Arthur D Little

Viewpoint

Why now is the time for banks to strategically review their IT spend

To deliver the future of banking, managing IT spend needs a new approach

IT spend is on the rise for banks. To deliver the future of banking, managing IT spend needs a new approach. Based on our experience and research from the past economic crisis, the most mature IT organizations responded faster during the downturn. IT total spend management is a crucial part of the forward-looking strategy, and there are three critical areas banks must consider: (1) creating transparency through granular analytics, (2) setting up the right IT spend strategy, and (3) building capability to operationalize this strategy while measuring the value created.

IT investment development

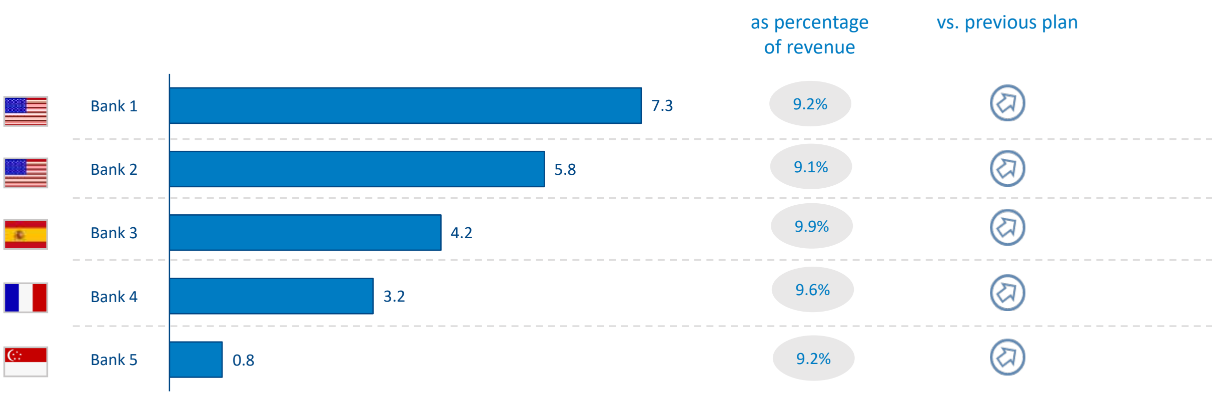
IT spend is on the rise for banks

Banks have experienced a short-term rise in technology spend over the past five years. Moreover, when examining the last wave of strategic plans, we see that even larger transformation budgets were announced to shift to digital and modernize an aging infrastructure. Through 2023, IT spend as a percentage of revenue is expected to be as much as 9% for some medium to large international banks (see figure below).

COVID-19 has amplified demand

The COVID-19 crisis exemplifies that a single event can have extreme impacts at a high magnitude. CEOs, COOs, and CIOs moved quickly to build responses in emergency mode and secured business continuity. This new environment forced banks to accelerate on digital. Digitalization of customer journeys, remote working at scale, process efficiency, and IT security are areas now at the forefront.

Yearly IT & digital expenditure by 2023 ($Bn)



Source: Annual reports, Bloomberg, and Arthur D. Little analysis

Leaders are strategically rethinking their business model, forcing IT investment spend to increase

Overall, not only are we seeing banks starting to increase their IT investment plans, but they are also investing differently to support innovation and new digital models so they can build a competitive advantage for the future. For IT, there is a need to further support a growth and diversification strategy while modernizing legacy platforms. The main expected benefit is to build a cloud-enabled technology platform, allowing real-time processing, advanced analytics/artificial intelligence (AI), and multiple third-party solutions (e.g., via fintechs). IT functions are expected to deliver – forcing most to transform their operating models.

Timing is the essence – IT cost management is top of mind

Looking back and using costs from 2005 as the baseline, our analysis (see figure below) shows that between 2008 and 2010, the most mature IT organizations responded faster to external pressures. They were able to reduce costs three times faster than others (6% on average per year as opposed to 2% on average per year for the others). There is a clear need to lower fixed IT costs of the legacy environment. Thus, to achieve superior advantage against the competition, banks must make a bold move forward.

Strategic considerations for managing IT spend

Managing IT spend is about IT strategy, not cost-cutting

Initially, IT spend measurement was constructed under the following lenses:

- Regulatory spend.
- Maintenance projects ("Run the Bank").
- Investment projects ("Change the Bank").

In this context, we can make the following observations concerning IT spend management:

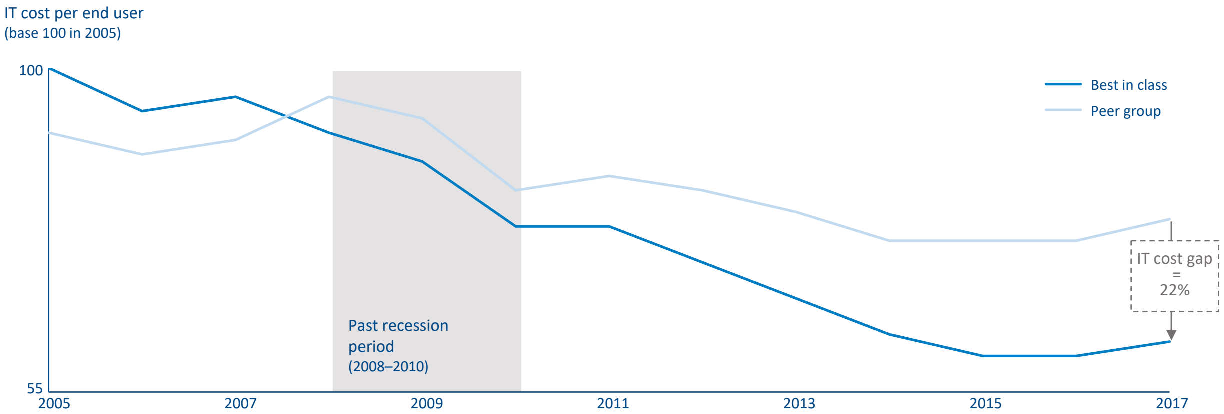
- First, all IT departments have processes and systems in place to deal with IT spend on a business-as-usual basis. Still, a vast majority struggle to get a consistent view on IT spend across business lines and geographies – shared between top management, IT, and procurement functions. Outdated IT taxonomies, inconsistent quality of data in systems, and reconciliation issues are common challenges.
- Second, the share of "Change the Bank" spend is expected to grow from approximately 30%-35% in 2014-2019 to 48% by 2022. Some digital and technology activities must be boosted or even created in the areas that support a growing share of activities and/or revenues (e.g., advanced analytics/AI, new digital business models).
- Finally, the financial services industry is under high regulatory burden, which translates into rising costs. Coupled with disruptive change and the constant nature of "Run the Bank," this all adds up to a difficult environment ahead.

To build the future of banking, these observations signify a call for action. Banks are being forced to take a broader look at their IT investment approaches in order to:

- Boost investments, finding the right balance between legacy and digitally native platforms.
- Better differentiate the "cost versus value" profile for each service delivered.
- Provide greater transparency on IT's return on investment, both to management and shareholders.

To move to the next level in terms of growth, innovation, and efficiency, the most mature organizations use granular analytics to measure IT spend and associated impact. This type of approach allows informed decisions on how to optimize the legacy while supporting large, new technology investments.

Evolution of IT cost per end user over the past 15 years – all industries



Source: Arthur D. Little analysis based on ADL IT benchmarking database

Measuring impact is key. Unfortunately, the situation is not the same for all banks. But while a vast majority are not able to measure the impact of IT investments on financial/operational metrics, there are some counterexamples. In Asia, for example, DBS Bank started an ambitious digital transformation journey in 2017, implementing advanced analytics on IT spend and building capability to measure the value created by digital (e.g., income per customer, cost-to-income ratio). This measurement cockpit is a powerful tool, not only to drive internally the digital transformation using objective trackers of maturity, but also to truly inform investors.

There are three key strategic considerations for handling IT spend, differing in terms of level of ambition as well as level of resources required:

1. **Create transparency through analytics.** Generate IT spend intelligence, building on an up-to-date and shared IT taxonomy and on in-depth analysis (e.g., per activity, fixed vs. variable, CAPEX vs. OPEX).

2. **Set up the right IT spend strategy, balancing short- and mid/long-term horizons.** Establish an IT and business work effort to drive out IT spend optimization opportunities, make clear choices on IT priorities over the coming 18-24 months (including with new digital offerings, branch/distribution network, remote and renewed workplace, IT budget/external spend profile, and IT operating model), and link IT spend levers with IT strategy, setting up specific IT financial and operational KPIs.

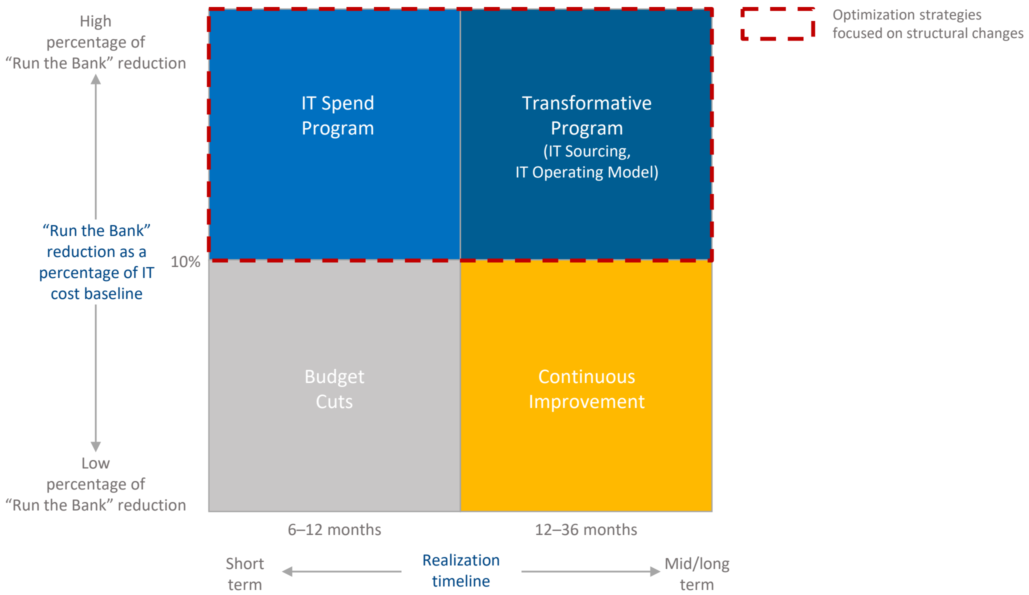
   The IT spend strategic framework in the figure below can guide decision making on which options to select by considering the following dimensions:

   - Magnitude of the IT spend – *How large is the IT budget as a percentage of revenue?*
   - IT sourcing model – *How dependent is IT on third parties? How large is the IT vendors panel?*
   - IT strategy and operating model – *What is the bank's IT strategy, operating model, and roadmap?*
   - Top management/business lines' view of the IT spend versus its business strategy – *Is the view of IT spend shared and aligned with management's view, both on the short- and mid/long-term horizon?*

3. **Build capability to operationalize the new IT spend strategy.** Set up a rigorous, accelerated approach that both supports reorientation of IT spend and ensures maximum alignment and engagement by the bank's executive team. Establish an independent unit to actively steer and monitor progress – clearly segregating investment on legacy and new technologies – and relentlessly measure the value created.

The exact setup will depend on each bank's context and starting point. For instance, a medium-sized domestic bank focused on retail banking would require a centralized IT controlling function. In contrast, a large universal bank with retail and corporate business lines would require a clear articulation of roles and responsibilities between corporate, business lines, and countries.

IT spend optimization strategies



Source: Arthur D. Little analysis

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When to reconsider IT cost management?

We have identified a combination of two factors:

- When "Run the Bank" IT costs have evolved at a flat/slow reduction pace over the past years, which signals that business-as-usual has eroded the ability of the bank to challenge more comprehensively the IT spend and build the right strategy. Indeed, the removal of complexity in the legacy environment should address three dimensions comprehensively:
  1. Core banking system and related connectors.
  2. Front-end systems.
  3. Data systems.
- When the source of growth for the bank is to come from nontraditional sources, which signals banks to reorient investments and to build a new operating model, featuring advanced digital capabilities, standalone entities, new talent, and risk control.

Conclusion

Now is the time to act: what to do to reorient IT spend?

IT spend steering can no longer be considered simply "nice to have" in today's recessive and highly uncertain environment. Moving forward, we suggest focusing on four activities:

1. **Deploy robust IT spend analytics** for accurate and timely information, comparable against external benchmarks.
2. **Invest boldly in new IT capabilities**, selecting the right levers to take IT spend to the next level of business performance.
3. **Build program to meet the new strategy**, engaging IT and business lines.
4. **Actively steer the plan for realization**, with clear gates for revision and evolution, since the environment will keep evolving.

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Arthur D. Little has been at the forefront of innovation since 1886. We are an acknowledged thought leader in linking strategy, innovation and transformation in technology-intensive and converging industries. We navigate our clients through changing business ecosystems to uncover new growth opportunities. We enable our clients to build innovation capabilities and transform their organizations.

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