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Is your bank ready for growth?

A more strategic approach to costs can help you prepare

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Contacts

Boston

John Plansky
Senior Partner
+1-617-521-8801
john.plansky
@strategyand.pwc.com

Chicago

Carl Hugener
Partner
+1-312-578-4897
carl.hugener
@strategyand.pwc.com

Kelley Mavros
Partner
+1-312-578-4715
kelley.mavros
@strategyand.pwc.com

London

Alan Gemes
Senior Partner
+44-20-7393-3290
alan.gemes
@strategyand.pwc.com

Gagan Bhatnagar
Partner
+44-20-7393-3747
gagan.bhatnagar
@strategyand.pwc.com

Munich

Johannes Bussmann
Partner
+49-89-54525-535
johannes.bussmann
@strategyand.pwc.com

New York

Jon Hagstrom
Partner
+1-212-551-6130
jon.hagstrom
@strategyand.pwc.com

Shanghai

Sarah Butler
Partner
+86-21-2327-9800
sarah.butler
@strategyand.pwc.com

Zurich

Andreas Lenzhofer
Partner
+41-43-268-2156
andreas.lenzhofer
@strategyand.pwc.com

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About the authors

Alan Gemes is a senior partner with Strategy& based in London, leading the financial services practice in Europe. He has more than 20 years of experience in strategy, *Fit for Growth** initiatives, operating model design, and transformation.

Gagan Bhatnagar is a partner with Strategy& based in London. He specializes in large-scale cost-fitness and *Fit for Growth* initiatives for financial services firms, particularly in the capital markets and securities area.

Dr. Johannes Bussmann is a partner with Strategy& based in Munich. He focuses mainly on operating model design, digitization, and IT-driven transformation for financial institutions. He leads the financial services practice in Germany, Switzerland, and Austria.

Andreas Lenzhofer is a partner with Strategy& based in Zurich. He specializes in business and operations strategy, operating model design, large-scale transformations, and cost-fitness initiatives for financial services firms.

Executive summary

Boosting profitability has been a tough task for banks since the 2008 financial crisis. The common reaction — to periodically make sweeping cost cuts — has proven inadequate and often counterproductive. Banks need to embark on a *Fit for Growth** initiative that balances prudent cost-cutting in non-vital and non-differentiating areas of the company with investment in distinctive capabilities. By investing in the three to six differentiating capabilities that set it apart from its competition, the bank positions itself to grow. Costs are thus transformed from inescapable burdens to exciting pro-growth choices.

Successful *Fit for Growth* programs roll out in three stages. First, leaders define the bank's strategy and capabilities and articulate how the company will face the market and create value for customers. Next, leaders review the operating model to determine how to transform end-to-end processes and deliver customer value. The goal is a new operating model with greater scalability and less complexity to maximize growth, as well as a master plan to guide the execution. Finally, leaders implement policies that accentuate appropriate behavior and foster sustainable transformation. Thus, the *Fit for Growth* exercise is not a one-time event, but a way to stay fit by cutting costs and deploying resources to maximum effect year after year.

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Adapting to the new reality

There's been no respite for banks since the financial crisis hit in 2008. After nearly five years, the industry still faces a ghastly macroeconomic climate, a low- to no-interest environment, a disillusioned and increasingly disloyal customer base, new capital adequacy and regulatory requirements, and limited funds to launch multiyear change programs. In this tough operating environment, revenue and profit growth are extremely hard to come by.

The extended pressure on profitability has prompted many banks to pare their cost bases. Mainly they've used classic cost reduction levers such as shedding workforces, thinning out layers, offshoring and outsourcing, and attacking controllable spend. Unfortunately, adverse market developments have often offset the results of these initiatives. Few banks have actually realized step-change improvements. As a result, return on equity (ROE) in the industry continues its downward trend (*see Exhibit 1, next page*).

To return to a profitable growth trajectory, banks need a different approach. They need to transform how they operate in a way that cuts costs while also creating the capacity to expand their business and attract new customers. Unbeknownst to many companies, the way they manage costs and deploy their most strategic resources often prevents the expansion they need. But banks that do cut costs thoughtfully and deploy their resources strategically will prepare themselves for the next round of expansion. At Strategy&, we call this approach *Fit for Growth*.*

An effective methodology for cutting costs and growing stronger contains several mutually reinforcing components. Most companies start by articulating a clear and compelling cost agenda from the front line to the back office. Their effort continues with the building of lean and resilient processes, systems, operations, and organizational structures, and culminates in the institutionalization of capabilities that

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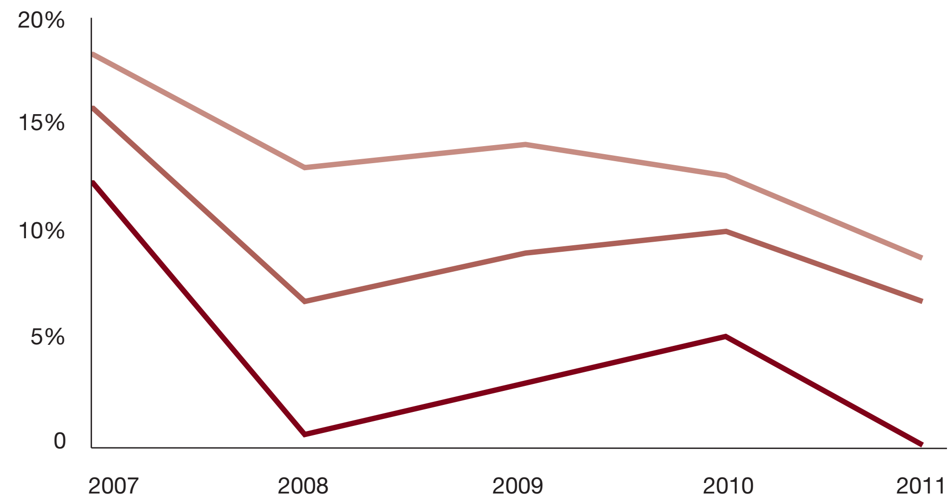
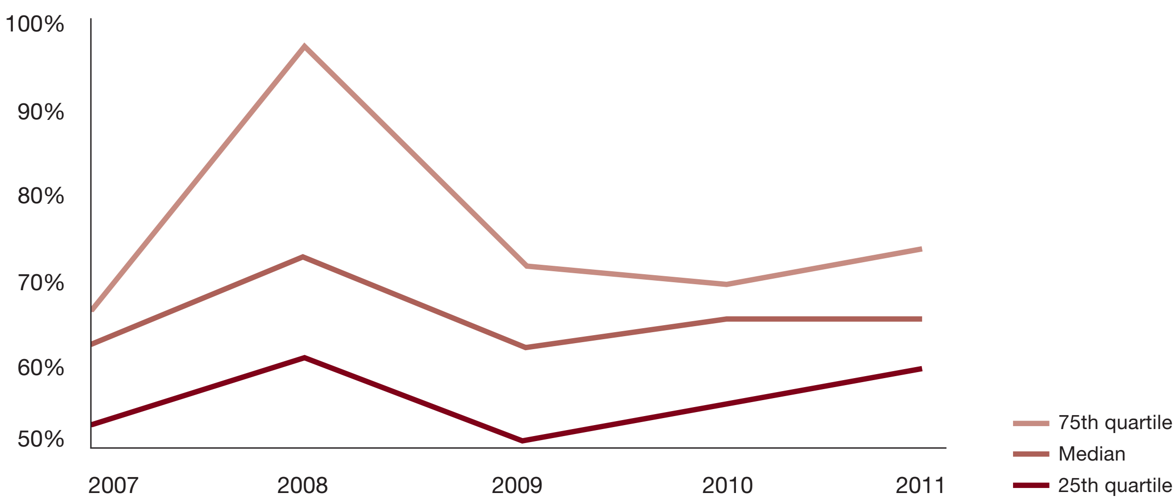
Exhibit 1
Change in key measures for top European banks,[1] 2007–11

Return on equity (%)



Cost income ratio (%)



[1] Top 20 European banks (excluding Groupe BPCE and ING), all with assets between €500 billion and €2,200 billion.

Source: Bloomberg; Strategy& analysis

keep resources flowing away from “bad” costs to “good” costs. In other words, you need clear priorities, focused on strategic growth that drives investments. Your costs need to line up with those priorities so that you can deploy resources toward these priorities efficiently and effectively. And you need to make it sustainable by changing the operating model.

Many banks still have not made the hard choices necessary to channel investments to the capabilities that are needed most while deemphasizing or eliminating their other expenses. Based on our transformation experience with numerous financial institutions, we have found that a successful *Fit for Growth* program starts at the very top of the organization and occurs in three stages:

- *Define the strategy and capabilities:* Leaders must make strategic choices so that costs flow from “bad” to “good”; they must define the bank’s singular value proposition (its “way to play” — the way the bank chooses to face the market and create value for customers). They must then articulate the bank’s differentiating capabilities: the handful of things that it can do better than competitors, that make it distinctive, and that allow it to deliver the way to play effectively.

- *Build a culture of continuous improvement:* Cut costs and grow stronger — through incremental operational changes, and by institutionalizing new behaviors. These changes must be executed rigorously and relentlessly throughout the entire bank with a well-defined master plan as a guide.

- *Evolve your organizational design:* Review your organizational structure and operating model to determine how to transform end-to-end processes and deliver customer value. The structure needs scalability and less complexity to maximize growth potential and agility.

Define the capabilities system

The first step in a *Fit for Growth* agenda is for leaders to make strategic choices that clearly articulate what the bank does, where it does it, and how it does it.

In other words, what is the bank's way to play in the marketplace? This is chosen, at least in part, to take advantage of your strengths: the three to six differentiating capabilities that work together as a system, setting your company apart from rivals, and giving it the "right to win." At Strategy&, we define the right to win as the ability to engage in any competitive market with a better than even chance of success — not just in the short term, but consistently. You earn the right to win by making a series of pragmatic choices that align your most distinctive capabilities with the way you approach your chosen customers, and with the discipline to offer only products and services that fit.

When you focus on differentiating capabilities, costs are no longer problems. They are choices.

For example, Capital One's ability to explore "big data," Goldman Sachs's approach to "real-time risk management," Credit Suisse's "one bank proposition," Deutsche Bank's "transaction banking franchise," and Santander's "industrial processing model" are well-known examples of distinctive capabilities that few, if any, of those companies' competitors can match. These capabilities don't necessarily stand alone; they are stronger when they are part of a mutually reinforcing system that works to give the bank its advantage.

These kinds of distinctive capabilities are inherently cross-functional, combining multiple skills and processes from different parts of the organization in a way that is greater than the sum of the parts. Building a system of interrelated and mutually reinforcing capabilities thus involves a great deal of operational coordination and commitment. It also requires significant ongoing investment.

But when you focus on differentiating capabilities, costs are no longer problems. They are choices. Banks that are ahead on the *Fit for Growth* curve have resisted the historical tendency to cut costs linearly or isolated in silos. The leaders of these financial institutions understand which processes, tools, skills, knowledge, and people are important for competitive advantage. They are prepared to spend heavily on those capabilities, even in strenuous times, and focus their cost reduction efforts on the ones that are not essential or that no customer would pay for.

This point about targeted cost reductions is critical. A *Fit for Growth* bank program does not downplay cost savings. In fact, most *Fit for Growth* programs yield savings in the range of 25 to 30 percent. But a significant part of that savings is redirected toward the critical capabilities that ultimately drive revenue gains.

For example, a wholesale banking firm recently determined that it could vastly increase revenue by investing to improve the turnaround time for loans. This outweighed the savings from possible cost cuts in credit risk management by three to one. In another case, a *Fit for Growth* program led a large Swiss wealth management firm to refocus its back office operations on improving its ability to provide "critical moments of truth" — those points in time where an individual experiences delight with a company's customer experience, feels a connection to that company as a result, and makes a decision to patronize its products or services. This Swiss firm made a relatively modest investment in IT along these lines; customer satisfaction surged and revenue climbed approximately 10 percent in less than 12 months.

Build a culture of continuous improvement

The one-time benefits from a *Fit for Growth* program are significant, but banks should not stop there; the strategy continues to deliver benefits over time. By institutionalizing a continuous improvement process that affects all aspects of the organization, a financial institution can see annual productivity improvements of 3 to 4 percent. To achieve these improvements and create a long-term competitive advantage in the marketplace, banks need to follow up the initial transformation with policies and actions that make the changes stick. This requires addressing "hard" operational and process issues alongside the "soft" cultural issues that often undermine transformational change.

Time and time again, we've seen the initial euphoria of a transformation vanish as people lose focus and slip back to old work styles. Successful *Fit for Growth* programs focus on these soft factors and create changes in behavior. This does not mean completely altering the culture; that's generally not possible. But a bank can build cultural momentum for change by accentuating the positive: looking for and reinforcing behaviors that can lead to higher productivity and engagement. As a first step, leaders need to speak very clearly about the few behaviors that everyone needs to display — and set an example themselves.

For instance, one large corporate bank undertaking a *Fit for Growth* initiative defined three critical behaviors to encourage: customer focus, leading by example, and pride. The same bank also established a hard measurement system to track progress over time. According to the bank's CEO, the mix of hard and soft factors "was the single most important piece of the bank's *Fit for Growth* journey." The most effective hard factors typically include ways to track bottom-line benefits such as cost reductions and time-to-market for new products and services. To sustain the gains, banks need to institutionalize cycles of continuous improvement and ensure that metrics are in place to allow executives and frontline staff to track the delivery and longevity of improvements.

Reorganize your operating model for growth

Based on the chosen way to play, a bank needs to align its organization's structure and operating model to best deliver its distinct capabilities. Where is the operating model not aligned with the strategic choices made by management? Which functions are not critical for the chosen way to play? The outcome of this phase is an operating model blueprint that describes in detail how those strategic choices — what the bank does, where it does it, and how it does it — should be executed. We use a three-tier framework to evaluate and design the operating model (*see Exhibit 2, next page*).

In our operating model design work, we use a set of standard design principles that include the following:

- *Streamlining:* Simplify and standardize business practices within chosen products/services

- *Risk reduction:* Improve risk controls and strategic responses to regulatory changes

- *Operational alignment:* Establish the right mix of global and local operations for each product

- *Geographic footprint:* Be in the right places for the right reasons with the right number of people

- *Talent portfolio:* Concentrate specialized skills in the correct areas

- *Platforms:* Enable the strategic platforms needed to support the firm's products and services

For example, a large global custody bank developed an operating model blueprint based on two differentiating capabilities: distinctive global processes that allowed it to offer sophisticated services, and cost leadership that allowed it to compete on lower fees. As part of the development process, executives answered a series of questions:

Exhibit 2
Fit for Growth operating model

What do we do?	Products & services portfolio
	Capabilities system
Where do we do it?	Footprint
	Organizational design
How (and how well) do we do it?	Functional model
	System landscape
	Behaviors & mind-set
	Talent management
	Key performance indicators & performance management
	Governance

Source: Strategy&

- What is the best way to provide a globally consistent customer experience?
- How can the bank bundle fragmented processing steps into globally consistent operating model components (otherwise known as centers of excellence)?
- What steps need to be kept local (and thus close to the customers)?
- What steps can be consolidated regionally, offshored to low-cost locations, or even outsourced?
- What technology infrastructure and governance structures are needed for each component of the operating model?

After defining the operating model blueprint, banks need to execute the plan: reengineer, reorganize, automate, and resource each "business component" within the boundaries and targets set by the operating model blueprint (*see "Eight Steps in a* Fit for Growth *Transformation," next page*).

In our experience, there are three ways to bring a blueprint to life:

- *Horizontally:* Implementation occurs end-to-end along value chains, "from the customer to the customer," and across multiple functions. For example, an end-to-end mortgage process might stretch across distribution (branch), credit risk management, and operational functions.
- *Vertically:* Implementation occurs for a clearly scoped function or organizational entity (such as securities operations).
- *Laterally:* Implementation occurs in "business cells" that are loosely connected. For each capability, links are established among the functions that are critical to delivering it.

All three routes have their merits. No matter which one is chosen, success depends on having a clear "end state" in mind for the bank to focus the execution. Success also depends on leveraging execution momentum and accelerating the pace of implementation whenever possible. For example, one global bank began implementing its new operating model blueprint at its offshore locations in Poland and India. But when the benefits became quickly and dramatically apparent — with a 35 percent capacity gain and significant improvements on quality and risk indicators — the bank immediately brought the program to a global scale.

Success depends on leveraging execution momentum and accelerating the pace of implementation whenever possible.

Eight steps in a Fit for Growth *transformation*

- *Set a strategic direction:* Top management must identify differentiating capabilities and articulate the right to win. This creates a guide for the operating model design (such as the bank's risk appetite and the customer experience the bank wants to create).

- *Create an operating model blueprint:* The organization needs to develop a clear set of best practices for operational effectiveness. The goal should be quantum leaps, not just incremental improvements — for example, putting in place a full-fledged straight-through processing (STP) system at once, taking advantage of real-time transaction technology, rather than moving toward such a system step by step. In designing the blueprint, leaders must make tough decisions about the operating model (for example, reducing organizational complexity, removing excessive management layers, and deciding whether to "make or buy" services — whether to keep them in-house or outsource them).

- *Develop a master plan:* Operating model components should be prioritized logically and organized into a coordinated rollout for bank-wide transformation, with a focus on front-, middle-, and back-office processes.

- *Maintain a customer-focused perspective:* Process reengineering requires an awareness and tracking of customer satisfaction; conducted properly, process reengineering includes input from business partners and uses data to uncover root causes of process failures, so solutions are based on facts rather than opinions.

- *Focus on a few critical behaviors:* Discourage resistance to change by looking for the positive movement that already exists in your culture. Identify aspects of behavior that represent the desired direction and that people already practice on their own. Find ways to recognize and reward them. Establish metrics to measure progress toward bringing them to scale.

- *Transfer capabilities:* Put high-caliber leaders in charge to drive change, so that capabilities are transferred to all levels of the organization from management to frontline staff.

- *Install mechanisms for continuous improvement:* Frontline personnel need key performance indicators that they understand and for which they can be accountable. Senior managers need to engage frontline staff and communicate clearly about whether or not employees are meeting expectations. Design performance management systems to promote continuous improvement.

- *Promote change that's "here to stay":* Leaders need to be publicly committed to both the initial transformation and sustainable change; they should use their clout and communications to generate momentum, identify and achieve "quick wins," and make sure savings are tracked and publicized.

Staying fit

As anyone who has lost weight and kept it off can tell you, the secret to fitness is never to return to old habits and instead to pursue an ethic of continuous improvement. Likewise, companies that follow a *Fit for Growth* initiative commit to adopting a lean mind-set. They are always honing their capabilities and cost structure so they can avoid large cost-cutting programs every several years. They also reorient themselves for growth, building muscle if you will, and adjusting the deployment of resources year after year. Most important, they do all this with a watchful eye on their unique value proposition and the distinctive capabilities that will allow them to grow.

Becoming fit and staying fit is no easy task. But the benefits for banks include a true competitive edge: improved customer experience and loyalty, a strong grip on operational risks, a significantly lower cost base, and a highly motivated and engaged workforce. With these elements in place, a virtuous circle of improvement can begin. As resources move from nonessential to critical capabilities, your bank can channel more capital into growth strategies. The cost side of your ledger will read less like a list of inescapable burdens and more like a register of exciting pro-growth choices, with a direct link between the money you spend and your prowess in the marketplace.

Resources

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