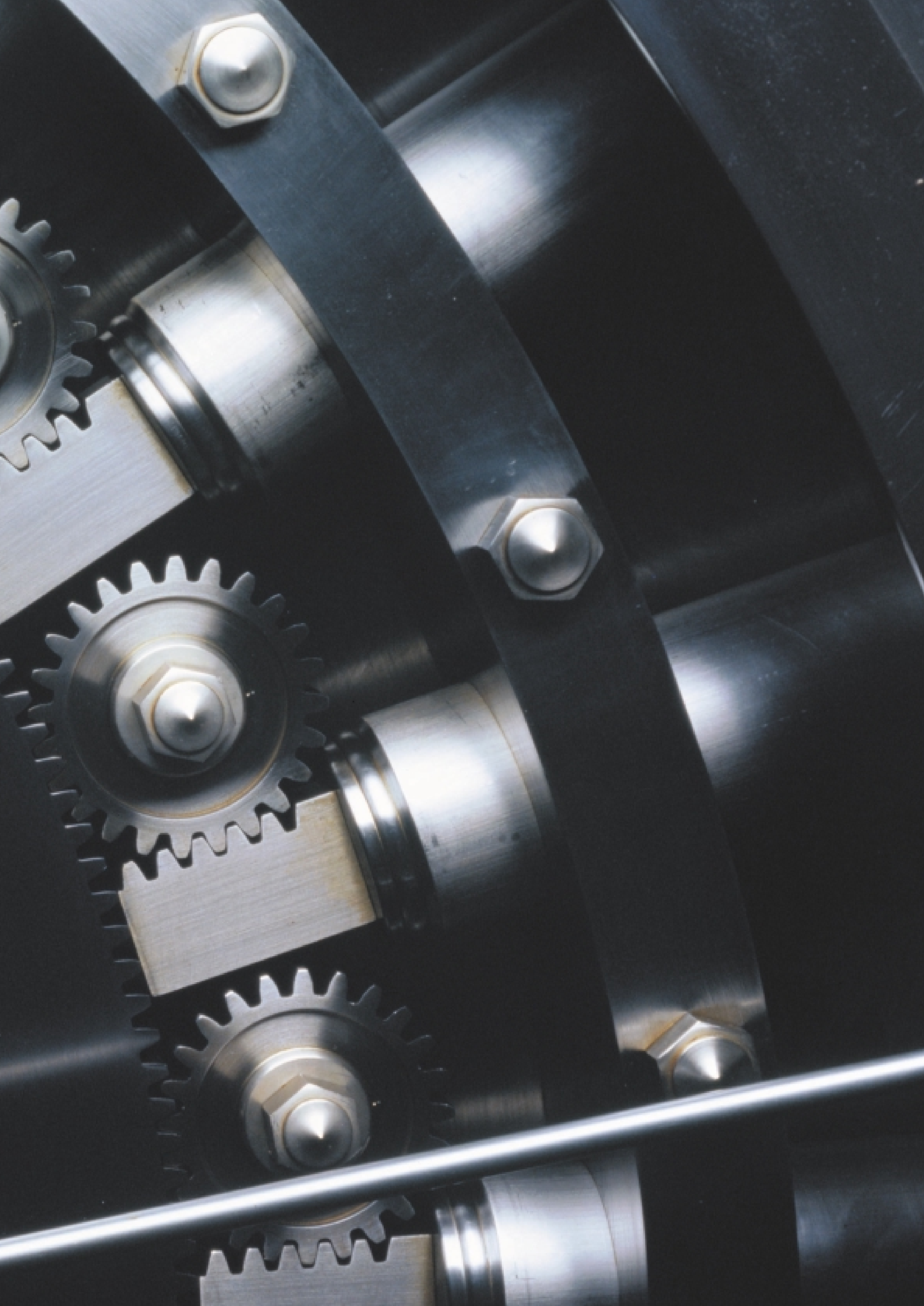
Industry Report | Banking

The right combination

By Norbert Linn and Trevor J. Gruzin

The 1990s redefined the environment for global banking. The survivors of the successive crises that battered the decade have emerged leaner, smarter and far better equipped to take advantage of the next wave of restructuring. But only a handful meet our strict standards for high performance.



The ability to combine the components of high performance in the right proportions and transform them into a winning strategy predisposes some banks to success as creators of value, setting these institutions apart from the mass of their competitors. But what actually distinguishes the favored few?

The essence of high-performance business is, of course, value creation, which boosts total return to shareholders and is thus the top goal of any public company. Value creation is also at the heart of Accenture's methodology for determining which companies in any industry are high performers (see "Measuring high performance," *Outlook*, February 2004). This article—part of a comprehensive research program at Accenture to explore, document and define the characteristics of high-performance business—focuses on the banking industry.

In banking, Accenture defines a high performer as a company that has delivered outstanding total shareholder return—stock market performance and dividends—over a seven-year period ("About the research," opposite page). Our methodology had to account for country and regional differences. To take one example, Canadian banks performed well in part because that country's economy was healthier than the economies of many other countries. But while we did classify all Canadian banks as high performers, we picked only one for in-depth analysis.

But if it is important to recognize that high performance should always be viewed from an individual market perspective, our research also reveals that there are five key characteristics and capabilities all high-performance banks do share.

A distinctive strategy

High-performance banks choose a differentiating strategy, adjust their business models accordingly and excel at building the competencies that will realize that strategy. This, of course, is usually easier said than done, because to deliver a differentiated value proposition to their clients, banks need to exit some lines of business as well as change the way they do others. And banks often find it difficult to make these kinds of tough choices.

Sticking to a differentiated strategy through thick and thin is not just about making a few key decisions. It means getting everyone in management and on the staff to understand exactly what's needed to drive the strategy forward, and then applying this understanding, consistently, to every day-to-day decision—even if that means abandoning markets. By picking a distinctive strategy and sticking to it, resisting the temptation to switch when others do so, high performers position themselves in good times to ride out the bad—and even to take advantage of them. The right positioning over two years can ensure success over 10. And this sort of consistency wins brand loyalty from both customers and employees.

Strong leadership

Such strategic resolution requires remarkable leaders. High-performance banks have unusually persuasive bosses who enjoy an implicit contract with their workforce and oversee a strong team culture. Employees are proud to work for these leaders because they are fair, though demanding, providing guidance, managing career expectations and thus

About the research

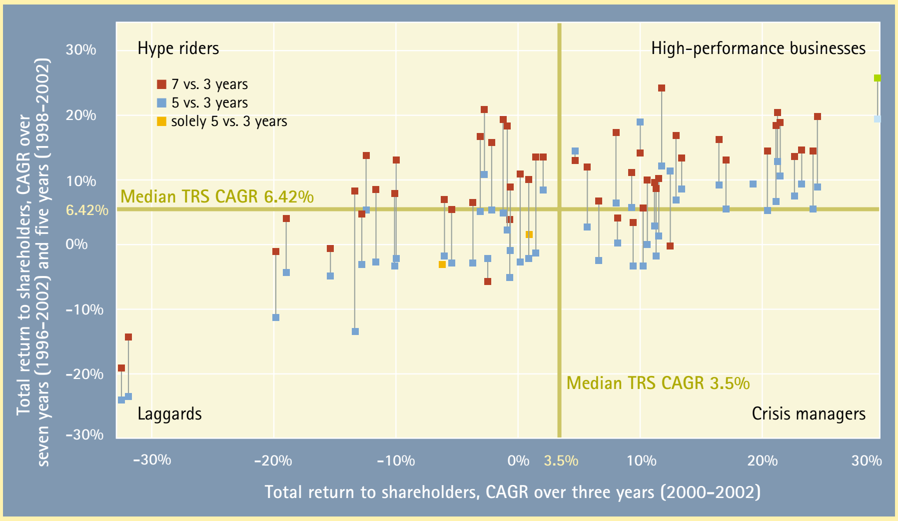
Accenture defines high performance in banking from a purely capital markets perspective—that is, on the basis of stock market performance and return to shareholders.

We undertook a "watershed" analysis, designed to help us understand the financial services industry cycle and to determine if seven years really does define a complete cycle. It does. Moreover, the years we examined, 1996 to 2002, were marked by three distinct watershed events—the emerging markets crisis of 1998; the stock market boom and subsequent bust; and the recession of 2001–02—each of which plainly had a huge impact on the financial services sector.

Our peer group of 77 institutions (64 banks and 13 capital market firms) accounted for more than 70 percent of global banking market capitalization. To identify the high performers and select a small group of them that we could then effectively analyze in depth, we employed a careful mix of art and science.

Total return-to-shareholder performance of listed banks

Quadrants are determined by medians

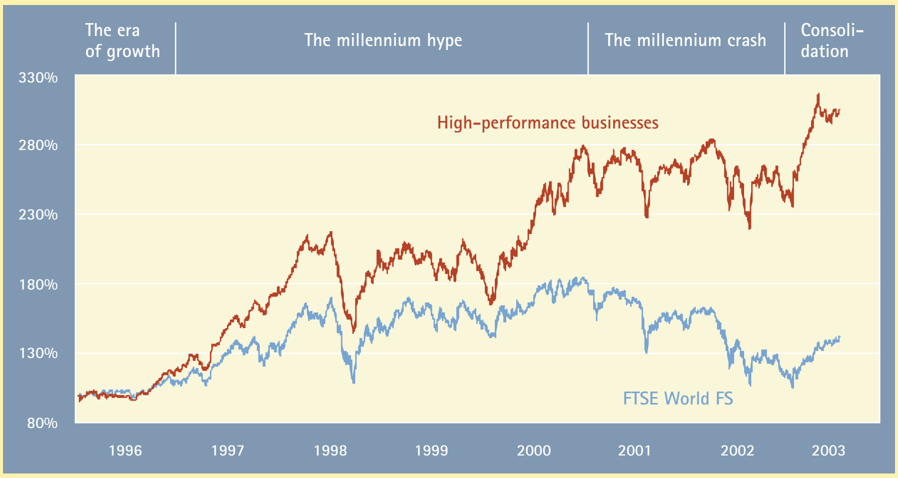


Top 64 banks taken into consideration (accounting for more than 80% of total global banking market capitalization)

SOURCE: BLOOMBERG, ACCENTURE ANALYSIS

Share-price development

Normalized January 1996 = 100%



SOURCE: BLOOMBERG, FACTSET, ACCENTURE ANALYSIS

We first calculated the total return to shareholders over three, five and seven years for each bank, then calculated the compound annual growth rate of the total return to shareholders for each bank over the same time periods. The median performance over three years—3.5 percent—is indicated on the *x* axis of the graph at left. The average of the medians over five and seven years—6.42 percent—is indicated on the *y* axis. Using these two data points, we plotted four quadrants. Banks that performed above both the three-year median and the average of the five- and seven-year medians fall in the upper-right-hand quadrant—22 banks and 2 capital market firms that constituted our initial group of high-performance businesses.

We quickly realized, however, that this group—which included, for example, all four Canadian banks—threatened to skew a sample that was meant to be as global as possible. So we screened the candidates again, this time on the basis of market value added, to account for the effects of M&A activities and other factors that would have an impact on our results. We also screened the group to take geographic coverage and business model variety into account.

The upshot: six banks (and two capital market firms) that met our definition of high-performance banking, sometimes outperforming the FTSE World FS index by a factor of 200 percent during a seven-year period.

keeping their teams together in bad times as well as good.

There is, of course, no one-size-fits-all culture that is appropriate for all banks, and each institution has, appropriately, its own distinct personality. But the leader of a high-performance bank nonetheless fosters a culture that encourages the right combination of collaboration and competition at all levels of the bank. These leaders also tend to handle succession issues more competently than their competitors.

The ability to create value from M&A

High performers don't make acquisitions just because they want to be big. M&A strategies at high-performing banks are carefully targeted to create value from every transaction. These banks buy for clear and specific reasons. They decide just how to integrate their acquisitions, and if post-merger tools and arrangements like shared services or distribution agreements are more likely to create value than strict integration programs, they'll choose them.

Flexibility in managing across the boom-bust cycle

Successful banks are distinguished by the ability to manage better than their competitors right *across* boom-and-bust cycles, not just within them. In boom times, high performers often grow at the same rate as their competitors. But because they are more disciplined

Royal Bank of Scotland: A hybrid with an appetite for risk

The Royal Bank of Scotland has focused on core markets in the United Kingdom, the rest of Europe and the United States, implementing an innovative strategy that combines the roles of both manufacturer and distributor of financial products designed to deliver flexibility in response to competitive threats. Its organizational structure promotes competition between the distribution businesses, each of which is expected to achieve performance benchmarks.

The bank maintains 22 separate brands, each targeting specific market segments, among them Direct Line insurance, Coutts & Company private banking and Virgin One, the United Kingdom's first offset mortgage product. Despite this brand proliferation, a consolidated product and IT platform makes meeting the promises of each brand relatively simple.

In the three years or so since the joint manufacturer/distributor model was formally established, the bank has realized some important competitive advantages. In the back office, the model creates centers of excellence, where employees with the appropriate expertise deliver consistent levels of service right across the group. Front-office staff members, meanwhile, are free to focus on more customer-facing activities.

Cost savings have been notable. Manufacturing reduced its overall costs by 6 percent between 2000 and 2001; within this amount, IT-related costs fell 13 percent. The bank's leadership pursues a ruthless drive for back-office efficiency, although it resists cost cutting in customer-facing functions: Customers can still dial their branch direct.

Synergies from the 2000 acquisition of NatWest Group have exceeded expectations. The bank's successful distribution strategy delivered organic revenue growth of 15 percent in 2002, a relatively weak year; a strong risk management capability helped it avoid significant credit problems in the subsequent downturn.

A robust business lending division delivers a superior trade-off between net interest income and loan-loss value levers. Innovative new businesses like Direct Line, which was the first UK insurer to use a direct-sales model to offer car and later other life and non-life insurance at huge discounts, deliver excellent non-interest income.

(by, for example, managing costs better) and focused on what they do best (by, for example, outsourcing more secondary functions), they pull ahead of the pack in terms of margins. As a result, come a recession, they have a greater capacity to manage their margins.

Given their distinctive strategy, their top line remains healthy as well. More important, when the recession is over, they have retained sufficient qualified and motivated personnel to take swift advantage of the upswing.

Mastery of value levers

High-performing banks know just which value levers to pull to optimize their financial performance. This relates to the execution of their distinct, differentiating strategies: They are focused on the precise metrics they need to hit to compete successfully rather than on hitting numbers or metrics that may or may not take them forward.

The right blend of these five characteristics of high performance is crucial. For example, a microscopic understanding of which value levers determine return on equity won't amount to much unless it's combined with the sort of leadership that challenges mainstream thinking. Sticking to a distinctive strategy through ups and downs is little more than plain stubbornness if it isn't tempered by the flexibility to make the changes necessary to continue to create value. Moreover, high performers don't necessarily excel at these attributes in equal measure. They combine their capabilities in different ways.

High performers in this sector choose a distinctive strategy and adjust their business models accordingly. Banks fall into three distinct groups—universal banking full-service providers, middle-market hybrids and niche specialists—each of which has an ideal business model (see case studies, below and opposite below). Interestingly, high-performance banks' business models are, in fact, very close to the ideal business model for their chosen strategy. Business models can be described using combinations of capabilities that fall into four categories.

Wells Fargo: A distribution specialist

Wells Fargo's strategy is differentiated by its focus on distribution. The bank, a diversified, super-regional US financial services company that competes in virtually every segment of the industry, seeks to deliver superior services to develop trust-based customer relationships. It treats service as a product and focuses on trying to grow the number of products per customer. The simplicity of the strategy, which leverages the company's roots in the stagecoach era by espousing modern values of safety, security and dependability, is clearly understood by all employees.

It is also clearly articulated externally: Wells's annual report devotes its first 20 pages to case studies of its best customers.

The bank's leadership rewards self-motivation, teamwork and superior execution. There's a strong emphasis on human capital development, and the bank's culture emphasizes both collaboration and decision-making autonomy, particularly for customer-facing staff.

Because the bank tends to buy at the bottom of business cycles, it has acquired more than 18 small insurance brokers and asset management firms to expand its presence in a weak wealth management market. Managers, moreover, must deliver growth regardless of market conditions, by increasing market share and cross-selling. The bank stays flexible across cycles, continuing to lay the foundations for long-term growth. Before aggressively pursuing the home equity business, for example, Wells assessed the market, brought in new management, built an infrastructure and installed supporting technology.

The bank focuses on superior trade-offs between net interest income and loan-loss levers, as well as on strong non-interest income (via its distribution capability). It has also developed strong risk pricing capability in consumer finance and business lending.

Top banks understand the links between operational performance and financial performance better than their competitors.

- They have leadership with the *vision* to identify and execute value-creating opportunities and the ability to communicate this vision to shareholders, customers and employees.

- They possess the means to develop appropriate *products*, flexibly priced and distributed through a multichannel structure.

- Their brand management expertise incorporates state-of-the-art segmentation skills and the ability to excite the *customer*.

- Their *business systems* encompass expertise in network and alliance formation, and they are highly skilled managers of technology and operations.

Comparing a bank's actual performance in the four areas with what it should be according to that bank's ideal business model helps us separate the high performers from the also-rans.

Value levers

Having decided just what their business strategy is, having adjusted their business model to their strategy and having set about building the competencies to realize it, high-performance banks are also unusually well equipped to make the choices—pull the value levers—that will optimize their financial performance.

They understand the links between operational performance and financial performance better than their competitors. They are also exceptionally good at managing the interdependencies between the two sets of value levers.

High performers know that operational value levers like customer focus, exposure to credit risk and market share not only directly affect their strategic agenda; they are also intimately linked to financial value levers like operating margin, loan-loss ratios and cost of assets. More important, they know just *how* they are linked.

A high-risk, high-margin business strategy, for instance, implies a high loan-loss ratio. As long as that is offset by higher net interest income, there's no problem. If, however, the risk management system is in poor shape, the credit portfolio will suffer. High-performing banks in such a position know that risks must be carefully managed if they want to reap the rewards of high margins. And they appreciate that although good risk management systems are expensive, they're a lot less costly than the kinds of mistakes that can happen without them.

High-performance banking requires a subtle blend of many skills. A winning strategy, a mastery of business capabilities, a precise understanding of value levers, the courage and confidence to challenge mainstream thinking, and the ability to change are all necessary attributes.

Few, if any, high performers in banking possess each of these skills in equal measure, of course. Yet they do all have one thing in common: They are masters of execution.

This involves, first, mastering complexity: identifying the few, vital changes that need to be made to achieve high performance. Second, high performers execute these changes—which often involve new capabilities—in short, sharp bursts rather than by placing all-or-nothing bets on multiyear programs. They do this while refreshing their strategic infrastructure: Simply put, they build for the short and the long term, an approach Accenture calls a "marathon of sprints." Finally, they are persistent and focused: They knuckle down to the job of making the necessary changes, avoiding the temptation to dabble in each fad that comes along.

This insight, which is based largely on practical experience, combined with a strong bias toward action, which is expressed as the will to win, is the essence of high performance. ■

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