Building an Operating Model for the Next-Generation Investment Bank

Carsten Baumgärtner, Chandy Chandrashekhar, Nick Glenning, Nicolas Harlé, Duncan Martin, Shubh Saumya, Achim Schwetlick, and Tjun Tang

July 2009
The financial crisis can still dominate the day’s headlines, but its concussive impact has started to diminish. Investors, businesses, and governments seem to be searching more for signs of a recovery than for indicators of a depression. For their part, investment banks are no longer focused solely on survival. Most are busy working out how to thrive in the new normal.

Even after the turmoil subsides, investment banks will face significant challenges. Some effects of the crisis—such as tighter oversight, lower leverage, and higher capital costs—are here to stay. As a result, banks will need to make their business models simpler and more specialized. On the whole, the industry will be less profitable, and investment banks will have little room for error in the way they run their businesses.

In light of these challenges, banks will need to evaluate their operations more closely. The next-generation operating model will need to be extremely robust and cost effective to ensure regulatory compliance and to counterbalance the forces weighing down returns on equity (ROE). For most investment banks, renewing the focus on clients—a must in this unsettled environment—will require an overhaul of operations.

Most of the principles for improving operations are both basic and perennial. But they were also easy to put aside when the industry was focused so intently—and profitably—on growth and innovation. Even during past downturns, the conflicting objectives between some of the tenets stymied efforts to transform operating models. Although the principles are not revolutionary, their implementation is far from straightforward.

The current crisis, despite having lost some of its shock value, remains a powerful catalyst for change. It has already prompted some banks to recast their business models. Without a commensurate change in operations, however, these new businesses will have little more than a strategic vision to ensure their success.

**New Business Models and the Need to Transform Operations**

Most investment banks are searching for ways to match their core strengths with the businesses that will dominate the postcrisis landscape. A select few institutions will create business models based on acquiring and distributing risk (including proprietary risk taking). Most banks, however, will gravitate toward business models that are based on facilitating client transactions. They will concentrate on mature businesses involving high-volume, low-risk activities. A combination of low profitability and increased competition will force them to prioritize scale and automation.

For most investment banks, the impact of the downturn on ROE is going to outlast the crisis because the downward pressure on performance stems from a fundamental shift in how banks compete. Their cost-cutting efforts will therefore need to extend beyond short-term initiatives, which can help restore stability but can tend to be more superficial than substantial.

The challenge is significant. Even if the industry were to achieve outstanding revenue productivity, banks would still need to cut costs significantly in order to counteract the effects of weaker leverage and profitability. In addition to improving revenue yield, a bank would need to cut costs by more than $100 million for every $100 billion in balance sheet assets to increase ROE from single to double digits.

As a result, operational efficiency will become a critical source of competitive advantage for most investment banks. But cost is only part of the equation. Operational efficiency, when achieved as part of a broader transformation, leads to operational excellence, which will underpin client-centric business models.
The push for operational efficiency will provide the greatest momentum for change, but it cannot be a one-dimensional effort. Other forces must be factored into the program for transforming the operating model. (See Exhibit 1.)

- Investment banks face a higher degree of regulatory scrutiny and will need to ensure greater transparency throughout the business. Providing this transparency will become more challenging as banks shift to business models that rely on high transaction volumes.

- The move to high-volume, high-frequency activities will require financial institutions to develop industrialized processes. More so than before the crisis, banks must have operating models that facilitate automation and maximize economies of scale.

- Banks have had to redouble their efforts to manage operational risk, which caused many of the losses associated with the crisis. Recent high-profile failures have done even more to highlight the importance of operational risk.

As they set out to transform their operating models, investment banks will need to account for these factors and achieve substantial cost savings—all while improving client service. They will face difficult tradeoffs between conflicting objectives and will almost certainly run the risk of cutting into vital processes and capabilities as they streamline operations.

Time is not on their side. Financial institutions are under increasing pressure to shift to business (and operating) models that suit the new competitive landscape. As one executive told us, “We have to make decisions based on one-third of the information we require, in one-tenth of the time we normally act.”

A Principles-Based Approach to Improving Operations

There is no single pathway for transforming operating models. Instead, investment banks face a series of choices, giving them countless options for reshaping operations. Conflicts and tradeoffs are inevitable. Where should a bank streamline operations to fund investments in growth areas? Where should it expedite processes to free up time for more intensive activities? Where should it rely on common utilities instead of customized functions?

<table>
<thead>
<tr>
<th>Forces</th>
<th>Examples</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>A changing market environment</td>
<td>Regulatory scrutiny, OTC trading transparency, industry consolidation</td>
<td>Harder tradeoffs between conflicting objectives</td>
</tr>
<tr>
<td>Evolving business models</td>
<td>A less lucrative business mix and increasing transaction volumes, a focus on client-centricity, differentiated operations and service needs</td>
<td>No margin for error despite the high degree of uncertainty</td>
</tr>
<tr>
<td>Run-the-bank operational needs</td>
<td>Operational risk management, investment constraints, increased industrialization</td>
<td>A high risk of cutting into vital processes while trying to reduce costs</td>
</tr>
</tbody>
</table>

As they transform their operating models, banks will need to account for these factors and achieve substantial cost savings—all while improving client service.

Source: BCG analysis.
Add to these choices the numerous pressures bearing down on operations, as well as the urgency to act, and it becomes obvious that banks need a structured approach for transforming their operating models—a process that will allow them to move quickly but also deliberately, weighing all of the tradeoffs in order to arrive at a model best suited to their specific role in the postcrisis world.

BCG has developed 12 principles for transforming the operating model. (See Exhibit 2.) Some relate to specific challenges that have arisen directly from the crisis. Others are simply best practice for banking operations: they were relevant before the crisis, but they have taken on greater significance because of the turmoil. The principles are grouped into four broad imperatives: align operations with the business, industrialize and strengthen processing, reinforce risk management and controls, and differentiate client service.

**Align operations with the business.** Operations must become more effective and efficient, given the little-margin-for-error mentality that will define banking for the foreseeable future. But the operating model should be something more than an efficient processing engine. When synchronized with business strategy, operations can reinforce the business model and create sustainable competitive advantage.

Create efficiencies to underwrite investments in high-growth businesses. In an effort to lower their risk levels and leverage, some institutions have been paring down their portfolios to concentrate on mature businesses, which tend to have low margins and high transaction volumes. Reining in activities will help stabilize banks but will do little to fuel stronger growth or profitability.

Cost-effective operations will be essential to making these businesses attractive. More important, increased efficiency in one part of the organization, particularly in areas that account for the bulk of transactions and processing activity, can free up considerable resources to pursue other opportunities—ones that promise better growth and profitability. With capital constraints limiting their ability to establish or expand more lucrative businesses, banks will become more reliant on such efficiencies to underwrite investments in dynamic businesses.

Expand the scope of operations to include upstream activities. To improve productivity, financial institutions may need to extend the purview of operations. In one bank, for example, one-quarter of all back-office resources were dedicated to correcting errors, many of which originated somewhere between the middle office (sales assistants) and the front office (sales traders). To address this problem, the bank required sales

---

### Exhibit 2. Twelve Principles Shape the Next-Generation Operating Model

<table>
<thead>
<tr>
<th>Imperatives</th>
<th>Principles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Align operations with the business</td>
<td>1. Create efficiencies to underwrite investments in high-growth businesses</td>
</tr>
<tr>
<td></td>
<td>2. Expand the scope of operations to include upstream activities</td>
</tr>
<tr>
<td></td>
<td>3. Track and report metrics linked to strategic objectives</td>
</tr>
<tr>
<td></td>
<td>4. Move from being an order taker to a business partner</td>
</tr>
<tr>
<td></td>
<td>5. Guide the transformation of the business</td>
</tr>
<tr>
<td>Industrialize and strengthen processing</td>
<td>6. Differentiate between fast-lane and high-touch processing</td>
</tr>
<tr>
<td></td>
<td>7. Strive for a cross-product processing architecture</td>
</tr>
<tr>
<td></td>
<td>8. Develop organizationwide process utilities</td>
</tr>
<tr>
<td></td>
<td>9. Instill a culture of continuous improvement and collaboration</td>
</tr>
<tr>
<td>Reinforce risk management and controls</td>
<td>10. Focus on improving detection and reducing excess measurement</td>
</tr>
<tr>
<td></td>
<td>11. Focus on the quality, not the quantity, of controls</td>
</tr>
<tr>
<td>Differentiate client service</td>
<td>12. Differentiate service by adjusting front-, middle-, and back-office processes</td>
</tr>
</tbody>
</table>

*Source: BCG experience.*
assistants to report to operations, which led to greater accountability, better process-management discipline, more consistent standards, more specialization, and ultimately fewer errors.

The bank took other steps to influence front-office activities. It standardized data fields and system protocols for front-office activities, introduced measurement and tracking systems to pinpoint the root causes of errors, and emphasized practices to prevent rather than just fix problems. These changes led to fewer errors, better client service, and a 15 percent reduction in costs. As a side benefit, the bank was able to provide middle-office staff with an improved career path in the broader operations organization.

Track and report metrics linked to strategic objectives. Investment banks need to keep their operating models focused on delivering outcomes for the business by tracking and reporting key metrics. While this was as true before the crisis as it is now, the scope of transformation makes it essential to have a set of clearly defined and closely monitored metrics.

A bank should specify a small number of overarching objectives for its transformation program—perhaps relating to efficiency, innovation, client service, risk management and controls, and talent management. The overarching objective for efficiency would be to process transactions at the lowest cost. The relevant metrics, in turn, might include transaction costs (as a percentage of revenues and total operating costs), productivity (the number of trades per full-time employee), and an assessment of operational process excellence and transaction throughput (peak hour uptime).

Move from being an order taker to a business partner. New business initiatives will spawn new processes—which may or may not build on existing policies and procedures but almost certainly will require new resources, skills, workflow applications, infrastructure, and metrics. It makes sense, then, for operations to be involved early in the planning process. In most banks, however, operations is more of an afterthought than a business partner. It is not part of the process for vetting ideas, approving business cases, or even accounting for operational requirements stemming from a new product. It fulfills the business’s plans; it does not help shape or inform them.

Rather than reacting to the launch of an initiative, operations should be involved in the early stages of its development, helping the business understand the service implications and providing feedback on feasibility. During the development of the business case, operations should analyze the practical ramifications, economic impact, and operational risks associated with the initiative. By incorporating such considerations into the design of new products and services, banks can maintain a high level of efficiency and minimize costly (and unnecessary) disruptions to the operating model. To ensure that operations helps shape the business, banks will need to formalize its role in key decision-making processes. Operations must have a seat at the table.

Guide the transformation of the business. Operations is also left out of decisions that determine an investment bank’s long-term strategy and business portfolio. In normal times, this is less of an issue: institutions tend to make incremental changes to the business, so the operating model can be changed gradually. In the wake of the crisis, however, banks are quickly redefining how and where they compete.

The COO should be part of this discussion, not only to describe how operations can support a new strategic direction but also to help set the course. The COO is in a unique position to identify the bank’s core capabilities and fundamental sources of competitive advantage. Which processes does the bank perform best? Where does it have an edge from an operations perspective? These strengths should steer the bank toward certain businesses—and away from others.

Industrialize and strengthen processing. To drive efficiency and economies of scale, investment banks will need to develop shared services that cut across traditional product silos and regions. These services should focus on common processes but still allow for customized activities that differentiate the bank. At the same time, financial institutions need to instill a culture of continuous improvement: the pressure to control costs is likely to remain strong for the foreseeable future.

Differentiate between fast-lane and high-touch processing. Banks typically have a one-size-fits-all approach to processing transactions. This lack of flexibility comes at a cost. If a bank gears its processes to maximize
speed and efficiency, it will invariably pay too little attention to sensitive or complex transactions, which can lead to operational failures or poor service. If a bank designs its processes more conservatively, it may spend an inordinate amount of time on basic transactions. Banks can avoid this tradeoff by separating routine, simple transactions—which lend themselves to straight-through processing—from complex activities that require more attention and human intervention.

**Strive for a cross-product processing architecture.** Over the years, the processing pendulum has swung from being aligned with functions to being aligned with products. Instead of jumping between these two extremes, banks should adopt a balanced approach to organizing the processing architecture. Only certain processes have to be aligned with specific desks or products; most can be shared across product lines. A balanced approach will boost efficiency while safeguarding the necessary product expertise.

**Develop organizationwide process utilities.** Investment banks have simple, non-client-facing functions that are identical across asset classes and sometimes across business lines. Yet these functions are often located within product factories and developed independently, which inhibits the standardization of both processes and technology. As a result, some banks have had to dedicate significant back-office resources—as much as 10 to 15 percent of their staff—to reconciling cash and security positions across internal and external systems. Banks should consolidate such processes in a single center of excellence, which could be located offshore, and make full use of standardized process and technology platforms. A center of excellence can free up scarce investment dollars, while reducing the cost base by as much as 30 to 35 percent.

**Instill a culture of continuous improvement and collaboration.** Just as a marching army risks catastrophe by outracing its supply train, a bank risks its operational integrity by assuming that its processes and procedures can keep up with aggressive growth and innovation. This is exactly what happened in many investment banks before the crisis. Back- and middle-office functions struggled to keep pace with the development of new products and lines of business. In some cases, the priority for operations was to avoid impeding growth, even if that meant resorting to inefficient, quick-fix solutions.

The challenge for investment banks is twofold: first, to eradicate the inefficiencies and compromises that arose from the precrisis sprint; and second, to ensure that their operational improvements are sustainable. It is not uncommon for such initiatives to lose traction. Operations can easily slip back into well-worn grooves. Inefficiencies can reemerge once businesses begin to expand, and operations can again find itself estranged from the business—reacting to, rather than informing, changes to strategy.

To ensure that improvements become ingrained in the operating model, banks must instill an organizationwide focus on operational excellence—a culture in which everyone feels responsible for making operations both effective and efficient. Good governance will be critical to reinforcing this mindset. A bank might designate a model office in each of its divisions to provide a test environment for new processes, track the impact of process changes, and provide feedback to a single group with business design authority, which would oversee the development and implementation of business processes.

**Reinforce risk management and controls.** The recent spike in operational failures can be traced back to several weaknesses in banks’ risk-management practices and organizations. Many of the frameworks for managing operational risk, while capable of measuring economic and regulatory capital, were more reactive than proactive: detection mattered less than measurement. In addition, an overabundance of controls created a fragmented environment, along with a false sense of protection and a dangerous lack of risk awareness.

**Focus on improving detection and reducing excess measurement.** Large operational failures are often preceded by warning signs that may be too faint to attract attention. In a rogue trading incident, the signals might include dubious explanations from a trader about a particular event or a canceled transaction. But the signs can be overlooked for other reasons as well. The proliferation of alerts and risk-related information creates too much noise. Moreover, in most banks the warning signs are likely to emerge from fragmented functions and silo-based systems. There is no single, aggregated picture of the potential threats.

Financial institutions have developed a few mechanisms for detecting risks, mainly concerning money laundering, but they are expensive to implement and operate. Banks need a pragmatic approach to
detection—one that requires less data, generates simpler output, and weaves judgment and expertise into the analysis. They should create a new function—a risk detection team—that is dedicated to identifying risks and developing immediate responses. The team would convert weak signals into strong indicators by triangulating information among independent sources and improving the connectivity of information in general.

**Focus on the quality, not the quantity, of controls.** In many banks, the thorny burden of managing unknowable risks—hidden threats that can trigger systemic failure or massive losses—has been passed over in favor of an approach that appears to be comprehensive, given the proliferation of controls, but is far from ideal. The abundance of controls can provide a false sense of security, masking critical gaps in the risk management framework. It is not clear who is in charge of what, which means that some responsibilities are neglected. Thousands of pages of reports are routinely produced but rarely examined.

To sharpen the scope of risk management, banks should create a “control of controls” function, which would assess the quality of existing controls by conducting stress tests. It would also identify overcontrolled areas and optimize both the number and cost of controls in a given business area. The function must include people who have the requisite business skills and the courage to confront individuals, if necessary. Its position in the organization should ensure its full independence.

**Differentiate client service.** To better meet client demands, banks need to differentiate service by adjusting front-, middle-, and back-office processes. For example, hedge funds, which tend to have intense, high-frequency trading strategies, have fundamentally different service needs than traditional money managers. Banks have realigned their front-office processes to suit such specialized needs, but most middle- and back-office processes still provide the same one-size-fits-all service. Financial institutions can steal a march on their competitors by molding some of their middle- and back-office processes around the needs of valuable client segments, such as hedge funds. They might, for example, provide real-time confirmations and prebooking netting, either on their own or through external vendors.

**Putting the Principles into Action**

Investment banks have had to make some of the quickest, boldest changes in response to the financial crisis. Acting out of urgency, their reactions, in some cases, were not founded in a deliberate, long-term view of their role in the postcrisis world. Few knew what that world would look like, and some institutions may have wondered whether they would last long enough to see it. Most were intent on surviving—not thriving.

But their immediate responses, while critical to stabilizing the business, have come at a cost. Months of aggressive cost cutting have taken a toll on service levels. Processes have been pared back to the point where their effectiveness has been compromised, giving rise to greater operational risk. Some banks have actually diminished their capacity to make substantial, long-lasting improvements to operational efficiency.

The shift from short- to long-term solutions will be momentous. Instead of doing more of the same, banks will need to make tough choices and tradeoffs, and set clear priorities for their new operating models. For example, these models will need to cut across product silos, establish shared services for common activities, and accommodate investments in new products, greater automation, and stronger risk management.

The transformation of the operating model will be a multiyear journey. The 12 principles provide signposts for how the transformation should unfold, but banks still face the challenge of designing a comprehensive plan for change. In our experience, the leadership of a bank’s operations can lay the foundation for a successful transformation by following three steps:

- **Confirm your understanding of the bank’s strategic direction.** A revenue-constrained environment limits the investment options for operations executives. But it also leads to higher expectations of what they can (and must) achieve across a broad range of issues concerning capacity, controls, operational risk, cost-effectiveness, and support for strategic initiatives. As a result of these pressures, operations executives should place a premium on understanding the bank’s strategy over the next several years. They
should confirm the priorities for the bank—its core businesses, key client segments, and main regions—and use them to shape the priorities for operations.

- **Design a target operating model consistent with the strategy.** During the precrisis boom, operations focused more on facilitating growth than on ensuring efficiency. There was a tendency to manufacture everything in-house and get new offerings to market quickly. But these growth-oriented initiatives were not always conducted thoughtfully, at least from an operations perspective. The operating model must now be aligned with the bank’s strategic priorities. In general, it will need to achieve much greater efficiencies by leveraging highly centralized, standardized, and automated processes. The model should also make a distinction between how it supports the bank’s core and noncore businesses. For the latter, investment banks will need to develop creative sourcing approaches to buy these services rather than build them internally.

- **Develop a road map to implement the target operating model.** Making the transition to the new model will not be easy, given the challenges that the crisis continues to pose. Many banks will be hard-pressed to marshal the financial and managerial resources to implement the target operating model. They will also need to make the transition while supporting existing business demands and delivering cost savings in the short term. To support the transition, banks will need to develop a multiyear transformation road map and an unassailable business case. The plan should fund itself as much as possible, with savings from early initiatives underwriting later ones. To minimize change management issues and secure funding, road maps may need to include pilot initiatives. Operations executives will have to be creative and opportunistic in synchronizing the initiatives with priorities in individual businesses and regions. The effort, as a whole, should be supported by a robust program-management structure and clear organizationwide communication.

Investment banks are at a critical juncture in the evolution of their operating models. Excellence in operating efficiency and flexibility, as well as risk management, will differentiate banks in a world of rapidly commoditizing, highly liquid products and tremendous margin pressure. Banks need to fundamentally transform their operating models to meet the requirements of the new normal. Incremental changes will not suffice. As a result, those institutions that define and implement a new operating model will gain a sustainable competitive edge over those that avoid wholesale transformation.
About the Authors

Carsten Baumgärtner is a partner and managing director in the Munich office of The Boston Consulting Group. You may contact him by e-mail at baumgaertner.carsten@bcg.com.

Chandy Chandrashekhara is a partner and managing director in the firm’s New York office. You may contact him by e-mail at chandrashekhara.chandy@bcg.com.

Nick Glenning is a senior partner and managing director in BCG’s Melbourne office. You may contact him by e-mail at glenning.nicholas@bcg.com.

Nicolas Harlé is a partner and managing director in the firm’s Paris office. You may contact him by e-mail at harle.nicolas@bcg.com.

Duncan Martin is a partner and managing director in BCG’s London office. You may contact him by e-mail at martin.duncan@bcg.com.

Shubh Saumya is a partner and managing director in the firm’s New York office. You may contact him by e-mail at saumya.shubh@bcg.com.

Achim Schwetlick is a partner and managing director in BCG’s New York office. You may contact him by e-mail at schwetlick.achim@bcg.com.

Tjun Tang is a partner and managing director in BCG’s Hong Kong office. You may contact him by e-mail at tang.tjun@bcg.com.

The authors would like to acknowledge the support and guidance of Jürgen Schwarz, John Garabedian, Niclas Storz, and Alenka Grealish in the preparation of this paper. They would also like to thank the following individuals for their input: Rashi Agarwal, Mukund Rajagopalan, and Ron Tamir. Finally, the authors would like to thank Dan Coyne and Philip Crawford for their editorial direction, as well as other members of the editorial and production teams, including Katherine Andrews, Gary Callahan, Angela DiBattista, and Kim Friedman.

The Boston Consulting Group (BCG) is a global management consulting firm and the world’s leading advisor on business strategy. We partner with clients in all sectors and regions to identify their highest-value opportunities, address their most critical challenges, and transform their businesses. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with 66 offices in 38 countries. For more information, please visit www.bcg.com.

© The Boston Consulting Group, Inc. 2009. All rights reserved.
7/09