

How can Financial Services drastically reduce their operational cost?

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My Lords, Ladies and Gentlemen,

11th September was a cataclysmic event in world history. Talk of war and warnings from the American and British military machine have already affected global markets.

War is a catalyst and accelerator of social and business change. The recent dramatic change in market capitalisation of the giant British Airways versus the flexible, low cost, budget operators like Ryan Air might have otherwise taken a few years, but 11th September has made it happen now. Ryan Air's current capitalisation, at over £2 billion, exceeds British Airways' at £1.7 billion. This is because Ryan Air focuses on operational cost reduction through fast turnaround times and eEnabling the booking, pricing and customer service processes. Swissair, that famous name synonymous with reliability and quality, is now bankrupt. Interestingly it is Crossair, its own low cost subsidiary, that will now end up cherry picking the profitable routes. I find this staggering and the implications are significant.

The dramatic success of these low-cost eBusiness operators versus the dinosaurs of the corporate world is an urgent warning to multi-nationals, banks and global insurance companies that unless they radically change and take out cost from their businesses, then they could easily suffer the same fate as the airlines via tectonic shifts in customer preference.

The cosy world in which these multi-nationals have depended on their own home-grown IT resources to bring about change and eBusiness solutions to their problems is now being aggressively challenged by the tough cost cutting from the outsourced services industry, which now replaces many of the management functions from these same corporations. This is the space in which we operate and we believe that the competition is only going to get more fierce.

The words "Global Recession" are now openly discussed. Following the bombing, NYSE and NASDAQ were shut for four days. This is an unprecedented event. On opening again on Monday 17th September, both NYSE and NASDAQ fell heavily. By 2nd October the Dow Jones Industrial average was 25% down on its peak of 14th January 2000. NASDAQ was 70% down on its peak of 10th March 2000 and the FTSE-100 was 30% off its peak of 30th December 1999. Analysts predict that the worst is yet to come.

Warren Buffet, the 'Sage of Omaha', the second-richest man in the world and the head of Berkshire Hathaway, who since 1964 has delivered an average growth in shareholder value of 24%, is now preparing for a famine. He predicts that the global economic slowdown could last for another eight years.

By the way, I'm happy to quote Warren Buffet, because one of his invested insurance companies is currently talking to mi2g about re-designing their eBusiness strategy and architecture.

So, was the technological revolution a surreal dream? A global herd mentality? Or was it just a gold rush without a pot of gold? No, the revolution was real and its power to transform the industrial economies has not changed. We now need to understand clearly what went wrong and what will still come right.

Computers have now infiltrated every part of the economy and in most industries, particularly in insurance and banking, eBusiness offers unrealised potential to increase productivity.

The challenge for a group like ours is to help financial services companies to develop their competitive edge and to make profits. As companies gravitate towards conservative solutions to profitability problems, nobody is going to make an eBusiness investment based on a leap of faith. As I have consistently said since mi2g was founded six years ago, the answer remains the same. Use eBusiness to cut operating costs and increase productivity.

When I last spoke here at Lloyd's I quoted insurance CEOs I have met. Their message is loud and clear. They are changing their businesses to use eBusiness to cut costs, to maintain margins and to generate shareholder value. Competitive pressure means they have to do this very quickly. Once upon a time the symbol of insurance within the financial services was that of a glacier - big, frozen and slow. Today, the rate of change is more like a jet stream.

Insurance companies, driven by the need to take cost out, are responding to the challenge and making major investments. Zurich Financial Services, ING and Allstate Insurance are to invest a total of \$4 billion in eBusiness over the next three years.

Lars Petersson, CEO of Skandia, is budgeting to save 15% per annum through eBusiness. Swiss Re says that eBusiness will help it achieve per annum cost savings of \$103 million by eliminating or outsourcing chunks of middle and back-office process costs. Dr Dill, CEO of Axa Colonia, is using Customer Relationship Management - CRM - to cut costs by delivering more efficient claims handling and policy issuance.

Insurance relies on labour intensive communication and data processing so eBusiness is particularly relevant to cut costs dramatically. Bain & Co has made its reputation by taking cost out for clients and Chris Dawson, a good friend of mine and a partner from their Toronto office, says that insurance companies are examining the deployment of eBusiness across all elements of their organizations to bring about cost savings of 20%-30%, which are already being identified and achieved, with relatively rapid realization rates.

Chris's fellow partner, Christopher Hopton, highly respected in the City, reckons impact of eBusiness on the Property and Casualty industry's overall operating costs, if properly addressed to distribution, administration and claims costs, could be as high as 9% overall.

eBusiness is at the sharp end of IT, where technology change is rapid and skills are short. Some insurance companies are still running back-office systems on legacy mainframes that were developed 25 years ago. Just sorting out the legacy systems is a major cost and management challenge to the IT Department. And every time they resolve the problem, another acquisition puts them back where they started.

We recommend in some cases that CEO's outsource their eBusiness development.

One of the first joint ventures for outsourcing in the UK was First Banking Systems, a joint venture for IT outsourcing between Peter Burt's Bank of Scotland and Xansa.

Nick Prettejohn, the CEO at Lloyd's, comments that expanding their eCommerce capability, both internally and through strategic partnerships, is a major factor in the modernisation of the Lloyd's market.

eBusiness outsourcing and joint-venture deals were once regarded as restrictive, but they now provide far greater flexibility, security, balance sheet benefits and cost savings. This matches the needs of large insurers operating in an increasingly commoditised and fast moving environment.

Those of you who are familiar with my doctoral thesis - The Creation and Protection of Value – will also have seen the Value Pyramid. Essentially the Value Pyramid suggests that there can be no real operational cost reduction, unless the disparate databases within an organisation are unified. There are high labour and technology costs in trying to unify the databases on a daily basis if they are maintained as separate entities. In the future it will not be possible to operate like this as customers demand online access to all their information.

Long-term competitive advantage is not just about saving labour cost. It is also about response time, productivity and being able to win deals consistently. In the 21st century, the leaders within any sector will demonstrate a consistently faster response to their customers for any activity or process. They will also be able to reach out to their customers through a range and richness of product that affords them a special product offering. This cannot be achieved unless the databases are unified.

Over the last six years, as I have visited many banks and insurance companies in North America, Europe and Asia, it has been interesting to see that money could have been used more judiciously and not spent on over-promised software products that fulfil one tiny part of the overall value pyramid requirements.

Unfortunately many IT departments suffer from the “not invented here” syndrome and are bombarded by product touting IT salesmen who offer salvation for complex legacy problems through a first-aid silver bullet solution. IT is only 10% of the issue, 90% is people related.

A well-known example is a large life insurance company - no names mentioned – that has developed a brilliant front-end using proprietary software. However this company has ten different products online and they all have their own back-end legacy databases as well as their own middleware engines. This suggests a very fragmented, quick and dirty approach towards getting a proof of concept.

In their case, the cost of each middleware engine with its database is about \$3 Million when it comes to paying for the software license, bespoking it and deploying it on servers. Ten times \$3 million is \$30 Million. However, if a more intelligent approach were to be taken at this insurance company it would mean that there could be a unified middleware engine built for about \$6 Million and the cost of a unified datamart would be another \$10 Million. This suggest that as much as \$15 Million could be saved by unifying the ten disparate eCommerce projects.

However there is an even smarter approach. Let me ask you this. Does a financial services group really understand complex technology and its fast moving trends? What is it fundamentally good at?

If the financial services group does not indulge in designing and building its eBusiness platform but simply farms it out to a Managed Services Provider, think about the cost savings and time to market.

It may be possible to do a five year or ten year contract at a fixed price of \$2 Million to \$3 Million per annum to get these services delivered to the customer to a service level that was deemed appropriate. This is a great hedging exercise and predicts that in the years ahead, financial services will increasingly outsource areas where they have no core expertise.

The operational cost reduction and management headache reduction that can result from a Managed Services farm-out can not only save several million dollars in expenditure but also create an excellent technology Hedging Mechanism.

My own views on joint ventures and cost savings have crystallized over the last few months and I can now confirm that Prem Watsa, Chairman and CEO of Fairfax a major C\$31 billion mi2g partner in North America, has signed a Heads of Agreement with mi2g to set up a joint venture called MFX. MFX will be an eBusiness outsourcing platform, tasked with developing COTS (Commercial Off the Shelf) eBusiness solutions, to service Fairfax’s subsidiaries and other banking and insurance clients.

MFX is going to be an independent and commercial joint venture. It has been developed from our existing partnership and it's target is to cut operating costs. Clients will benefit from MFX's innovative solutions, its speed-to-market and competitive rates.

There are new technologies now available which provide greater reliability, security, faster operation and lower maintenance costs, and they also have lower purchase and maintenance costs.

For instance, the revolutionary open source Linux operating system developed by Linus Torvalds at the Helsinki University and published for free use on the internet 10 years ago last month, is now integrated into partitioned IBM mainframes and servers and represents one of the fastest growing threat to Microsoft Windows and Sun Solaris.

When the New York Stock Exchange announced last month that cost and reliability factors had prompted them to change their Sun Solaris system to Linux operated IBM servers, Sun's shares dipped 5% and they had to call a mid quarter conference call to re-assure investors.

Jerry Skaggs, Head of Information Services at UPS, says "We see a big future for Linux. The next step is to use Linux to simplify consolidation onto fewer mainframe systems. This would drop maintenance, support and staffing costs and reduce total cost of ownership."

Cisco's Chairman John Chambers recently likened the change in the markets to a 100 year flood, Well, whatever the damage caused by the flood itself, the after effects on the people trying to clear up the mess are typically confusion and disorientation, and that is certainly evident in the markets today.

By the way, you'll not be surprised to know that we at mi2g have a very clear view of the future and I can let you know that Linux open source is likely to more closely resemble a tidal wave - a 'Tsunami'. But we'll discuss that in more detail at our next dinner here at Lloyd's on 17th October.

When I am talking with the CEOs of Financial Services about their operational cost reduction and about creating a joint venture for their eBusiness development, we apply **10 Golden Rules**.

1. People first strategy second – According to Jack Welch, to build a successful business, you first have to get the right people in the right place. Make sure you give them the authority to run the business and make changes. Great presentations on strategy are not what delivers results. Senior management must have the right skill sets, a successful track record and the right attitude to make results happen.

2. Your back room is someone else's front room – Concentrate your energy on what you do best and make sure that you get the necessary commitments to deliver from your technology partners. The new independent business will be entirely focussed on delivering you eBusiness results.

3. **Keep the model flexible** – Technology is changing fast and the joint venture needs to be scalable to accommodate your changing requirements, which nobody can accurately predict on day one.
4. **When using offshore suppliers** (say from India) make sure that your joint venture includes a local IT integration house, to programme manage the deliverables and to control costs and don't let the joint venture tie you to one offshore supplier – Have at least two to create an internal market.
5. **Create a Distributed Secure Environment.** Post September 11th, security issues have moved centre stage and it is essential that your chosen outsource partner has the right track record and skills in all aspects of managed security.
6. **Trading with your competition can stretch to IT and eBusiness.** You'll have to make sure that the joint venture is independently branded and sits apart from your main operation. Then your independent eBusiness operation can sell economies of scale and time-to-market solutions.
7. **Remember The 80:20 rule for IT projects.** COTS (Commercial Off The Shelf) software will normally be tried and tested and fulfil 80% of your requirements when integrated. Another 20% may have to be customised for your purposes or may be farmed out. This 80:20 rule ensures that no-one wastes time and money re-inventing the wheel and huge cost savings can accrue.
8. **Choose your IT partners smartly.** Are they willing to go for a risk-reward model? This fundamentally incentivises them to ensure that the project is delivered to deadline and they make revenue from your revenue stream. Are they going to add value or are you just another customer?
9. **Set up Strategic Alliances.** These allow you to leverage your existing customer base to cross-sell and up-sell. These strategic alliances can also be encouraged to share some of the investment in new IT projects.
10. **Don't be obsessed with an IPO for your new IT joint venture or spin-off.** If the joint venture can save money for your operation and become profitable in serving other companies within your sector; then it should already be achieving its strategic objective. Too much focus on an IPO may detract from the core deliverables.

For now, I hope that I've provided you with some useful insights into outsourcing, and how these can be used to cut costs.