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THE NEW MINIMUM

How financial institutions must redefine their cost structures

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As the number of cases of the Coronavirus (COVID-19) increases, the focus of companies continues to be on limiting the direct impact on employees and customers whilst supporting efforts to limit the spread of the virus. The healthcare sector, airlines, travel firms, and supermarkets have seen immediate impacts, and face a significant challenge over the coming months to respond effectively to the emerging crisis. As we outlined in a recent publication, *Responding to COVID 19: Six Things Banks Should Do To Minimize The Impact To The Economy*, the financial services industry may have the greatest single influence on the global economy, and how businesses and consumers are affected by the pandemic.

Against this backdrop, firms are already starting to see early impacts of COVID-19 as cash flow pressures increase. Even at this relatively early stage in the outbreak, our analysis suggests that the impact of falling interest rates, reduced economic activity, and expense increases (for example, additional customer support and increased resilience requirements), will present a significant challenge. In certain cases increases in loan provisions for banks, and business interruption claims for commercial insurers, are already impacting profitability. All of this is on top of the pre-existing commercial difficulties for the industry brought about by pervasive low interest rates and increased market disruption from newer competitors.

The question for the industry is whether it responds in a way which amplifies or dampens the acute economic damage from COVID-19. Inevitably, institutions will need to approach the cost containment question — how they do this will, in part, determine which firms will be most successful emerging from the pandemic.

HOW TODAY'S APPROACH TO COST WILL BE DIFFERENT FROM BEFORE

Complicating any efforts on cost are the step changes that institutions are experiencing in terms of how their customers and employees are interacting with them.

Many firms have effectively conducted an obligatory Zero Basing exercise: shutting offices and branches, trimming service hours, reducing products and features, settling claims via apps and moving clients to digital channels. Many are calling this "the great disruption", and it is forcing firms to radically rethink their future survival minimum across a number of dimensions.

So far, this **"new minimum"** has largely been defined through the lens of business continuity measures taken to date (in other words: what do we really, really need to be doing). The system has been put under unimaginable stress, and we have proven that we can survive with levels far below our historic thresholds of the survival minimum. Furthermore, we have proven that when in crisis mode, if we put our minds to it, we can deliver in a matter of weeks what previously would have taken months. The key question that firms now need to ask is whether they can avoid returning to the old ways of working and establish this as the new normal.

Exhibit 1. Example observations of financial institutions re-defining the new minimum

	Example observed learnings	Impact/implications on survival minimum
Customer Experience	• Increase in online banking (for example, a leading SEA bank has seen 10K new account applications in just three days) • Rapid digitalization of branch activities (for example, a leading SEA bank digitized 14/15 trade finance branch activities in one week) • Claims are resolved via digital channels in seconds/minutes • Increasing Insurtech and Fintech sales, reducing incumbent customer interaction	• The question on branch footprint is no longer "what can I close?", but rather "what do I need to keep open?" • Tangible impact can be derived from digital without significant system investment or lead time • Challengers gain market share and force incumbents to play catch up
"Ways of working"	• Between 60 – 80% of employees working from home (where lock-down in place) • Virtual meetings with clients (RM efficiency increasing by up to 30 – 40%) • Resources having to work from slower servers, therefore reducing productivity • Restrictions or limitations on number of resources able to connect to VPN (e.g. only 50%), therefore severely reduced workforce • Virtualization of claims process, conducted by 3rd party assessors • Shortened and simplified decision-making circuits required	• Required corporate real estate footprint to be revisited • Productivity increase optimization opportunities • Decreased "minimum" activity, and therefore resources required, to "keep the lights on" • Capability to work with partners (for example, claims assessors) in a smooth, fully embedded process will be required • Increased need for more agile organization to reduce complexity and increase speed of response to changing situations

Source: Oliver Wyman interviews and analysis

HOW TO APPROACH COST IN SUCH UNCERTAIN TIMES

Given the uncertainty surrounding COVID-19, in particular around its severity and duration, it will be crucial to take a structured and systematic approach to cost and efficiency management efforts under a variety of scenarios. Institutions will have to balance immediate cost containment actions with efforts that will more sustainably bring costs down over the longer term, and more radical options that may have historically been deemed unpalatable.

We see five pillars to the response spanning two main areas of activity. Importantly, underlining these pillars, will be the need to apply the "new survival minimum" mindset throughout, and avoid returning to the same pre-crisis work. This will require constant questioning of what is truly necessary, and what are discretionary choices based on what we have learned, and are continuing to learn, through the crisis.

Exhibit 2. Pillars for the COVID-19 cost management response

Application of "the new minimum" mindset throughout

A. Understanding cost through COVID-19

1 **Develop scenarios**
Develop the COVID-19 driven spectrum of business scenarios and impacts by flexing potential customer behavior and ways of working implications (for example, migration to digital, employee productivity, operating model, technology)

2 **Understand how the cost base changes**
Iteratively build transparency into the cost base today, and understand how that changes under given scenarios (both during the height of the pandemic, and in the post-COVID-19 world)

B. Removing cost

3 **Reduce cost in the short-term**
Investigation, or re-investigation of short-term, no-regrets cost efficiency levers to reduce cost within 2020

4 **Reduce cost through structural opportunities**
Investigation of longer-term, structural efficiency levers that are aligned to new customer behavior and ways of work norms

5 **Prioritize the project portfolio**
Surgical assessment of the project portfolio to determine which activities should be stopped, delayed, or accelerated in light of the new reality (for example, some projects may no longer be feasible, or may be less relevant)

UNDERSTANDING COSTS THROUGH COVID-19

DEVELOP SCENARIOS

Go-forward cost targets will need to be set — in line with broader pandemic related forecasting and planning exercises already happening at your company. These targets should be de-averaged across multiple impact/response scenarios — ranging from slight course corrections to revert to business as usual in the relative near-term, all the way up to a complete revolution in how the firm operates going forward.

Exhibit 3. Example scenarios/cost actions

Customer experience and employee ways of working

Increasing permanency of "in-crisis" changes →

	Scenario 1: Revert to BAU	**...**	**Scenario N: Digital revolution**
Customer Experience	Increase in digital transactions, however, largely revert back to physical channels for product acquisition and servicing		Significant proportion of customers continue using digital channels for transactions, acquisition and servicing; only revert to physical channels for activities that can't be done digitally
"Ways of Working	Largely revert back to prior working arrangements • Working on premises • Face to face client meetings • Traveling for meetings and events Modest reduction in branch coverage in line with customer behavior		• Significant increase in work from home arrangements • Branch footprints significantly shrunk • Client meetings almost exclusively held digitally • Radical reduction of product footprint and streamlining of front-to-back processes
Potential Savings Range	4-5%		30-40%

Naturally the size of the potential opportunity will be dependent on the firm's appetite to invest and disrupt during these uncertain times. As firms align on the most desirable, and also most likely scenario (and thus targets) — we recommend starting with the following questions:

What are the new things that firms need to do that they were not doing before?

Firms will need to ask themselves whether they should re-assess their **channel strategy** and reprioritize based on the new situation. Re-allocating teams and resources will also need to be considered, as will the way in which enterprises leverage third party capabilities and embed these smoothly into end-to-end processes. With the prevalence of working from home, firms will need to assess whether they have the appropriate technology and **cyber infrastructure** in place.

What are the new things firms can do now that they could not do before?

With increased remote working, firms need to ask themselves whether the pandemic has shown that they can double down on remote working and re-position their **real estate** strategy. As customer behavior is shifting, enterprises have the ability to speed up the shift to digital. Furthermore, many should consider whether now is the right time to approach the board, competitors, and regulators on paradigm-shifting **consolidation/mutualization** opportunities.

What can firms stop doing now based on what COVID-19 has proven to us?

In terms of **distribution**, moving from a “which locations should I shut down?” mindset to a “which ones do I need to keep open?” one is a good place to start. And asking which so-called “must-have” **processes** and associated service levels need to be revisited in the wake of recent learnings should also be considered. Finally, looking at what **features and functions** of a firm’s products and services are no longer creating value versus the cost of production will be key.

UNDERSTAND HOW THE EXPENSE BASE CHANGES (UNDER DIFFERENT SCENARIOS)

Importantly, in order to make the scenarios tangible and reliable, firms will need to invest in improved transparency around their cost base and drivers of cost.

This granular transparency will allow the firm to understand where expenses will grow and shrink during and after the pandemic.

Questions that should be asked to achieve this include: What is the true cost of the work that we do?; Where do I have inefficiencies that drive up my cost base?; Can we improve the elasticity of our cost base so that it can flex with the business profile (that is, how can we variablize the cost base during times of uncertainty)?; What levers should I pull to reliably move the needle on cost to the greatest extent?

Case study 1

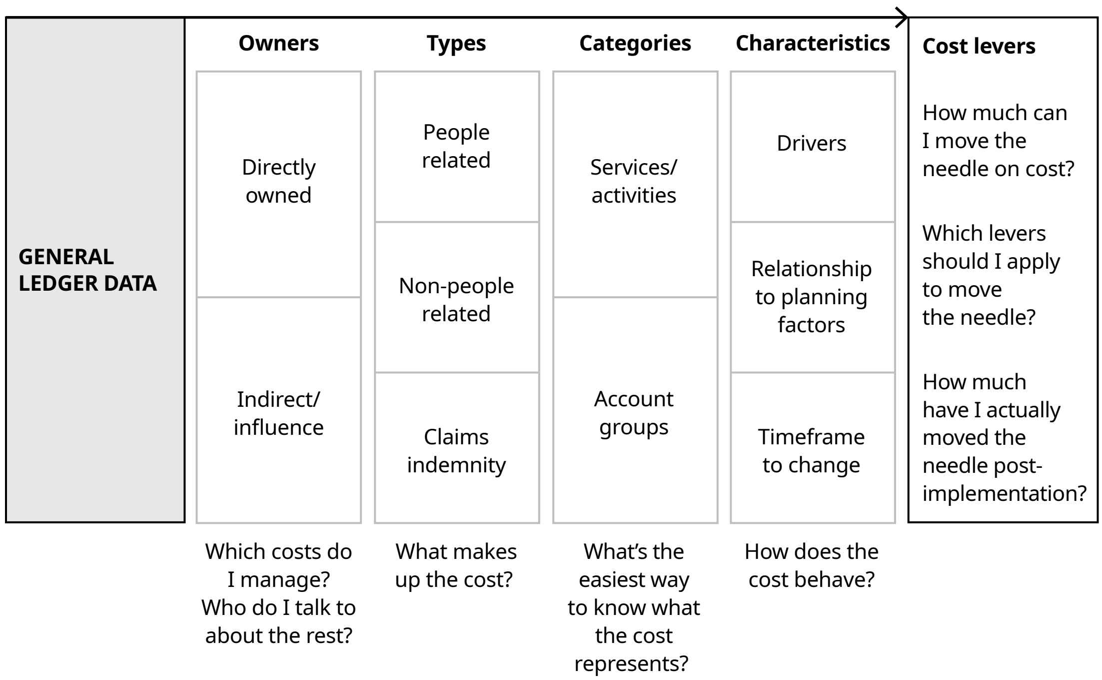
Understanding the drivers of expense changes

After the Great Recession, a mortgage servicer performed a driver analysis of its cost base to determine relationships between delinquency and costs. It found that a 2 percentage point increase in average delinquency rate raised its cost base by 30 percent.

Source: Oliver Wyman Analysis

Building transparency starts at the general ledger, but extends far beyond just the data — to what is sitting behind that data. Cost needs to be allocated, categorized and studied for behavior. This provides a robust fact-base on which to build hypotheses and make data-driven decisions on what can drive tangible impact on the cost base going forward.

Exhibit 4. Oliver Wyman cost transparency framework



Ultimately, in addition to forming the basis of the scenario analysis, the outputs of the transparency exercise will also support cost-out lever identification, sizing and prioritization. Eventually this foundation of common information should also enable post lever implementation benefit monitoring and tracking, to demonstrate tangible impact.

We recommend that this transparency into the cost base be built iteratively — with the following versions:

- **Version 1.0:** largely leveraging "off the shelf" data/reports and used as a critical baseline input into company-wide scenario analysis and/or the other cost workstreams.
- **Version 2.0+:** Refinement, greater depth and industrialization over time as additional information can be collected, scenarios are better understood, and as the pandemic (such as data on human resources, processes, and locations) plays out. We anticipate that this will include connecting cost data to other sources of info (such as human resources, full time equivalent, process, and location), as well as working on the associated tooling and infrastructure.

REMOVING COST

VISIT, AND RE-VISIT SHORT-TERM LEVERS TO REDUCE COST IN 2020

Some cost levers will have to be taken off the table, whilst others might become more attractive and easier to implement. In the short-term we would envisage that certain headcount reductions must keep in mind operational resiliency requirements and political/social considerations. Specific areas of credit, claims management, and technology (in particular collections, distressed asset management, cybersecurity, remote working provisions, and call centers) are likely to be highly pressured and may necessitate additional investment.

Case study 2

Constrained cost levers
Many financial institutions have committed to not cut jobs — publicly announcing that employee jobs are safe through 2020; others have announced that programs in place prior to the crisis will continue down their initial path.

Source: Oliver Wyman Analysis

Most financial institutions have already pulled many short-term cost levers repeatedly post-financial crisis. We would, however, expect them all to conduct another round of actions in light of COVID-19, that should both minimize upcoming expenditure (cost avoidance) and cut the existing base (cost reduction). These actions are likely to consist of no regrets moves (events, travel, marketing, and a hiring freeze), and near-term levers to deliver this year (reducing contractors, overtime management, and reviewing end-user licenses)

Exhibit 5. Example short-term cost levers financial institutions are implementing/considering

	Immediate cost avoidance	**Near-term cost reduction**
Lever type	Clear discretionary spend items that can be cut or deferred with limited risk	Classic cost out levers that can be applied relatively quickly
People	• Hiring Freeze • 2020 bonus freeze • Encourage voluntary temp. leave	• Reduce discretionary roles • Reduce contractors • Rationalize shadow (BU embedded) functions
Non-people	• Delay device upgrades • T&E freeze • Conference/training freezes	• Rationalize data consumption and end user licenses • Reduce software maintenance contracts • Consolidate/re-negotiate with vendors

IDENTIFY MEDIUM-TERM, STRUCTURAL LEVERS THAT DELIVER UNDER THE "NEW NORMAL"

We anticipate that for most institutions, this year will be a year of laying the foundations for more structural levers, with implementation to take place in 2021.

This is because of the ongoing uncertainty around the severity and duration of the pandemic — including the potential for the emergence of second and third waves. The need to ensure operational resilience and, in the case of banking, ensure the flow of credit to those most impacted by the crisis, will also be a factor. In the case of insurers, tight management of COVID-19-related claims (for example, event cancellation, business continuity) are already high on the radar.

Although that may be the case for some, there will also be many institutions who have ongoing operational excellence and efficiency initiatives (often with associated shareholder commitments) that may be forced to accelerate implementation, or at the very least update their targets and reprioritize their work.

Regardless of the point of departure, which will vary by institution, we anticipate that all will benefit from an intent driven review of levers, with a particular focus on those which are facilitated by the pandemic, such as achieving consensus to exit certain businesses and geographies. Rethinking the real-estate footprint (both in terms of corporate center, and the physical branch network), and expediting the transition from traditional channels (such as branches) to digital channels and self service will also need to be considered.

Case study 3

Exploring new opportunities

Coming out of the great recession, a major Swiss bank took the opportunity to shift away from its investment banking business (which had been a large source of losses during the crisis) to re-focus on global wealth, retail and corporate banking. Additionally, the bank took the decision to exit multiple fixed income business lines — allowing the bank to substantially shrink the size of its balance sheet.

Source: BIS.org, Oliver Wyman Analysis

Upcoming quarters (and years) will present a window where investors and shareholders will understand and accept restructuring costs. This provides a good opportunity for institutions to build momentum and secure budget for end-to-end digitization programs, remote workforce efforts, agile transformation and cloud migration projects, and other efficiency transformation programs that might have been considered high risk or lower priority before the pandemic.

Exhibit 6. Example medium to longer term levers that financial institutions have license to consider

	Incremental cost down	Game changers
Lever type	Classic cost out levers that require additional time and/or investment to accrue	Structural levers that fundamentally change how the organization generates cost
Examples	• Internalization/labor-rate efficiency • Compensation variablization • Role purification and staff juniorization • Demand management/Increase end-user self-service • Service model/levels review and optimization • Process optimization • Adoption of consistent data lineage • Continuous procurement optimization	• Material sourcing strategy changes (for example, outsource, offshore, nearshore) • Shift to agile, project-based organization • Large-scale centralization of support/group functions • Participation choices (for example, region exits, BU/portfolio exits, product rationlization) • End-to-end process re-design (such as lending, claims) • Game changing digitization efforts (for example, digitization of the branch, virtual RMs) • Real Estate footprint optimization (branch and corporate) • Cross-bank mutualization/utilities

As institutions implement this work, they will need to continue to reinforce the cost-conscious culture brought on by the pandemic (such as the emphasis on virtual meetings and the reduction of travel), while also strengthening partnerships with their human resources organizations. This will help them think through the implications of any measures that impact headcount, people deployment, workforce productivity, and overall staff engagement.

RUTHLESS PRIORITIZATION OF THE PROJECT PORTFOLIO — CONDUCT A SURGICAL REVIEW OF ALL INITIATIVES

The focus of this effort should also yield both cost avoidance benefits in the short-term, and efficiency benefits in the medium-term, across two distinct sets of actions.

Firstly, firms should **prune the project portfolio**, forcing the decision to cease certain initiatives or efforts that are not aligned with the its strategy or vision.

Secondly, there should be a **re-balancing of the project portfolio to prioritize efficiency**. As outlined in this year´s edition of our *The State of Financial Services Industry* report, considerable transformation investment and activity is underway across the industry, but improved profitability is rarely the result. Instead, there is a fundamental struggle underway between those with a longer-term, more visionary mindset and those more focused on short-term value-generation.

In the wake of COVID-19 we expect firms will be under increasing pressure to deliver tangible return on their investments. This will necessitate efficiency generating projects/initiatives to be given the priority over the revenue-generating/customer experience projects of recent years.

Exhibit 7. Example "Force-Rank" investment framework

1. Financial benefit

Potential inputs (MN)	**Focus**
Cost savings	Primary
Revenue growth Revenue protection capital benefits	Secondary

2. Strategic impact

Potential inputs	**Focus**
Regulatory compliance Linkage to Exec agenda	Primary
Op risk and controls improvement Business enablement Client experience Innovation	Secondary

3. Impact of COVID-19

Potential inputs	**Focus**
Feasibility under new reality Relevance based on new minimum (higher or lower) Operational risk under "new reality"	Primary

As priority, in-scope projects to be classified as:

- Stop
- Delay
- Accelerate
- Other

Option to further classify "Other" projects into:

- No change
- Consolidate with other projects
- Reduce scope
- Staff/resource differently

CONCLUSION

COVID-19 is creating immense cost pressures for institutions across industries. With depressed revenues and a disrupted operating model, companies will now need to set their costs to a level that allows them to be profitable for the business profile that they will have, not the one they had.

Radical change has been made available by these unique times, and now is the time to be thinking big. Institutions have the rare opportunity to completely (re)define how they want to operate in a post-pandemic world. The key will be to take the "new normal" mindset throughout, define the future business profile and strategy, all the while addressing short-term, acute cost challenges.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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