



# A Change for Good in Core Banking Systems

A new era in banking demands a new approach

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## SUMMARY

### Impact

As institutions in the banking industry adjust to an altered competitive landscape and a revised set of priorities, the role of the core system has never been more important. The new era of banking demands a fresh technological approach, as banks must rid themselves of the burden of inflexible solutions designed and implemented when the financial world was a very different place.

### Ovum View

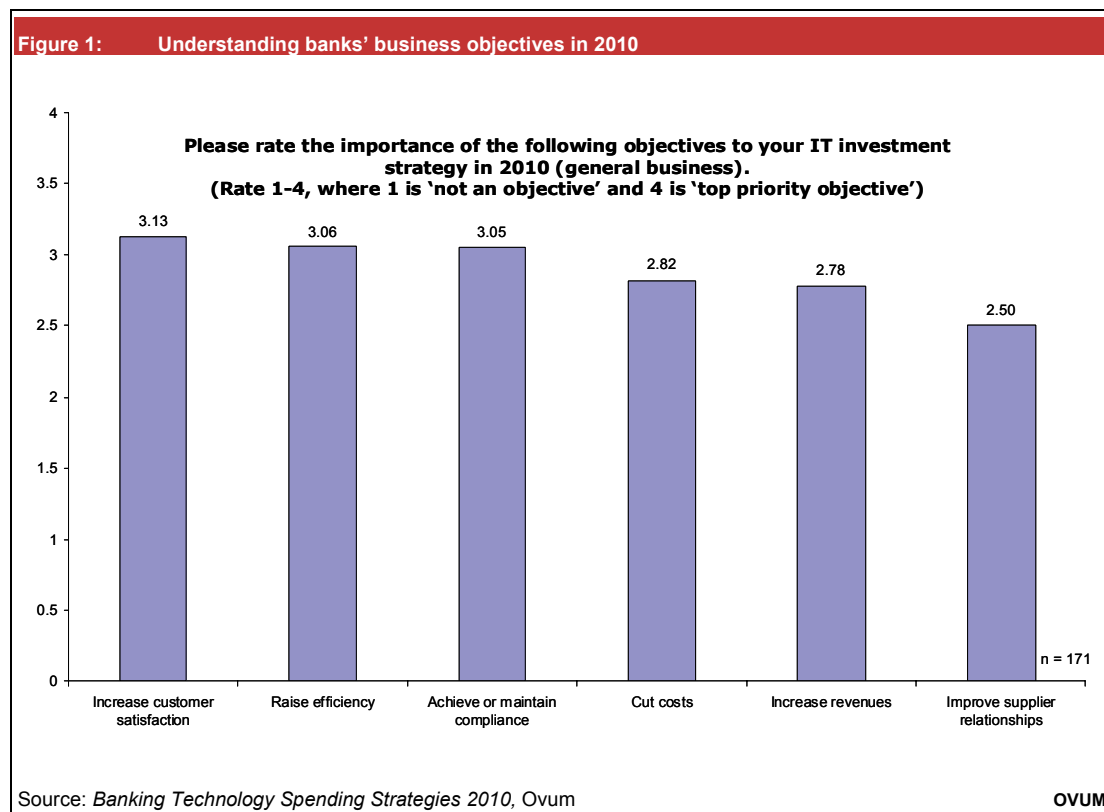
The core plays a leading part in achieving banks' strategic objectives, and this is reflected by the business drivers that are influencing investments in existing systems. Unsurprisingly, complying with new regulatory requirements has risen to the fore in 2010, and will remain a leading priority for many years. However, there is also a direct line-of-sight between streamlining end-to-end processes and systems simplification activities, which is all about efficiency *without* compromising service standards or raising risks. This leads neatly to banks being able to increase cross-selling opportunities: if the recent crisis taught the industry one thing – although it actually gave many lessons – it was that responsible cross-selling must be the order of the day.

It is all well and good to increase sales through service, and indeed to enable the faster time-to-market of new products, but this must not be achieved recklessly. The core system delivers and underpins many different operational activities, and its role in protecting an institution from unwanted exposure to risk cannot be overstated. Consequently, Ovum anticipates the core system will assume greater prominence from 2010 onwards. Ovum believes the core system will see something of a paradigm shift, and instead of being of interest to the IT community, only business-side users will take a hands-on involvement. Against the backdrop of the industry crisis, it is encouraging to witness banks sanctioning investment in their core systems once again, thereby tacitly demonstrating an acceptance that existing technologies require improvements in order for a bank to remain competitive. Institutions should select a solution which is not only capable of meeting today's challenges, but tomorrow's too, implemented at pace that's comfortable.

## MARKET CONTEXT: THE BANKING LANDSCAPE IN 2010

### Acknowledging the new operational agenda in banking

It is impossible to discuss the banking industry in 2010 without acknowledging the epoch-making events of 2008 and 2009, which indelibly reshaped the banking landscape in a dramatic and rapid fashion. However, the purpose of this white paper is not to dwell on the past, but to give consideration to the present and future. With the dust from the industry crisis settled, and with their long-term existence seemingly assured through various means, institutions are adjusting to life in what unquestionably is a heavily (and forcibly) transformed competitive environment. In this new era, a resultant set of revised business priorities has emerged. As might be expected, well-established operational objectives – such as increasing revenues and efficiencies while simultaneously decreasing costs – remain prominent. This notion is clearly illustrated in Figure 1 below, which is based on Ovum's latest end-user research conducted among a representative cross-section of banks in Europe, North America and Australasia.



There are two other areas that merit mention. Firstly, increasing customer satisfaction is afforded far greater importance in 2010. This is a significant development, as it indicates that many banks have recognised the need to reconnect with their customers once again. In the midst of the industry 'bad times' of the previous two years, institutions were, with thorough justification, ruthlessly focused on cutting costs and boosting productivity. Satisfying the needs of account holders was pushed further down the list of priorities. But for 2010 (and, in all likelihood, continuing into the future), the customer has seemingly returned to the heart of banks' strategic – and tactical – decision-making process. Ovum believes this cannot be



solely attributable to an altruistic desire among banks to rebuild trust amongst account holders, whose belief in the banking system was severely tested as a result of the industry travails. Rather, running parallel to this is the rise of empowered consumers, who are armed with easy access to comparative information on financial products and services, pricing alternatives and market reviews, and typically possess a wilful urge to share their positive and negative experiences through social networking sites and online communities. Consequently, individuals often appear better informed about the products and services they purchase than banks are about their customers. This imbalance is a growing obstacle to overcome, and could potentially develop into a competitive disadvantage as consumers demand more personalised services. While this is certainly not an all-new concept for this year, institutions that recognise the importance, power and potential threat of consumer empowerment are better equipped to provide an experience that is of consistently high quality based around personally tailored products and service. During the last decade, banks have talked a good game when it comes to customer service. From 2010 onwards, such words must be supported by tangible actions. In an ideal world, the 'new' banking sector would be a platitude-free environment.

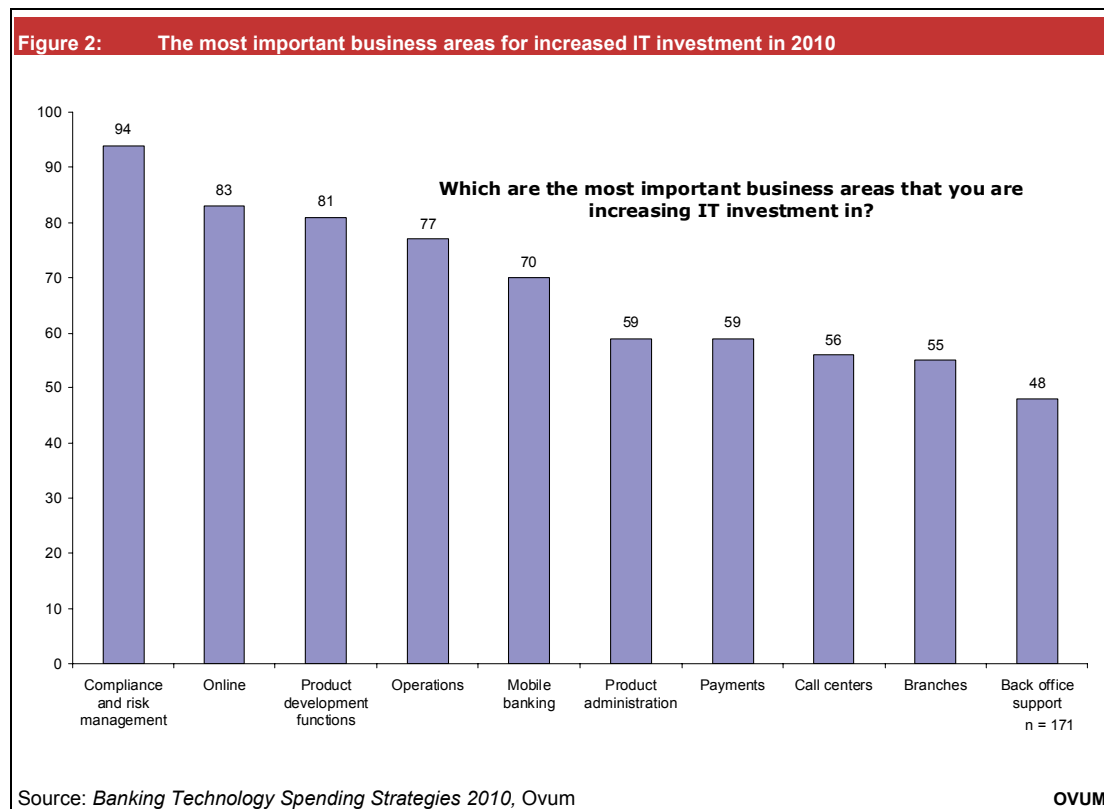
Secondly, achieving or maintaining regulatory compliance also features prominently on the agendas of banks throughout the world. In the wake of the paralysing industry crisis, this is both unsurprising and welcome in equal measure. In many country markets, greater political scrutiny and tighter regulatory controls are recognised features of the transformed banking sector, although this in itself is not without significant challenges. For example, a recent meeting of the G20 industrialised nations (held in South Korea during June 2010) revealed differences of opinion among officials and ministers on the Basel III proposals that are due for finalisation in November 2010. These disagreements cover the scale, scope and timing of the increases in capital and liquidity banks will be required to hold, as well as the leverage they will be allowed. If the global banking industry is to re-establish itself on firmer foundations, it is imperative to avoid diluting the principles of Basel III, and the implementation timescales could potentially be extended as a result.

## **Structural separation activities are an unavoidable consequence**

Ovum believes the significant reprofiling of the banking industry is destined to continue well-beyond 2010. To this end, several top tier institutions will be dismantled by industry regulators, as momentum builds behind the structural separation of retail and investment banking divisions and the disposal of non-core assets. Both of these activities have major implications for institutions, and in certain regions—most notably the European Union—legislation has already compelled banks to concentrate on core products and country markets in order to adhere to antitrust rules and continue to receive state assistance. For example, ING of the Netherlands is to divest its successful internet banking operation in the US (ING Direct) as part of an agreement with the European Commission on a mammoth restructuring plan to separate its banking and insurance activities worldwide. Under the program, ING will dispose of all of its insurance operations by 2012 in order to repay a \$10 billion bailout by the Dutch government. In the UK, Lloyds Banking Group announced a £180 billion reduction in assets, involving the divestment of its retail banking business (involving at least 600 branches, a 4.6% current account market share and approximately 19% of the group's mortgage book). Furthermore, one of the fundamental agreements reached in May 2010 by the new Conservative-Liberal Democrat coalition government emphasised that *"reform to the banking system is essential to avoid a repeat of the financial crisis, and the parties wish to reduce systemic risk through the establishment of an independent commission to investigate separating retail and investment banking"*. With the UK seen as a bellwether for developments in the banking industry, Ovum anticipates similar activities taking place in other countries.

## The heightened role of technology in delivering business objectives

In order for banks to make their evolutionary journeys not only as smooth and risk-free as possible, but financially successful too, appropriate consideration must be given to implementing innovative practices and processes, which are enabled by similarly innovative technologies. In the post-financial crisis world, technology plays an intrinsic and heightened role in delivering the aforementioned operational objectives, and Figure 2 below demonstrates the most important business areas that banks are increasing their IT investments in.



Institutions are understandably anxious to adhere with both existing and new regulations so as to avoid suffering punitive penalties, and it is therefore unsurprising to observe investments in compliance and risk management technologies occupying a prominent position.

## Budgets will remain flat, and transformation programs must deliver healthy RoI

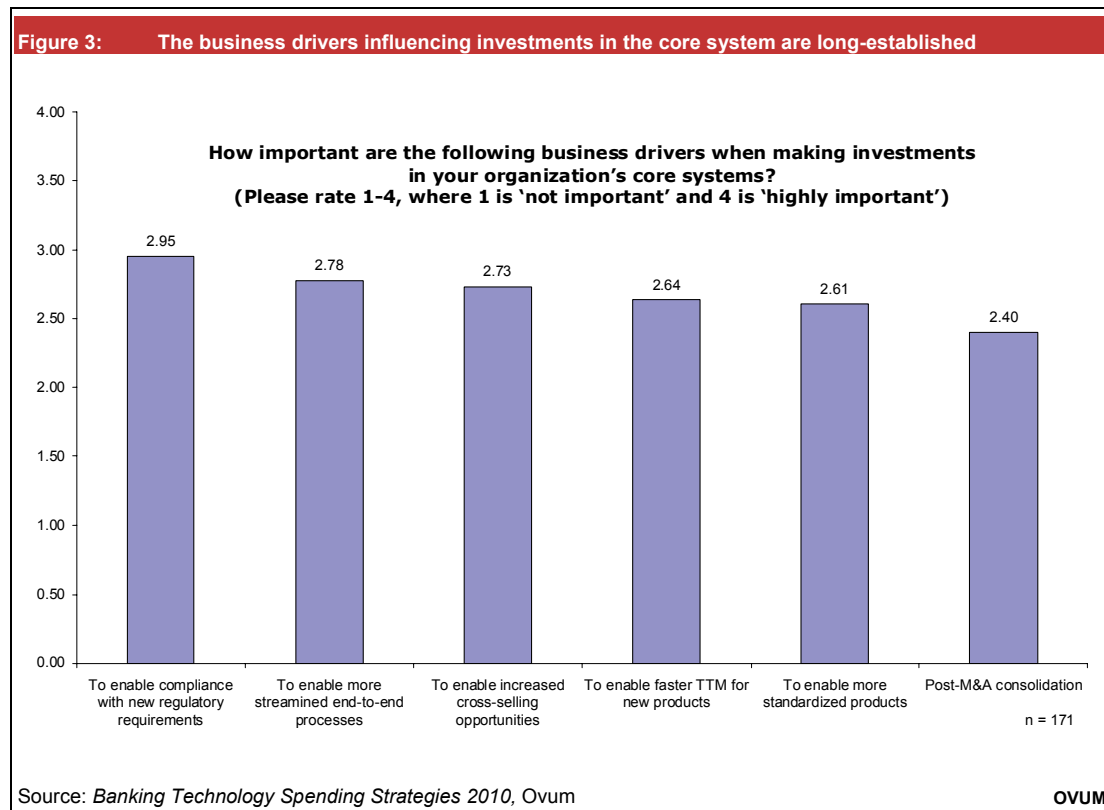
IT investment has largely been focused on run-the-bank activities, although large-scale mandatory change initiatives (such as SEPA and the PSD) have received funding. Budgets have been flat, and based on Ovum's end-user research appear destined to remain so in the short-to-medium term. However, where transformation programs have been sanctioned, without fail these must deliver anticipated RoI as failure is no longer an option. Importantly, the size of the institution will influence the particular approach taken for a large-scale transformation program. 'Rip and replace' is attractive for smaller banks, whereas for larger players this is difficult to achieve without a simultaneous (and unwanted) increased risk exposure.

**TOPIC FOCUS: CORE SYSTEMS IN RETAIL BANKING**

**In 2010 and beyond, retail banks will need more from their existing core systems**

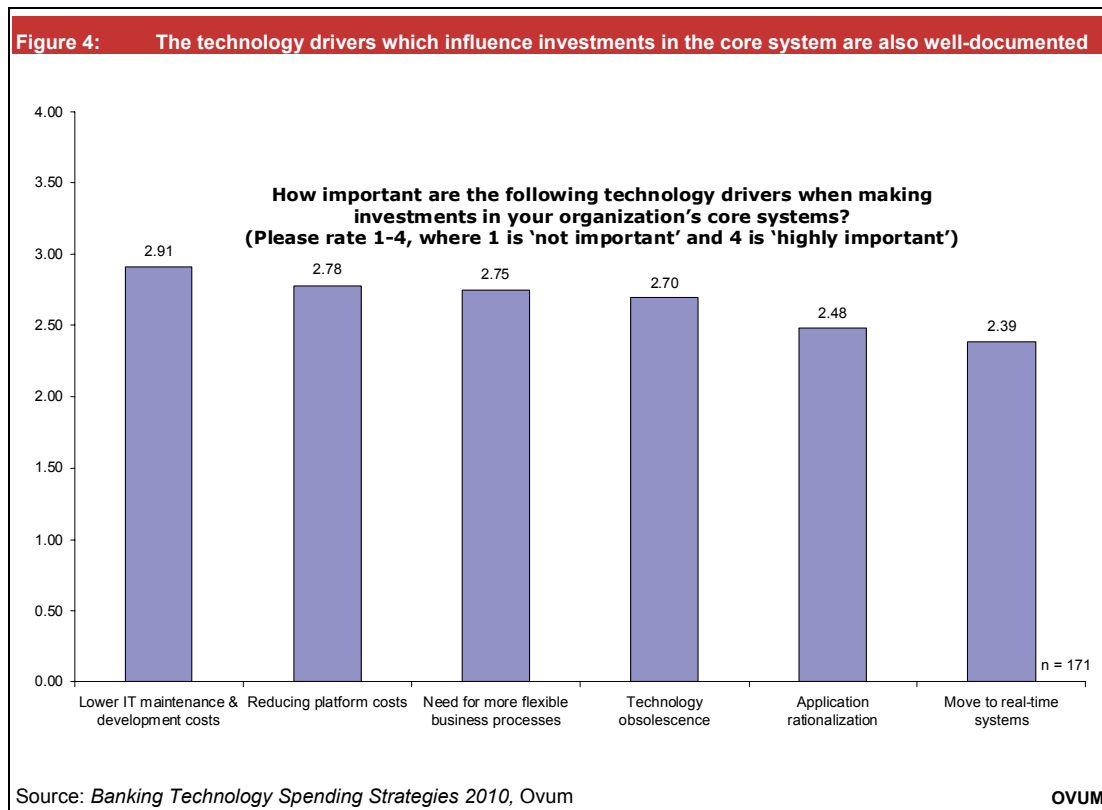
As institutions adapt to an environment with new demands from both industry regulators and consumers, Ovum believes banks' success (and by extension their very survival) will require the transformation of existing business strategies and operational processes. In turn, this will necessitate significant changes to existing core banking systems, many of which are decades-old and in desperate need of remedial attention. Put simply, it is a falsehood to assume that each and every installed core system is adequately equipped to deal with future challenges. Granted, Ovum explicitly recognises that core systems modernisation programs have been a feature of the banking sector over the past decade, but this activity was by no means universally undertaken. For every bank that opted to undergo major surgery, another would decide that the core system could tolerate a few more years of life before being wheeled into the operating theatre. Moreover, some institutions preferred to pursue a blinkered strategy based around performing cosmetic enhancements (typically justified on the grounds of lower-cost balanced against risk), and thus behind an attractive veneer there potentially lurks a fast-decaying core technology infrastructure which will severely hamper banks' abilities to successfully respond to fast-changing conditions.

Figure 3 below illustrates the business drivers influencing core systems investments being made by banks during 2010.



In Ovum's opinion, these drivers have remained largely unchanged for many years, although the problems which befell the banking sector from mid-late 2008 has undoubtedly had an influencing effect. From a regulatory standpoint, the introduction of policies including, but not limited to, MiFID, Faster Payments Processing, the PSD and the Capital Requirements Directive potentially demanded an overhaul of the core system if it was deemed unfit for the purpose of compliance. Furthermore, streamlining end-to-end internal processes, increasing cross-selling opportunities and faster time-to-market of new products is intrinsically linked to improving operational performance and revenue in a competitive, increasingly commoditised environment where genuine differentiation is difficult to achieve. Again, there is nothing radically new in this. Post-M&A consolidation in the post-crisis world is similarly unsurprising: no institution would opt to run two core systems simultaneously for any longer than is strictly necessary (the acquired bank will typically be migrated onto the acquirer's platform, regardless of whether this is the optimum strategic option or not).

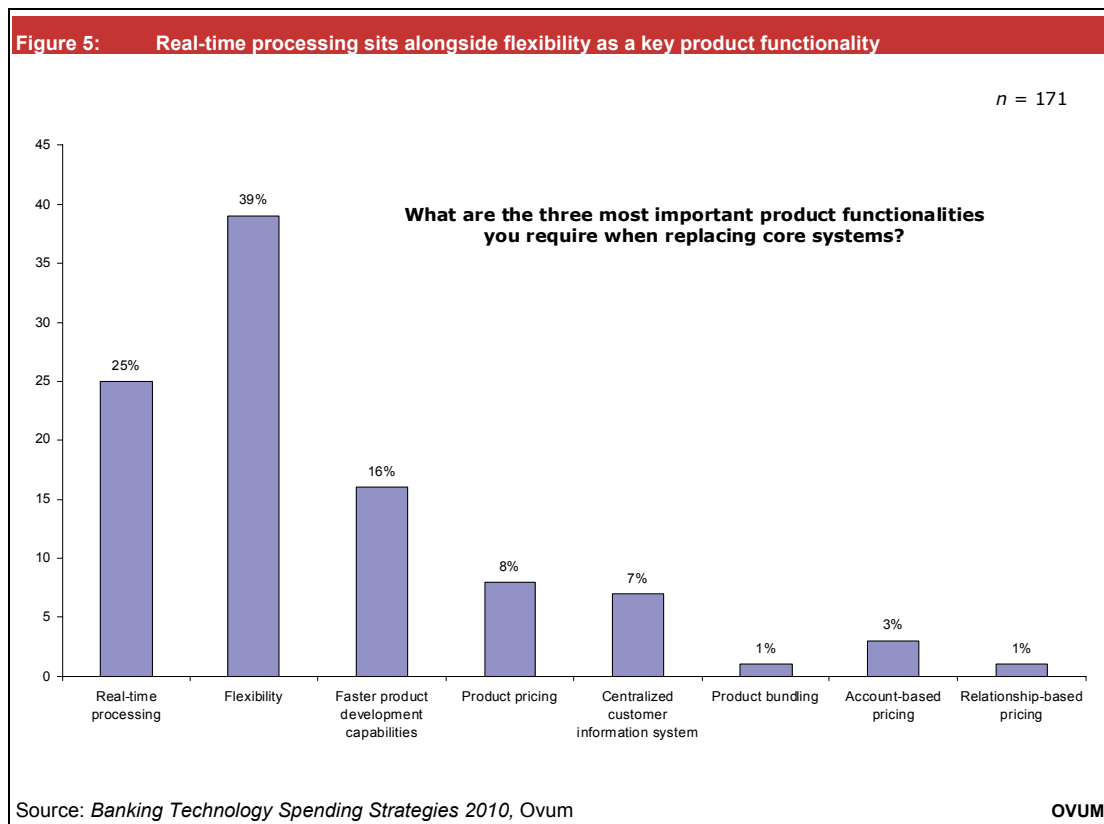
As seen in Figure 4, the technology drivers influencing investment in the core platform are similarly familiar to anybody who with an historical interest in banking technology.



The desire for a reduction in the cost of platform provision, maintenance and support (around 70% of the total IT budget), along with improving systems scalability, flexibility and modularity are all long-standing objectives for banks' IT departments. As banks evolve, Ovum does not envisage these drivers disappearing entirely from view. This begs a fundamental question: in the wake of a seismic shift in the banking industry, is this a textbook example of *plus ça change (plus c'est la même chose)* where core systems are concerned? The answer, in Ovum's opinion, is a resounding 'no'. Rather, these 'traditional' drivers and operational requirements are being joined by a new set of challenges, arguments and business imperatives, which have significant implications for existing platforms and will hasten the replacement of aging, unsuitable technology.

Figure 2 cited earlier in this white paper overtly illustrates that investment in channel technology – most notably for online activities – is a high priority in 2010. In turn, this supports the aforementioned notion that banks need to meet the ever-increasing needs of empowered customers, who have demonstrated themselves to be comfortable with using the internet to perform both rudimentary and complex transactions and account servicing activities. To a certain extent, banks are playing a perennial game of catch-up, as collaborative web-based technologies (ostensibly for personal use) have witnessed phenomenal growth in the last three years. By way of example, when radio was first introduced, it took 38 years to reach 50 million users. In stark contrast, Facebook gained 100 million users in 9 months. In the same timeframe, Apple's App store registered 1 billion downloads.

Consequently, as consumer and enterprise technologies converge, so banks' online channels must extend beyond the boundary of a dedicated, secure website to encompass wikis, blogs, user communities and other forms of social computing. But the channel challenge does not end there. Mobile banking, call centers and the branch network are all receiving additional investment, which has a direct impact on the existing core system. If the core is incapable of supporting processes seamlessly across all interaction mechanisms and in real-time, the consumer experience can only ever be mediocre at best. As seen in Figure 5 below, it is worth noting that, along with flexibility, achieving real-time processing remains one of the most important functionalities for institutions considering the replacement of the existing core system.



Furthermore, and worryingly for traditional institutions, basic banking products are becoming increasingly commoditised making it much easier for new entrants to offer financial services products. Retailers in particular represent a threat, and while they may not have a history in the financial services industry, their brand strength and deep understanding of



customer experience management means they are coming to the market with a fresh perspective. Furthermore, new entrants such as these will have an operational advantage as they are not constrained by legacy core systems. Instead they are starting from scratch on sophisticated, modern packages which will enable them to be far more responsive than incumbent banks that have not yet made any changes. Banks face the very real risk of losing clients to innovators that are continuously improving client collaboration and segmentation capabilities. For example, a recent IBM study found that 50% of customers would only give their bank two chances to fail in meeting their requests for service or new products before considering a change in financial provider.

And then there are the regulatory requirements to consider. Quite apart from the potential structural separation of retail and investment banking activities, institutions need to be capable of rapidly producing reports as to their capital positions and risk exposures. In the UK, for instance, the Integrated Regulatory Reporting Programme (IRR) contains a component dedicated to Mandatory Electronic Reporting, which uses a system called GABRIEL (Gathering Better Regulatory Information Electronically) to collect data from firms in an efficient manner. The ability to produce such reports that are both timely and accurate is absolutely essential. Heavily customised and inflexible legacy systems make it both hard and prohibitively expensive to support both current and future regulatory requirements.

**Core systems transformation is on the agenda but must occur at a safe pace**

Against the backdrop of a new banking landscape fraught with both long-standing and new challenges, institutions with core systems that are either outmoded or no longer capable of meeting the needs of the business will be compelled to take action. Whereas the option of doing nothing was once viable and acceptable, Ovum believes that banks cannot run the risk of allowing core systems to stagnate and become an insurmountable obstacle to accomplishing high priority business objectives.

As institutions gradually pull clear from the turbulent waters of the economic crisis, so IT investment has begun to rise, and core systems transformation is firmly on the agenda. As seen in Table 1 below, Ovum's latest market forecasts on core systems growth (published in June 2010) demonstrate that spending is set to rise continuously through to 2014.

**Table 1: Forecast spending on core systems, 2010 to 2014**

Spending (\$m)	2010	2011	2012	2013	2014	CAGR %
North America	6,495	6,721	6,942	7,160	7,432	2.2%
Europe	6,621	6,777	6,997	7,223	7,502	1.9%
South and Central America	436	459	489	525	550	6.7%
Middle East and Africa	675	716	767	824	872	7.4%
Asia Pacific	3,547	3,696	3,878	4,081	4,334	3.6%
<b>Global</b>	<b>17,774</b>	<b>18,370</b>	<b>19,073</b>	<b>19,812</b>	<b>20,689</b>	<b>2.7%</b>

Source: *Banking Technology Spending Model Through 2014*, Ovum OVUM

The developing regions of Asia Pacific and South and Central America, and the emerging market of the Middle East and Africa are showing particularly strong potential. However, there is also evidence that established European and North American banks will be overhauling their existing systems too, alongside new entrants who will come into individual countries to directly challenge the incumbents.



In this heightened era of risk-awareness in banking, it is imperative that the transformation of the core system takes place at a pace that is comfortable for individual institutions while simultaneously avoiding – or at the very least mitigating – any detrimental financial and operational impacts. For institutions in the upper tier (measured by asset value, see the Definitions section for details), a carefully phased migration approach is the safest option in Ovum's opinion. A specific tranche of a bank's business can be initially migrated, and based on both the success and quantum of problems and issues encountered, other functional areas are moved onto the new system in due course.

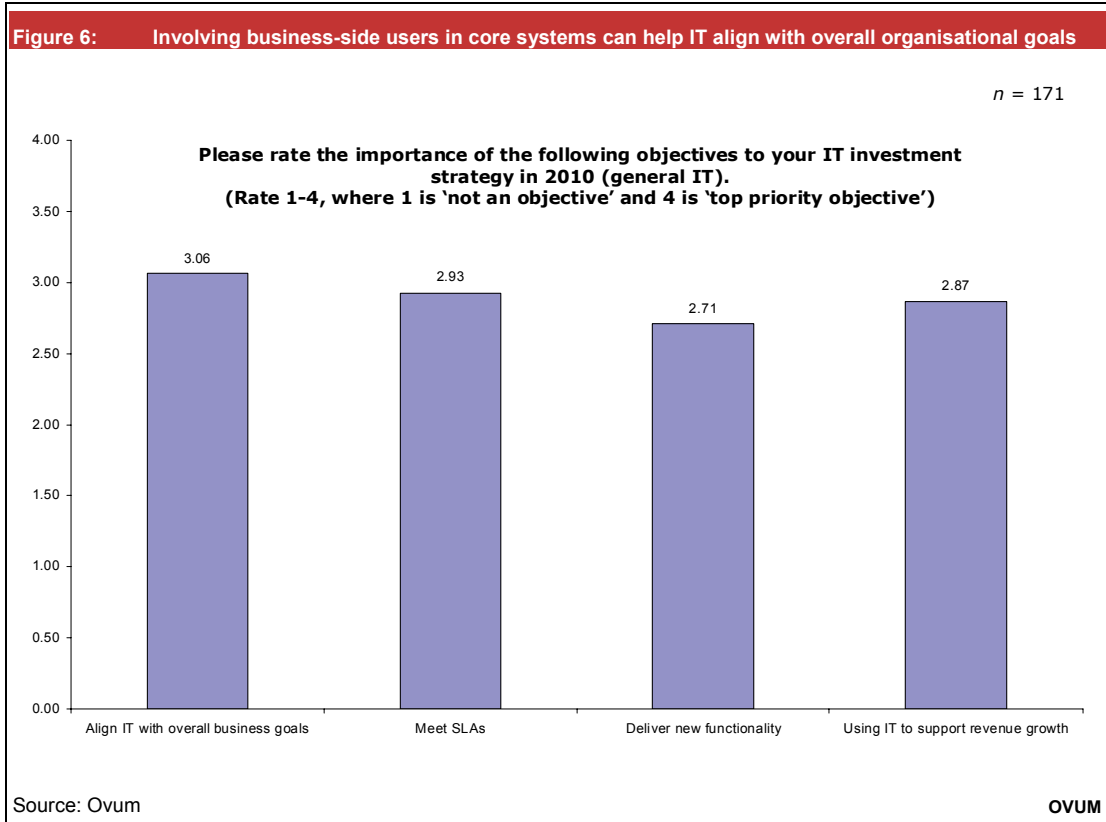
However, for smaller institutions in the lower tier, the option of rip and replace is palatable. Taking a proverbial wrecking-ball to an entire systems infrastructure and implementing a freshly packaged version can deliver immediate tangible benefits. Naturally, risks still need to be identified, quantified and mitigated, but providing a bank has chosen the right technology vendor and systems integrator partners, rip and replace is entirely the right way to go. Institutions considering this approach can take comfort – and learn valuable lessons from – their peers who have already opted to undergo a big bang migration as opposed to a phased one.

### **Business-side users must play a greater role in core systems development**

Historically, the core system has been the sole preserve of the IT department, who have orchestrated any changes at the behest of business-side users. However, it is widely acknowledged that such changes are typically far from straightforward to perform, and the complexity of development, coding, testing and deployment can see many weeks – if not months – elapse before a change finally goes into the live environment. In an industry sector as competitive as banking, the longer the time taken to perform an amendment, the greater the likelihood of losing share to a rival institution or prolonging unwanted exposure to risk. No executive worth their salt would find this situation remotely acceptable.

Given how the core system delivers and underpins a multitude of operational activities, its role in protecting an institution from unwanted over-exposure to risk is often unfairly overlooked. During 2010 and beyond, Ovum anticipates the core system assuming greater prominence, and it will shift from being of interest to IT only to something the business takes a far greater involvement in. While speaking to systems providers in the market, Ovum has found one company – Misys – which has detected similar messages being broadcast loudly from its customers and prospects, and has engineered its BankFusion platform accordingly. From the intuitive drag and drop graphical user interface (allowing for the rapid creation and customisation of business applications and processes) to the straightforward transition from 'design' into the live runtime environment, institutions are no longer constrained by arcane, restrictive, time-consuming and horribly complex practices that are only understood by a handful of specialists residing deep in the bowels of the IT department. Rather, business-side users can exercise a far greater degree of control and ownership than has been seen historically; thereby extracting tangible benefits (such as cost reductions) directly from the core system and without operating in fear of being left in a paralysing knowledge vacuum should internal IT expertise disappear (through staff attrition or retirement).

Through business-side users taking a more active role, a better degree of ownership can be achieved, along with an increased likelihood of actually delivering the new (or amended) product or service demanded by different customer-facing functional areas (such as transaction banking). This scenario also delivers genuine business-IT alignment, which – as illustrated in Figure 6 below – has long been cited as part of overall IT investment strategy.



The core system will permanently remain at the heart of a bank's operational infrastructure, but the days of it being a dark art are thankfully drawing to an end.

### As the banking industry evolves, a new breed of core systems will emerge

Core systems have been largely unchanged for decades; banks have adapted to technology rather than technology adapting to banks. Ovum believes that in the new era of banking, the balance needs to be redressed. Institutions must no longer be shackled by the constraints of inflexible legacy technologies that were designed when the financial services world was a very different place and time was not of the essence. The optimum next generation core system must be built around a service-oriented architecture, and with a high degree of hardware, database and operating system independence. The rapid implementation and revision of business processes are the critical drivers for banks that lack the flexibility they require in their legacy systems.

Ovum envisages that a common language will emerge where the core system is concerned: that language will be visual (through a GUI with drag and drop capabilities), rather than consisting of millions of lines of computer code. This translates easily into both the business and IT communities within a bank, and gives institutions the best opportunity for success in the new competitive environment. Finally, the new core system should also offer something fundamentally different from what's gone before. One such way to achieve this is through the creation of a recognised industry platform licensed to third party developers for the purpose of creating specific incremental applications without the need for reassembling all aspects of the



underlying technology architecture. This unique approach is being taken by Misys as part of the evolutionary roadmap for BankFusion. It remains to be seen whether other core banking software vendors follow suit.

## APPENDIX

### Ask the analyst

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### Definitions

- Tiering – Ovum segments the banking market by asset size split
  - Tier 1: Banks with over \$250bn in assets (Upper tier);
  - Tier 2: Banks with \$50bn to \$250bn in assets (Upper tier);
  - Tier 3: Banks with \$10bn to \$50bn in assets (Upper tier);
  - Tier 4: Banks with \$1bn to \$10bn in assets (Lower tier);
  - Tier 5: Banks with less than \$1bn in assets (Lower tier).

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