JOHNSTON CARMICHAEL

Designing strategic dexterity

June 2024

Setting the scene

The UK's success as a leading financial services centre is built on its reputation for innovation, new technology, and entrepreneurial spirit.

An open approach to regulation has supported this position. After the financial crisis of 2007-8, UK firms are in good shape with strong capital reserves and liquidity, evidenced by much more stringent stress tests.

Yet it remains an uncertain and unpredictable world – the last five years seeing geopolitical disruption, an inflationary cost of living crisis, trade protectionism, and a global pandemic. At the same time, businesses have experienced more localised challenges including sophisticated cyber threats, operational resilience failures, legislative and regulatory change, evolving business models, and rising customer expectations.

Addressing these trends, whilst seeking to remain efficient, has often led Financial Services players towards greater organisational complexity. For example:

- Growing beyond existing geography, to access new markets or reduce costs by offshoring.
- Outsourcing routine operations to multiple third-party suppliers.
- Setting up Technology & Data business functions to service multiple business units, including the increased use of Software as a Service (SaaS) solutions.
- Pursuing inorganic growth strategies to drive scale, including resetting the portfolio.
- Disposing of non-core parts of the business.

Many of these options have been driven by a regulatory obligation or commercial opportunity. All have brought additional cost and complexity. For example:

- The British government and Bank of England supported HSBC's acquisition of Silicon Valley Bank's UK operations in March 2023. The transaction ensured stability for bank customers, but also added an additional 1% to HSBC's cost base, according to their Q3 2023 earnings release.
- The integration of AIG's UK protection business into Aviva will improve scalability, following the acquisition of AIG Life in September 2023. However, as the merger brings two different cultures together, the anticipated leadership turnover and embedding of organisational change will be a complex route to navigate.
- The Financial Conduct Authority's Consumer Duty represents the largest regulatory initiative of the past decade, bringing industrywide structural changes to accommodate provisions.
- Many firms are considering how their strategy and change portfolio aligns to the Bank of England's Climate Transition Plan.
- Private Equity increased its focus on investor returns as the higher interest rate environment of the past 12 months resulted in an uptick in profitability. They may be more willing to sell part of a business to realise a return or reinvest for further growth.

Faced with these varied challenges, how can Financial Services firms be far more agile in taking advantage of market dynamics and demand? Can 'strategic dexterity' – creating optionality through multiple available strategies – enable firms to quickly adapt to an uncertain environment?

Designing for dexterity

Taking a 'long position' (i.e. buy low, sell high) remains a favoured strategy for growth, applicable to businesses of all shapes and sizes. Banks and insurers have sought value from mergers and acquisitions. Private equity and other entrepreneurs continue to utilise their expertise and market data to take advantage of favourable market conditions. By identifying the ideal time to invest and to sell on, firms have been able to increase shareholder value as a result.

What underpins this approach is the capability to quickly realign an organisation's structure and ensure they are strategically dexterous. For example, Barclays, HSBC and other global banking institutions have set up a Servicing Company (ServCo) to provide enabling operations and IT services, which also supports their ring-fencing requirements.

Yet, designing a stand-alone Target Operating Model is the easy part. Envisioning an organisation's transitional states is much more difficult.

- Determining the core capabilities and competencies to manage individual parts of an organisation should enable each to eventually 'stand on its own two feet'.
- IT services and systems should be front of mind when designing a stand-alone or hybrid business model, or even planning for independence from an existing provider. Flexibility and use of the latest technology could frequently be a better option than retaining older, less scalable infrastructure. It is also worth considering whether re-platforming or outsourcing is required as the adoption of a proven market-leading IT system / package / support provider can add to digital distribution capability, deal value, and therefore 'attractiveness'.
- A high priority is to determine which functions sit outside of the core business. Often functions like HR, Risk, Finance and Legal can be successfully shared, especially if they are not differentiated or required to be specific to a particular business line.
- Finally, and most importantly, it is vital to fulfil a firm's obligations to customers, investors, and regulators throughout the transition. The organisation should be able to prove that it can effectively operate with – and manage – risk.

Delivering dexterity

Armed with a clear understanding of the desired business model and having completed due diligence on technology and business function alignments, focus can now shift to implementation. There are a number of crucial elements in this next stage of delivering dexterity, which includes:

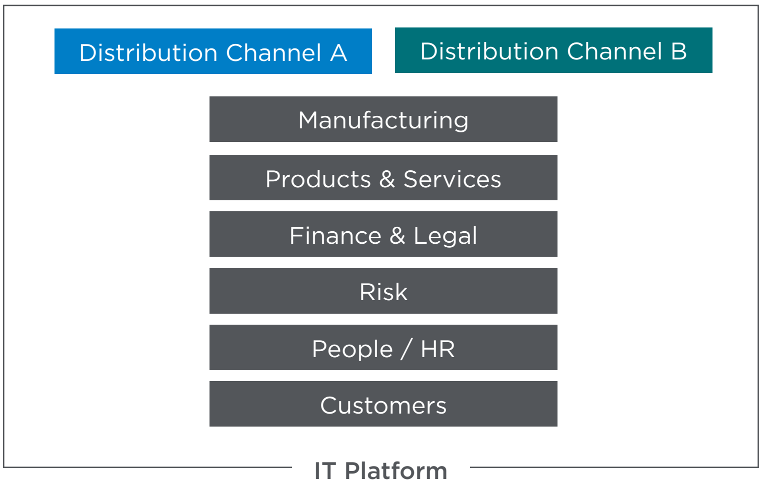
- A well-articulated Target Operating Model (TOM), with corporate vision at its core and defined remits that establish clear dividing lines between business functions. This is particularly important for businesses with functional overlap or 'grey areas' around shared responsibilities.
- A robust financial model which demonstrates how costs are split between business lines.
- Formally negotiated and agreed contractual documentation between corporate entities.
- A firmly established Master Service Agreement (MSA) and Transition Service Agreement (TSA) that states how services will be managed, particularly those intended to be outsourced or hosted elsewhere.
- Well-defined Service Level Agreements (SLAs) articulating performance levels and associated Key Performance Indicators (KPIs) for each service provider.
- A mechanism to ensure outsourced and/or insourced service providers are monitored and incentivised on consistently achieving levels set out in the SLAs.
- Governance considerations and where new execs/ board members may be required – for example, to ensure independence.
- A detailed internal user guide outlining roles, committees and processes by which employees of the two corporate entities exchange information during the term of the SLA.
- Careful consideration around individuals' roles and where they sit, both now and in the future, facilitating any potential TUPE agreement(s).
- Thorough consideration of other implications for the organisation, including pensions and property.

Businesses will continue to realise value from inorganic growth strategies. However, the complexity inherent in doing so will continue to make the process difficult, especially for Financial Services firms in an ever-evolving regulatory environment.

The organisations wanting to be more agile and strategically dexterous should at the very least consider:

1. Seeking experienced advice that can help to envisage, design out, or mitigate any potential pitfalls from the outset.
2. Identifying the causes of organisational complexities (e.g. pain points), breaking them down to simplify the area of concern, and developing appropriate mitigations.
3. Selecting the latest Tech and Data solutions that are scalable, flexible, and easy to integrate and update.
4. Thinking through the practical implications of an MSA and TSA without over-relying on the legal wording – if things 'go legal' it is more difficult to resume constructive relationships.
5. Managing the expectations of external stakeholders, investors and regulators by operating on a 'no surprises' basis.
6. Lastly, taking all employees along the journey, ensuring they understand the logic and rationale of what the organisation is doing.

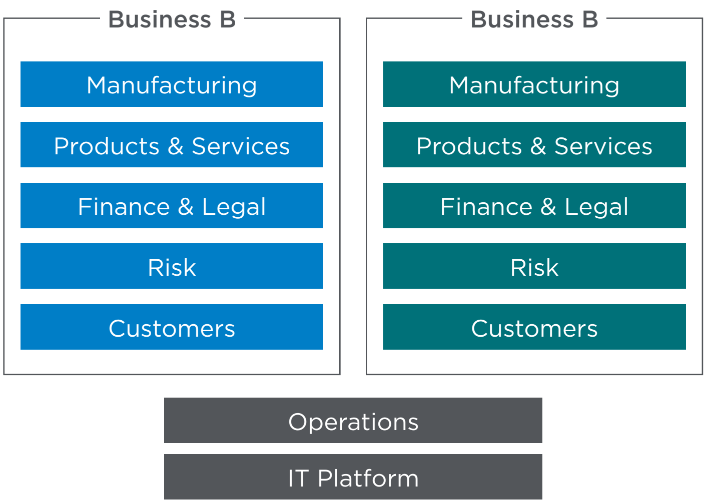
Fully integrated business



Considerations

- What will be the retained business look like post separation?
- What are the core capabilities?
- Can common business components be outsourced?

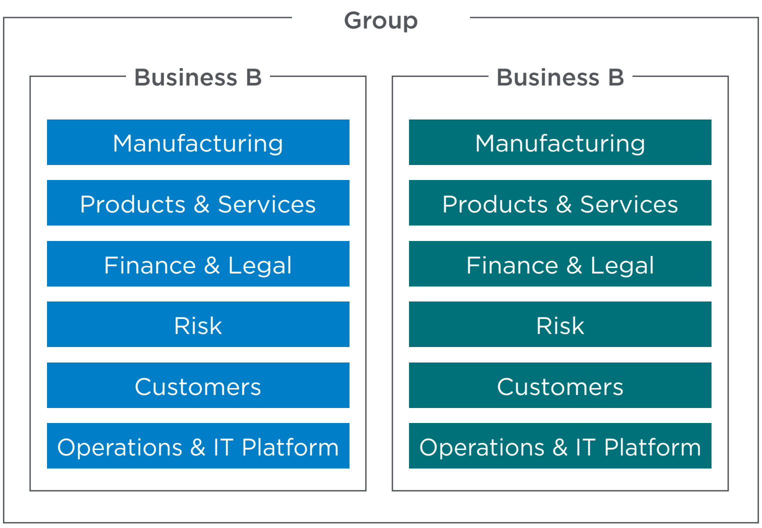
Hybrid/Outsourced business



Considerations

- Is there a clear strategy for common business components?
- Have separation risks been identified and a mitigation plan in place?
- Is outsourcing an asset of liability to prospective purchasers?

Stand alone business



Considerations

- How can impact on the retained business be minimised?
- What functions may be surplus to requirements of the purchaser?
- How can deal value be maximised?

We can help

Johnston Carmichael supports a diverse range of financial services organisations, with expertise in strategy development, performance optimisation, complex change delivery, project management, assurance and change governance. Please get in touch if you would like to explore how support could be tailored to your requirements and budget.

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