

PERSPECTIVE

Get More from the Core: Drivers of Back-office Transformation



Not so long ago, banks were esoteric institutions that acted as custodians of cash and handed out loans – making money out of the difference in the deposit and lending rates. Today, banks have been transformed into dynamic, multichannel organizations bringing innovative products to the marketplace in an effort to improve profitability in the face of relentless competition.

Delicate Operation

Core systems affect everything banks do from both an IT and a business process perspective. Yet, for reasons of risk and cost, banks hesitate to replace core systems, even though the existing IT infrastructure hampers growth.

Risk: Replacing or modernizing the back office is often compared with replacing the engine of a Boeing 747 in mid-air. It is the most complex, risky and expensive IT project that a bank can undertake, and even a minor error can cause a bank's system to crash.

Cost: European banks' renewal initiatives, spread over a decade, will be in the € 100 billion range.

Awake to a changed reality, banks realize that it is no longer sufficient for them to offer customers an either-or deal – either superior services or niche products or cost-effective offerings. Savvy and demanding customers want it all: personalized products at ever-lower prices and universal banking across multiple channels.

Banks must also anticipate customer needs while ensuring organizational excellence and operational agility against global banking titans as well as regional satraps. Even as margins are being squeezed, banks need to understand and respond to changing market dynamics.

However, not many banks are in a position to perform all these tasks that are critical to their very survival. As the business requirements of banking increase, the IT systems and software that support operations need to grow ever more agile and sophisticated. However, despite core banking systems being mission critical, many banks continue to use systems designed decades ago, when business requirements were very different.

According to a Core Banking Systems Survey, almost all top retail banks globally use legacy

systems dating from the 1960s and 1970s in domestic markets despite the growth of packaged banking solutions in international operations. These ageing systems lack the agility, flexibility and scalability needed to meet today's challenges and fail to provide a foundation for future growth.

Banks need to modernize and transform their core banking systems or run the risk of paying a heavy price in terms of higher costs and lower profits. Faced with this reality, many banks are looking to replace their aging back office systems. According to a survey of European banks, 53 percent of respondent banks had core system replacement initiatives in place and 27 percent were planning to do so, while 9 percent reported already having completed such a renewal. Smaller banks began to do so earlier, with 90% of the smaller banks surveyed saying they were willing to have a common architecture.

With the core system being the heart of the bank, transformation or modernization is a risky and costly undertaking. However, the benefits are huge. As the emergence of new business realities forces banks to rethink their approach to the market, they also demand that banks re-examine their legacy core systems. This paper details the drivers for transforming legacy core systems and examines the factors a core system needs to address to ensure a flexible banking operation.

White Elephant?

Legacy core systems are enormously expensive to maintain because the code has to be opened each time a product or regulatory change needs to be made. Duplication in processes contributes to billions of dollars in IT waste annually. To connect the myriad core systems with the many front-office and business applications, a large financial service institution may maintain thousands of custom interfaces at an annual cost of up to \$100,000 each. Research shows that FSIs are paying fortunes maintaining decaying core systems, and up to seven times more than that in inefficient business processes.

Drivers for Core Banking Modernization

Across the world, banks are enjoying a high level of earnings. After-tax profits for banks have zoomed to a historic high globally: from \$372 billion in 2000 to \$788 billion in 2006, or \$672 billion in constant dollars. As an industry, banking has the highest absolute level of profits.

However, with the US now heading into a depressed phase, banks need to prepare for a future that may be uncertain. They need to opt for core operating systems upgrades and changes if they are to stay ahead of the game and sustain growth in difficult times.

Banks have added an array of products to their erstwhile simple portfolio of saving and lending services. However, the technologies underlying such advances have often been introduced in a piecemeal fashion, creating a hopelessly complex IT landscape which hinders growth. Banks that modernize these systems will not only reduce cost and complexity but also lay the foundation for better service and increased revenue.

Let us examine the catalysts driving banks toward core system transformation.

Globalization and Standardization

A few decades ago, banks were mainly local entities with national operations. Over a period of time, they moved to being national institutions with a regional vision. Today, many banks are striving to become either regional or global leaders in a race for scale and profits. Customers have also become more globally mobile.

While pursuing global ambitions, many international banks have acquired local core banking systems to support their geographic activities when they merged operations. Banks have also allowed the IT systems of merged partners to co-exist. Since banks' processing has developed in a series of silos, they have multiple systems which duplicate functions, leading to wastage of time and resources.

However, the realities of international market, demand that banks standardize processes across time-zones and entities, making each function a global process. This is because banks need to comply with varied regulations specific to nations, geographies and the world. Regulations and market demands are forcing banks to move towards same-day payment. Diverse customers are

demanding tailored products at a low cost and multiple product channels.

In such a situation, a bank needs to consolidate its back office through centralization and maintain standardized operations across geographies. This back office can be located in low-cost regions, allowing banks to improve operational margins.

Global processing enables a bank to process transactions from anywhere in the world within seconds. Multi-channel co-ordination, inter-bank payments, debit cards and online and mobile banking are driving customer demand for real-time core banking systems.

With centralization, one set of standards are created throughout a bank. This provides the bank a 360-degree view of the customer allowing the latter to enjoy real-time banking anywhere and at any time. With a centralized back office and standardized processes, a bank can offer products anywhere without having to create full-fledged brick-and-mortar branches.

Therefore, even as initiatives such as Continuous Linked Settlement (CLS), Real-Time Gross Settlement (RTGS), Target2 and Basel II have made it a requirement, technology such as Service Oriented Architecture (SOA) and Web 2.0 has made standardization possible.

Customer-centric Operations

Customers are redefining the rules of the game as they get more demanding and tech-savvy. Shifts in demographics, incomes, attitudes, and behavior, in addition to easily accessible information, are empowering customers to demand greater responsiveness and transparency from their banks. Not only do customers want personalized products, but they are willing to exercise the freedom of choice and go to another bank that gives them a better deal.

In such a situation, banks need to fulfill customer needs and ensure customer satisfaction to increase their wallet-share. They need to ensure that customers get a one-stop shop for banking products that are customized and offered at competitive prices.

How can a bank attain these seemingly paradoxical requirements? According to a survey, a bank can succeed if it meets the following three conditions:

- ▶ Differentiation in the marketplace with innovative products that are better than those of the bank around the corner
- ▶ Simplification on the inside by replacing redundant and complex legacy systems and operating a streamlined core banking system
- ▶ Excellence in execution on a day-to-day basis and in their strategic vision

Banks historically have pursued a product-centric strategy and their IT architecture reflects that mindset. However, as banks move towards a more customer-centric view, their systems will need to support the new reality.

Banks will have to migrate to a core system that comprises an integrated suite of significantly fewer component-based systems if their IT landscape is to enable flexibility and product differentiation. Banks that postpone the tough decision about core system modernization are likely to lose their competitive edge.

Innovation and Agility

Business agility is a fundamental imperative. If banks are to take on competition and succeed in an unpredictable market, they must anticipate trends, adjust the type of services supplied and develop the ability to deliver customized products rapidly. Only then can they take advantage of new opportunities. Investing in an appropriate IT landscape becomes a prerequisite to ensuring this.

In this era of globalization, standardization and fickle customer loyalty, a bank can maximize its competitive advantage by offering differentiated, customer-focused products. Any bank's products basically consist of savings, borrowings, transactions, and so on. How can a bank ensure that its offering is different from that of the bank around the corner, it is innovative, and meets the varied needs of individually diverse customers?

Leveraging SOA for IT can help banks deliver such products. It enables product bundling, cross-selling of products and service customization. With SOA, banks can use data mining techniques to analyze customer behavior, thus creating cheaper, innovative and differentiated products. Not only will this strengthen customer satisfaction, but it will also increase repeat purchases and attract new customers.

With SOA, banks can introduce value-added components to existing offerings. These include personal financial planning tools in consumer online banking sites, real-time reporting and analytics for corporate cash management solutions, and budgeting and forecasting tools to complement their payments processing businesses.

SOA enables technology integration and thus simplifies the IT landscape, allowing banks to make their technology environment more responsive to dynamic business challenges – either strategic or day-to-day. It helps provide real-time data, greater efficiency and better risk management and compliance. Integrated into business processes, these streamline business processes to allow growth.

Today, any business decision triggers an IT event. Any new product requires additional IT support. Legacy core systems are inflexible, making simple product changes onerous, entailing long periods of costly development and product testing. Given the increasing competition in banking and rapid technological evolution, IT needs to align with business needs. It needs to be flexible enough to respond quickly to changing business requirements. SOA fulfils these requirements.

Organizations that move first to renew their core systems will thus have a distinct advantage. It is interesting to note that more banks are opting for packaged solutions for core banking transformation since they help meet business expectations in terms of agility, time-to-market and operational support.

Costs, Automation and Scalability

In the end, it all boils down to money. With intensifying competition and demanding customers, revenue opportunities have become very thin for banks. In such a scenario, a bank must put in place a cost-effective structure to increase growth and profits.

The crucial requirement of keeping costs low can be ensured through a scalable technology platform and automation. To serve the evolving needs of the marketplace and changing regulations, banks require scalability to welcome new customers, agility to create appropriate banking products tailored for different customers, and readiness for mobile and Web-based transactions integrated with branches, call centers, ATMs and the web. Above all, the automated process needs to be error-free and secure, to ensure customer satisfaction and credibility.

Access to up-to-date, centralized information is essential to ensure cross-selling effectiveness, by providing the right information to front office employees. Additionally, real-time processing allows simplification of many of the operations functions required for reconciliation and should reduce back-office workload, facilitating the business requirement for greater end-to-end processing and automation.

It is interesting to note that the cost and risk of maintaining legacy core systems now exceeds the cost and risk of core systems renewal. Thus, banks will end up spending more on their core systems only because of the failure to renew their core platform.

Globally, the industry spends \$214.5 billion maintaining existing infrastructure with third-party providers. This includes all systems that are part of a bank's IT budget. Core systems take up a huge 73 percent of that total, a proportion that underscores the critical role of core systems. This leads to a vicious cycle, wherein banks have less money for new technology investment because core systems become increasingly expensive to operate, forcing banks to cut IT and business initiatives.

Thus a one-time cost of core system replacement is likely to help a bank save money not only in the area of IT but also in business operations.

Conclusion

A core system needs to be robust and have the flexibility and capacity to modularize and standardize processes. It needs to be able to address the needs of demanding and diverse customers and roll out new products quickly and efficiently. The processes a back office handles must be standardized across borders, products and legal frameworks.

Using IT architecture based on SOA allows banks to align their IT landscape with the business operating model. This helps banks assure customer-centricity, product innovation, straight-through processing capability, while ensuring scalability and lower costs.

Banks need to urgently look at modernizing their core if they want to bring their operations in line with market requirements.

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