EY white paper
July 2017

# The allocation game

## Managing cost before money is spent

Building a better working world

# Foreword

The financial services industry has cut billions of dollars in expenses, and many banks have sought to optimize their business mix in order to increase return on capital or to resolve issues identified in the aftermath of the 2008 financial crisis. During late 2016 and early 2017 banks have seen increases in interest rates and client flows, which have boosted their earnings and, given the anticipated rate-hikes, further growth opportunities are expected. This is quite a turnaround for an industry where the top five US-based banks by market capitalization have experienced an average decline in interest-related income of about 19% between 2011 and 2015[1].

However, the US banking industry is still facing steep and increasing regulatory requirements and capital needs, while facing off increasing threats from FinTech firms that are aiming to introduce disruptive technology-enabled business models, and that are currently not subject to the same regulatory standards imposed to the large banks. Additionally, banks continue to face significant costs for fines and litigation, with some institutions spending a few billion dollars in the last three years for this item alone. Financial institutions need to continue their cost optimization journey and focus in particular on lowering infrastructure costs to restore returns on equity above the cost of capital and free up working capital to divert toward investment in products and technology to defend and grow market shares.

Three challenges stand in the way of market practitioners achieving sustainable cost leadership:

- Identifying and removing *stubborn cost*
- Avoiding *myopic cost cutting*
- Managing *stranded cost*

***Stubborn costs*** are the costs that banks incur to continue with a legacy way of doing business that could be changed through the adoption of the latest technologies, methods or standards. For example, despite the advancement of the digital agenda in banking, some of the largest institutions are spending about US$1b a year moving cash in armored trucks. Other examples include the cost of replacing credit cards, sending paper statements via post and maintaining a population of plastic credit cards.

***Myopic cost cuts*** are the cost cutting initiatives that while delivering on short-term reduction targets, typically present three challenges: difficulties in tracking the estimated reductions back to the bottom line, inability to retain the cost savings over long periods of time and the prevention of the recurrence of these same costs upon an increase of business volumes. For example, US banks have cut their branch population since 2009 and further reduced branch personnel across the board. However, in response to negative customer feedback about long waits, one US bank noted that, in some cases, they had to add branch tellers and bankers back to their operations and modify their branch strategy.

***Stranded costs*** are those expenses that would not cease to be incurred when discontinuing the product or function to which they are related. For example, when closing a trading desk or a retail branch, there are elements of the cost base that will remain in the profit and loss statement (e.g., office lease, application licenses).

The path to cost excellence under the current industry dynamics needs to encompass a comprehensive rethinking of the way costs are managed as opposed to traditional cost reduction levers such as the elimination of management layers or branches. The largest European banks have cost-to-income ratios between 62%–119%[2]. Most banks have a long way to go to enhance their efficiency and recover the returns to shareholders.

This paper focuses specifically on how banks can improve management of their infrastructure costs, which account, on average, for about 40%[3] of most banks' entire cost base. This segment of expense has been traditionally challenging to understand and difficult to control. The practices described in this paper are examples of ways that banks can cut costs in a sustainable way before money is spent through: increased transparency (including identifying and managing *stubborn and stranded costs*), improved abilities to cut cost without harming growth (including avoiding *myopic cost cutting*) and embedding cost management within business routines as opposed to point solutions.

# The allocation game

# Executive summary

When it comes to managing the allocated cost base, most banks find themselves focused on the academic exercise of cost accounting and allocation rather than an objective of controlling or reducing cost. Cost allocation, as a traditional exercise, seeks to fully distribute the overhead costs of an institution on an equitable basis, and by that process, contribute to determining the profitability of the businesses at a granular level. The process often does not add value beyond that and is geared only to inform business units of their share once during the planning season and then again after the money has been spent. We often see this process create significant internal friction due to the lack of cost transparency in particular around consumption data and billing rules. Most banks experience significant workload to investigate and manage allocation disputes, often at a level of minutiae, that is not in keeping with cost reduction objectives nor is relevant when compared to the total cost base. This also distracts the organization from what really matters: optimizing the bank-wide cost base. This paper details EY's views on how banks should shift their focus from distributing incurred costs to proactively controlling costs.

We advise our clients to:

- **Lay the foundation for a bank-wide costing orchestration** through the definition of common guiding principles within the organization, and facilitate an easier dialogue and improved transparency through a common bank-wide language (i.e., service taxonomy) that ultimately allows for consistent delivery, avoids duplication of activities between linked but disjointed processes and minimizes the reconciliation effort.
- **Enable actionable cost management** through revamping the cost allocation methodology to balance simplicity with the need for fully loaded costs, improving the linkage between drivers and business fundamentals, remediating data quality and optimizing data sourcing, upgrading the technology platform to minimize disruptions to business as usual, and ultimately sharpening cost analytics to cover the entire cost base and shift focus on forward-looking indicators to drive down costs.
- **Build sustainable cost management through integration with key business processes (with a focus on the finance function).** A bank's ability to sustain cost management routines is rooted in its ability to embed cost control into business rhythm and cadence, as well as integrate cost allocation within existing key processes such as financial planning, transfer pricing and pricing of critical services (e.g., living wills) to generate a consistent view and understanding of costs within the organization.

# Table of contents

# Lay the foundation for a bank-wide costing orchestration

# Governance

## 1. Adopt an overarching governance to pursue bank-wide objectives as opposed to silo-based solutions

The single most important change that most banks have yet to accomplish to manage costs is the creation of a consistent language and common standards across the bank. Too often financial institutions deal with an amalgamation of multiple and conflicting taxonomies, different product hierarchies and different account processes, with different definitions for many of the same terms. For example, one institution maintained, managed and reconciled 55 different definitions of headcount: total headcounts without contractors, total headcounts without personnel on long-term leave, etc.

**Cost excellence begins with the ability to orchestrate cost management from a bank-wide perspective based on common overarching governance and standards.**

While this does not call for a stringent universal standardization of all terms across the bank, it does require a practical effort to create a minimum common denominator so that overhead costs and corporate shared services can be more easily managed with bank-wide objectives, as opposed to having business unit arguments about who picks up what share of the costs. This approach might improve an individual business unit's profit and loss statements, but it is highly ineffective in reducing cost for the bank as a whole. As one of our clients said: *"It is not about making my slice of the pie smaller, it is about making the whole pie smaller."*

A bank-wide costing governance can provide a unified approach based upon common and agreed guiding principles. This will improve cost transparency and cost awareness across the bank and facilitate synergies between linked costing processes such as cost allocation, cost to serve, transfer pricing and pre-funding requirements for *living wills*.

As this study focuses on the allocated cost base for financial institutions, we have identified the five features of an effective cost allocation governance structure:

- Overarching cost allocation policy
- End-to-end cost accountability
- Cost allocation roundtable
- Senior management sponsorship
- Clearly defined roles and responsibilities

### Overarching cost allocation policy

The overarching cost allocation policy sets common standards and principles for distributing costs consistently throughout the bank. This typically includes an agreement on whether the bank will adopt a service catalog-based approach to distribute cost, whether costs are fully loaded or only representative of direct expenses and whether the entire corporate cost is distributed or a portion is kept centrally. The policy may be supplemented by additional policies issued by business units. This preserves the need for bank-wide consistency without sacrificing the ability to incorporate specific business unit nuances.

### End-to-end cost accountability

**69%** **of institutions are starting to assign end-to-end accountability to service recipients[3].**

Assigning end-to-end cost accountability to cost recipients breaks the habit of the recipients considering themselves accountable for their direct expenses only. The extended accountability creates the incentive for recipients to collaborate with service providers to improve the understanding of the cost components behind charge-backs and opportunities to change consumption behavior and drive down costs.

Throughout the rest of this paper we will present several features and capabilities that can help improve cost management. However, assigning end-to-end cost accountability is a prime factor as it provides the incentive to act.

The other features will provide the tools needed to achieve results, but the process starts by incentivizing all parties to change and removing excuses such as *"This is not my cost" or "I cannot influence this cost."*

"It is not about making my slice of the pie smaller, it is about making the whole pie smaller."

*— Senior financial executive at a leading European bank*

### Cost allocation roundtable

**69%** of institutions have implemented or are moving toward enabling cost allocation roundtables to resolve allocation disputes[3].

The constitution of a cost allocation roundtable, chaired by senior management, can help defuse internal frictions typically related to the distribution of cost in environments characterized by limited cost transparency. The roundtable, in fact, provides recipients with a chance to voice concerns and ask for clarifications about charge-backs. However, we recommend the implementation of a materiality threshold for admission of claims. This will allow the roundtable and the organization itself to focus on material costs without being trapped in discussing minutiae. For example, one of our clients had its central allocation team investigate a dispute of US$4k, which is a very small fraction of the tens of billions of dollars in its cost base. Implementing thresholds will balance the incentive for teams to be vigilant about cost management while also applying the correct level of effort to reduce costs according to size and opportunity.

### Senior management sponsorship

The involvement of senior management throughout the allocation process enables better dialogue and interaction between the service provider, recipient and centralized allocations team. Senior management often can serve as the independent voice between the service provider and the recipient alleviating conflict and ensuring enterprise interests are pursued.

### Clearly defined roles and responsibilities

**62%** of participants declare they do not have clearly defined roles and responsibilities[3].

Clear and agreed roles, responsibilities and timetables should be defined to regulate the broader cost allocation process, including the development of cost (e.g., unit costing), distribution of central costs to recipients and enterprise cost reporting.

This contributes to improve cost awareness and accountability within the organization and helps increase the accessibility of cost data. For example, many of our clients' allocation teams declare they have a reasonable amount of data while the lines of business still complain about a lack of data.

### Improvement of cost allocation governance is the ideal starting point to generate immediate results.

Governance is the ideal starting point to increase cost transparency across a bank due to its relatively shorter implementation cycle when compared to process re-engineering or technology implementations. Additionally, creating a consistent overarching governance model based on common guiding principles will improve the quality of bank-wide conversations, the visibility of cost origination and how it flows throughout the service delivery chain and, ultimately, it will help shift the costing dialogue from cost disputes towards management and reduction.

# Strategic execution

## 2. Create a costing center of excellence to orchestrate efficiencies and bank-wide consistency

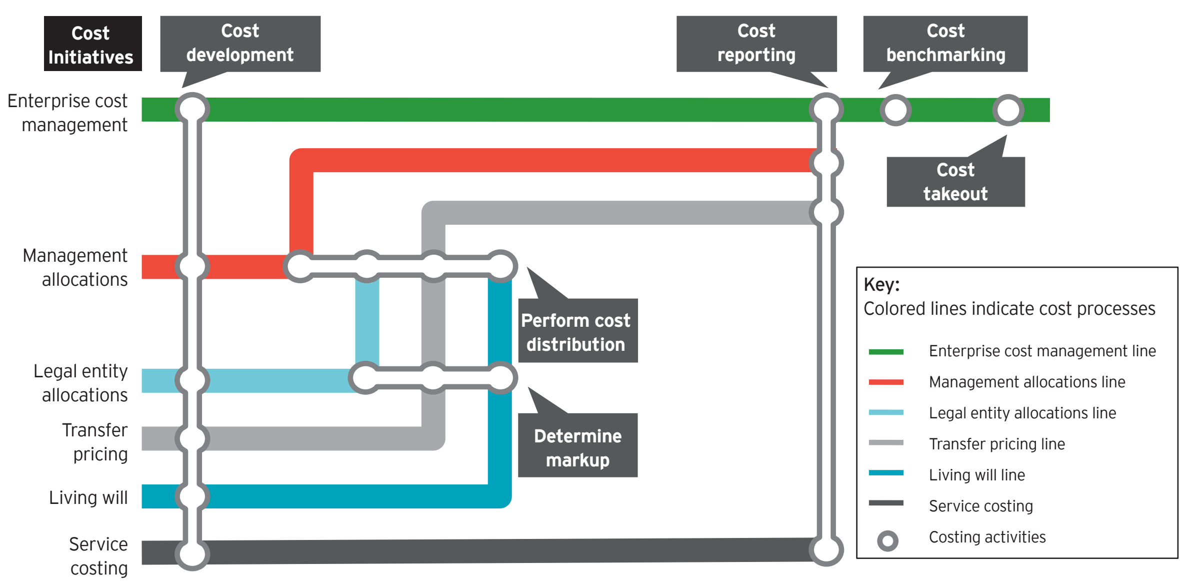
One of the main barriers to adopting a bank-wide costing governance model is the fact that banks typically run parallel and/or duplicative costing processes across the bank, often resulting in different methodologies being applied, challenges in reconciliation and inconsistency leading to impaired ability to perform overarching cost management. In particular, when we look at the three main costing activities, i.e., cost development (unit costing), cost distribution and cost reporting, we find that most banks perform duplicative costing activities as part of the following key processes:

- Cost management
- Transfer pricing
- Cost allocation to business units
- Cost allocation to legal entities
- Cost-to-serve initiatives
- Pricing of critical services (living wills)

Banks find themselves in this situation usually due to a misplaced focus on silo solutions that deliver tactical and rapid responses to senior management, regulators or tax authorities and/or to manage to internal objectives (e.g., cost-to-serve initiatives to reduce technology spending within one line of business). While the initiatives address the right questions, the lack of integration inhibits the opportunity to create consistent and effective costing practices throughout the entire organization.

We advise our clients to adopt a centrally coordinated model to run the bank's relevant costing processes in a consistent and efficient manner while leveraging common sets of data.

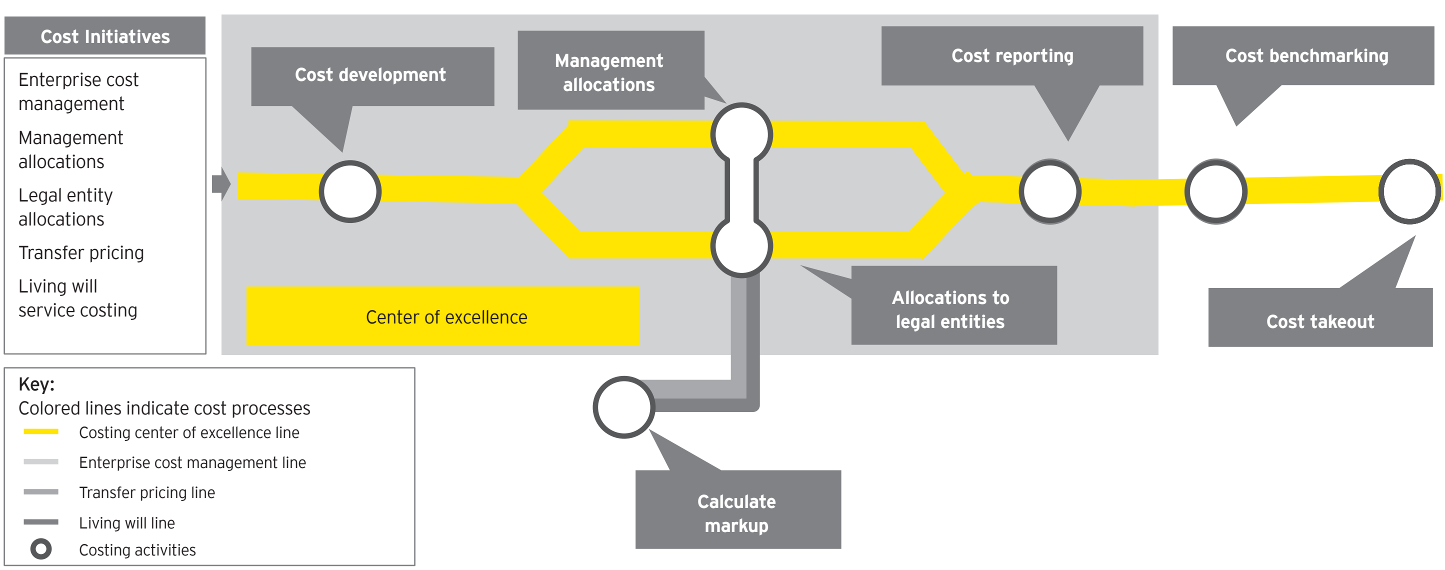
Figure 1: View of stand-alone costing initiatives



Central coordination could be coupled with central execution leading to the creation of a costing center of excellence. Clients who have adopted these models have seen the following improvements:

- Streamlined costing process that avoids duplication of activities
- Application of consistent methodologies across the bank
- Allocation of costs to legal entities and management within the same process
- Required data gathering at the most granular level that makes data available to all users
- Identification of additional cost levers to improve margin utilizing a more consistent view across the bank

Figure 2: Costing center of excellence



# Service catalog

## 3. Adopt a common taxonomy to improve the dialogue across the organization and focus on bank-wide goals

The foundation for bank-wide cost management is the existence of a common language across the organization with regards to the internal services market (i.e., service catalog) that facilitates a proactive dialogue between service providers and recipients. Traditionally, most banks have invested in the development of service catalogs for transaction-based functions such as technology and operations. However, it is essential that this tool is extended throughout the entire organization, including corporate overhead.

**77%** of financial institutions do not have a bank-wide service catalog but are aspiring to create one[3].

The development of a bank-wide service catalog presents a challenge for most banks due to:

- Existence of multiple and conflicting taxonomies causing inconsistent bank-wide views
- Service catalog design driven mainly by service providers causing low buy-in and ownership from service recipients
- Excessive level of service granularity causing loss of transparency and inefficient production processes
- Unclear roles and responsibilities — in particular the absence of service owners — leading to delayed decision-making and inability to progress the design of the service catalog

While the creation of a service catalog may seem like an administrative project, it is a foundational component to effective cost allocation practices, and when coupled with good governance, business cadence, actionable reporting and consistent bank-wide methodologies, it can open opportunities for the bank to lower its overall cost base by controlling expenditure at the right point in the consumption cycle (i.e., before money is spent).

By implementing this effectively, institutions can generate improvements in the spending patterns and benefits across various processes, such as recovery and resolution planning (RRP), transfer pricing, tax and location strategy.

This effort benefits the broader bank by giving it a framework, a language and a method to improve expense management and ultimately manage costs before they are incurred.

### The service catalog should be a Finance-led exercise for the benefit of the entire organization.

It is critical that Finance lead and coordinate this effort as part of the overall responsibility for financial planning and analysis. Finance is in the best position to manage the dialogue between the consuming and the billing organizations in order to shift the focus to lowering the bank-wide cost base as opposed to disputing and defending the charges. In addition, if Finance is not setting the agenda about how service catalogs are developed and used under a common framework and interlocked with the financial planning calendar and standards, there will be a proliferation of taxonomies and use cases. As a result, these taxonomies and use cases will not be easily reconciled and will have to be explained to senior management, regulators and tax authorities as to why they exist in isolation and are, at worst, in conflict with and, at best, diverge slightly from the financial standards of calculating service costing and the allocation of those costs to consuming businesses for different purposes (i.e., management allocations, legal entity transfer pricing, resolution and recovery financial projections). Additionally, the multiple taxonomies will generate parallel and duplicative processes that will have to be maintained as business as usual, posing an operational efficiency burden alongside the reconciliation challenges indicated above. Ultimately, the bank would be challenged by reaching the right balance between revenues and costs if the members of the bank holding company are using multiple, and perhaps conflicting, methods for managing, allocating and reporting expenses.

A more granular bank-wide service catalog will create increased transparency supporting bank cost optimization through:

- Enhanced insights to develop location strategy for service delivery
- Improved ability to price critical services *(living wills)* and minimize the amount of working capital set aside for pre-funding of operational continuity

"We need the right details, not just details per se."

— *Corporate allocations executive at a global financial services firm*

- Improved margin and enterprise value due to better understanding of cost origin, cost drivers and cost reduction levers
- Reduced regulatory capital requirements for CCAR's pre-provision net revenue (PPNR) as a result of improved ability to model indirect expenses under stress scenarios and avoidance of over-conservative assumptions
- Improved consistency between cost allocations for financial projection, actuals and use cases like RRP and CCAR
- Increased ability to take advantage of VAT exemptions that may be currently overlooked
- Improved consistency of language and taxonomy leading to better collaboration across functions that is aimed at reducing costs rather than defending allocation charges

### A top-tier service catalog should balance simplicity with the need for actionable cost insights.

Our view is that a service catalog should be *as simple as possible, but not simpler*. In other words, the service catalog should be simple by design and include additional granularity only when justified by materiality or by the ability to influence costs. A stratification of services (e.g., more granular subservices) according to their materiality and ability to influence can support a targeted approach to improving transparency, enhancing influence from a service consumer perspective and enabling granular detail that is fundamental for the push-down of allocations. Industry-leading practitioners use data granularity as a competitive advantage by leveraging consolidated data for budget conversations and only using granular data for ad hoc analyses where the business case justifies the cost.

Investment in establishing up-front design principles for granularity and in gaining consensus on the methodology and allocation keys applied across the service catalog creates the foundation upon which an allocation methodology can be built in an aligned, consistent and scalable manner. For material services that are primarily transaction driven, a more detailed service catalog improves linkage with the business activity and, therefore, the understanding by businesses of how their actions could influence costs.

# Enable actionable cost management

# Methodology

## 4. Balance simplicity and need for cost insights through a tailored costing methodology

Most financial institutions have reacted to the lack of transparency in the allocated cost base by increasing the level of granularity available throughout the allocation process. Specifically, the allocated cost base has become an area of prioritized focus due to regulatory and profitability pressure. For large institutions with a cost base of US$30b-$50b, maintaining high levels of granularity across the whole cost base is expensive and challenging. By making the right cost methodology decisions, financial institutions can provide a valuable compromise between complexity and transparency by identifying the areas where increased granularity is worth the investment. Banks can maneuver the following cost methodology levers to strike that balance:

- Allocation waterfall (e.g., sequencing of cost distribution)
- Cost distribution method
- Application of unit costing

***The partial waterfall is the ideal compromise between simplicity and the need for fully loaded costs leading to actionable cost insights.***

**54%** of organizations do not currently use a *partial waterfall* allocation methodology[3].

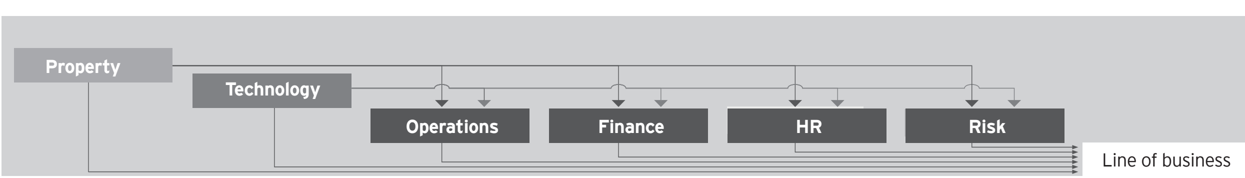
Banks are using a wide variety of allocation waterfalls. Some institutions prioritize simplicity, while others focus on having a fully loaded cost view. Still others are leaning toward hybrid models. However, the majority of financial institutions indicate that a *partial waterfall* methodology is their preferred methodology.

The *direct waterfall* methodology is simple and maintains transparency but does not provide a view of the fully loaded costs. *Direct waterfalls* are used by service providers when allocating to recipients only the direct expenses. This is the simplest allocation methodology, and it provides the highest degree of cost transparency through the allocation process. While simplicity and transparency are at the forefront of a bank's cost management aspirations, the lack of availability of fully loaded cost views may impair awareness by the service recipient of the entire cost behind the services they receive and might lead to misguided costing decisions or behaviors. Additionally, this methodology does not align with the ongoing industry trend that assigns end-to-end cost accountability to the service recipient.

The *reciprocal waterfall* methodology is the process where each service provider allocates their fully loaded service costs to each service recipient. This creates an allocation system where multiple steps are required. One institution has to perform nearly 20 steps to build a fully loaded allocation picture. It often leads to political friction and an environment where conversations between providers and recipients of a service are focused on defending allocation charges rather than discussing how to improve cost management. *Reciprocal waterfalls* display the true cost of providing a service, but transparency is often lost, subsequently impairing the ability to control costs.

The *partial waterfall* is a hybrid methodology where most material providers — typically real estate and technology — allocate costs to each service recipient. Other providers allocate both direct expenses and their share of incoming allocations received from real estate and technology to recipients. The industry is trending toward this waterfall methodology as it still offers a quasi-fully loaded cost

Figure 3: Example of *partial waterfall*



"If we get transparency, cost reduction follows."

*– CFO, enterprise staff functions at a large US bank*

without generating unnecessarily complex repetitive allocations. After all, as one Finance executive put it, "Fully loaded costs are viewed as the person, the seat they sit in and the technology they consume."

The partial waterfall allows institutions to build up the cost view required to comply with Dodd-Frank's Living Will standards and facilitates using the allocation process in compliance with the regulation.

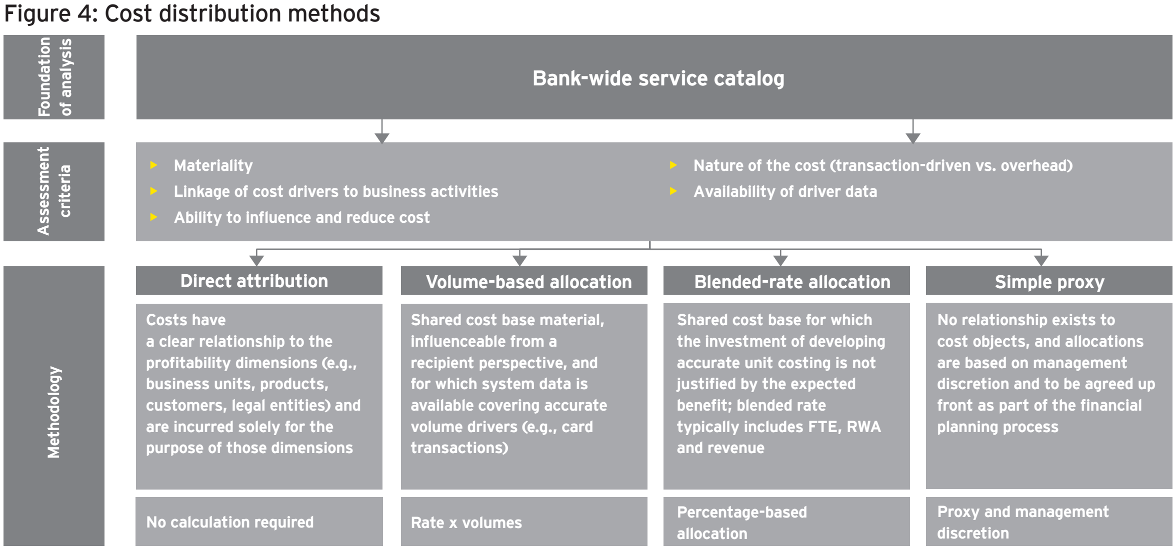
### Tailor cost distribution methods are based on the nature of the service and data availability.

There are four methods (see Figure 4) for distributing costs from service providers to recipients, and we advise our clients to assign the proper one to each service, based on the nature of the service and the characteristics of the underlying cost base. Specifically, materiality and ability to influence the service cost are the two most important criteria used to drive the selection and evaluate the case for investing in the bank's ability to improve the availability and quality of driver data.

### Adopt unit costing based on forecasting to increase cost awareness, transparency and the ability to act.

Unit costing increases transparency into allocated charges as it links costs to volumes recognized by the service recipient. EY research shows unit costing is a key enabler in assigning cost accountability based on actual control and influence over the cost base. In particular, service providers should be accountable for the unit costs and responsible for optimizing their service value chain to reduce the cost to serve. Service recipients should be accountable for the accuracy of volumes they forecast, as volume accuracy is a key input to the provider's optimization tasks. A major source of inefficiency within the banking industry is due to unused capacity, i.e., the situation in which a bank's infrastructure is set up to support the delivery of higher volumes than actually consumed. While a measure of excess capacity when carefully planned might be considered conservative, unplanned or unmanaged capacity is an unnecessary and wasteful expense.

Figure 4: Cost distribution methods



"There are fewer excuses from divisions to say 'This is not my cost.' Divisions are held accountable and need to find ways to manage and drive down costs. But it all starts from making them accountable."

— *Finance controller at a leading European bank*

Unit costing is also useful to analyze budget vs. actual variances and identify whether the difference is due to volume variances (e.g., different volume than planned) or to efficiency variances (e.g., higher unit cost than expected). Variances could also be due to the impact of foreign exchange rate fluctuations. This type of insight strengthens the level of cost accountability and improves the ability to trace the root cause of the variances. There are various approaches for applying unit costing. They are based on using actual, budgeted or forecasted figures for both unit cost and volume.

By allocating costs based on budgeted figures, recipients are typically more comfortable with the charges as the allocations are more predictable. However, true-ups must be completed periodically and can reveal unexpected variances, especially if true-ups are only completed on an annual basis. Allocations based on actual figures increase accuracy and awareness on real spending patterns; however, calculating this on a monthly basis is time intensive and can slow down the financial close process. A compromise between these two options is to allocate based on forecasted figures with a quarterly true-up; this provides a balance between predictability and accuracy while not consuming too much time during the close cycle.

# Drivers

## 5. Adopt unit costing with allocation drivers linked to business fundamentals

Allocation drivers are one of the most effective catalysts that banks have available to incent changes to the organization's spending behavior. There are two types of drivers: cost drivers and allocation drivers. Cost drivers are the metrics that explain how costs are incurred, their origin, their cause and effect, and what levers are available to drive them down. Allocation drivers are rules agreed within the bank that regulate how a service will be charged out to each recipient. Considering that each recipient is driven by the objective to minimize their charge-backs in order to have more favorable profit and loss (P&L) statements, banks need to choose allocation drivers that incent the cost recipient to modify its consumption behavior in a way that optimizes bank-wide cost while improving the recipient's P&L statement.

### Increase use of unit costing to improve cost awareness and ability to drive down costs and compliance with CCAR's PPNR.

We advise our clients to increase the size of cost base that is allocated through unit costing, and carefully select the right allocation and cost drivers in order to influence spending patterns, which may, in turn, lead to:

- Increased cost transparency (understanding the cause and effect of costs) and cost awareness
- Better alignment of accountability with the ability to influence the cost (e.g., service providers should be responsible for optimizing unit rates, and recipients should be responsible for optimizing consumption behavior and volume forecast accuracy to make sure they do not push the plan for unrealistic volumes and generate additional unused capacity costs)
- Improved capability to model expenses under stress scenarios and avoid over-conservative assumptions while complying with CCAR's PPNR

EY research shows that currently less than 40% of the allocated cost base is allocated through unit costing with drivers tied to business activities as opposed to technical parameters (e.g., loan transactions vs. CPU usage time). While CCAR's PPNR and Regulation W are pushing banks to increase the use of unit costing, banks are typically facing a common set of challenges:

- Difficulty in tracking service volume consumption at the required granularity
- Volume-based drivers selected based on data availability rather than cost analyses and materiality
- Difficulty reaching consensus across the organization on which allocation driver to use (e.g., number of trades processed vs. number of trade exceptions) due to the impact on each recipient's P&L statement
- Unclear, and often conflicting, cost accountability models

We propose to tackle these challenges through a six-step approach that weighs the benefit for introducing unit costing, with a pragmatic lens of current data availability and is supported by a governance framework aimed at reaching consensus across the organization.

Figure 5: Proposed approach for unit costing

| 1 Define scope and governance | 2 Cost analysis | 3 Determine drivers | 4 Data gathering | 5 Produce unit costing report | 6 Validation |
|---|---|---|---|---|---|
| ‣ Define unit costing design principles<br>‣ Review service catalog and identify services in scope<br>‣ Identify stakeholders for working group and steering committee | ‣ Determine cost origin and cost type (e.g., overhead, business-driven)<br>‣ Understand current state cost drivers<br>‣ Identify potential cost reduction levers | ‣ Propose initial drivers based on cost analysis and EY's viewpoint on leading practice<br>‣ Assess volume data availability and confirm or change proposed drivers | ‣ Gather financial data (e.g., cost pools)<br>‣ Gather volume data (e.g., # of transactions) | ‣ Calculate unit cost per service<br>‣ Produce unit cost reports with additional detail | ‣ Validate unit costs with working group<br>‣ Obtain steering committee sign-off |

"To be effective in cost management, you really need to understand the driver and the origin of the cost."

*— Finance executive of a leading international banking group*

## Allocation volume drivers have a significant impact in incentivizing the right cost behavior.

With the majority of banks' cost bases being either fixed or semi-fixed, some of our clients are asking us how they can extend unit costing to areas where the majority of the costs have already been committed or incurred. We believe that even in areas where the ability to take down the cost seems limited, such as traditional overhead cost, there is still significant benefit to applying unit costing to improve the consumption behavior or the actual use of a service by the organization. Below, we have indicated two client anecdotes, one of which depicts a positive effect and one that shows the unintended behavior triggered by the choice of the allocation driver.

### Example of good effect of using the right allocation driver

One institution improved its cost to serve for delivering trade processing services by switching the driver from "number of transactions" to "number of exceptions."
Upon the analysis of the delivery value chain, one of our clients identified that the main driver for costs was not the volume of transactions processed, but the time required to process exceptions. We advised our client to charge out this service using an allocation driver, based on the number of exceptions. Following this change, the buyers (recipients) of these services were incentivized to improve the documentation quality and to gather the required information prior to submitting the trade for processing. Through this new focus, and effectively a change in consumption behavior, our client was able to record a reduction in the cost to serve due to a lower number of exceptions and, at the same time, recipients received lower charge-backs and achieved improvements in their business unit P&L statements.

### Example of unintended behavior triggered by using the wrong driver

One institution invested millions of dollars to create a dedicated training facility for its employees. They decided to charge out the training facility costs to each business unit based on the number of employees that attended training courses. The result was that business units pursuing a cost-reduction target discouraged their employees from attending any non-mandatory training, thereby missing out on the advanced learning experience that the organization wanted to offer to its employees.

However, while there are minor pockets of variable costs such as on-site technical support, cleaning and maintenance, catering and other costs, the most material part of the cost for this training facility has already been incurred by the bank. At this point, there would be no incentive in holding back employees' participation.

Service recipients are likely to operate under the assumption of optimizing their individual P&L statements. The right allocation driver should consider this and use this knowledge as a leverage to incentivize the intended behavior. In this situation, the institution could have considered alternative charging drivers. For example, it could have charged out the cost of the facility to the business based on the percentage of employees, that although eligible to attend training, did not attend.

# Data

## 6. Refocus annual spending to improve data management at the source as opposed to investing in a multitude of point solutions

Every element of the cost management ecosystem, in order to be executed efficiently and accurately, ultimately relies on the quality of the available data. And that is where the going gets tough for most banks, especially large banks with complex multi-billion dollar cost bases. We have observed that most banks have data at the line of business level — effectively siloed and not consistently managed from line of business to line of business. Additionally, that data is inconsistent across lines of business in terms of its quality, definition, timing, and frequency.

From cost allocations to regulatory reporting — firms have been spending significant sums to "fix" the view of the data at the point it has to be reported versus fixing the root cause of why the data doesn't look right to begin with. The challenge with this approach is that the actual problem is never remediated — instead it is covered over with a veneer that only adds complexity and rigidity to the environment — making all other subsequent programs more complex and costly. These symptoms typically lead to an impaired ability to trace data back to the source, duplicative, inconsistent data management activities, and even more concerning, discrepant views across the functional departments (line of business management, Finance, Tax, etc.) impacting the ability to steer the bank. One client shared that they have over 30 different mortgage origination systems feeding over 20 mortgage accounting systems, all using different taxonomies, along with massive challenges around lineage documentation, transparency and reconciliation for regulatory reporting.

Institutions are increasingly being called upon by investors, regulators and their boards to manage their business in a centralized fashion to optimize the allocation of limited resources. Comprehensive data management is no exception.

### Enforce bank-wide data governance program with consistent standards and metrics that embed data steward and custodian functions to remediate data issues.

In order to achieve a well managed data environment firms need to enable and enforce data governance functions aimed at measuring and pro-actively remediating identified data issues at the root cause. In particular, we advise our clients to focus on key data management issues that have the most valuable impact on the firm:

- Drive a program that creates a comprehensive Master Data management capability linked to the firm's business processes. Master Data forms the anchor from which to drive not only cost allocation at customer, product, and account levels, but also to get a true picture of customer and product profitability, sentiment analysis and customer satisfaction measures, improve customer billing, and even drive more meaningful cost center analysis. For each process, the linkage between the Master Data and dynamic data informing the process should be optimized from a data provisioning standpoint to support the process in as efficient and timely manner as possible. This links back to a robust data provisioning strategy as part of your overall enterprise level data management framework. Create and enforce consistent enterprise governance standards across the data lifecycle from data sourcing, storage, calculation engines, and through to reporting to make sure the same tasks are performed, captured, and documented in a consistent manner across the firm to improve transparency capabilities and enable data lineage
- As part of enterprise governance, establish data stewardship and data custodian programs to provide oversight over the execution of data management and remediate at the root cause level, versus downstream "fixes" that mask the true problem.
- Quantitatively measure data quality through bank-wide metrics that track the adoption of common standards, such as number of null fields/total number of fields provided, number of fields mapped to the bank-wide and LOB taxonomies as well as fit-for-use metrics.

### Improve data at the source as opposed to point-solutions reporting

Many of our clients are investing significant resources and budget to support large-scale reporting programs due to the complexity of the regulations and ever growing need for management insight. These programs often offer only point solutions that adjust data at an intermediate layer while failing to address the broader end-to-

"We likely have enough resources, but we need to adjust their focus to data analytics."

*— CFO enterprise staff functions — large US bank*

end data management issues. Given the multitude of use cases that leverage the same set of data, we believe that those investments would generate significantly higher returns if spent to improve data provisioning strategy and execution avoiding tactical solutions that are likely difficult to scale and maintain over time. In particular, we guide our clients to:

- Refactor data sourcing using a consistent sourcing framework, MDM architecture and metadata management approach to automate business and regulatory requirements
- Rationalize the application landscape to reduce overall environment complexity, volume of data taxonomy and decommission duplicative systems
- Link data to bank-wide taxonomies such as the service catalog and product taxonomy leveraging a robust metadata environment

We recognize that this effort requires significant investment for banks. However, once we consider the broader data and technology spending dedicated to intermediate level fixes to address issues with management and regulatory reporting, we believe this to be money well spent. The subsequent maintenance cost of running multiple, inconsistent processes, systems and the related reconciliation efforts, along with the increase in complexity brought to the bank data model, the cost of running duplicative applications and cost of missed opportunities (e.g., data quality is improved on intermediate systems for the benefit of a few use cases as opposed to the actual source for the benefit of all use cases), provides more than enough fodder for institutional business cases.

We strongly believe that the overall investment is comparable to what banks are already undertaking — for far greater benefit.

Banks need to rethink their data management strategy, shifting from tactical siloed-solutions to the creation of a bank-wide governance and data standards, including the centralized management of data investments that is based upon the understanding of bank-wide requirements and use cases.

# Technology

## 7. Leverage advancements in technology to increase cost transparency while minimizing disruption to current processes

**Most banks prefer to leverage existing technology platforms, but only less than one-third have a dedicated system to perform allocations across the bank.**

**31%** of organizations use one dedicated allocation system across the enterprise[3].

While banks understand the key role that technology plays in the broader cost management framework, they are aiming at leveraging and evolving the existing technology platform whenever possible, instead of replacing it, in order to contain the costs of the transformation. Additionally, leveraging the existing platform avoids the disruption to business as usual (BAU) processes that typically are associated with a technology migration.

EY research also indicates that there is not a prevailing trend among banks toward a specific cost allocation technology platform. There is, however, a variety of software platforms used for developing unit costing and for distributing costs. Our clients tell us that the choice of cost allocation tools is driven primarily by the broader finance technology landscape rather than specific software features.

**Outdated legacy systems coupled with the use of multiple systems for varying purposes contribute to the loss of transparency in cost allocation processes.**

Most of our clients still use outdated legacy systems for cost allocation processes, including custom-built systems that often are challenging to scale. While these systems adequately store the direct cost information (input data) and the total allocated results, they tend to lose traceability of intermediate allocation steps due to the data volumes generated and consequent performance impacts, which generates a loss in transparency.

It is common for our clients to indicate that they believe they have sufficient costing data information at the starting point of the process, but they are not able to leverage this information further down the process because of the lack of traceability and accessibility. The systems used for cost allocations by most banks typically only provide visibility into the data inputs and the end result (i.e., the portion of cost to be distributed to each recipient). The lack of visibility into the intermediate calculation steps impairs the recipients' ability to trace back the cost to its origin. The latest technology platforms have evolved to retain visibility of the intermediate calculation steps allowing the recipients access to more granular data to perform additional cost analysis.

**Improvements in the latest technology platforms have created new features and functions that are relevant to improving cost allocations and transparency.**

- In-memory solutions and the support of data virtualization, allowing for data to be accessed in near real-time reducing reconciliation effort and supporting the execution of parallel and faster processing
- Integrated planning and versioning capabilities supporting driver based projections and allocations with increasing visibility on cost generation factors and root cause analysis enabling more relevant, analytical models and simulation
- Allocation lineage supporting the ability to drill back to each step of the allocation process increasing transparency on fully loaded costs

We advise our clients to adopt a *sidecar* approach when migrating technology. This approach is designed to leverage existing data and business rules and run initially as a parallel process through the new technology platform, allowing for a smoother transition toward the decommission of the incumbent system.

The *sidecar* approach provides a safe environment where our clients can perform financial modeling and projections of the impact resulting from the changes to cost allocation methodologies or drivers. In particular, the cost recipients can help evaluate and understand up front how these changes will impact their P&L statements and any tax implications. This ultimately contributes to acceptance and adoption of the new cost allocation framework, as the unknown financial impact to business unit performance metrics is a typical barrier to cost allocation programs.

Finally, we advise our clients to leverage cloud-based technology solutions to accelerate the implementation cycles and the delivery of the anticipated benefits, while optimizing the upfront investment. In fact, cloud-based solutions have lower upfront infrastructure requirements and by allowing a closer alignment to usage (e.g., the number of upfront licenses), it typically results in lower run rate costs while maintaining the ability to be scaled up.

# Cost analytics

## 8. Focus on generating actionable insights rather than just reporting numbers

While all cost management capabilities are relevant and can be complementary to each other in the effort to build a top-tier cost management environment, cost analytics presents a differentiating feature. It is, in fact, the only capability that, if developed, can make up for some of the shortcomings in the other capabilities. It is important to note that cost analytics will also rely heavily on the maturity of other cost management capabilities, in particular data and technology. We are not advising our clients to focus solely on this feature, but rather we encourage them to consider it as a more impactful starting point in the cost transformation journey alongside governance and a service catalog.

### Effective cost analytics will improve the transparency of the allocated cost base and the ability to drive down costs.

There are three key value drivers needed to provide the path to cost excellence:

- *Transparency* enables better understanding of the costs and leads to fair allocations.
- *Influenceability* enables identification of the levers and changes in spending behavior required to drive down costs.
- *Sustainability* enables maintenance of transparency and influenceability in an efficient, repeatable and scalable manner.

### The use of analytics in cost management is increasing throughout the industry; however, the majority of banks still do not use analytics across the entire cost base.

**58%** of banks do not use cost analytics across their entire cost base[3].

Most banks have invested in the development of analytics in areas such as technology and operations, two highly material areas of the cost base. However, they are lagging in terms of extending the coverage to traditional overhead costs such as those for finance, risk, legal, marketing and compliance.

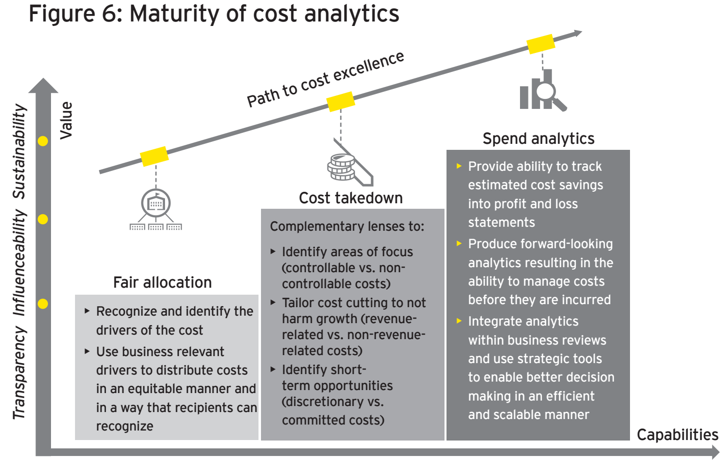
**46%** of banks use analytics to allocate cost more fairly, but not to drive down cost[3].

EY research shows that while over 85% of large banks use cost analytics with the purpose of allocating cost in an equitable way, for example by improving the ability to measure the actual consumption of the service provided, over 50% of banks declare that they are not using analytics to empower their cost-reduction efforts.

### Opportunities exist to extend analytics to cover the entire cost base and increase focus on cost takedown.

There are significant opportunities to improve the quality and insightfulness of existing cost analytics. We advise our clients to improve the balance mix of leading and lagging indicators and to leverage analytics to forecast allocated charge-backs. In fact, most banks miss out on the opportunity to manage costs looking forward and gather actionable insights on reduction levers and cost patterns before cost is committed. We believe this to be a major capability gap that banks should address in order to deliver against their cost reduction targets.

Figure 6: Maturity of cost analytics



"The goal is not just to allocate costs in an equitable manner."

*— global investment bank*

Additionally, banks should invest to improve their ability to perform advanced variance analyses and determine the root cause of any discrepancies between actual and budget figures for allocated costs. This will likely improve cost accountability and ownership and incent the right cost behavior throughout the organization.

### Shifting from reporting numbers to generating insights.

The majority of banks face the significant challenge of delivering insights in a consumable manner. Too often reports are large documents with an excessive number of pages, typically filled out with tables and charts and very little actionable commentary. These reports are usually very labor intensive to produce given the manual input required and do not hit the mark in terms of supporting decision-making. We advise our clients to simplify their reports and refocus them on depicting the key actionable outcome of analyzing those charts and tables in a format that delivers a lean document. Ideally, these reports should be presented in a narrative format and provide analysis, insights and possible conclusions for the readers' consumption.

Reports should not require readers to review and analyze data in order to draw their own conclusions, which are going to be influenced by differing levels of knowledge and technical skill. Better reports prevent insights from being hidden in plain sight.

The delivery of cost analytics should be focused on making an impact on the cost base. Reporting should be focused on generating immediate value to the organization through understanding the flow of costs through the delivery chain and variance analyses.

Actionable cost analytics will add value to the entire organization by:

- Driving changes in spending patterns and behavior to generate cost optimization opportunities
- Improving the operational efficiency of report production in a way that avoids duplicative processes and minimizes reconciliation efforts
- Identifying the key data points and prioritizing data quality remediation efforts

Ultimately, investments in cost analytics improvements will lead to sharpening a bank's competitive advantage over peers by unlocking management by insight and optimizing the use of scarce resources in a manner that adds more value to the organization.

# Build sustainable cost management through integration with key business processes

# Financial planning

## 9. Manage the allocated cost base within financial planning and business reviews

Most banks manage cost allocation as a stand-alone process with weak or absent integration with the financial planning cycle. Separate approaches and different cost drivers and methodologies between planning and cost allocation inhibit financial institutions ability to right-size the service provider organization during strategic and annual financial planning periods. This missed opportunity contributes to the myth that the majority of the cost base of a financial institution is either fixed or semi-fixed and, therefore, executive management has limited leeway to influence or take down costs.

**85%** of financial institutions do not have a cost allocation process integrated with the planning, budgeting and forecasting process[3].

### Identification of unused capacity can help to right-size the service provider organization.

Unused capacity is one of the largest contributors to inefficiency for financial institutions. To tackle this challenge, banks need to manage their allocated cost base during the financial planning cycle in conjunction with tighter accountability for service recipient volume forecast accuracy and the use of common or easily reconcilable cost drivers, data and methodologies. We see most of our clients overlooking this prospect even when they adopt driver-based planning, which naturally creates an opportunity to align planning drivers to costing drivers.

### Implementing an integrated approach to cost allocation will have significant benefits with little investment required.

To integrate cost allocation and financial planning, we advise our clients to consider the following strategies:

- Adopt easily reconcilable drivers between costing and financial planning
- Create an integrated annual financial planning calendar to encompass key roles and milestones of the cost allocation process
- Implement a centralized, or at least a centrally coordinated, financial planning process to allow easier collaboration between functions and lines of business, and consistent standards and data management
- Establish a process to update and agree all drivers, metrics and reporting for financial planning and cost allocation on an annual basis (off cycle or just prior to the planning season)
- Evaluate appetite to perform zero-based budgeting whereby overhead planning is built from the bottom up and each incremental increase is justified

Integrating cost allocation within the financial planning cycle creates the opportunity to achieve significant benefits such as:

- Ability to discuss and manage allocated costs during the budget cycle
- Exploit cost optimization opportunities and reduce unused capacity as the discussion takes place before costs are committed or incurred
- Process efficiency and reduced effort to reconcile financial figures by using common data sets and synergy among data remediation and data quality

# Resolution and recovery planning

## 10. Leverage cost allocation to minimize the pre-funding required for operational continuity

Recovery and Resolution Plans (RRP), also known as *living wills*, are a regulatory response to the financial crisis aimed at limiting the risks that a Global Systemically Important Financial Institution (G-SIFI) poses to the broader economy in the event of a resolution scenario.

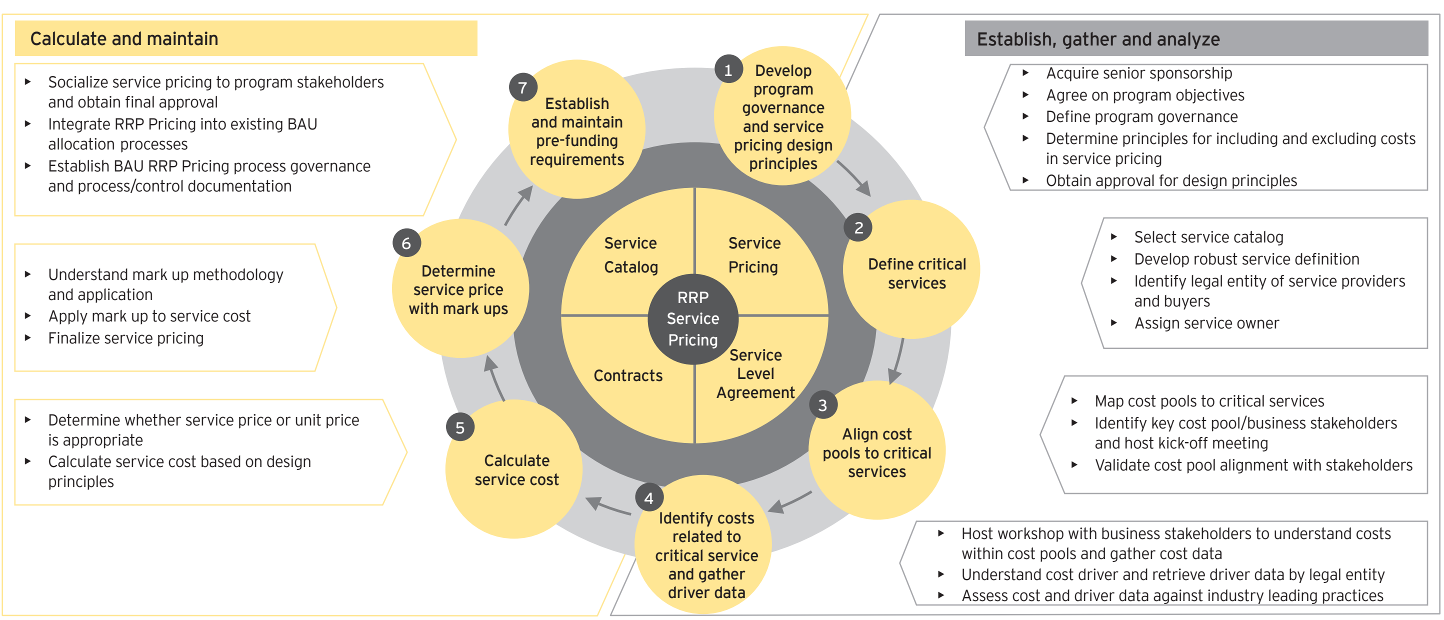
As part of an institution's *living will* a G-SIFI is required to pre-position a portion of the operational expenses and capital associated with the shared services that support a bank's critical operations (i.e., those operations that if interrupted would cause a detriment to the economy or a decline in the bank's franchise value).

**38%** of banks are very satisfied with their current state on pricing of critical services for RRP purposes[3].

The regulator is looking at this matter with increased scrutiny. In fact, in April 2016, the US Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) determined that the *living wills* of five out of eight G-SIFIs were not credible plans in a resolution scenario. The findings of the report determined that in the event of another financial crisis, these banks would not be able to adequately wind down with minimal impact to the broader economy without access to taxpayer money.

Figure 7 below illustrates EY's approach to performing an integrated calculation of the critical services pricing while minimizing the impact on operational efficiency and avoiding the need for excessive, and often manual, reconciliations.

Figure 7: EY's approach to calculating pre-funding requirements



**Most institutions were not adequately prepared for, and are now incurring organizational fatigue to meet, RRP regulatory compliance requirements.**

Most of our clients have responded to this regulatory ask through a siloed, one-off exercise that is carried out with limited integration with other linked processes such as financial planning, cost allocation and transfer pricing. While this approach might provide an accelerated path to meet the *living wills* requirements, it will create a significant operational burden to maintain one additional process with highly manual input and will require reconciliation efforts to avoid inconsistent views being delivered to the senior management, regulators (living wills), and tax authorities (transfer pricing).

**63%** of participants are unable to determine what percentage of their allocated cost base is related to providing critical services[3].

Most G-SIFIs are facing similar challenges to comply with RRP requirements, including:

- Uncertainty around identification of services as critical based on regulatory definitions
- Due to a lack of cost transparency, service pricing is typically calculated with conservative estimates, resulting in setting aside higher levels of working capital than required
- Current critical service pricing processes are not leveraging information from other processes (e.g., cost allocation, transfer pricing), yielding inefficient, redundant processes and inconsistent methodologies
- Inability to identify which portion of cost base is related to support critical services

**Calculation of pre-funding requirements should be led by Finance and managed as a use case for financial projections.**

**57%** of interviewed institutions manage the pricing of critical services either as a stand-alone process or partially integrated with linked processes[3].

We advise our clients to manage the pricing of critical services and the determination of pre-funding requirements by leveraging the synergies (e.g., data, methodology) of other connected processes and to do so under the leadership of Finance as part of their overall responsibility for financial planning and projections.

This will allow banks to achieve a higher operational efficiency while improving accuracy and consistency of the final output.

# Tax and regulatory compliance

## 11. Factor tax and regulatory constraints into management of shared services to avoid erosion of operational efficiency due to unforeseen tax and legal entity complications

**The benefits realized by shared services centers and centers of excellence have often been eroded by unforeseen tax and legal entity complications.**

Shared Service Centers (SSCs) and Centers of Excellence (COEs) have proliferated in the financial services industry in recent years given the emergence of faster data transfer speed. In addition, the need to reduce overall operational costs and comply with regulations including those under Dodd Frank has played a role in the move toward SSCs. Unfortunately, and all too frequently, the benefits realized by SSCs and COEs have been eroded by unforeseen tax and legal entity complications.

**While tax authorities can impose taxes and fees, regulators can shut businesses down indefinitely.**

Of the legal entity complications, legal and regulatory issues are the most important. While tax authorities can impose taxes and fees, regulators can shut businesses down indefinitely. Consequently, it is critical that any regulatory constraints be identified and factored into the business case at the earliest stages.

Many countries and the EU have laws restricting access to private client data. Under such laws, data may be required to remain on servers located within the country and under control of the local corporation with whom customers shared the data. Limitations also exist on the ability of employees outside the country to access this data. In practical terms, when validating the business case, managers need to consider whether some group companies can be migrated to the SSC or COE. Failing to identify such restrictions early on could result in higher average costs for all users and a failure to achieve the project return on investment (ROI).

Bank and Insurance regulators in some countries restrict the services that may be provided by employees of one company in the group to other group members. In the UK, for example, employees of an insurance company cannot perform services for another group member. Similarly, under US banking regulations, a bank that transacts with a non-banking affiliate must do so on terms that are equivalent to *market terms or better*.

Limitations also apply to extensions of credit from banks to other group members. In some cases, restrictions on permitted services can be avoided by transferring employees from the regulated entity to a non-regulated entity in the same jurisdiction. However, this approach may require setting up new legal entities and can result in additional compliance costs to prepare financial statements and file tax returns — costs that must be factored into the overall business case.

The *market terms or better* standard referred to above is found in Section 23B of the Federal Reserve's Regulation W (Reg W), which imposes requirements on banks that overlap in some ways the applicable transfer pricing requirements. The regulation requires banks to document the following items with respect to their intercompany transactions with non-bank affiliates: service description, business purpose, pricing, justification, ongoing vendor management process. Banks generally prepare pricing *justification memos* (PJMs) to address the Reg W requirements. The Pricing section of the PJM should include, for example:

- The process used to determine the pricing and rates charged for the products and services offered with supporting exhibits (e.g., diagram providing an overview of the process)
- The process for structuring the expense allocation and establishing the cost structure for services with supporting exhibits
- The pricing for the products and services provided to bank by affiliates and how it is calculated (e.g., actual usage on a per unit basis multiplied by the per unit rate applicable with supporting exhibits)
- How the pricing for the products and services was calculated based on the drivers and rates listed in the exhibits

In the Justification section, the bank should provide a pricing comparison based on third-party benchmarking and transfer pricing studies conducted on the applicable service level agreement (e.g., IT infrastructure) to establish that the prices charged to the Bank are in line with fair market pricing; a description of the most relevant service level agreement market analysis benchmarking study; as well as how results of the market analysis show that the bank is paying a fair market price for the products and services provided by affiliates.

### A recent EY survey of tax directors identifies transfer pricing as the most contentious tax issue

Most countries determine the amount of taxes that an enterprise owes based on the amount and nature of the activities performed in that country. When members of a multinational group provide goods or services to one another, the amount paid for these activities (called the transfer price) affects the profits earned (and taxes owed) in each country. Because countries around the world have different tax rates and groups have an incentive to minimize the taxes they pay, the US and most other countries have implemented *transfer pricing* rules that require that the price associated with transactions between related parties, including intragroup services, be consistent with what unrelated parties would be willing to pay when dealing at *arm's length*. This requirement, referred to as the *arm's length standard* or the *arm's length principle,* while an elegant legal framework, can be very tricky to apply. According to a recent EY survey of tax directors, the number one most contentious tax issue that groups face is transfer pricing. Transfer pricing is difficult because the tax rules seek to establish a *market price* for goods and services for which developed markets do not always exist. In the absence of publically available data, companies often rely on transfer pricing methods in which the price of services is set to equal the cost to the service entity providing the service plus a markup. In setting the transfer price and defending it from challenge, companies must confirm that:

- The service provides an economic benefit to the recipient
- The full cost of providing the service is charged and reflects a reasonable allocation basis
- Charges are made pursuant to proper agreements and are reflected in the books and records of the recipient.

The first requirement, called the Economic Benefit Test, requires that in order to take a tax deduction for a related-party service, the recipient must receive, or reasonably expect to receive, a benefit from the service. Activities that benefit only the provider, such as monitoring activities performed by an affiliate, or that do not provide (or are not reasonably expected to provide) a direct benefit to the recipient are not services under the transfer pricing rules and are therefore not deductible. It is also important to consider the reasonable alternatives available to the recipient to engaging the related service provider. For example, a parent company may require that all affiliates have 24/7 data back-up and recovery and the services and speed of a Tier 1 data center, but if such services are not commercially prudent for the affiliate given its size and market position, some of the costs associated with these services may not be appropriately charged out under the transfer pricing rules.

Cost-based transfer pricing policies require that the full cost of a service (including all reasonable overhead) be charged. Marginal costs or direct costs are generally not allowed under US and OECD transfer pricing rules. Transfer pricing rules do not prescribe allocation keys to allocate costs to services, but the US rules state that allocations used for management reporting purposes should be given consideration. It is worth noting, however, that some countries (especially Mexico and South and Central American countries) have formal or informal rules that require all intercompany service fees to be based on the amount of time involved in providing a service rather than allocating costs based on a pro rata basis.

Many countries do not allow a deduction for an intercompany service fee unless such services are invoiced and cash settled in the entity's books and records. Even in jurisdictions that do not require service agreements and formal invoicing, the taxpayer's ability to take a deduction in the recipient location is greatly enhanced by ensuring that all intercompany services are provided under formal service agreements, detailed regular invoices are prepared, and charges are reflected in the books and records through the payment of cash or the recognition of an intercompany receivable.

# Jump-starting your transformation

# Jump-starting your transformation

Most of our clients recognize the need to improve the way they understand and manage the allocated cost base. Transforming cost allocation for large financial institutions with complex cost bases can easily become an overwhelming exercise, especially when we consider the multiple regulatory urgencies. We have seen many of our clients opting for incremental improvements, dragging suboptimal processes and tools, in order to rush to provide regulatory responses or urgent management insights. This typically leads to point solutions, often developed in silos, that are challenging to scale for whole bank coverage and that create an organizational burden to be maintained.

At EY, we believe that a successful bank-wide costing transformation relies on the ability to create a balance between developing future state capabilities aimed at generating consensus and agreement on common principles, and creating immediate and continuous value to maintain momentum.

In particular, we advise our clients to start the transformation with the alignment of the entire organization behind a common understanding of the current issues, the bank's priorities and the way forward. Based on our experience, we find that organizing a working session with senior management from Finance and the functions providing and receiving the services is an effective catalyst for change.

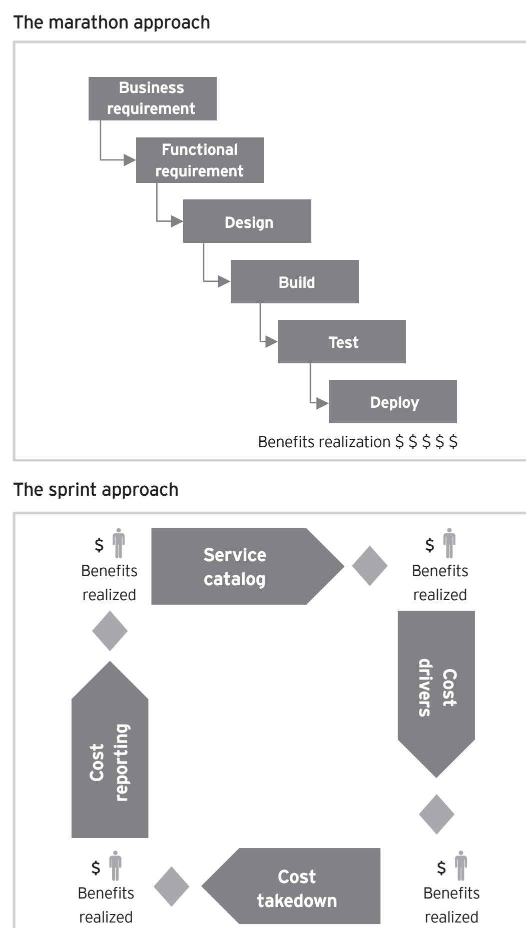
Upon the organizational agreement on the above items, we typically advise our clients to plan for a strong start by focusing on the following three capabilities:

- Governance
- Service catalog
- Cost reporting (pilot)

We believe governance is the ideal starting point because of its rapid implementation cycle and the ability to unlock a centralized way of managing costs based on bank-wide principles and policies. Governance plays a fundamental role in defusing internal frictions by providing a cost allocation roundtable and clarity on cost ownership, which is a powerful incentive to drive the right costing behavior within the organization.

A service catalog provides an organization with one common language resulting in better conversations and collaborations across functions, as well as the ability to create a consistent bank-wide consolidated view of the services that the bank provides internally, improving transparency on cost origin and flow throughout the delivery cycle.

Figure 8: *The marathon and sprint* approaches



Finally, we urge our clients to start a cost reporting pilot to maximize the early benefits of the cost allocation transformation, as well to deliver actionable insights to manage the allocated cost base. The pilot is also a useful tool to improve the use of readily available data and identify and prioritize data remediation needs. Additionally, the cost reporting pilot will support the refinement of the target state requirements through socialization and use of the reports.

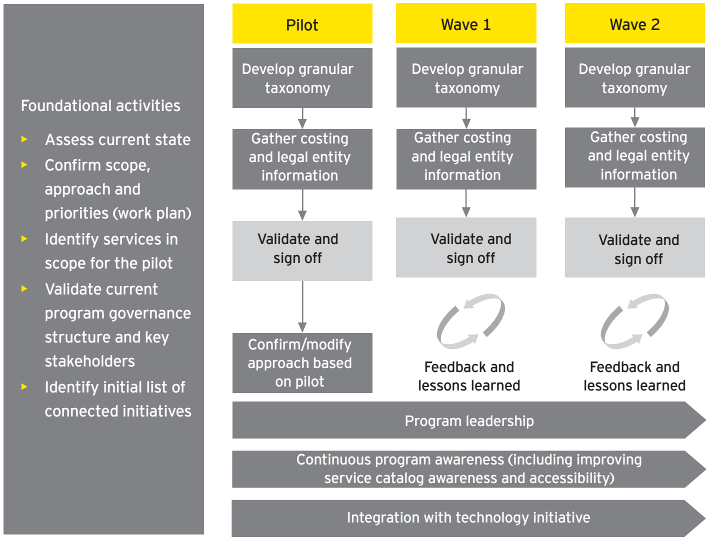
After securing a strong start, including sponsorship and active participation of senior management across the organization, banks can plan the implementation cycle in a way that continuously builds momentum by delivering intermediate business outcomes before the completion of the program.

Typically, transformation programs use the *marathon or sprint approach*. With the *marathon approach*, requirements are defined in detail at the beginning of the program. While this helps in managing scope and the delivery timeline, it usually yields stakeholder fatigue, budget consumption prior to final delivery and delayed benefit realization.

Opposite to the *marathon approach,* the *sprint approach* realizes benefits in the short term, but projects are carried out in uncoordinated silos that increase program risks and undermine the return on investment. These projects are typically aimed at maximizing benefits for one part of the organization as opposed to serving the broader bank needs and goals. The *sprint approach* is actually very common among our clients, typically prompted by the need to provide urgent and rapid tactical responses to the latest regulatory standards.

EY believes there is a third approach that merges the benefits of both approaches. The *relay approach* is a series of coordinated *sprints* with consistent feedback loops enabling business engagement throughout the delivery cycles (waves) and resulting in realized benefits at the end of each wave. Additionally, through this approach, it is possible to capitalize on the learning points of each wave and recalibrate the approach and team mix for the subsequent phase.

Figure 9: The relay approach



# Case study 1

## Creation of a bank-wide service catalog: a Finance-led exercise for the benefit of the entire bank

Our client, a Europe-based global universal bank, was facing limited end-to-end transparency on services performed by the bank. As a result, they were unable to identify the related costs or the legal entities that were buying and selling these services. These challenges became even more pressing as our client was working to achieve compliance with *living will* regulations and an internal legal entity restructuring.

### Creation of a bank-wide service taxonomy and costing

EY led the design and delivery of a global service catalog, developed with the objective to create one consistent taxonomy and language across the bank and the goal to enable improvements to numerous use cases such as cost reduction initiatives, tax optimization, compliance with regulatory standards and vendor management. This comprehensive approach to the service catalog has generated high levels of consensus between the different stakeholder groups and prevented the bank from creating a proliferation of siloed, and potentially conflicting, taxonomies that would have negatively impacted the bank's cost management capability.

EY deployed a globally integrated team with costing skills, understanding of banking regulations and experience in designing and delivering similar projects. The team was deployed to mirror the location of key stakeholders and was focused on building rapport and consensus, two differentiating factors for the success of these types of initiatives, and maximizing the adoption of the final work products across the organization. In fact, we advised our client on day one not to consider the endeavor as a costing program but rather as a change management program.

### Results and outcomes

Alongside the creation of a common bank-wide taxonomy, which formed the foundation for better cost management, the program supported the generation of additional benefits for the client, such as:

- Providing *living wills* teams with sufficient transparency to identify critical services at a more granular level and ultimately contribute to the minimization of the working capital required for pre-funding requirements
- Avoiding unnecessary organizational fatigue in maintaining a set of regulatory requirements (e.g., service level agreements, key performance indicators) for granular services that are not, in fact, critical services
- Enabling tax to increase the ability to identify VAT exemptions that were previously overlooked and confirmed markups in compliance with the arm's-length principal
- Providing the vendor management function with a taxonomy to feed into new service agreements and contributing to the mapping of each service to the vendor database
- Providing input to the bank's location strategy through increased transparency of services in terms of service components, providers and recipients (by legal entity and function), volume metrics, cost and headcounts

# Case study 2

## Improvement of cost reporting and transparency without disrupting existing processes

Our client, a global investment banking organization required modeling and forecasting of direct and indirect expenses under stress scenarios for their US CCAR submission. The bank had sufficient transparency into the size and drivers of its direct expenses but less so relative to the indirect portions.

Following a rapid diagnostic, we determined that the most immediate challenge to cost transparency was technology. In fact, the current system was not retaining traceability of each calculation step that was part of the cost allocation journey and only stored the final results. This is a common example of costing data being available at the beginning of the process, only to be lost throughout the delivery cycle.

The lack of transparency of the allocated costs will most likely lead to the bank making over-conservative assumptions as part of its PPNR obligations, which may result in higher regulatory capital requirements.

### Improvement of cost reporting and transparency without disrupting existing processes

EY deployed a team with technology and costing skills to design and deliver improvements to cost reporting without disrupting the BAU processes.

EY identified the data points required to perform the calculations and confirmed the existing calculation rules. Subsequently, the project team implemented a transition parallel cost management technology that encompassed modeling capabilities to support real-time simulations and what-if scenarios. The implementation leveraged the same actual data and the same calculation rules resulting in a system that stores each intermediate step and retains the transparency required for reporting, without any reconciliation effort.

The creation of a parallel engine, through what we called a sidecar approach, allowed for a smoother transition from one technology to another without immediate changes to the current architecture. Our client was able to keep leveraging its current financial reporting and general ledger expense recognition processes. The *sidecar* approach contributed to reducing risk and simplifying the implementation of the cost allocation technology and also provided an additional environment, leveraging the latest technology developments, to perform impact analyses connected to changes in allocation methodologies and drivers. This provided our client with the opportunity to optimize the management of its allocated cost bases.

### Results and outcome

The new cost allocation technology allowed our client to achieve:

- Increased traceability and transparency of allocated costs
- Reduced reconciliation effort and increased support and control of manual processes
- Improved capability to simulate changes in allocation methodologies and assess the anticipated financial impact
- Enhanced forecasting and modeling capabilities and PPNR integration
- Increased cost reporting capability

# About the white paper

# Authors and contributors

## Authors

**Steve Krueger** is a principal with Ernst & Young LLP in New York. He co-leads the Managing Financial Performance and Risk (MFP&R) proposition.

**Matt Polvara** is a senior manager with Ernst & Young LLP in New York. He co-leads the Strategic Cost Management offering.

## Key contributors and subject-matter resources

The following people from Ernst & Young LLP assisted in the development of this paper:

### Key contributors

Anne Bost

Bill Thomas

Geoff Burkholder

Mary Margiotta

Nuno Fonseca

### Partner/principal review panel

Adam Girling

Andrew Wilson

Anita Bafna

Clayton Baker

Keith Novek

Scott Keipper

For a conversation about cost allocation and management, please contact us:

**Steve Krueger**
steve.krueger@ey.com
+1 212 773 6624

**Matt Polvara**
matt.polvara1@ey.com
+1 917 515 3018

Steve Krueger and Matt Polvara have recently co-authored another EY publication on cost management

**Cost excellence: viewing costs from a new perspective**

# References

The statistics within this paper were sourced from the following references:

[1]Source: Average decline in interest-related income based upon 2015 annual report filing for Goldman Sachs, and the 2015 and 2013 annual report filings for Wells Fargo, Bank of America, JP Morgan & Chase, and Citigroup.

[2]Source: European banks' cost-to-income ratios calculated using 2015 annual report filings from Barclays, Deutsche Bank, HSBC, BNPP, and Group Credit Agricole.

[3]Source: EY Global Cost Allocation Survey — Cost excellence: Viewing costs from a new perspective. EY conducted global survey with 13 global financial institutions, across the Americas, EMEA and APAC. The purpose was to document the views, insights and observations of banking senior financial officers around the world, as well as our view on cost allocation and cost management leading practices. The global survey report combines responses to a 50-question survey for each participating institution with EY's view on leading practices and global experience in designing and delivering cost allocation and cost management transformation programs.

EY | Assurance | Tax | Transactions | Advisory




SCORE No. EYG 01963-171Gbl
1705-2324499

ED None




ey.com