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A winning partnership: Financial institutions and strategic suppliers

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For financial institutions, working with truly strategic partners is, and should be, very different from managing other supplier relationships.

Today's financial institutions rely more heavily than ever on entities outside their four walls (Exhibit 1). Increasingly, vendors and suppliers oversee core activities such as engaging with customers through contact centers—tasks that are essential to run and grow the business. Moreover, the largest relationships are becoming more concentrated and complex. A single relationship may cover a disparate array of products and services across a large swath of the enterprise.

But are institutions generating as much value from these relationships as they could? Even speaking of value represents a change. For years, institutions viewed procurement primarily as a source of savings—one that was often more palatable than finding internal cuts to make. The outsourcing revolution then amplified savings opportunities as institutions shifted more work to third-party specialists.

These moves raised new strategic and operational dangers, which both the institutions themselves and their regulators increasingly recognized required robust management. Consequently, the procurement function at many financial institutions focuses on balancing the twin priorities of value and risk.

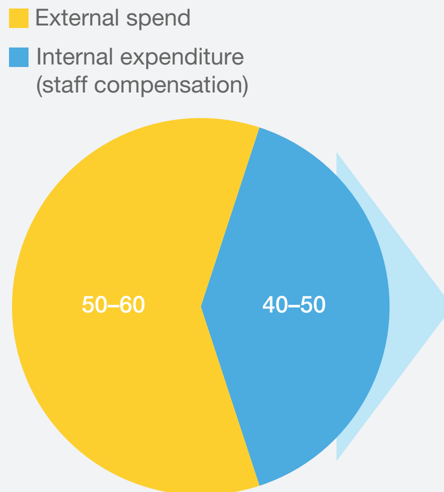
Both focuses are necessary. But it is increasingly apparent that they are not enough, not when so many institutions are following the same basic supplier management approach, even as the business world is rapidly changing.

A few institutions are recognizing that their 20 or 30 most strategic suppliers really are partners—whom they can engage in generating even greater value for mutual benefit and competitive advantage. What these organizations discovered along the way is that working with truly strategic partners is, and should be, very different from managing other supplier relationships. Finding the highest-impact value-creation opportunities requires quite a lot more than sharp negotiations, risk ratings and supplier scorecards.

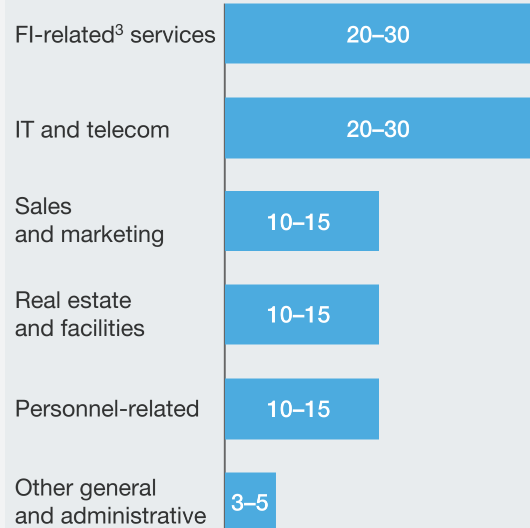
Exhibit 1

Financial institutions[1] typically outsource 40 to 50 percent of operating expenses—but are their procurement and supply-chain capabilities keeping pace?

Typical operating expense portfolio for financial institutions,[2] %



Typical external spend breakdown, %



[1]Banks, asset managers, and insurers.
[2]Percentages vary depending on size and type of FI.
[3]FI-related services include spend areas such as claims, ATM, armored car, custodial services, fund transfer and clearance services, index services, banking services, record-keeping services, and market data and information services.

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First, it requires a thoughtful approach to identifying which suppliers are truly “strategic” for the institution as a whole. That means taking a much broader view than the procurement department’s risk-and-cost perspective or one division’s opinion of a supplier’s importance. Even more important, once that list is made, the institution must adopt new mind-sets toward these partners, with new capabilities that will help in aligning strategies, developing common goals and boosting performance. New governance structures typically will be needed as well, to foster cross-functional insights and ensure continued progress.

None of these goals will be possible without a very deep—and very public—commitment from the senior-executive team. But the payoff can be substantial. A major property-casualty insurer found that applying these ideas just to its most critical legal-services suppliers increased the company’s recoveries by almost 80 percent while reducing legal staffing needs by one-third. And for one large US-based bank, prioritizing its 25 top supplier partnerships across all categories helped unlock even more value in multiple dimensions. Thanks to suppliers’ improved contract performance and stronger collaboration with the bank, problems that previously took months to address can now be resolved in weeks or even days. Product development is faster, too, with new features debuting in the same quarter they are proposed. And revamping processes now takes less than half the time it formerly required: a new finance process took about five months to deliver, compared with the previous standard of a year.

A farewell to arm's-length transactions?

The notion that supplier management should generally focus on maximizing savings opportunities and minimizing risk remains powerful for a simple reason: for the vast majority of supplier relationships, it is true. A whole ecosystem of scorecards, performance targets and model service-level agreements has helped organizations understand savings in ever-more-sophisticated ways, letting them quantify trade-offs among cost, speed, quality and risk with almost Cartesian precision. For many spending categories, analytic techniques such as clean-sheet costing mean that category managers sometimes know their suppliers' cost and risk issues better than the suppliers themselves do.

All that can lead to tremendous value. But what those techniques cannot readily quantify are the strategic considerations that arise when a supplier's services are critical to the health of an organization's business model, or when they are so intertwined throughout a company that quantifying separate cost or speed metrics produces vastly different answers depending on which part of the business provides the data.

That is the situation the US bank mentioned earlier found itself in. Like many companies throughout the financial services industry—encompassing banking, insurance and asset management—the bank had transferred responsibility for more and more of its operations to major suppliers. The strategy made sense. Keeping up with every IT advance had become increasingly difficult for a bank that naturally focused on serving its clients. But the risks were also growing. Data breaches at major universities, retailers and—most worryingly—credit-card issuers underscored the institution's vulnerability to its suppliers' weaknesses.

At the same time, senior executives began wondering why relationships with the same supplier could vary so much between business units, with business unit A signing the supplier up for more work even as business unit B complained of the supplier's missed deadlines. Or unit C might negotiate an entirely new master service agreement with the supplier, apparently unaware that unit D had already created an agreement of its own. Units with similar problems chose different suppliers, generating more complexity while reducing efficiency—or they chose the same supplier but with radically different expectations and service-level agreements. No one seemed to look at what the institution needed as a whole.

These concerns finally rose to the CEO, who decided that there had to be a better way to manage the most important suppliers, just 25 of which accounted for about half of the company's third-party spending. There had to be a way to create partnerships.

Which suppliers are truly strategic?

Partnerships take work—a lot of it. Consequently, among the many hundreds (or even thousands) of suppliers that an institution may work with, only a few can qualify: typically no more than 1 percent, and often quite a lot less than that. The real question an institution must therefore ask is which suppliers are truly strategic, without including too few, or too many.

Trouble at the extremes

Each extreme is tempting. For an institution with an extensive retail network, facilities management may be one of the largest spend categories, and the single largest supplier from a cost perspective may be a real-estate-management company. But few would describe their facilities services as critical to an institution's strategy.

Even a supplier that is important from a risk perspective may not qualify as strategic. Investment banks entrust their financial printers to protect clients' data for upcoming share offerings, but few would describe those vendors as strategic partners (for more on managing vendor risk, see "Managing when vendor and supplier risk becomes your own," Hamid Samandari, John Walsh, and Emily Yueh, July 2013, McKinsey.com). Conversely, the digital revolution illustrates how a savings-based filter can be underinclusive as well. A contract with an exceptionally skilled mobile-device application developer may be quite small but essential to a consumer lender's future viability.

Right-sizing 'strategic'

McKinsey finds that, as a practical matter, identifying strategic partners is equal parts science and art, centering on several qualitative factors in addition to size and risk (Exhibit 2):

- Business criticality. If the business cannot function without the supplier—for example, when suppliers operate most or all of a company's IT systems—the supplier is strategic almost by definition. But the size of the contract may matter less than the qualitative impact. Outsourced "white glove" concierge services for private-banking or elite credit-card customers may represent a relatively small cost yet be a major differentiator in the market.

- Future revenues. The next major category of strategic suppliers includes those whose capabilities will have a disproportionate effect on the institution's future revenues. In retail banking, a credit-card partner—such as an airline or retailer that awards points to cardholders based on their spending—may not pay any up-front fees but provide crucial additional revenue streams as the lure of points stimulates greater card usage. Similarly, certain consumer-oriented financial brands rely so heavily on advertising to reach new customers that their marketing and advertising agencies would likely fall into this category as well.

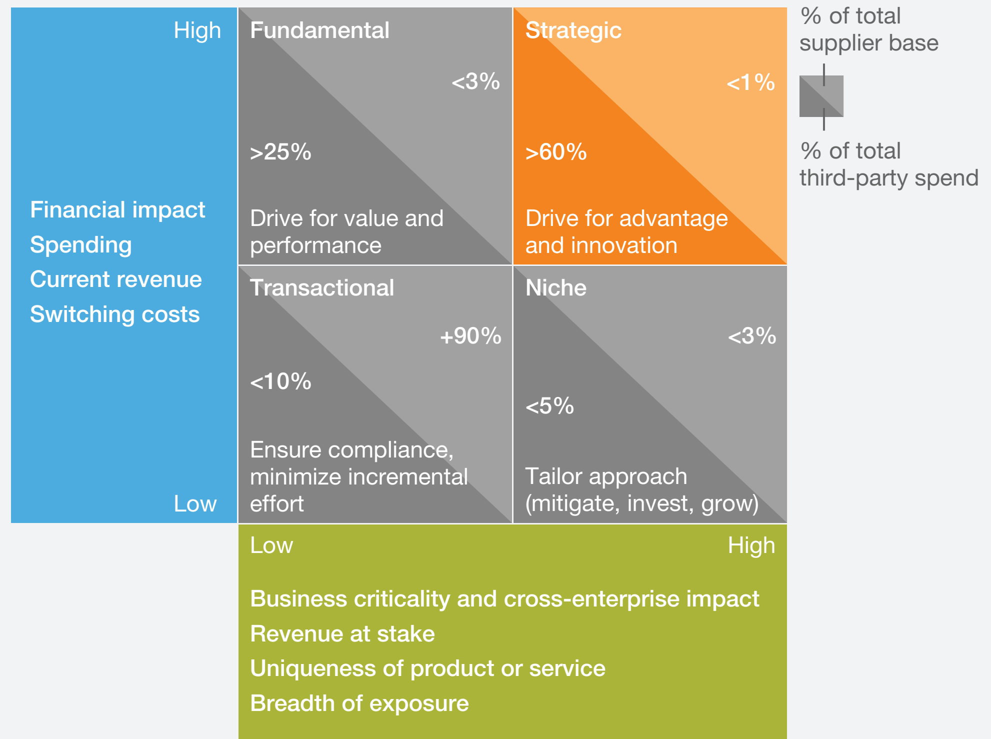
- Cross-enterprise impact. A supplier whose services touch many parts of the business (or many support functions) is likely to be strategic even if the total spending is modest. A cloud-services contract, for example, may not count very high in dollar figures, but a failure by the supplier to deliver will affect almost the entire organization.

- Switching costs and uniqueness. A supplier whose capabilities are difficult or expensive to replace—either because there are few alternatives or because the supplier is deeply embedded in the business—is much more likely than others to be strategic. That

description might apply to an executive search firm whose understanding of the company's culture and needs has given it a unique ability to fill important leadership roles.

Exhibit 2

Strategic partnerships go above and beyond the typical sourcing process.



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Reaching agreement

Few organizations are structured so that a single person—or even a group of people—has a complete perspective on any supplier whose potential impact is large enough to qualify as strategic. Accordingly, deciding which suppliers make the cut requires coordination across a wide range of internal stakeholders.

Business-unit leaders will naturally have the deepest insights on questions of business criticality, strategic differentiation and future revenues. Senior supplier-relationship managers with a perspective on supplier-management guidelines and performance management will help identify complex interdependencies among supplier relationships that may not be visible at the

category level. Procurement-category managers' expertise on sourcing-strategy development will help in assessing switching costs, while third-party-risk managers will be needed to clarify hard-to-measure risk implications, such as those due to dependency on single sources.

But, as the US institution demonstrated, the essential stakeholder is typically a member of the top team, whose identification of strategic sourcing as an organization-wide priority will help foster alignment. "The CEO's leadership on this issue brought all the required expertise together," explains the institution's top procurement officer. "That group now provides ongoing enterprise-level oversight of our supplier partnerships."

Building effective partner relationships

As the partner-identification process gets under way, the institution must also start transforming how it manages its strategic suppliers. The cost and risk focuses of current supplier-management practices typically allow very little room for nurturing relationships with strategic suppliers—and in transactional, commoditized categories, relationships usually have only marginal value. But for a strategic partnership, the relationship is central. Accordingly, a new accountability structure, new priorities, new metrics and new governance will all be needed. Only then will the company be able to work with the designated strategic suppliers to start identifying and creating new value together.

An accountable team

It starts with a strong team to manage each relationship, with clearly defined roles, responsibilities and supporting resources. A wide range of expertise will be needed across functions. In addition to procurement's expertise in supplier economics and legal's depth in contract oversight, specialists from finance, customer operations and product development must weigh in as well to understand all the potential strategic and practical implications of working with a major supplier.

At the same time, the team will need effective leadership. The US bank created a simple hierarchy, starting at the top with an "executive sponsor" at the C-suite level who could intervene to resolve major issues and whose very involvement highlighted the relationship's importance. Reporting to the sponsor, a "relationship owner" would have an enterprise-wide perspective on the relationship and would work with a senior counterpart at the partner to set the partnership agenda. Day-to-day operation of the partnership would be the responsibility of one or more "relationship managers," while "supplier-performance managers" would continually synthesize information about the relationship for the rest of the team.

But adding new responsibilities presents a new danger: that they will be perceived simply as add-ons to the long lists of tasks that executives and managers are already balancing. Too often institutions overlook these basics, and within a year or two, the gains from strategic-partner relationships fade. The bank therefore made sure to incorporate all the formal HR support that any role requires: detailed job descriptions, explicit delivery targets and objectives, and integration into existing performance-management and incentive systems.

Clear priorities

Once the team is in place, it must work with its counterparts at the partner to clarify a set of joint priorities describing what the parties ultimately want to create based on a partnership. Initially, the ambition may be pragmatic, centering on operational excellence. Once the two sides build more confidence and performance stabilizes, however, the goals can become more aspirational, centering on enhancing client service or strengthening innovation.

For the insurer mentioned earlier, greater two-way transparency with its external law firms on the cost and revenue implications of current litigation allowed for the elimination of cases that were unlikely to be worth further investment. The result was a 10 percent reduction in total litigation costs. The bank, meanwhile, worked with one of its IT strategic partners to create a new set of continually updated tools that replaced daily reports on critical financial metrics. The new system enhanced decision making throughout the organization, in part by allowing analysts to focus on analysis rather than on tedious reporting tasks.

Metrics for management

In parallel, performance management of the partner must become far more consistent, based on metrics that reflect the joint priorities. While scorecards remain a vital part of the mix, what those scorecards record must change to support the value that the partners are trying to create and to prevent gaming of results. That means understanding the interdependencies between different metrics, including both the top-line result the partners are aiming for—such as efficient customer operations—and its most important components, so that the supplier achieves the goal in the right way.

An auto insurer working with its rental-car supplier, for example, may want to reduce the amount of time that customers keep using their rental vehicles after their repaired cars are ready for pickup. But focusing only on a single metric—length of rental—could backfire on the insurer in the long run if the rental agency reduces rental times by treating customers badly. Integrating a customer-satisfaction measure into the agency's performance rating makes it far more likely for the agency to find ways to encourage the prompt return of rental vehicles while keeping customers happy.

Ideally, the metrics should inform not only the performance evaluation of the supplier but also of the organization itself. As the leader of the US institution's strategic-partnership program put it, "Applying the metrics revealed that there were times when our own processes were getting in the way. Those internal conversations were difficult but necessary. It also revealed a need for the supplier to work with our individual-performance-assessment system, so we could see whether their people and ours were following the new behavior in their day-to-day work."

A cycle of collaboration

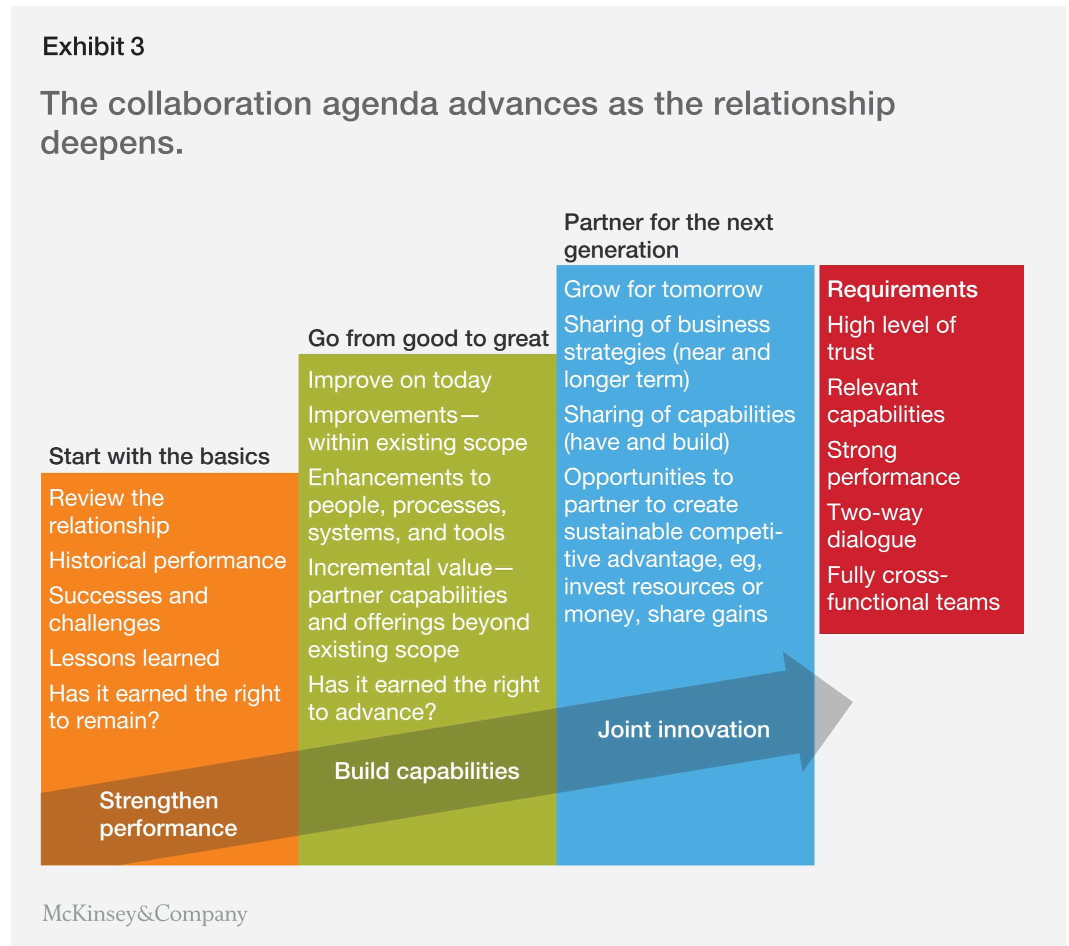
The final requirement is for each strategic-partner team—from relationship owner down—to meet with their counterparts at the partner at least once a quarter to assess how the

relationship is doing. “Making and keeping that program commitment is logistically difficult but absolutely vital,” says the institution’s chief procurement officer. “We plan them out a year in advance—that’s the only way to coordinate the schedules of senior officers, especially since one of the relationship owners is actually our CEO. But the simple fact of committing so much executive time to maintaining the relationship underscores how important it is.”

The content of the meeting naturally shifts as the relationship deepens (Exhibit 3). Early on, discussion centers on the past—how the supplier did. As performance improves, the scope expands to include new capabilities that the supplier (and, in some cases, the institution) can build to develop new value. Deploying electronic payments, for instance, enabled the insurer and its law firms to cut costs and reduce cycle times by three weeks. These sorts of measures further strengthen trust until both sides start investing in joint capabilities, such as a work-allocation tool that the insurer’s legal department and law firms could use to distribute caseloads based on capacity and performance.

Exhibit 3

The collaboration agenda advances as the relationship deepens.



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Managing transformation change

Building a strategic-partner-management capability is far from a one-time event. It requires constant reassessment as the business changes. Since the US institution initially rolled out its changes, about 20 percent of its strategic-partner list has changed: “Not surprisingly given the broader market evolution, today one of our mobile-payments partners is on the strategic list. Meanwhile, certain app-development partners dropped off the list as those services become more competitively available,” says the strategic-partner-management program leader.

The capabilities the bank is looking to build have also changed. “Three years ago, we were coming out of a relatively siloed structure, so our emphasis was on enhanced internal coordination. We believe that the governance we put in place is handling that challenge pretty effectively. Our next challenge is to automate more of our revised reporting and score-carding, so that we can spend less time tracking data and more time on what the data represent.”

For a financial institution that is reassessing its supplier management, a first step is to think about how it is working with its suppliers right now, keeping a few basic questions in mind. Which suppliers matter most to the business, and are they treated differently from other vendors? Can the individuals who currently manage those relationships represent the institution as a whole? Is the institution focusing more on future opportunities with those suppliers or on reviewing their historical performance? The answers will help guide a transformation of what a supplier relationship can produce, informing not just today’s operations but tomorrow’s competitiveness. □

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