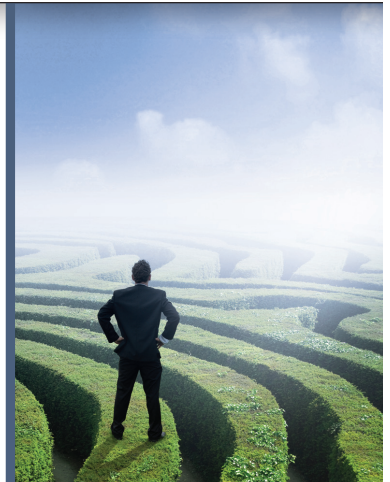


# Managing Complexity Preemptively

## How financial institutions can return to profitability

*“We are committed to top-down cost reductions,” explained the bank CEO to employees. Such proclamations sound good, but cost cuts are not how great companies survive bad times. As the financial services industry strives for new growth and profits, top firms will focus on complexity; not eliminating it but deciphering bad complexity from good complexity—the useful kind that delivers products that customers want and need. Those that successfully manage complexity will find the key to profitability.*



After half a decade of relative prosperity, financial institutions now face an unprecedented crisis across all lines of business. Revenues are falling and trust is all but vanishing among clients, badly disappointed by recent losses and confused by increasingly complex offerings. At the same time, difficult market conditions are inducing regulators to place stricter and more expensive capital requirements on banks.

To return to profitability, financial institutions are once again focusing on cost reductions, but with limited success. Indeed, due to extreme volatility both in trading and commissions, and forced to accumulate massive provisions for credit losses, only six of the top 10 banking groups worldwide have managed to reduce costs in 2007-2009, mostly in the second year (*see figure 1 on the following page*). While cost reduction strategies can be enforced in the short term, they are hardly an ideal approach to increase profitability in the medium- to long-term.

Improving profitability requires a two-fold approach: reducing costs while also managing the structural complexity that surrounds all financial institutions.

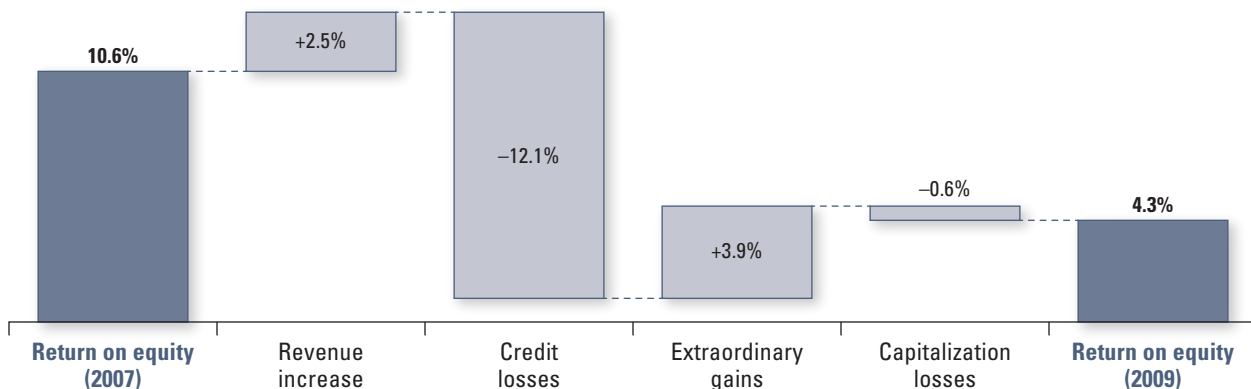
### The Complexity

No one argues the vast complexity in financial institutions. The product range is often rich in intricate bundles, combining or bolting on features once associated with more diverse products. The additional complexity inherent in such bundles is not counterweighted by the value perceived by clients or, worse, often adds to the difficulty in understanding a product and its high price.

Similarly, complexity resides within the organization as operations busily develops new offerings, often doing so within old-fashioned product “silos”—focused on producing a product or service without collaboration with other relevant functions. Restructuring away from such silos is on the agendas of

*Rather than increasing complexity for the good of the customer, or eliminating it for the good of the firm—the focus should be on determining the right level of complexity.*

**FIGURE 1:** Overall profitability in financial services decreased between 2007 to 2009



Note: Revenue increase includes 13.4 percent decrease in 2007-2008 and a 15.9 percent gain in 2008 and 2009.

Sources: A.T. Kearney analysis of 2007, 2008 and 2009 financial statements of the top 10 global banking groups (Barclays, BNPParibas, Credit Agricole, Citi, Deutsche Bank, HSBC, JPMorgan, Mitsubishi, RBS and UBS)

most CEOs, but it will take time, manual work and IT investments to perform such turnarounds: HR and IT represent two thirds of bank's administrative costs on average. And the situation is complicated by the seasonality of the finance business, forcing firms to cope with production peaks and valleys.

### Don't Get Rid of Complexity, Manage It

Complexity is often construed as a negative—increasing operating costs, overloading systems, draining management time and resources. But it is not necessarily negative.

Truth be told, complexity is often simply the result of financial institutions striving to deliver more to their clients through customized products, improved services and new channels. Complexity only turns negative when the desire to deliver more to clients does not deliver more value to them. For example, adding a feature to a product that does not match a client's expectations only adds extra time and

work to a process, stifles creativity to develop better products (because the entire organization is focused on the unwanted ones), and ultimately impedes a once fast and flexible organization. Institutions get trapped in costs and efforts not matched to clients' expectations; this only increases complexity without generating revenues.

Rather than thinking of complexity in terms of black and white—either increasing it for the good of the customer, or eliminating it for the good of the firm—the focus should be on determining the right level of complexity. You want to manage complexity by accurately assessing and delivering what your clients' desire from their financial institutions (*see figure 2*). Capital One did this a few years back when it began issuing variable interest rate credit cards to customers based on their credit scores. Internally, this new product increased complexity significantly, but it more than paid for itself in improved revenues.

Banks that manage complexity understand the two advantages: (1) in

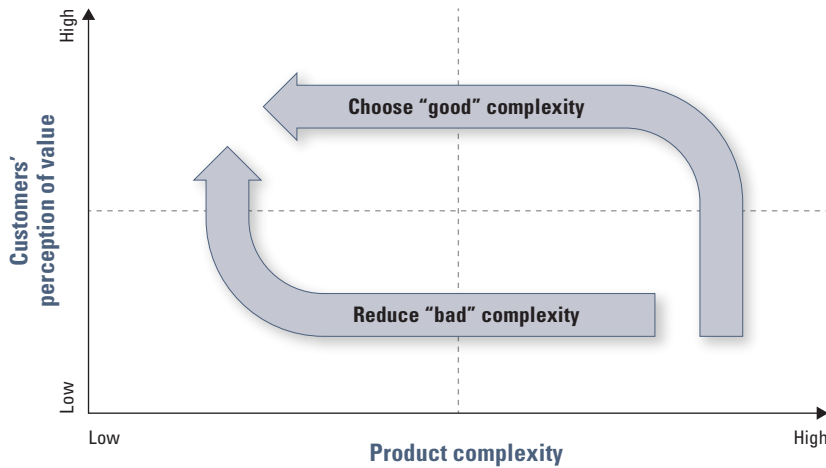
cost reduction (through process reengineering, IT and organizational optimization) and (2) in revenue generation by improving customer satisfaction, developing a healthier relationship with customers, narrowing the scope of the product range, and improving pricing. Indeed, by combining cost-cutting efforts with complexity management, you can create more value-added products and features for a broader customer base.

Going back to figure 1, we found that the double digit ROE of 2007 cannot be achieved through cost reductions alone; you would need to address an average 25 percent of the cost base. However, 10 to 15 percent are realistic targets for reducing costs and managing complexity in select areas.

### Locating Complexity in Financial Institutions

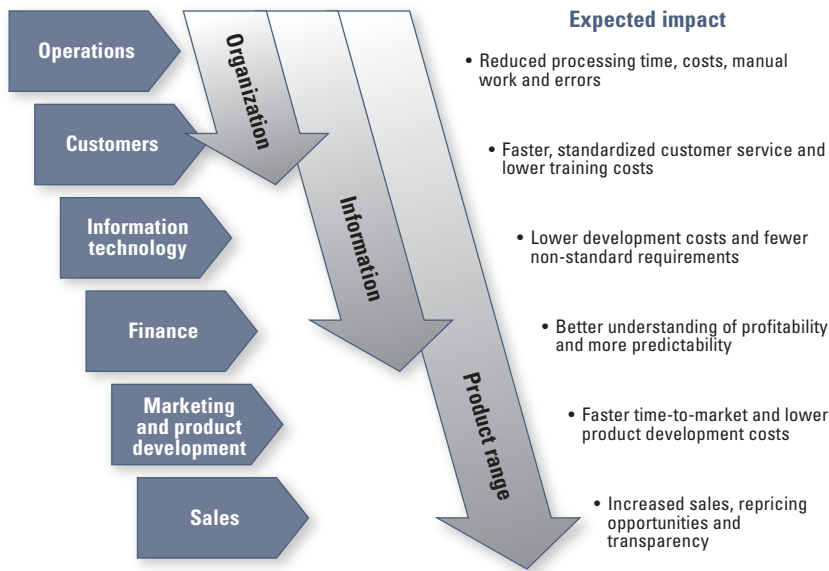
The first challenge in complexity management is locating it: What is generating complexity? Where is it concentrated? What is its impact? The search for complexity begins in the

**FIGURE 2:** Customers understand the value of “good” complexity



Source: A.T. Kearney analysis

**FIGURE 3:** Managing complexity across three areas



Source: A.T. Kearney analysis

three areas shown in figure 3: organization, information and product range.

**Organization.** The root cause of complexity often lies in the structure of the organization. Again, structures built year by year, mostly based on product silos are forced to bundle

several products by client segment. Product silos are not only inefficient but also tend to add complexity as they require handoffs, reconciliations, manual work, and overlapping functions and responsibilities. Resolving such organizational complexity requires

moving from a product-based organization to a process-based organization—one that ensures cooperation within and throughout all organizational units.

**Information.** Complexity often occurs when budgeting and reporting systems are not aligned properly to the real organization, and business decisions are made without a true understanding of the real impact of such decisions on the bottom line. A good example is when a bank launches a new product based on commercial costs and the potential to increase revenues, with limited understanding of the “hidden” costs in support functions such as IT, branch networks, customer care, real estate, rental properties, merchandising and postal charges, among others.

The solution lies in financial controls—the engine of the management reporting system and partner of everyone in the budgeting process. The goal is to diffuse and homogenize information throughout the organization and enforce a culture of informed decision making. The rules to evaluate investments must be “complexity-proof” and adopted across all management levels.

**Product range.** The key to managing product complexity is to stay continually attuned to customer expectations, understanding products and features customers actually value and are willing to pay for. Every product must be bullet-proof, based on a marketing and sales point of view of customers’ true expectations and real-world requests.

Resolving this issue begins with delisting less-valued products and features, but doing so without affecting

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customer satisfaction. (This step will help build-back margins but is only taken after first tackling organizational and information complexity.) The ultimate goal is to mass-customize—to think of every product and service as a set of modular features that can be combined as necessary to meet your customers’ unique needs. Mass customization requires reorganizing the manufacturing process, relying on automation both within your operations and throughout channels. Simplicity and transparency can delight clients. Several direct insurance companies simplified their product ranges and now allow clients to build their own products; BBVA Tu Cuentas has online systems in place to allow customers to customize their financial products and services.

Additionally, coherence between product and market expectations is key to determining the right pricing

*Complexity only turns negative when the desire to deliver more to clients does not deliver more value to them*

strategy. A transparent and simple cost structure allows for a price reduction every time complexity is limited and for “right-pricing” every time complexity is directly associated with improved revenues.

### Stepping Up

Managing complexity is a strategic issue. It determines not only the efficiency of a financial institution, but also its competitive position—reducing prices when customers’ ex-

pectations require “no frills” and charging more when complexity is a differentiating factor that leads to improved revenues. Today, CEOs of financial institutions are being asked to lead the charge for complexity management. Many have stepped up to the challenge and are preemptively evaluating their investments and establishing new rules to reinforce the value of their offerings. For those who have not yet stepped up—now is the time.

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