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THE SEVEN RULES OF COST EXCELLENCE IN BANKING

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Over the past decade, banks in developed markets have been struggling to cut their operating costs but with little success.

Digital technologies and other advances, such as artificial intelligence (AI) and robotics, promise to change this—radically. They can improve efficiency not merely by 5% here or 10% there; they can make processes a thousand times faster and reduce marginal transaction costs to zero. They also have the potential to strip most of the labor cost out of banking while improving customer service.

These advances are an opportunity for incumbent banks, but they are also an existential threat. By not adopting them quickly to effectively cut costs and improve the customer experience, incumbents may cede ground to competitors—many of which will be fintechs—and go the way of bookstores.

Making the most of new technologies may seem to be a technical challenge for the IT departments that specialize in them. And, in part, it is. But it is also a managerial challenge. Fortunately, institutions can rely on a set of general principles for running cost reduction programs and sustaining their gains. Success requires following the seven rules of the cost excellence framework.

The Cost Imperative

Return on equity (ROE) in the banking sector has remained subdued since the global financial crisis, averaging 5% in Europe in 2016 and 9% in the US—several percentage points below the average cost of equity.

It will be difficult to increase ROE by growing revenue, though. Margins have been narrowing as a result of persistently low interest rates. Fee income is being constrained by tighter consumer protection regulations and by increased competition from new market entrants—often fintech players with low-cost digital offerings in market niches, such as payments. And investing in new lines of business isn't attractive in the current environment of ever-tightening banking regulation in Europe and heightened political uncertainty around the world.

Given the constraints on revenue growth, banks must seek to cut costs—and they have been trying to do so. But most programs conducted over the past decade, while picking some low-hanging fruit, have failed to change processes in ways that not only achieve lasting cost reductions but also improve the quality of the customer experience.

Digital technologies provide banks with an opportunity to break this deadlock. Customers have been quick to shift from branch and telephone transactions to digital channels on which the marginal cost of many transactions is zero. And new advances, such as AI and robotics, allow banks to automate processes that are expensive to conduct manually, such as assessing credit, detecting fraud, opening accounts, and advising on investments. In short, adopting new technologies allows banks to overcome the tradeoff between providing good service and minimizing operating costs.

Doing so is not only an opportunity but an imperative. In addition to low-cost fintech players, digital giants, such as Amazon and Apple, are entering the market. So far, these companies have focused mainly on the payments business and credit niches, such as peer-to-peer lending and merchant financing. But they are beginning to expand into other lines of business. Incumbent banks burdened with predigital cost structures will be systematically undercut on price and outperformed on service—and thus unable to compete. Whether or not to adopt new technologies is no longer a question for debate. It is a question of do or die.

Achieving Sustained Cost Reduction

Alas, when it comes to achieving sustained cost reduction, dying is easier than doing. The task is inherently complex. New technologies must be integrated with legacy technologies. Old processes must sometimes be maintained even after new ones have been developed. And employees must be convinced to learn how to use new technologies that improve performance but may ultimately eliminate their jobs. Reports, meetings, control functions, management layers, and operating models often multiply as a bank tries to cope with complexity, undermining attempts to achieve large and sustained cost reductions.

To help financial institutions pursue cost cutting without being derailed by complexity, we have applied BCG's complexity-management framework, Smart Simplicity, to cost management. The result is a cost excellence framework that can be summed up by the following seven rules.

Set bold targets. Challenging goals make staff think beyond existing parameters; digital processes enable entirely new levels of efficiency. Goals, therefore, should deal in "digital absolutes": for example, zero defects, a 100% completion rate, and zero reworks. When such goals have been validated by research and set, a central control function can work with senior managers to select KPIs. The compensation of business unit managers should then be linked to meeting KPI targets.

Of course, most end-to-end processes cut across business units. So targets must be set not only for organizational entities but also for entire process chains. This means that individuals' performance will be measured and rewarded by outcomes they can influence only through collaboration with others.

Tailor data and analysis to each business. Different lines of business have different efficiency drivers. The data and analysis that inform process redesign must be tailored to each business unit. For example, the cycle time of a secured loan is an important efficiency measure in credit businesses but not in payments businesses. Taking a tailored approach will allow opportunities that offer the highest value to be identified quickly and prioritized. This requires the cost reduction team to include people with a solid understanding of the economics of each business line.

Ensure budget accountability. Budget management can impede cost reduction. For example, setting a unit's budget on the basis of the previous year's spending encourages managers to spend money they could have saved, especially as the year-end approaches. This practice is known as "saving next year's budget."

A rigorous and transparent process should set an annual budget and then break it down across the organization. Budget responsibility should be clearly assigned to a decision-making body or individual at each level, and an escalation process for dealing with changes throughout the year should be well defined.

Target costs at their source. Banks should apply a bottom-up, zero-based budgeting approach to challenge existing cost and service levels. Then they should design a new cost structure that considers the efficiency drivers for each business line as well as the interfaces with customers, suppliers, and regulators. Banks should determine, for example, where costs are added because operations are not yet fully digitized and how those costs can be eliminated through further digitization.

When examining costs that arise from interactions with customers and suppliers, banks should look beyond their boundaries. Helping customers or suppliers digitize their processes may be an effective way of cutting their costs as well as the bank's. And helping them make these gains will build lasting goodwill toward the bank.

Get quick wins. Quick wins are critical for building momentum and excitement in an organization. The largest opportunities should be prioritized, of course. But some that are easy to achieve should also be put at the top of the list. Quick wins help convince staff that change is possible, and they can generate early savings that fund subsequent work.

Manage the interdependencies. Functions or processes that are carried out in one part of a bank often affect other parts. These interdependencies must be accounted for in any cost reduction plan. For example, eliminating the production of a report might save time and money for the department that produces it. But if the report is of value to other departments, then its elimination would result in a net loss. An experimental approach can be helpful in such situations. Discontinue the report and see what breaks; then fix only what is broken. This way, only the necessary portion of the report survives.

Communicate. The goals of the program must be communicated early, openly, and consistently. For example, managers can be tempted to keep employees in the dark about likely job losses or, worse, to mislead them. This is a mistake. When the truth eventually emerges, the loss of morale and resulting disruption will be far greater than if managers had been upfront with employees from the beginning. Uncertainties should be identified openly, along with the actions that are being taken to resolve them.

The ultimate goal is to create an organization that is permanently self-optimizing and therefore cost conscious. This can be achieved only with a culture that encourages open communication and discusses costs regularly. The cost reduction program should aim to create this culture.

Cost Excellence at an Online Bank

Traditional banks are not the only financial institutions that must implement new technologies to reduce costs. To remain competitive, online banks must do the same. Some are beginning to realize this.

Senior management at a profitable European online bank that had attracted more than 5 million customers was concerned about looming challenges: low interest rates, a growing regulatory burden, and new competition from fintechs and digital giants—largely the same issues that concern traditional financial institutions. With low costs and no branches, the bank could price competitively. But customers' expectations for the quality and speed of services were rising. Management wanted to build an operating model that would be not only more cost efficient but also scalable. It wanted to find new ways of using digital technologies and push them to their limit.

The bank set its goals and then applied the second rule of cost excellence, conducting an assessment of each business segment. This included assigning all employee time to process steps to get an accurate picture—without overlaps or omissions—of where labor costs were being incurred. It also meant evaluating the organization structure and the current degree of digitization. By combining this analysis with management interviews, priorities for improvement quickly became evident:

- Expanding online services to reduce the frequency of customers' calls to the bank
- Increasing process automation, especially in the back office, through greater digitization and robotics
- Redesigning the operating model for support functions and reducing the number of employees
- Creating a flexible organization by reducing the number of management layers and increasing spans of control

Implementing these changes alone is expected to reduce the bank's total annual costs by more than 7%. Digitization will contribute the most. The analysis identified more than 50 initiatives that the bank could undertake to automate back-office processes and expand online services. Implementing these initiatives is expected to improve efficiency in the respective units by about 25% and reduce the bank's total costs by 4%. Redesigning the operating model for support functions and reducing the number of employees is expected to cut costs by about 15% (or 3% of the bank's total costs).

Cost reduction is not expected to be the only benefit of the work. The bank's decision-making capabilities should also advance, because making these improvements requires clarifying roles and responsibilities. All in all, the bank will have achieved a lot, but it is eager to do more, and it has a clear path toward further improvements.

The opportunities for radical cost reduction created by digital technologies and other advances, such as AI and robotics, only increase the imperative to realize them. Many banks surely will. However, those that also pursue cost excellence will not only reduce costs but also improve the customer experience and sustain their gains, earning a competitive position in a fast-changing marketplace.

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