Financial Services INSIGHT

Five Habits of Highly Efficient Banks

How Banks Ride the Cost-income Curve — *August '08*

Cost-efficiency gives a bank freedom to manoeuvre. Strong, free cash flow allows it to invest in new markets, products or technologies, to reward its shareholders and, if it chooses, to channel value back to its customers in terms of better service or lower prices. Conversely, low cost-efficiency limits a bank's options in the marketplace, and makes it vulnerable in times of financial crisis. But if, as shareholders recognize, cost-efficiency is an indicator of a well-run bank, how can it be achieved?

A survey of 51 major European banks conducted by Arthur D. Little has found that Europe's most efficient banks have five important characteristics in common:

- Very cost-conscious cultures where cost-efficiency and operational excellence are continuously encouraged;
- A high degree of straight-through processes and automation and heavy investment in IT;
- Flat hierarchies with short communication channels and a high degree of decentralization, with decision-making taking place primarily at a local branch level;
- A focus on embracing the right (revenue-creating) costs whilst shunning costs that bring little or no value to the customer; and
- The use of a pragmatic list of key performance indicators and mostly numerical objectives for costs and efficiency.

"For banks with a cost-income ratio higher than the European average of 59,2%, the habits of the most efficient banks can provide useful inspiration for improvement."

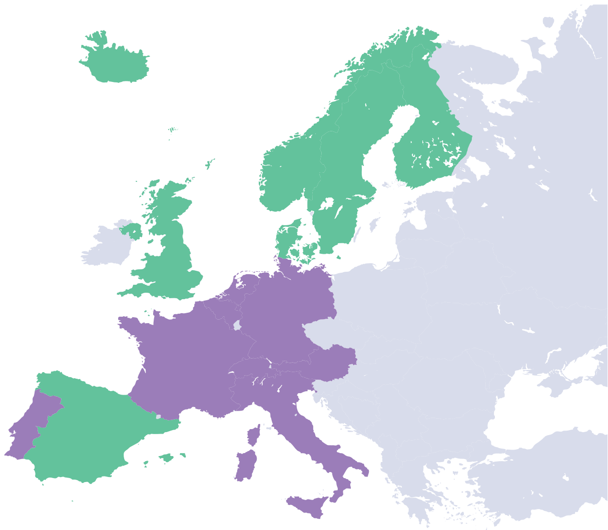
The banks displaying these characteristics and taking the top places in the survey's cost-efficiency ranking (See figure 1) achieve cost-income ratios that are dramatically lower than those of banks at the bottom of the ranking. For banks with a cost-income ratio higher than the European average of 59,2%, the habits of the most efficient banks can provide useful inspiration for improvement.

Figure 1: Banks ranked by average cost-income ratio 2004–2006 (ratio obtained by dividing operational cost, including amortization and depreciation by total income).

	Rank	Bank	Country	CIR %
Above*	1	Banco Popular	Spain	37,8
	2	Kaupthing	Iceland	39,3
	3	Sv. Handelsbanken	Sweden	42,1
	4	Glitnir	Iceland	43,7
	5	HBOS	UK	44,7
	6	RBS	UK	45,0
	7	BBVA	Spain	46,4
	8	HSBC	UK	51,4
	9	Lloyds TSB	UK	51,5
	10	Caja Madrid	Spain	51,7
	11	Swedbank	Sweden	51,7
	12	Dexia	Belgium	52,7
	13	Sampo Group	Finland	53,1
	14	Danske Bank	Denmark	53,7
	15	DnB Nor	Norway	54,0
	16	Nordea	Sweden	55,8
	17	OP Bank	Finland	55,8
	18	Raiffeisenbanken Switzerland	Switzerland	55,9
	19	UBI Banca	Italy	56,4
	20	Banco Santander	Spain	57,6
	21	KBC Bank	Belgium	58,5
	22	Banco Sabadell	Spain	58,8
	23	Unicredit Group	Italy	58,8

Source: Annual Reports, Arthur. D Little analysis
Note: *Versus average (59,2%)

Figure 2: Countries ranked according to the efficiency of their banks



	Rank	Country	Average CIR %
Above*	1	Iceland	41,5
	2	Spain	50,5
	3	UK	50,5
	4	Sweden	53,0
	5	Norway	54,0
	6	Finland	54,4
	7	Denmark	56,8
Below*	8	Italy	59,6
	9	Belgium	59,9
	10	Austria	61,3
	11	France	63,8
	12	Switzerland	64,5
	13	Netherlands	67,8
	14	Portugal	68,0
	15	Germany	73,5

Source: Arthur. D Little analysis
Note: *Versus European average (58,6%)

On a country level, Iceland is the most efficient country, followed by Spain and the UK (See figure 2). Sweden, Norway, Finland and Denmark are also above the European average. The least efficient country among the 15 examined is Germany, just behind Portugal and the Netherlands.

External Factors

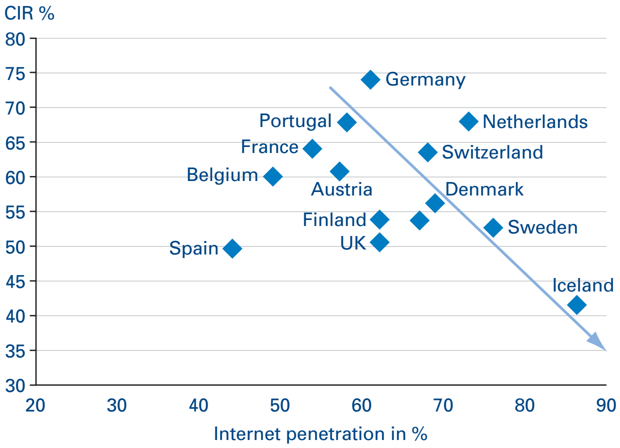
The strategies adopted by banks play a key role in their success, but external factors also have an important impact on each bank's performance. Internet penetration, outlet density and consolidation are among the most important external factors. High internet penetration in the Nordic countries (See figure 3) has forced the banks to use the internet as sales and transaction channel and but has made it possible to make significant reductions in costly administration and human involvement.

Large differences in the degree of consolidation also affect cost-efficiency (See figure 4). Germany has a registered bank per 34,000 inhabitants, whereas UK and Spain include 178,000 and 213,000 citizens in an authorized bank respectively. Lowering the CIR of the largest German banks to the average European level through increased consolidation and internet penetration could mean potential lay-offs of every fifth employee.

Develop a cost-conscious culture

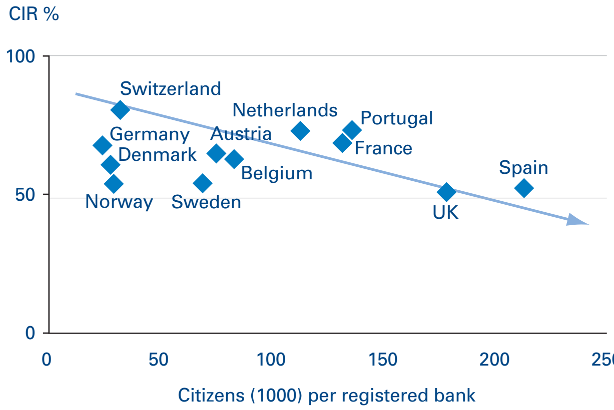
In banks that have a corporate culture where cost-efficiency undergoes continuous improvement, cost-consciousness is deeply integrated in overall strategy and is encouraged throughout the whole business. Top management makes cost-efficiency a priority.

Figure 3: Internet penetration vs. CIR



Source: internetworldstats.com, globaltechforum.eiu.com, interviews, Arthur D. Little analysis

Figure 4: Banking consolidation vs. CIR



Source: Association of German banks, Svenska Bank föreningen, Financial Services Authorities UK, Danish Bankers' Association, Association Française des Banques, Norwegian Financial Services Association, Swissbanking, Banco de Espana, Banco de Portugal, Österreichische Nationalbank, Arthur D. Little analysis

This is evident among a number of top performers. At HBOS, for example, achieving cost-leadership over competitors is one of five strategic key elements that act as a guide for day-to-day business. At Svenska Handelsbanken, a key financial goal is to have higher profitability than competitors, and this is to be achieved through greater customer satisfaction and lower costs. At Banco Popular, "systematic enhancing of efficiency" is one of three key management criteria.

Leading banks use a number of approaches to turn strategy into reality and encourage cost-consciousness throughout the organization. At BBVA and Caja Madrid, for example, large parts of salary are variable and depend on staff achieving different performance targets, many of them based on efficiency. At Svenska Handelsbanken, part of the bank's profit is put into a profit-sharing program for distribution on condition that the bank's profitability target (which is to be reached through low costs) is achieved.

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Invest in IT

Advanced IT systems have an important role to play in improving efficiency. Their impact is on two fronts: they help reduce human involvement and they support faster and more accurate processes.

A high degree of automation makes it possible to lower costs by reducing expensive human involvement. This is seen in action in a number of the top performers. Lloyds TSB, for example, has been able to reduce total staff numbers by 6% by increasing the automation of administration and back-office functions. At Svenska Handelsbanken, an increased use of IT has allowed staff to focus on revenue-generating activities and make more time for customers. Meanwhile, RBS has been able to lower operational costs by automating marketing functions, such as direct mail and call centers.

IT makes it possible to distribute information through a large organization and helps in maintaining control over a multinational company with several divisions and operations worldwide. At RBS, thanks to its advanced productivity and performance-management reporting tool, managers can access bench-marking data from the whole group, forecasts of future workload and status on current projects, allowing them to make more-informed decisions in a shorter period of time. At HBOS, virtualization technology is expected to deliver major cost savings due to more efficient allocation of storage.

Adopt the right organizational structure

The way a bank is organized is crucial for its cost-efficiency: a flat hierarchy, shared support functions and decentralization are common characteristics among the top performers.

A flat hierarchy with short communication channels reduces bureaucracy and administration. For example, at Kaupthing, slow and cumbersome decision-making is seen as more risky than fast decision-making, since slow decision-making creates the risk of missed opportunities. Similarly, Glitnir has a dynamic and flexible organization designed to allow the bank to provide services faster than its competitors, both to satisfy customers and to lower its own costs.

By centralizing support functions such as IT, HR and other expertise banks can gain large economies of scale. RBS knows this. It gathers all its support functions into a single manufacturing division. This gives the bank greater purchasing power and improves efficiency by avoiding sub-optimal performance at a divisional level which would hurt the group as a whole.

By adopting a decentralized structure successful banks ensure that business decisions are taken as close to the market as possible. At Svenska Handelsbanken, for example, all credit decisions are taken at branch level and this has reduced credit losses and, simultaneously, speeded up processing. By letting the local manager design the branch, SHB makes sure that every branch has the optimum fit with its own market.

Balance cost-cutting and revenue generation

When it comes to cutting costs, it is crucial to cut the right costs; there has to be a balance between reducing the cost base and retaining the capacity to generate revenue. The Icelandic bank, Glitnir, recognizes that the size of the cost is not as important as how efficient the cost is in generating revenue. The bank understands that it costs money to make money and as long as the return is sufficient the organization should not be afraid to take on costs.

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Cost-cutting should focus on unproductive and non-value-generating activities. At BOS and Lloyds TSB, for example, newly launched cost-saving and productivity programs focus on reducing costs for non-value-adding administrative and support functions.

Choose the right targets

Explicit targets help the best banks to focus their efforts and motivate staff to work towards cost-efficiency. Among the top performers three types of targets are used:

- **Profitability targets:** By adopting a profitability target such as ROE, banks indirectly set targets for cost-efficiency. Svenska Handelsbanken's financial goal, for example, is to be more profitable than its competitors. It aims to reach this goal by having more satisfied customers and lower costs. Although not explicit, the profitability target works as a cost-efficiency target in the end.
- **Cost-income ratio targets:** A CIR target helps top banks focus on getting as many units of income as possible out of every unit of cost, and provides the incentive to cut unproductive costs as a result. At HBOS, for example, the CIR target for 2010 is the goal for the bank's newly launched cost-reduction program. At Glitnir, the bank's standing target for CIR tells management whether costs and income are in line with plan or not.
- **Cost growth targets:** A cost growth target helps successful banks focus the business solely on the cost side of efficiency and gives a clear signal to staff to hold down costs as much as possible. HBOS uses cost growth targets as a complement to its CIR target, which also emphasizes the income side. By having an explicit cost target, everybody knows how much costs are expected to grow; there is no room for unnecessary cost increases just because income is unexpectedly high in certain periods.

Conclusion

The degree of cost-efficiency in Europe's largest banks spans a wide range. The most efficient banks achieve a cost-income ratio of less than 40% while the least efficient of the banks surveyed by Arthur D. Little has a cost-income ratio of over 80%. Clearly, there is great scope for many banks to improve their cost-efficiency and in order to stay competitive they need to do so. Analysis of the data collected for the survey show that, over time, banks' cost-efficiency ratios are decreasing.

The most cost-efficient banks as identified by the Arthur D. Little survey share a number of important characteristics in their approach, encompassing corporate culture, the use of IT, organizational structure, decisions on cost-cutting and the choice of performance targets. Looking more closely at the strategies adopted by the most cost-efficient banks can provide important pointers for other banks seeking to emulate the survey leaders' success.

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