with it operationally. For most organisations, this will require a substantial re-architecting of their existing value chain. For example, banks pursuing a niche segmenter or digital engagement evangelist model will need to think hard about what activities exist in the customer engagement layer of their operating model, and how they leverage partners to fill in gaps.

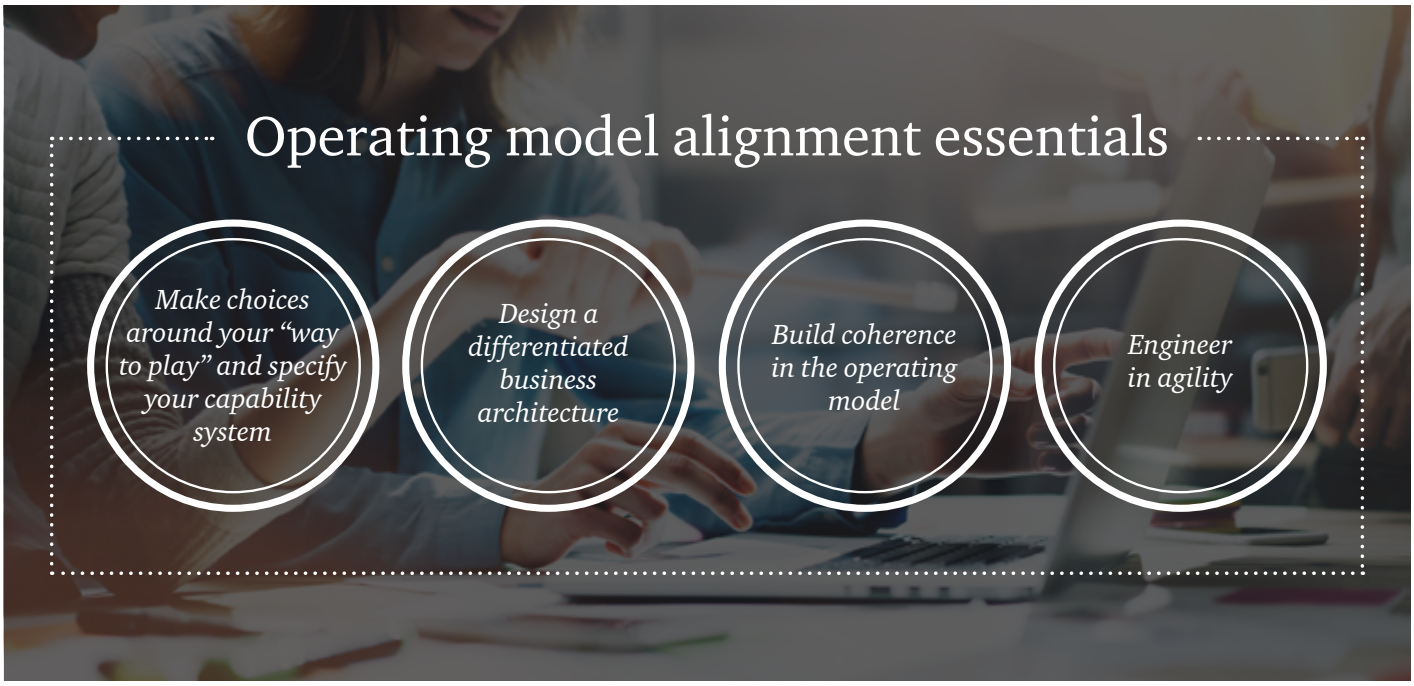
They will also need to scrutinise everything that is not crucial to creating a differentiated customer experience – from product manufacture to operations and technology. As the market evolves, they will need to make better use of OEM players, platform providers and industry utilities.

In contrast, OEM players will likely seek to build either very large balance sheets, or the capacity to sustain extremely high asset velocity (or, more likely, some combination of the two), which will have profound implications for the concentration of capital, liquidity and risk in the Australian financial system.

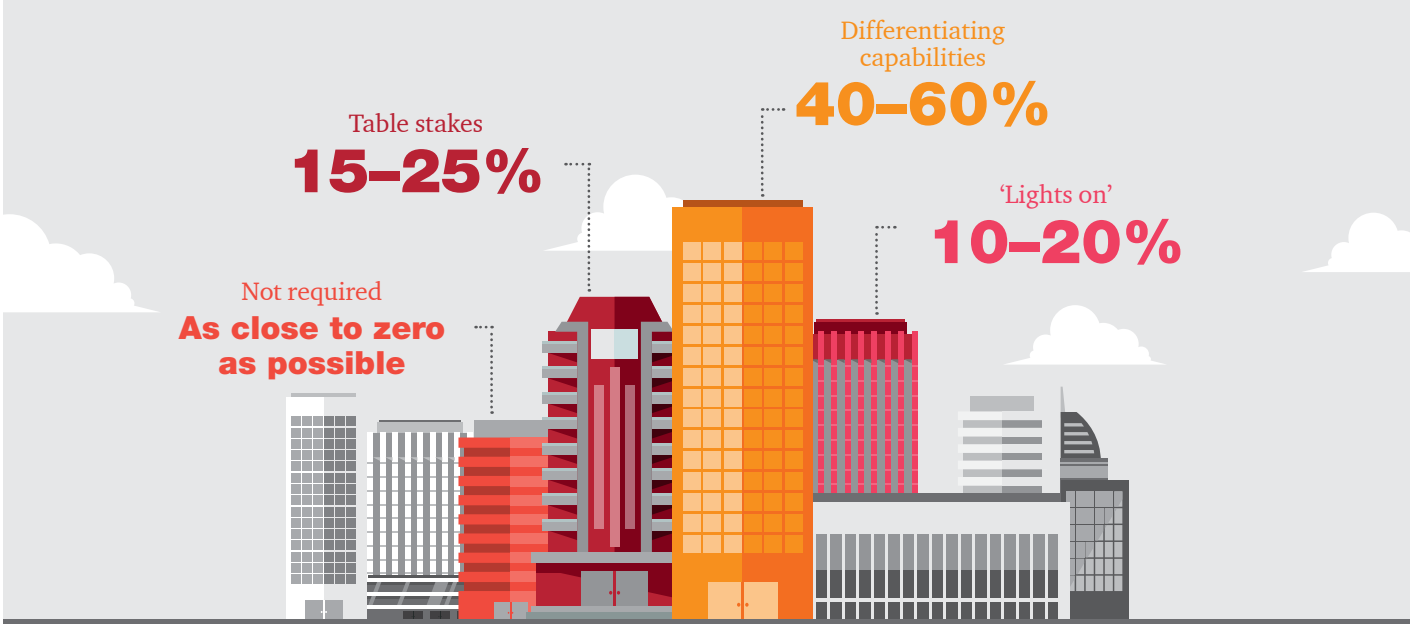
Successful players will not only manage the evolution of their own business and operating model, but they will do so within the context of an entire industry in flux.

Four operating model alignment essentials

Aligning business and operating models requires the focus of the entire organisation on differentiating activity while ensuring sufficient flexibility to adapt and respond to change. In our experience, there are four essentials to aligning the operating model as described below:



Invest your spending where it will drive your strategy



1. Make a choice around 'way to play' and specify your capability system

While most executives can articulate their strategy, four in five admit it isn't well understood within their own company.[2] The challenge for executives is to enunciate strategy at a level of detail which provides a clear 'way to play' and defines a set of differentiating capabilities. By way of example, Charles Schwab and Wells Fargo are two customer-centric banks building vastly different capability systems. Charles Schwab, who focus on providing integrated solutions to clearly defined customer segments, prioritise capabilities like segment-based solution design, product integration and channel management. For Wells Fargo, who focus on personalisation of product bundles, the priorities for investment are customer data, cross-channel integration and product modularity.

In both examples, strategy is grounded in a clearly articulated capability system allowing the organisation to focus. Often it is only when you are specific about why customers will give you their next dollar that are you able to have clarity about your way to play and the capabilities that really matter.

2. Design a differentiated business architecture

With the key capability system described, the second step is to focus resource effort and investment. A well-described business architecture connects people, process and systems within the organisation to business capabilities, providing a lens by which talent, strategic initiatives, capital and operating expenditure are prioritised. Most organisations overspend on non-core capabilities, or those required to keep the lights on. A more focused approach liberates organisations by introducing zero-cost budgeting around capabilities that are truly needed, and then redirecting scarce resources to the capabilities that are differentiating. Those differentiating should account for 40–60 per cent of capital and operating expenditure, with much less on 'table stakes' and 'lights on' capabilities (see figure above). In most financial services organisations the opposite is true with 'table stakes' and 'lights on' capabilities taking the majority of expenditure. One potential strategy to tilt towards differentiating capabilities is for banks to look towards industry utilities discussed earlier.

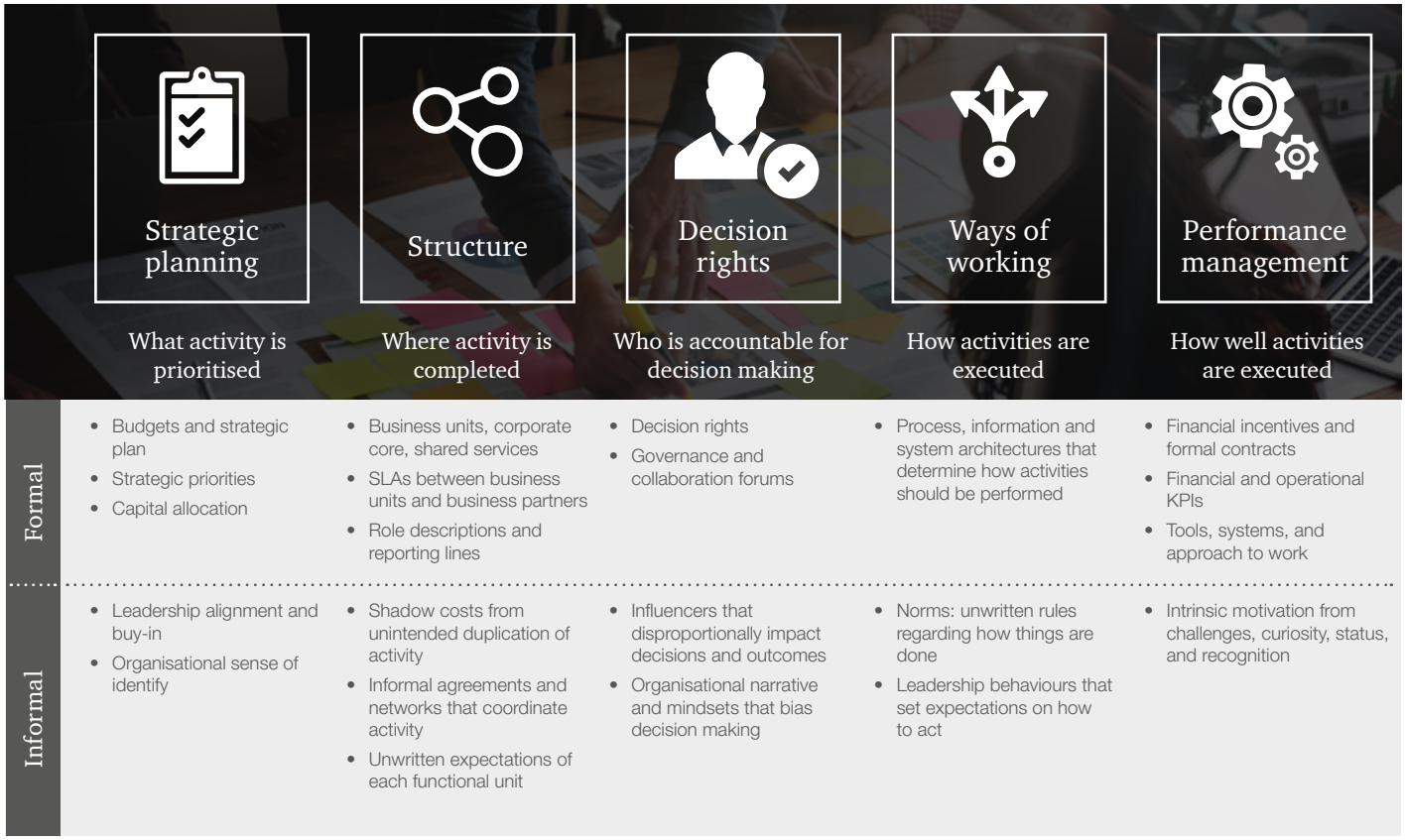
3. Build coherence in the operating model

Too often changes to the operating model are used to cut costs through organisational restructures without consideration of the full set of levers required to coordinate activity effectively. The most effective operating models are coherent in all dimensions of model design: strategic planning, structure, decision rights, ways of working and performance management (see figure overleaf). This coherence comes when an organisation's resources are collectively focused on building differentiating capabilities in service of the customer.

Informal levers for activity coordination are as important as formal ones, with many successful organisations putting their culture to work by leveraging leadership, influence, norms, narrative, networks and other intrinsic motivators. Informal methods of activity coordination can provide stability during structural change. USAA, for example, frequently changes the structure of their organisation while the culture remains a constant guide through change.

[2] *Strategy& survey of 4,400 senior executives, Fit for Growth Survey of 500+ senior executives. Fit for Growth is a registered service mark of PwC Strategy LLC in the United States*

Building coherence in the operating model



4. Engineer in agility

Finally, as technology innovation increases the pace of disruption, businesses must engineer in agility. Agility goes beyond its well-known connotations in the realm of technology and IT. It requires shrinking planning cycles and a shift in focus from input steering to outcome steering so that resources can be deployed to programs with demonstrated benefits.

It requires resourcing models that balance the need for scale and functional domain knowledge – typically best served through functional teams – with the need for innovation and change better served by multi-disciplinary, self-directing teams.

We see banks exploring several options: separate run the bank from change the bank through large transformation programs; structure teams based on whether the underlying activity is focused on innovation and change vs standardisation and scale; or build innovation into every employee's role.

Operating model decisions can also be used to accelerate strategy by replicating the desired state. For example, many banks are collecting all customer-facing functions within a single busine`ss unit to standardise processes and delivery omni-channel capability.

In this hot topic, we have reviewed some of the most likely changes we see in store for the Australian FS industry as suggested by global developments – changes already happening in Europe and North America. In Australia, industry players need to know how they will be transforming their business model and, just as importantly, creating alignment between their future business model and operating model.

For more information

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