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Improving productivity in a disrupted landscape: How to transform Latin American banking

Latin American banks have long sought productivity breakthroughs to meet rising customer expectations and the challenge from new, digital players. COVID-19 is making transformation even more urgent.

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This article was a collaborative effort by Fabio Domenech, Mariano Galmarini, Ignacio Gorupicz, Nicole Grzmot, Angela Samper, and Alejandro Sandoval.

The Latin American banking market is among the fastest growing in the world. However, banks in the region are relatively expensive to run because of factors including structural inflexibility, reliance on physical distribution, and manual processes. Growing customer expectations and pressures from new digital players are therefore intensifying a need to raise productivity levels across the business. The good news, though, is that many of the tools to get there are readily available—provided that leaders are ready to embrace transformation and drive change throughout the organization.

Some institutions are making progress: for example, many banks in Brazil, Colombia, and Panama cut their cost-to-income ratios (CIRs) between 2010 and 2017. But the savings they achieved were largely incremental rather than transformative, averaging between 3 and 7 percent[1] —while banks in Argentina and Chile saw their CIRs rise. Moreover, there is a wide performance disparity within countries, with a difference of up to 40 percentage points in CIR between the best- and worst-performing banks.

Banks can radically improve their CIR metrics by focusing on the areas of expenditure that are most amenable to efficiency measures. These include branch networks and office buildings, indirect costs, and investment in IT and digital channels, which together account for around 85 percent of the total cost base. In addition, there are smaller savings to be made in marketing, employee benefits, administration, and non-branch physical channels.

The keys to transformative change are the combination of digitization, automation, and simplification—and, as the COVID-19 pandemic has led to the acceleration of digital uptake among consumers and businesses, the need for decisive action becomes more urgent by the day. Those that seize the moment can help their customers navigate a tough environment and reduce their operating costs by 20 to 30 percent, thereby protecting margins, reducing CIRs, and potentially increasing profitability.

Strong performance but rising costs

In past years, Latin American banks were able to outgrow their global counterparts, as a result of relatively modest levels of penetration, a young and dynamic population, and accelerating demand for financial services. However, the environment is evolving fast, amid technological, behavioral, and regulatory shifts that mirror global trends.

Digitization is transforming the ways in which people live, work, and communicate. In banking, a new breed of digital attackers is targeting the most lucrative niches in the value chain, and winning market share in some core activities. Non-bank players in fields such as electronic transfers and card processing now account for around a quarter of institutions offering payment services, according to the Bank for International Settlements.

As data proliferate, new entrants are leveraging advanced analytics and artificial intelligence to make their services more personal, efficient, and responsive. Emboldened by digital comparability and ease of switching providers, customers now expect more and at a lower price. Digital platforms are also becoming entry points to entire financial ecosystems, creating an imperative for data sharing and partnerships. In a culture that thrives on innovation, there is ferocious competition for talent. The common effect of all of these trends is to raise costs in areas ranging from capability building to innovation to scaling change.

Three areas of expense matter most

Our research finds that on average, branches, indirect expenses, and digital offerings account for the lion's share of a bank's costs (around 85 percent), while marketing, employee benefits, and administrative services account for 4 percent, and nonbranch physical channels such as call centers account for 3 percent.

[1] Top 10 financial institutions in each country. Source: SNL Financial; Cost-to-income ratio = total operating expenses divided by total income

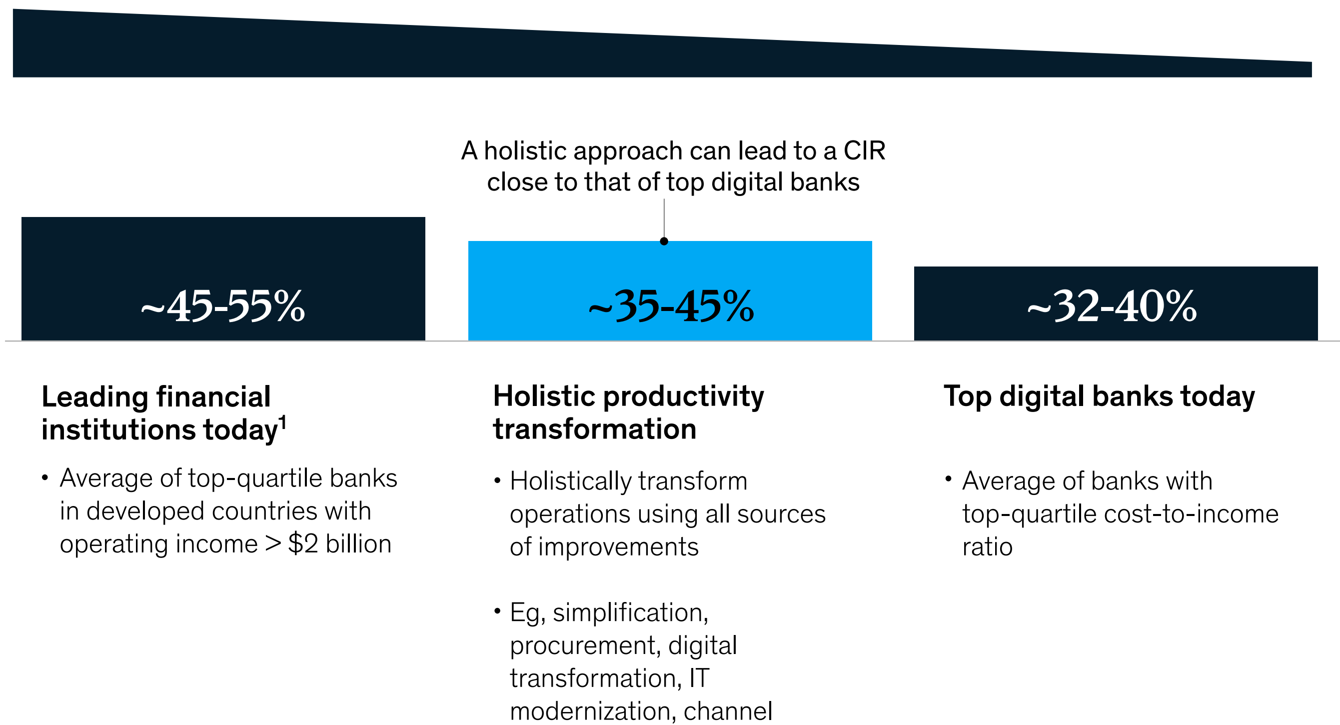
Office buildings and branch networks (including ATMs and cash management) remain the single largest source of pressure on budgets, which account for around a third of costs on average. Branches tend to underperform for reasons either of capacity or effectiveness. Overproduction is common, for example, through generation of longer-than-necessary documents, and process inefficiencies are rife. Often there are mismatches between skills and requirements. Productivity is further undermined by highly manual back-office processes, and factors such as labor scheduling delays. Despite significant reductions in some markets, branch footprints are still extensive, and variable levels of productivity suggests there is work to do in standardizing operating models.

Indirect activities—ones that do not directly support client relationships—account for 29 percent of total expenditure on average. These include back-office and support functions such as finance, HR, and risk. Often these processes are suboptimal, amid a lack of systems to measure to improve performance, structural complexity, and an excess of spans and layers. Roll out of automation tends to be piecemeal rather than holistic.

Not surprisingly, IT and digital require significant investment, and on average currently account for around 22 percent of banks' spending. Banks are investing in new digital channels, data and IT architecture, telecoms, ecosystems, data analytics, and cybersecurity. Moreover, almost

Exhibit 1

Financial institutions can drastically improve cost-to-income ratios by taking a holistic approach.



[1] Banks headquartered in North America and Continental Europe, with operating income > $2B; top quartile measured by cost-to-income ratio.

Source: SNL Financial; Cost-to-income ratio = total operating expenses divided by total income

all departments make unconstrained demands on IT, both for standalone projects and business continuity. An important question for Latin American bank leaders is whether the productivity gains from IT expenses offset their cost on an ongoing basis. For many institutions, the answer too often is no. Many face a deficit, and have not yet found the right balance between investment and risk-adjusted returns on IT.

Lifting productivity to cut costs

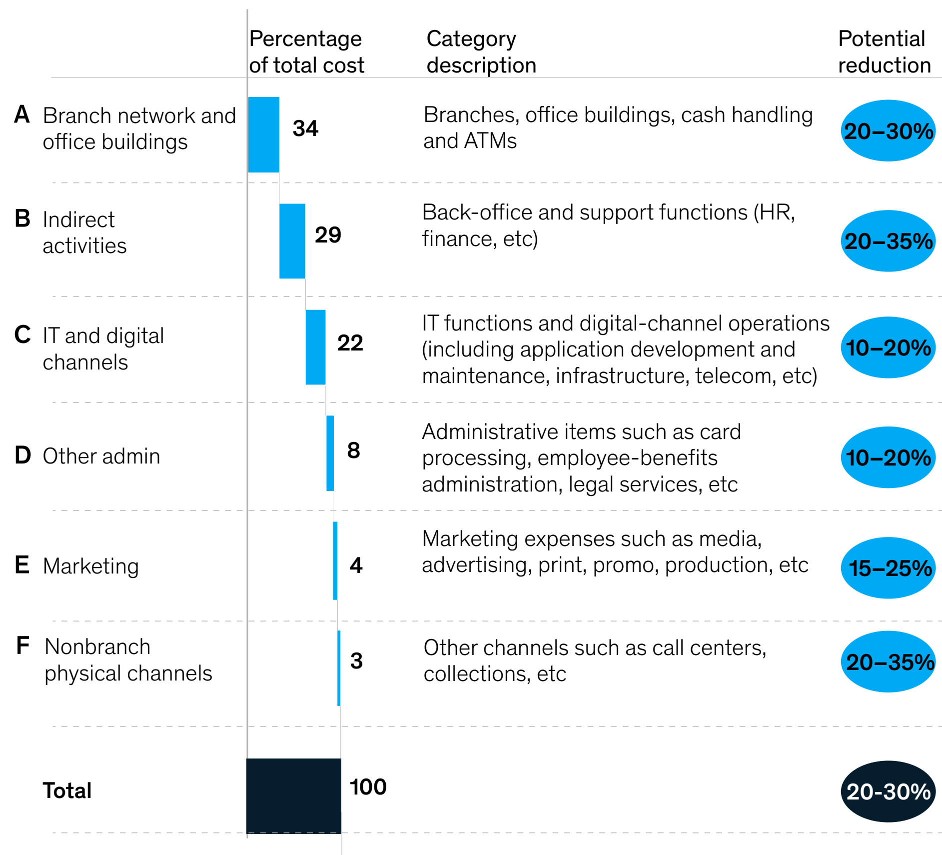
The top quartile of developed-market financial institutions with an operating income of more than $2 billion have an average CIR of 45–55 percent.

The leading digital banks, by contrast, run at a CIR of 32–40 percent (Exhibit 1). We estimate that if leading banks can successfully execute a holistic productivity transformation across their main costs centers, enclosing the customer preferences, they can reduce their costs by 20 to 30 percent (Exhibit 2). Financial institutions can drastically improve CIRs by taking a holistic approach.

In the three critical areas of spending, banks can focus on a range of levers to create significant impact.

Exhibit 2

Comprehensive cost-to-income optimization can generate savings of 20 to 30 percent.



The bank-wide cost cube provides visibility into the bank's full spending, and ensures that no business line or support function is off limits.

[1] Application development and maintenance

Branch networks and office buildings. Our research finds that as a rule of thumb, the top 10 percent of branches in any portfolio perform more than 3.5 times as well as the bottom 10 percent on a market-adjusted basis. Banks can therefore generate significant value by analyzing factors such as transaction volumes, run rates, and customer willingness to travel. Changes may include making digital the number-one channel for sales, while promoting remote advisory, reskilling branch workforces, and implementing innovative approaches, such as rural mini-branches shared with partners, shared ATM networks, and digital service models. As a result, a bank can close some branches and realistically free up 10 percent of capacity in the remaining portfolio.

Branches can be redesigned to enable the salesforce to work more effectively, reducing complexity and non-value-adding client interactions. Quite basic redesigns can nudge customers toward self-service. Staffing levels should be calibrated to account for higher levels of productivity and provision of different services, such as helping novice customers navigate mobile or web banking.

Indirect activities. Banks can look at structural simplification of their back-office and business support functions, reviewing spans and layers and modernizing the operating model. That means redesigning processes end-to-end to take better advantage of options such as business process outsourcing, digitization, and advanced analytics and automation. The requisite foundational elements include new data and application architecture, lean management systems, and a fresh approach to culture, capabilities, and mind-set changes.

By making the redesign process zero-based, change leaders can more easily ignore what is already in place and instead imagine processes that offer the best possible experience given existing barriers and constraints. Some banks have set up centralized design studios to create a start-up environment that leverages shared risk analysis, including know-your-customer and anti-money-laundering processes and hubs.

As for digitization, it pays to adopt a structured approach, starting with strategic first steps and that can be tested and evaluated quickly through the product-development and implementation phases. For many institutions, this will likely mean creating new roles and investing in automation for routine tasks and processes. Where complex data sets are involved, artificial-intelligence solutions such as machine learning may be useful.

Several financial institutions around the world have adopted agile methodologies to help them respond quickly as business requirements or regulatory context evolve. Shared service centers (SSCs) further enhance operational flexibility by bringing transactional and administrative activities under one roof, enabling easier optimization in terms of their technical systems, management systems, and mind-sets and behaviors. Larger SSCs tend to work best, especially if they are highly automated and are tailored to the bank's network model—whether a global factory for relatively uniform services network-wide, or regional factory or hub-and-spoke model designed to accommodate greater variability.

IT and digital. The first step in helping IT become more productive is to break down its spending by "tower"—application development, maintenance, data center, end-user services— and category, including internal, contractor, outsourced, purchased. Cost metrics can be calibrated to factors including risk, quality and availability, value, and maturity. It often turns out that a third of IT services could be eliminated or replaced. Armed with this knowledge, a bank can develop a plan to simplify the application landscape and ensure remaining systems are productive.

At the same time, it's important to ensure the project portfolio remains sensible from a risk-return perspective, and that each project is backed by a detailed business plan. Using a centralized IT capacity-planning tool, leaders can focus resources on high-value projects (filtered based on in-depth analysis of targets, pipeline, and resources), and deploy technology judiciously in cutting cycle times and resolving pain points.

The cloud can play a role in enabling infrastructure services that are scalable on demand. Some

institutions have struggled with adoption, for example because of migration challenges, regulatory concerns, or higher-than-expected data costs. However, the structural shift from standard build-to-consume IT orthodoxies is likely to be permanent, so the long-term question is less whether to move the cloud but when, how, and to what degree.

In addition to these three major cost centers, banks can make significant savings in non-branch physical channels, marketing, and administration. Some of the biggest savings are available in non-branch physical channels, such as contact centers, at which as many as 80 percent of non-value adding calls can be reduced or eliminated or shifted to an inter-bank service center. New digital channels and virtual agents can both improve service, bringing higher levels of customization, and reduce operating costs. Again, digital levers such as robotic process automation (for routine tasks), real-time authentication (via voice biometrics software), routing engines, and analytics can play a leading role—and our research finds that than two out of every three tasks at contact centers are either partially or fully automatable.

A three-pronged approach to optimize the three core expenditures

Some banks in Latin America are getting serious about fostering productivity through a highly-automated and digitized operating model. However, few banks have completed the journey. Common unresolved challenges include optimization of channels and of organizational structures. Meanwhile, many programs have faltered during implementation. The best way to minimize the risk of slippage is to take a methodical approach, starting with a scoping exercise and leader interviews, followed by three crucial steps: assessment, design, and implementation.

Opportunity assessment: A great place to start is to ask the question, “How good can we become?” To answer that, banks can identify the gaps in their performance compared with best-in-class players for each spending category. Useful tools include business-support-function benchmarks, sales-navigator benchmarks, and productivity assessments. Together the resulting data will support a rapid estimate of the size of opportunity across major improvement levers, considering both incremental and radical changes.

But data forms only part of the picture. Walk-throughs of bank operations, conducted with experts, reveal important qualitative differences that data alone cannot capture. The exercise should be accompanied by leader interviews.

Program design: Executives can prioritize initiatives based on their potential impact and viability. They can then focus on planning initiatives in detail and drafting a design workplan for implementation.

Make it happen: In launching the program, project managers aim to capture sustainable value, emphasizing capability building and mind-set transformation. A good early strategy is to go for quick wins that will encourage stakeholder buy-in. An agile approach is recommended; as programs are developed, they should be monitored, tested, and adjusted as necessary.

Uncertainty about future growth and customer shifts toward digital mean that a focus on costs will be essential for banks to compete with fintech and digital-only players. The way to do that is to move beyond money-saving initiatives to structural change that boosts productivity front to back. By leveraging digital tools and focusing intently on execution, banks can achieve significant change over a short period and maximize the chance to prosper in the years ahead.

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