Deloitte.

What's driving my cost base?

Realising insight through cost transparency

Financial Services Industry

October 2023

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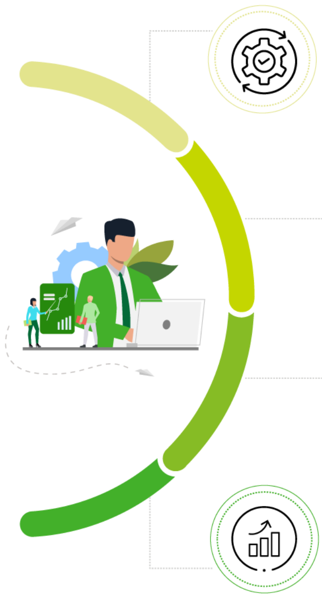
What's driving my cost base?

How much profit am I generating from each of my clients and what is driving this? This is a question many leaders in the Financial Services Industry (FSI) ask themselves ... some say it's the holy grail of cost transparency. Having this insight would allow organisations to make more informed decisions around where to deploy resources to deliver the greatest returns.

For many this is still a long way off, however for a few, this is a working reality offering up considerable competitive advantage. This paper consolidates the conversations held with leaders from organisations across FSI, discussing approaches to cost transparency, common pain points, regulatory changes, increased disclosure burdens, and proposing key foundational principles that achieve positive results in the face of economic headwinds.

We observe that FSI organisations experience similar pain points around cost transparency:



Allocations upon allocations
Overly complex routines, usually cascading through multiple levels and sometimes iterative, obscuring any hope of cost transparency

Marathon run times
Month end allocation run times typically taking more than 1 day to complete (in one case, 3 days!), limiting review times or opportunities for refinement

Manual processes, too much excel
Considerable mouse-clicks and keystrokes performed in ungoverned spreadsheets to manipulate data sets for processing, increasing the risk of errors

Spurious outputs
Large volumes of allocation data and reports being generated which often provide very limited insight, leading to analytical fatigue and wasted efforts

Many firms are trying to overcome these challenges through technology. Some migrate to Enterprise Resource Planning ('ERP') tools such as Oracle PCMCS/EPCM, SAP PaPM (or more complicated bespoke tools). However, success is frequently limited due to the repetition of existing complexities and pain points.

Successful firms embark on "intelligent design" before progressing to enterprise-level builds. When executed well, cost transparency can radically transform an organisation, driving greater collaboration and delivering meaningful cost base reductions.

This document shares key insights gathered from over 50 interviews and first-hand experience with a wide range of organisations across the Financial Services Industry.

For more information, please contact Andrew Mummery and Matthew Lock.

Summary of key insights

1

Cost allocation DOES create insight

Cost transparency is about understanding which resource levers an organisation can pull and having the foresight to know how this will impact on performance

2

Insight DOESN'T come from complexity

The key is to avoid spurious allocations with excessive granularity which could draw misleading conclusions

3

Having a clear vision is critical

Confidence starts with knowing "what am I solving for?" A clear vision provides direction around what to analyse and why

The cost transparency challenge

What is cost transparency and why does it cause so much pain?

Cost is often regarded as the more complex half when it comes to analysing business profitability. This is because it is often hard to say with certainty how a given expense directly contributes to the value created.

What is cost transparency? Starting from first principles, the objective is to understand how a firm deploys its resources to perform activities that create value; for example, driving better client experiences that will ultimately improve revenue, or engaging the IT developer to build applications that improve productivity.

Cost allocation is a core part of this which involves allocating support function expenses (e.g. IT, Finance, Risk, Real Estate etc.) to business units that generate revenue (e.g. selling products, providing services).

Across all FS institutions interviewed, this process is regarded as an ongoing challenge with **cost allocations rated as a top 5 issue** for CFOs and FP&A Professionals. **Common pain points** observed and their underlying causes are:

Allocations are performed for many different reasons

Product profitability, intercompany charging, regulatory reporting are some of the reasons why allocations are required. We observe that this often leads to multiple disparate approaches, processes, and data being manually maintained in uncontrolled spreadsheets. Many businesses view it as a 'zero-sum game', however when done right it can empower business leaders to further enhance strategic decisions.

Allocations create unnecessary tension when done wrong

Allocations cut across the organisation and draw in many different stakeholder groups (e.g. Business units, group functions, tax/transfer pricing, regulatory reporting) each with their own (sometimes conflicting) requirements. Limited transparency can drive intense scrutiny of cost owners to justify their spend, driving defensive behaviours.

Allocations becomes very complex...very quickly!

"It's a bit like solving a 10x10 Rubik's cube!"
For example, allocating costs for legal entity reporting and yet ensuring amounts reconcile with business performance can result in a high degree of granularity (often spurious). We observe situations where it takes over 3 days to run the month end allocations process, where in 80% of instances allocated costs were less than £10 for a multi-billion pound organisation providing minimal (if any) insight.

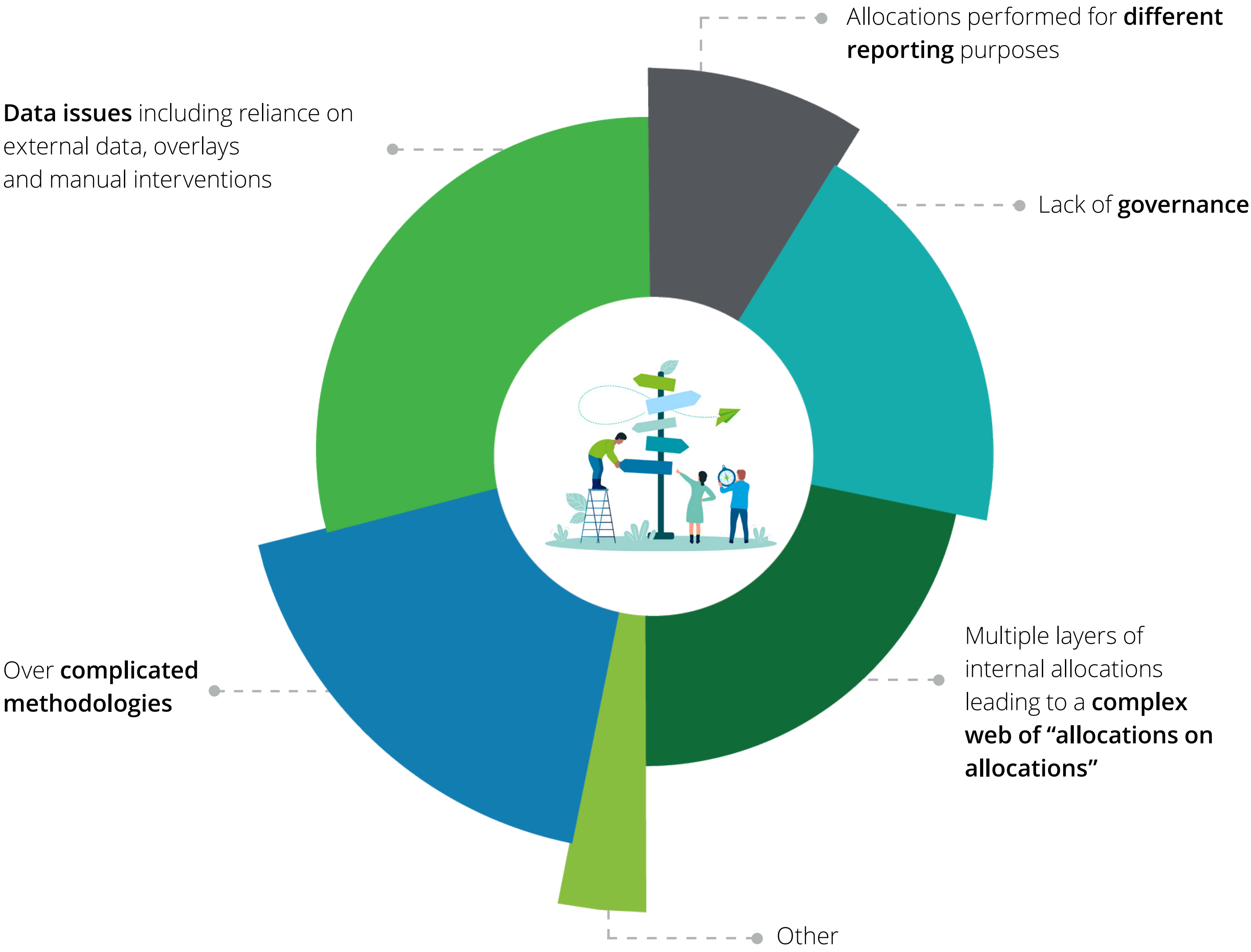
Trying to solve with more money and more computing power

Simply attempting to move existing allocations approaches into enterprise/cloud environments (e.g Oracle/SAP/In-house custom tools) is rarely an effective strategy and is typically a costly development exercise without an understanding of why, and the intended benefits to business users. In most cases the complexity and run-time increase!

The culmination of issues can often lead to organisations pursuing overly complicated, time-consuming processes with numerous exceptions that become overly burdensome. The reported outputs become difficult to stand behind and to communicate to stakeholders.

However, it is not all doom and gloom! More recently, some organisations have experienced real successes designing and implementing cost transparency environments that create real business insight and help to drive better decisions around where to deploy resources.

Top allocation challenges for Financial Services organisations



Data and methodology represent the biggest challenges for organisations.

Positive trends and influences

Simplicity creates transparency

Profitability concerns have intensified with recent macro-economic events including rising interest rates, labour shortages, and volatile energy prices. As a result, cost transparency and cost transformation are again at the top of the CFOs agendas, and allocation has a central role in helping identify where and how savings can be made.

Based on insights from banking, insurance, and asset managers, we observe 5 key trends that are enhancing transparency:

1. **Being smart, allocating less –** Finance teams are making the conscious decision to avoid granularity where it does not serve a business purpose. This is to limit situations where large volumes of data are being generated that could contribute to misleading conclusions.

2. **Avoiding cascade or recursive approaches –** Organisations are no longer performing allocations-on-allocations (e.g. attempting to apply a waterfall of real estate, HR, Finance and IT costs to individual staff costs to calculate a "fully loaded" cost per person). These approaches make it harder to understand what elements can be truly influenced by changes in business behaviour.

3. **Organisations acknowledging** there are different allocation use cases which may require different resources and approaches:

   a. **Monthly/recurring** allocations for the purposes of business performance measurement (plan, forecast and actuals) and legal entity recharging. We see innovators moving toward a higher degree of **automation and self-service** in which business units and functions manage this with limited need for oversight (subject to robust governance).

   b. **Strategic decision making –** Working with leaders to explore options and scenarios for specific events e.g. product profitability following a period of M&A. This often requires different capabilities including data curation, financial modelling, insight leads, cloud-based solutions etc.

   c. **Serving key stakeholder groups** with prescribed outputs such as **tax, reporting, transfer pricing** (TP) and other regulatory based disclosure requirements. There is a drive to co-ordinate this as part of a holistic solution.

4. **Standardising and centralising –** Enforcing consistency in the use of allocation methods when applying to the cost base – all contained within a single platform. Recently, a global bank made the decision to stop allocations under £1m (cut off the "long tail") and rationalised the number of allocation methods to five (with clear guidance around which to select). The result being much greater transparency with £100m+ of annual costs being allocated to 30 product groups.

5. **Developing enhanced skills and capabilities –** Cost transparency teams maturing into powerful analytics and insight creation hubs. CFO priorities are demanding teams to have greater multi-disciplinary skillsets (e.g. critical thinking, story-telling and understanding how to leverage AI, automation, analytics).

Where to start?

Starting with a clear vision

A critical success factor in achieving greater transparency is the need for **clear leadership and vision** – this starts simply with knowing "what am I solving for?" This is particularly important in building confidence to eliminate spurious processes or analysis, which often stems from spending valuable time and resources on a path that leads in the wrong direction. Time should be spent **engaging with stakeholders**, discussing their requirements, aligning key **principles** and planning the right approach – we have supported many organisations in these critical first steps to develop end-to-end allocation environments.

Intelligent design

We've worked with a broad range of organisations which have taken a radical approach to abandon existing allocation processes and begin again with a blank page. We often recommend **starting at the end and working backwards** by defining a vision of the organisations target state – "what do I want allocations to do?" This involves deeper engagement with the key stakeholder groups to consolidate their requirements and refine a coherent vision and design that is aligned to the organisation's strategy. It is important to develop a series of design principles that will guide the approach and help answer important questions like "how much detail is too much detail?"

Mocking up **concept outputs and dashboards** are effective steps to internally socialise the anticipated outcomes and impact.

Future proofing – selecting the right tool

Cost allocations are usually one component of a wider finance process (actuals accounting, transfer pricing, strategic planning, product and customer profitability). Tool selection should not be chosen in isolation, and should fit within broader finance and analytics use cases (planning, MI, product and customer reporting).

Allocations can quickly generate very high data volumes, therefore, the timing and cost implications for the end-to-end architecture should be considered as part of the high level design. Process impacts, including performance and timing considerations, should be considered upfront and factored into the final solution architecture design. We have supported organisations to implement a range of vendor platforms and tools, with varying degrees of sophistication and cost, with a focus on **the right tool for the job** being selected and aligning to the original vision.

Planning for change

Timing is key. The two main areas where this has an impact are **restructuring and restatements** (how to maintain a consistent view of allocations over a suitable timeframe to support comparability), and **exceptional items** (noise in the current month, and corrections to prior periods). The more complex and granular the methodology, the harder it is to unravel the allocation history to drive any meaningful comparison. There are pros and cons of different approaches (e.g. using year-to-date or rolling averages) and depend on the level of change within the organisation.

From a technology perspective, this can be challenging, as large volumes of data may need to be reprocessed/restated, or cost transparency is lost in a TP/statutory accounting process if prior periods have been billed or reported externally – an **intelligent design** process should provide for these change scenarios.

Conclusions

When executed well, cost transparency can radically transform an organisation driving greater collaboration and deliver meaningful cost reductions. It requires strong leadership, discipline, and co-ordination amongst stakeholders to achieve these outcomes.

When attempting to improve cost transparency there are five key takeaways to consider:

1. **Take a step backward to go forward** – Simply using more power and more data to create insights rarely works. It is generally preferred to design an environment that focuses on the future needs of the organisation, typically involving fewer and simpler allocations processes.

2. **If in doubt...don't** – There is a balance between simplicity and accuracy, and FSI organisations often find themselves at the wrong end of "spuriously accurate". This drives unnecessary complexity which has a compounding effect. Avoid offline and ungoverned spreadsheet-based analysis.

3. **Understand which stakeholders can truly influence a cost...it's fewer than you think** – Avoid situations where overhead costs are allocated based on business related volumes (e.g. number of products/ number of users) as it gives a false impression of steerability.

4. **Timing is everything** – It is important to make changes in a structured way ensuring alignment to other finance processes. This typically involves updating once a year and to be co-ordinated as part of annual planning rather than in-year changes that would require restating budgets.

And, critically:

5. **Cultivate curiosity around the cost base** – Leaders will want to understand correlation and causation between an organisation's behaviours and its cost base. Answering these questions is the primary role of a world-class cost transparency team!

Contacts

We're a team of experienced finance professionals having worked with a wide variety of Global Banks, Insurers and Asset Managers designing, and implementing cost transparency solutions. We'd be delighted to understand your specific circumstances that enable the unlocking of insights around your organisation's cost base.

Matt Lock
Partner
mlock@deloitte.co.uk

Andrew Mummery
Director
amummery@deloitte.co.uk

Neil Parmar
Associate Director
neiparmar@deloitte.co.uk

Tim Wright
Associate Director
tdwright@deloitte.co.uk

Adam Williams
Senior Manager
adwilliams@deloitte.co.uk

Deloitte.