Core banking transformation: Five strategies to find the capital within

The current environment of uncertainty, consolidation and cautious economic outlook will drive compression in ROE coupled with an increasing investment slate dominated by regulations and growing non-bank financial intermediation.

Banks will have to balance these pressures with the need to modernise their core banking platforms to drive the required business and operating model change.

We discuss five strategies to transform their core without additional capital, using the banks’ current investment slate and opportunities presented by the new normal.

The 100-metre hurdle

A recent McKinsey study anticipates that, as a global average, banks will need to grow their profits at 20% CAGR to keep their RoE significantly above the cost of capital, inflated by the Euro-zone crisis and high cost of funds. Banks will struggle to achieve this unless they respond to the challenges of the new normal depicted below (Chart 1).

Opportunities arising from the new normal

The above challenges present new capabilities and opportunities necessary for success. Banks can use the investment in these capabilities towards a core systems modernisation without additional capital overflow. Firstly, with the accentuating Eurozone sovereign debt crisis, any systemic risk or change in market sentiment results in a rush for liquidity. In such times, stability, availability and capacity of platforms that support Flow business are critical. If that is affected, customers will switch. We have seen an increase in investment on operational resilience programmes to balance Flow business considerations, most of which are on the Core platforms.

Secondly, changing market dynamics will prompt banks to penetrate new market zones. Increasing proliferation of non-cash instruments is resulting in higher rates of settlement outside the bank’s networks by non-bank providers. These reducing transaction volumes will significantly lower profitability due to increased complexity and overheads of existing bank payment hubs and gateways. This necessitates a business model change and investments away from an integrated instruction to settlement to either initiate or settle payments.

Winners of tomorrow will be banks who can effectively create and manage liquidity churn and profit through gain from spread.

Banks can expand the market for non-transaction products and services by effectively tapping risk-averse, cash-rich HNWIs, creating experimental offer pools triggered by certain business events.

Thirdly, to create more customised offers, banks should engage customers beyond the banking eco-

system through focus on lifecycle services leveraging transaction spend analytics providers. This will feed into an enterprise-wide customer experience amphitheatre, integrating behavioural scoring models with demographic and segmentation analysis.

Fourthly, “Intelligent” exposure-based transaction pricing will need to evolve for effective liquidity management.

“We need a Dynamic Pricing capability that reflects the cost of funds taking into account objective risk at any given time, so that high value deals are quoted “off the market” may become prevalent.”—HCL in a conversation with a Senior Executive at a Global Bank.

Fifthly, stress-test regulations by the central banks along with considerations of efficient deployment of working capital (balancing liquidity and operational risk) will require investments on proactive risk analytics.

“We are working on the ability to calculate real time exposure and capital management by individual countries and markets to generate a real time balance sheet.”—Senior Executive, Leading European bank.

Transforming the genetics of Core
We outline an approach of how, using a combination of strategies, frameworks and processes, banks can progressively transform their core.

As a starting point, banks should review their 3–5 years investment slate to identify opportunities to implement the strategies below for systematic transformation.

Requirements on wind-down and proprietary trading ban in Dodd Frank and separation of businesses in Glass Seagull Act, for instance, can be leveraged to deliver continuous evaluation and re-definition of businesses required to sustain competitive advantage.

Re-structuring organisations in the backdrop of these regulations will require banks to:

• Continuously update their enterprise roadmap of new capabilities against the new normal imperatives leading to a blueprint for transforming their Core Banking landscape. This could reside within the Strategy function, but periodically refine and report its findings to the CEO and the board.

• Create an enterprise-wide, but lean, business product architecture team to progressively simplify the business process and technology delivery.

• Consolidate Applications and Infra operations across the bank under a unified structure to extract maximum efficiencies from operational resilience programmes.

• Establish a Business Benefits Monitoring division to manage and track business benefits from converting investment opportunities into a progressive refresh strategy.

• Establish decommissioning as a service and also enable their supplier ecosystem with the right incentives to execute.

To solve the legacy core puzzle, we recommend using resilience investments to do:

• Automated analysis of the core application suite with quality assessment generating heat maps.
• Process Discovery and Source Code analysis generating process maps and relationships between Business Process, Application, Database and Infrastructure layers.

• Sub-process and activity monitoring with a view to understand individual cycle times with transactions that go through exception processing.

HCL has an integrated set of tools and frameworks—Assess Smart, Prism, Process Watch and Discovery—which will help identify high cost, high impact, less efficient (with high cycle time) and high exception processes first for maximum ROI. This will enable an iterative transformation through a series of self-funding future phases leveraging investment opportunities discussed in the previous section.

Redefinition of business architectures through segregation of business and technology processes into industrialised, delivery and custom (offer) processes is one of the key levers of transformation. Industrialised and delivery processes are largely standardised banking processes which can be shared between various entities/country operations reducing TCO and time to market.

In addition, we recommend a five-pronged approach:

a. Defining a parameterised and rationalised set of business products

Most banks have witnessed a proliferation in their products portfolio, largely due to incremental developments on legacy platforms. Engaging in a rationalisation of their products portfolio using the investments is paramount.

b. Distribution in, Core out

This strategy involves continuous separation of distribution from manufacturing components by extracting and building it out from core utilising customer experience investments. Fundamental to this is a multi-channel integration (MCI) framework which will enable real-time, uniform access to customer and transaction data across all delivery channels.

Systematically building out stateless applications which are stand-alone and platform agnostic, from core into distribution exposing critical customer services using the investment opportunities will form part of this strategy.

This strategy should also enable Product Experimentation in social media, collecting behavioural data and feedback, running campaigns, launching pilots and proof of concepts of new product innovations using Customer Experience investments.

A leading African bank is targeting ROEs of 20%+, cost to income ratio reduction from 60%+ to 41% and product per customer increase from three to six across the next three to five years. Balancing the economic constraints with transformational benefits, the bank embarked on a core transformation following the Distribution in, Core out strategy. It prioritised customer experience and channel transformation by extracting customer needs analysis, campaign management, cross sales architecture, offer management as components reducing its investment slate and time to market.

c. Integration Surround

Systematically build reference architecture by de-ruling the core from horizontal process and Technology services leveraging the yearly investment slate.

Abstracting and de-coupling business services progressively like the fee engine from the product factory, a bank achieves faster and cost-efficient product creation and bundling. This architectural change will require extensive planning and design.

Business Event Management Service will bring in event correlation, integrated analysis of log messages and prioritised event catalogue in a single view, to manage events across the enterprise.

Key to Process Optimisation is the decoupling and extrication of business rules and services from the core into the integration layer.

A user defined business application layer can be formulated by integrating UI design and execution features like styling, experience templates into an enterprise platform.
d. Dis-intermediate Core through industrialisation and tiered factories and schemas

Create a two-tiered factory ecosystem (Chart 3), by abstracting the vertical specific components within various product systems and isolating the horizontal components from the CIS into a factory layer.

Leading European FS major faced high cost of maintenance for its core platform and was 30% slower in time to market for new products compared to its competitors. The primary challenge was that changes to the core systems were complex, costly and time consuming. Without the big bang refresh, the bank used the two-tier factory ecosystem by externalising Product business rules; fees, charges and interest components from core banking application as part of phased use of their investment money to transform painful core processes.

A new segmentation schema would need to be created through investments on product innovation factories.

e. Subsidiaries/Satellite operations led Core transformation

This can be created by a business-sensitive combination of products-in-a-box and functions-in-a-box.

While the products represent the static parameters that define actual deals (transactions), the functions—e.g., interest calculation, fee billing, underwriting—represent the horizontal services that a transaction avails of during its lifecycle. Piloting the re-engineered business process from subsidiaries to main entity is key to a low investment implementation.

An essential component of competitiveness is an effective data strategy and architecture that hinges on the creation of an enterprise-wide, integrated Data Management Layer across products, comprising data services (maintain, enrich, etc), master data (product and customer) and data analytics in a centralised framework. Regulatory and risk analytics investments can be used to abstracting these using the below architecture tenets (Chart 4):

b. Data factories design with enterprise wide industrialised ETL or ELT processes and templates.
c. Integration and management of other elements of core data, for example, limits and exposure by customer and customer group.
d. Rationalisation of data elements.
e. Reporting factories.

In conclusion, a successful and effective strategy for implementing a core system refresh programme lies in aligning the objectives of the programme with “new normal” capabilities. This implies adopting a holistic transformation approach that encompasses both business processes and technology, and maximising ROI by pursuing a componentised and incremental refresh of the core system.