



EUROPARTNERSHIP WHITE PAPER

Tackling efficiency and cost savings targets



**Do you ever have to plan and manage change
to improve service delivery...whilst at the same
time reducing cost?**

CONTENTS:

Tackling efficiency and cost savings targets

Introduction

Strategic Cost Management – lessons from the private sector

Strategic Surgery

Forces of Change

1. *Delivery method proliferation*
2. *Consumers in the know*
3. *Pressure from external forces – be financial markets or Government*
4. *Emergence of product category specialists*

Why traditional cost management fails

1. *Across-the-board cuts seldom work*
2. *Customers are very different*
3. *Accounting tools can be misleading*

Strategic Cost Management – a new approach

1. *Determine where you need to be*
2. *Deploy costs and resources to maximize customer value*
3. *Move with a bias for action*

Strategic Cost Management Approach

Case Study: Major discount broker

Case Study: Major retail bank

Postscript

Europartnership's "Performance Management Toolbox" Series examines approaches and tools that can be deployed when implementing change and improvement programmes. Our aim is to bring together leading practice from around the World in an easy to read set of articles.

Tackling efficiency and cost savings targets

Introduction

UK Government has set out the expectation that each local authority will achieve efficiency gains of at least 2.5% per annum.

These year on year savings have increased and been split between cashable and non-cashable. This message is reinforced in the 2008 Cabinet Office policy "Excellence and Fairness"

"Each council is free to choose how best to achieve that expectation. No targets have been set for individual local services, which recognises the fact that individual authorities will have made more progress in achieving efficiency gains in certain sectors than others. Furthermore, it is clear that some authorities have made better progress on efficiency than others. Nevertheless, by working together and promoting good practice methods, we believe it will be possible for all authorities to identify ways of making improvements.

Inevitably, there will be an impact on local authorities' relationships with their current and potential suppliers and stakeholders, both in the private and voluntary and community sectors. We are aware of this issue, and we recognise that it is something that authorities will wish to handle carefully."

Strategic Cost Management – lessons from the private sector

Public Sector organisations can learn a lot from the experiences of the private sector when it comes to looking for cost efficiencies and savings. A decade on, the downsizing and re-engineering initiatives - so prevalent in the early '90s - have largely proved financially short-sighted. With hindsight, we now know that almost half of downsizing companies reported lower profits the year following their cutbacks. This fall in profitability directly equates to an equivalent reduction in service delivery performance for public sector organisations. Research found that cost-cutters struggled more than those who addressed both cost and performance together. Less than one in five cost-cutters were subsequently able to put their companies back on a performance improvement track.

This failure of “across-the-board” cost cutting has meant that more effective “cost management” has become a critical discipline practiced by successful, value-creating companies. In all sectors, pressures on costs come from many external quarters, be it shifting customer priorities, the emergence of new competitors and channels, or stretching government targets. How can we reconcile the experiences of downsizers and cost-cutters with those of more successful organisations and, more specifically, how can your organisation manage costs effectively and avoid the pitfalls of cutting too deeply or in the wrong place?

Much of what is cut in the name of efficiency is misdirected, leaving major areas of the entity untouched, while inadvertently starving other parts of the organisation of the resources required for improvement. One of the World's leading consultancies has developed an approach they call *Strategic Cost Management*.

Strategic Surgery

What's strategic about this approach to cost management? Traditional belt-tightening tools such as cost benchmarking or process re-engineering typically do not recognise the value created by resources, but focus instead on the cost incurred and present a one-time “snapshot” view that can overlook important seismic shifts in the business. Most organisations recognise, for example, that certain services are assuming higher priority than others; that some will grow while others atrophy; and that the way they do business today will change as the operating environment of tomorrow changes.

As the model changes, Strategic Cost Management helps organisations ensure that their scarce resources are used to create sustainable value and efficiencies in high priority areas, while resources that may be going to low value activities are redeployed or eliminated.

Forces of Change

Managers today operate in a much more dynamic environment that reflects the convergence of profound technological and behavioural changes. These forces of change are compelling senior management to challenge the most fundamental operational assumptions of their businesses. Previously successful business designs - especially those featuring substantial embedded costs - are becoming unsustainable and, ultimately, obsolete. The alternatives call for organisational change - something that is never easy - as organisations look for new, sustainable business designs.

Factors that are impact and which highlight the importance of Strategic Cost Management include:

1. Delivery method proliferation

New ways of delivering service are reshaping the landscape everywhere. As customers become familiar with and apt for new choices, the economics of existing models come under tremendous pressure and become less relevant.

A private sector illustration: One of the World's leading broker and their experience with e-business and online trading provides a timely example. For years, they held a commanding lead over "traditional" brokers by competing on price. They pioneered the discount brokerage business by bundling products and services through a "supermarket", coupled with the attractive pricing sustainable by their economies of scale. This business model generated a very attractive return on equity and stock market valuation. However, the advent of Internet-based trading through firms - which charge a fraction of discount brokerage fees—placed the traditional discount brokerages in a real bind. If pricing remained unchanged, they would lose the most valuable customers. Yet to compete on price would mean reducing costs by 25 to 40 percent. Either scenario forced the industry to address fundamental issues related to the business.

Brokerage houses are not unique! Every industry is facing similar pressures to a lesser or greater degree and driven from their own set of pressures.

2. Consumers in the know

Customers are becoming more knowledgeable both about available products and service offerings. Customer awareness, lower transaction costs, and increased access to information have resulted in a growing trend to put pressure on costs. In whole segments of service industries, providers face the need to redeploy their resources and differentially manage costs to avoid being "priced out" of certain markets while under serving customers in others.

Consumers are also proving less loyal, increasingly discerning and more vociferous when it comes to services. In the private sector, take the way we re-evaluate existing credit cards, mortgage, insurance, and investments whenever they are offered new solutions. This has resulted in increased "switching" between providers and will create significant cost pressure for the financial services community. Financial services providers will need to spend more and focus on their most valuable customers. More choice for customers of public sector services will echo these forces – with competitive service suppliers having to consider "marketing and acquisition" to replace those that do defect.

3. Pressure from external forces – be financial markets or Government

Business is now under "real-time" scrutiny by Stock Exchange analysts - who monitor, review, and analyse a myriad of operating statistics for publicly traded companies on a daily basis. The financial markets award higher valuation to those companies that demonstrate greater levels of productivity and efficiency. Indeed, it is not unusual for large financial services organisations to review staffing or headcount projections with analysts, further illustrating the premium that Stock Markets place on productivity and efficiency. There is an exact parallel with Best Value reporting and Comprehensive Performance Assessments.

4. Emergence of product category specialists

The growth of companies that focus on a single product has also created a new set of economic pressures for established multi-product companies. These “category killers” build their operating model with a single-minded focus, often resulting in a lower cost position within their chosen market segment. The parallel with an ever more open public service market is striking.

Another illustration: The credit card industry. In the past few years, a handful of organisations have leveraged information management to generate superior customer knowledge – a reduction in accepting high-risk customers has improved acquisition performance and, as a result, lower costs. For every customer acquisition “marketing dollar” spent, the sector leaders achieve a return many times that of traditional banks when measured by account growth, assets, and credit risk.

Superior performance captured by category killers demonstrates that - short of rethinking their entire business design and core competencies - traditional credit card providers will be at an increasing disadvantage in terms of costs, profitability, and marketplace valuation.

Why traditional cost management fails

Managers who recognise that their current business model is outmoded and are intent on change have become frustrated with traditional cost management approaches.

What can we learn from the unsuccessful cost management strategies and initiatives? The factors that led to failure are summarized here:

1. Across-the-board cuts seldom work

Broad cost-reduction programs, accompanied by sweeping goals such as “reduce costs by 10 percent,” are seldom successful because they fail to recognise differences in the value to the customer their subsequent behaviour. Typically, a small percentage of customers (population) account for the majority of transactions (customer value) for a company.

Across-the-board cuts that fail to recognise or accommodate a company’s key customers will likely result in decreases in profitability (service levels) as those customers leave for other suppliers that prove themselves more willing to cater to their specific needs.

Understandably, as customers “vote with their feet,” and give voice to their dissatisfaction, the entire cost reduction initiative is often attacked by internal factions and frequently is disbanded.

2. Customers are very different

Traditional cost management projects frequently result in operational changes that can negatively impact the customer experience. The economics of different customer segments vary as dramatically as does consumer preference for different delivery methods and customer service requirements.

Reengineering or cost management projects that fail to recognise these differences will destroy value either by alienating a company’s most valuable customers or by failing to rationalise the resources devoted to marginal or unprofitable customers.

3. Accounting tools can be misleading

Managers frequently rely upon tools and methodologies based on traditional accounting rules and paradigms—but these seldom incorporate the ways in which value is actually created in the organisation. While traditional accounting rules are useful and appropriate for financial reporting purposes, when used as a decision support tool, they can lead to decisions that destroy rather than create value.

Strategic Cost Management – a new approach

Strategic Cost Management, which is built around the following tenets:

1. Determine where you need to be

There is an old adage that says, “if you don’t know where you are going, any road will get you there.” It is important to define, at a high level, the cost targets and expected economic and operating environment a business needs to compete in if it is to be successful.

These targets are similar in nature to those tracked by external analysts and observers. Moreover, the experience of commerce and industry can be very useful in helping managers define and confront the challenges facing the business. For example, look at how the economics of computer manufacturing and distribution changed with the advent of Dell Computer. Finally, adopting this perspective can help galvanize the organisation by better understanding of the need for change.

2. Deploy costs and resources to maximize customer value

The next step is to understand the company’s customer base and the distribution of value or service within that base. To learn this, we typically identify customer segments of varying requirements, as well as the services, products, channels, and resources they use. With this information, we can address other significant questions:

- What products and services do our most attractive customers value and how effective and efficient are we in delivering them?
- What percentage of our resources are devoted to customer segments of marginal attractiveness or need? How can we reduce that percentage?
- What non-strategic services should we outsource to more efficient providers?
- What product, customer segment, or channel areas should we exit entirely?

3. Move with a bias for action

The approach is built upon early program implementation. While this requires concrete senior management support, it is a necessary ingredient for achieving results is an expectation that we can implement programs in the very near future (typically three to four months). Too many change projects fall into a death spiral of “analysis paralysis” - action can’t happen until just one more piece of research takes place. The approach is built around the premise that we can “act our way to a new way of thinking” and focus on implementing programs, achieving quick wins while simultaneously assessing areas that offer more significant opportunity and change.

Strategic Cost Management Approach

The approach, as it has been applied in the private sector, is tailored specifically to the needs and requirements of each client. However, the generic approach was adapted as follows by real-life organisations.

The generic private sector approach has a number of discernible steps:

1. Understanding how value is being created and setting targets for the enterprise - targeted **Competitive Economics**
2. Understanding customer profitability and the **Performance Drivers** that create value
Customer Understanding and Valuation
3. Comparing resource deployment relative to value-added activities and understanding competitiveness on a process basis - enterprise wide **Operation and Economic Analysis**
4. Determining efficient deployment of resources - **Opportunity Identification and Prioritise** in order to choose between:
 - **Eliminate** - De-emphasise low value adding activities;
 - **Reengineer** - Improve efficiency;
 - **Re-allocate** - Invest in underserved high value-adding activities
5. Data-driven analysis geared toward action and results - **Effective Implementation**

Case Study: Major discount broker

A major financial services company that had full service and discount brokerage operations needed to build a nationwide distribution strategy. The brokerage was operated independently from - and without the support of - the client's mutual fund company, full-service brokerage, and consumer loans and trust lines of business. The brokerage, which was directly pitted against industry leaders, some of whom had incurred substantial losses.

The first step was to define, at a high level, the potential for achieving profitability and setting target economic goals for the business. Unfortunately for the organisation, initial analysis of the economics of the business and the competitive environment cast great doubt upon the viability and practicality of their strategy. Their current average cost per trade was significantly higher than the competition - and was actually higher than competitors' prices (with full margins). Furthermore, using an "experience curve analysis" indicated that they had no chance of catching up in the foreseeable future - others could still price them out of business. Additionally, their customers generated fewer trades on average than the competition and also produced significantly less revenue per account.

Second, we examined the priorities of their customers. Many of the brokerage customers were self-directed investors interested only in a low-cost transaction channel, whereas many of the parent bank's customers - especially the more affluent - were more interested in a multi-product advisory relationship. This brokerage business design not only attracted fewer clients, but those it attracted were significantly less profitable than industry norms and were substantially different from the bank's core customers.

The analysis caused a rethink of the entire allocation of resources and distribution strategy. Ultimately it concluded that they couldn't - and shouldn't – take on the leaders head-on. A standalone discount brokerage just did not make economic or strategic sense. Instead, it invested in an integrated business design to enable customers to easily pick and choose the products they required and the people that would service their business, choosing between branch office representatives, full service brokers, or financial advisors.

Case Study: Major retail bank

A leading retail needed bank to improve the efficiency of its retail distribution network. Like many financial services organisations, this company was feeling significant pressure to reduce its expense ratio and, at the same time, to boost earnings through improved productivity and growth. The bank focused on its retail branch network to achieve these goals due to its importance as a sales channel and the magnitude of the costs embedded in the branch network.

An internal team had already analysed this channel on a branch-by-branch basis and, based on traditional profitability measures, identified a number of branches that could be closed. The internal team had come to its conclusions by simply aggregating deposit and loan volume for each branch, applying average margins to balances and comparing the results to each branch's operating costs.

Applying the Strategic Cost Management framework called for an understanding of customer value and behaviour. The first step was to estimate customer lifetime value for each customer, taking into account retention, cross-sell rates, credit risk, and balances. At that point it was possible to segment the customers into deciles based upon customer value. This showed significant variations in customer value between segments.

The second step was to understand channels and branch usage by each customer segment and, where appropriate, assign a measure of customer value to each branch based on the customers who utilized that branch and their usage patterns. This analysis illustrated that some of the most valuable customers relied heavily upon branches.

Finally, using predictive models that considered such issues as proximity to other branches and certain geo-demographic variables (crime rate, per capita income, new housing rate, etc.) we were able to predict the impact on customer attrition of closing certain branches.

Most important, the analysis recognised differences in customer value and behaviour and depicted the impact of different scenarios on the future profitability of the bank. This analysis resulted in a significantly different perspective regarding branch closings when compared with the traditional analysis.

The bank recast much of its closure plans according to these findings. On a practical level, senior management perceived two important benefits from this approach which are firmly based upon a strategic understanding of the customer:

- It helped them avoid decisions that resulted in losing its most valuable customers.
- It help them avoid making decisions based upon false or unattainable increases in productivity and cross-sell from closing certain branches due to unanticipated customer attrition.

Postscript

Despite all the attention paid to customer relationships today, few organisations have segmented their customers sufficiently to identify their most valuable and profitable customers. Without this work as a foundation, any cost-cutting initiative, no matter how well intentioned, is little more than a game of blind-man's bluff to "pin the tail" on the non-value-adding parts of the business.

Strategic Cost Management has been helping organisations address issues related to cost or economic structure of the business resulting from forces of change present today. Most important, Strategic Cost Management can help managers translate their efforts into significant and sustainable improvements to the bottom line.

The pressures on public sector organisations to change and adapt to new challenges, cost and performance targets, and to use opportunities arising from technology, closely echo those of the private sector. New solutions and approaches need to be explored. The outcomes – optimising the delivery of services at acceptable cost levels – are, in these respects, no different from the private sector.

There is a good case to be made for looking to adopt and adapt successful private sector strategies in tackling the challenges of public service in the 21st Century.

ABOUT EUROPARTNERHIP



Europartnership is a management consultancy that offers high quality services to clients designed to improve organisational performance.

This includes the provision of consulting services; software; facilitation; and training in performance management and strategy development.

Europartnership's skilled staff and consultants deliver ethical consulting services and work in partnership with clients to deliver continuous improvement programmes.

Our unique proposition and added value is that we work with organisations and, in so doing, transfer our knowledge and skills. Our aim is always:

“to equip organisations to improve performance”

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