GROWTH OF FINANCIAL INSTITUTIONS VIA IMPROVED COST EFFECTIVENESS

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Recently the global economy has been faced with several problems. The bubble in technology firms' equity prices burst, spending and consumption worldwide are stagnating, the volume of capital investment is falling rapidly and growth in world GDP is only marginally recovering from its low. This environment negatively affects most businesses' operations.

The performance of financial institutions is furthermore exposed to continual changes in connection with huge advances in technology, deregulation and competition, pushing down interest margins and profit.

The pressure of this environment brings with it the need to improve the efficiency of a business's performance. This challenge is now facing the majority of large financial service institutions. Companies wanting to be successful in dynamic and changing conditions must re-evaluate their current business strategies, adapting them to the new conditions and integrating them into their everyday activities. Business strategies cannot represent merely a static unchanging vision, but should be permanently re-evaluated and adapted in line with market development in order for the company's performance to be as efficient as possible.

An array of indicators exist for measuring an enterprise's efficiency. An efficiently functioning enterprise should first and foremost be able to generate capital over the long-term. Companies wanting to operate successfully in the market over the long term should re-evaluate their strategy from the aspect of the economic value created, meaning that the net present value of expected future cash flows exceed capital costs to the maximum extent. And it was precisely this fact that came to light when companies outlaid huge amounts on various activities without paying due regard to whether this spending will actually bring value. A classic example are companies from the telecommunications sector.

A company's market valuation is connected to its performance. Measured over the long term the equity market always values realistically a company's ability to create value in the form of future cash flows. Companies aimed at creating sufficient value, both through increases in their share price and dividends paid out create value for their shareholders, i.e. their owners.

Each business strategy, activity or decision adopted should thus be evaluated as to its ability to create value for the shareholder. Currently, a variety of methods are used for this purpose.

The well-known is Shareholder Value Analysis method.

Businesses should eliminate all activities reducing value created and aim at strengthening those that create value. For these activities they should subsequently create cost-efficient strategies that support and optimise them in the maximum possible measure (meaning the least expenditure for the highest revenue).

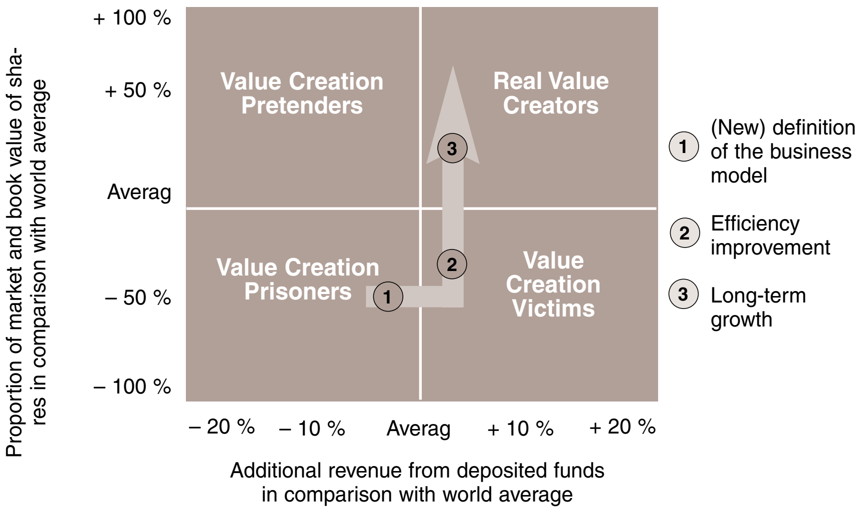
A cost strategy should however focus not solely on the unlimited reduction of expenses. Aiming solely at reducing costs while ignoring the strategic view for the company's overall cost effectiveness also often has the result that after some time costs return to the previous level without the company having implemented the necessary changes in its processes and technologies. Reducing costs in a business model that does not create sufficient value over the long term improves neither the company's performance nor its market standing. Only those organisations which are able to permanently increase efficiency and optimise their costs, while improving the ability of their key business activities to create sufficient value, will be successful.

It is a real challenge to achieve such a ratio between possible future growth of the company and effectiveness of spending made today on the company's operations and growth to ensure the necessary added value. Successful financial institutions should then firstly ensure that their business model is aimed at creating value. They should subsequently draw up a plan for checking and optimising expenditure that not merely supports, but itself creates, potential growth in the company by means of creating and improving business activities that strengthen competitive advantage.

The following graph shows the options for strengthening a company's market standing as regards its ability to create real long-term value for the shareholder. [1]

The majority of companies are located in the quadrant between "value creation prisoners". Their business activity creates only minimal value for shareholders. As can be seen from the graph the path to the quadrant "Real value creators" is achieved most simply by improving the performance of business activities in order that each operation creates sufficient value with emphasis on long-term company growth.

With regard to the given facts, as results from research carried out by Accenture [2], most leaders in financial service provision set themselves the ambitious aim of optimising by 2010 working processes so as to eliminate 40 to 50 percent of their operating costs without this having a negative effect on their performance and thereby help in creating real economic value. They want to achieve this aim in particular by identifying the already mentioned radical possibilities in a mutual ratio between company growth and cost effectiveness.



Ensuing from the research included in the stated study, the majority of financial institutions have real potential through optimising their processes over the time horizon of two to three years to reduce their operating costs by 20 – 30 percent. The study also identifies seven main fields of financial institutions' activities with significant potential for reducing costs. These are shown in the following table.

Field	Typical cost reduction potential as a ratio to total operating costs
Distribution and sales	15 – 35 percent
Product management and marketing	25 – 35 percent
Administration and support operations	15 – 40 percent
Human resources support	25 – 40 percent
Overheads including internal finance and purchasing support	20 – 30 percent
Lending process (mainly banks)	15 – 25 percent
Information technology	20 – 40 percent

Source: see supporting material No. 2

Distribution and sales

For most financial institutions distribution and sales costs represent the highest share of their operating costs. Activities in distribution and sales thus represent one of the most important fields of potential for improving effectiveness of operating costs.

A key element for improving efficiency is developing a suitable strategy for managing contact with customers and using a distribution channel that on the one hand best suits the individual needs of the customer, and on the other hand also the business needs of the company. A suitable strategy should thus bring a reduction in operating costs for services without reflecting negatively on the satisfaction of the most important customers.

The main instrument for improving the efficiency of distribution channels is the implementation of an appropriate Customer Relationship Management (CRM) strategy that improves the quality of interaction between customers and the company. Using this instrument enables a strategy to be focused primarily on understanding the needs of customers and for communication with them and for this strategy to be designed so as to lead to the greatest return on sales and distribution costs.

Concurrently, it ensures that the most appropriate combination of distribution channels is used for contact with the customer, thereby achieving the greatest possible cost effectiveness and at the same time increasing the benefit from each interaction.

Financial institutions often, due to incorrect segmentation of their customers and an inappropriate method of contact, compose their marketing mix incorrectly, outlaying significant funds without achieving the expected effect. Recognising better their customers' needs would enable them to maximise the effectiveness of their marketing budget.

Product management and marketing

Financial services providers often find that their target customers do not appreciate a large number of products and product variations provided to them. A better understanding of the connection between products offered and the value of the utility brought to customers is a basic step on the road to identifying possibilities for improving the efficiency of the product portfolio. Providers should identify a set of target products bringing the greatest value and focus on them, eliminating products bringing little value and costly administration and rationalise all supporting product systems and processes.

This means then that effective product management should lead to a significant optimisation of costs, in particular through simplifying and rationalising existing products, integrating new products into the existing product portfolio and improving the efficiency of development processes and introducing new products.

Administration and support operations

Financial institutions should in today's environment re-evaluate their business model and adopt only cost-optimal solutions that enable the company's further development and growth. They should utilise the huge potential of alternative approaches to the customer and internal electronic information flows, mainly via the internet, intranet and other electronic distribution channels. They should also re-evaluate the possibility of using the resources of a third party to raise cost effectiveness.

And finally they should automate processes as far as possible, using technical solutions. They should eliminate all duplication of data between products and departments and should re-evaluate and improve the efficiency of the existing operating process flow of activities.

Human resources support

In the field of human resources support the process of improving cost effectiveness can be helped also by removing duplication of working activities and improving the efficiency of the reporting system so that management receive only relevant and accurate data and information in the decision making process.

This field of the activity for all subjects, and thus also financial institutions, does however also have great potential for utilising capacities and third party resources. Costs can also be reduced through automating decision–making processes and reporting instruments and also with the aid of outsourcing activities such as the payment of employee wages and remuneration.

Overheads including internal finance and purchasing support

The key to success should be the ability to eliminate overheads that do not create value and automate the management process wherever possible. The company should identify how and where activities connected with an operation create and add value, identifying ineffective areas and opportunities for improvement.

In the fields of internal finance and purchasing support the company should reduce operating costs by means of improving the efficiency of the decision-making process, improve the flow of support information, increase the qualification of employees, use electronic invoicing services and possibly with the aid of outsourcing certain support activities.

Lending process

In the activities of banking institutions an improvement in the lending process can be achieved through standardising the decision-making criteria and competences through reducing the need to burden senior management with the need to agree and look over each credit relationship., Ccredit management should be pro-active and in the case of each individual transaction it should be monitored whether a given transaction falls within the financial institution's wide spectrum credit portfolio. It is here, in my opinion, where there lies great potential primarily for the banking markets of transforming economies.

Information technology

Years of intensive investments development into new technology systems and improvement of existing systems have enabled financial institutions to operate better, faster and more effectively. Further technological development should, however, be harmonised with the business strategy of the financial institution. Continual analysis and specification of their own needs and the market's needs should allow the greatest effect to be achieved in the relation between costs for providing services and costs of further technological development.

The combination of these process changes in improving the efficiency of activities could in the framework of optimising expenses, save a financial institution over the course of two years 20 to 30 percent of its costs. The resulting effect depends on its initial position in the market, internal structure of processes, aims, as well as also the geographical territory of its operation.

If, though, a company in improving its cost effectiveness wants to go even further, it should aim at a more significant change of its operation primarily in the fields:

• the pro-active use of technologies for the company's supporting internal and external electronic interconnection,

• the correct combination of own and outside resources

• continual improvement in the organisation's spending culture.

This should result in a 40 to 50 percent reduction in expenses over the subsequent three to five years. Through its effect it could concurrently surpass the market average through the operation of internal forces, as well as with the aid of mergers and acquisitions. [2]

Use of new technologies

A company utilising internal and external electronic networks (intranet and internet) will in future be able to redirect a large portion of its clients (40% against today's 5%) to its more cost-effective distribution channel, the Internet. This will enable it to substantially increase the capacity of contact centres, optimise the number of employees and in the end also optimise the total number of contact centres.

Strategies using outside resources

A correct strategy for using outside resources can increase a company's flexibility and thereby create significant competitive advantage. Flexibility itself enables a company to adapt quickly to new uncertain and quickly changing market conditions. It is of primary importance to harmonise possibilities in the internal use of resources (insourcing), joint resources (co-sourcing) and the use of outside resources (outsourcing). A successful company should through utilising alternative resources create added value, competitive advantage and improve the effectiveness of its operating costs.

Continual improvement of cost effectiveness

The successful application of continual improvement of cost effectiveness in each organisational component and in everyday activities of every employee should assist financial institutions in achieving long-term growth and raising cost effectiveness.

Pressure from the environment and market brings with it an ever stronger need for growth in the effectiveness of business activities. This challenge is presently faced by most large business institutions operating in the financial services sector.

Companies wanting to be successful over the long term should analyse their ability to create value for the shareholder. They should eliminate activities that reduce the value created and aim at strengthening those that conversely create value. For these activities they should create cost strategies that support their functioning in the maximum possible measure and optimise the ratio of costs and revenues. Among the activities of financial institutions there can be identified several fields that have the potential, with the help of change to the processes and use of technologies, to be optimised and thereby in the end contribute to increasing the economic value of a business and to its ability to compete and survive in the market over the long term.

Sources:

1. Avoiding the Value Trap, 2002. (A paper published by Accenture).
2. The New Challenge: Driving Growth Through Cost Efficiency, 2002. (A paper published by Accenture).
3. Unlocking value through customer insight, 2001. (A paper published by Accenture).