McKinsey & Company

Seven lessons on productivity transformation for US regional banks

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The recent announcement of the biggest US banking merger since the financial crisis shines a spotlight on fundamental challenges facing US regional banks. Scale advantages are emerging (Exhibit 1, next page) as large banks outspend smaller competitors on innovations in digitization, technology modernization, analytics, data, and marketing. Regional banks are under pressure to keep up, and fundamental strategic questions are being asked around the boardroom table: What is our distinctive niche? What targeted investments do we need to make to win? How do we become more efficient and free up investment dollars?

For regional banks, efficiency ratio improvement should be a top agenda item for 2019. There is a strong correlation between efficiency ratio and return on assets (ROA) (Exhibit 2, next page), and banks that reduced their efficiency ratio aggressively over recent years have seen substantially higher share price appreciation and return on equity (ROE) improvement than peers (Exhibit 3, page 4). With the potential for a recession or slowdown on the horizon, late-cycle growth bets bring inherent risks. Efficiency is the biggest controllable lever, and we believe a 5 to 7 percent efficiency ratio improvement is within reach for many regional and mid-cap banks.

Lessons from successful productivity transformations

Achieving lasting productivity improvement is very difficult. Most banks have been working on cost-reduction efforts of one form or another for the last five years. Budgets have been squeezed, excessive layers have been attacked, and policies have been changed—but in many cases materially improved performance has not fallen to the bottom line.

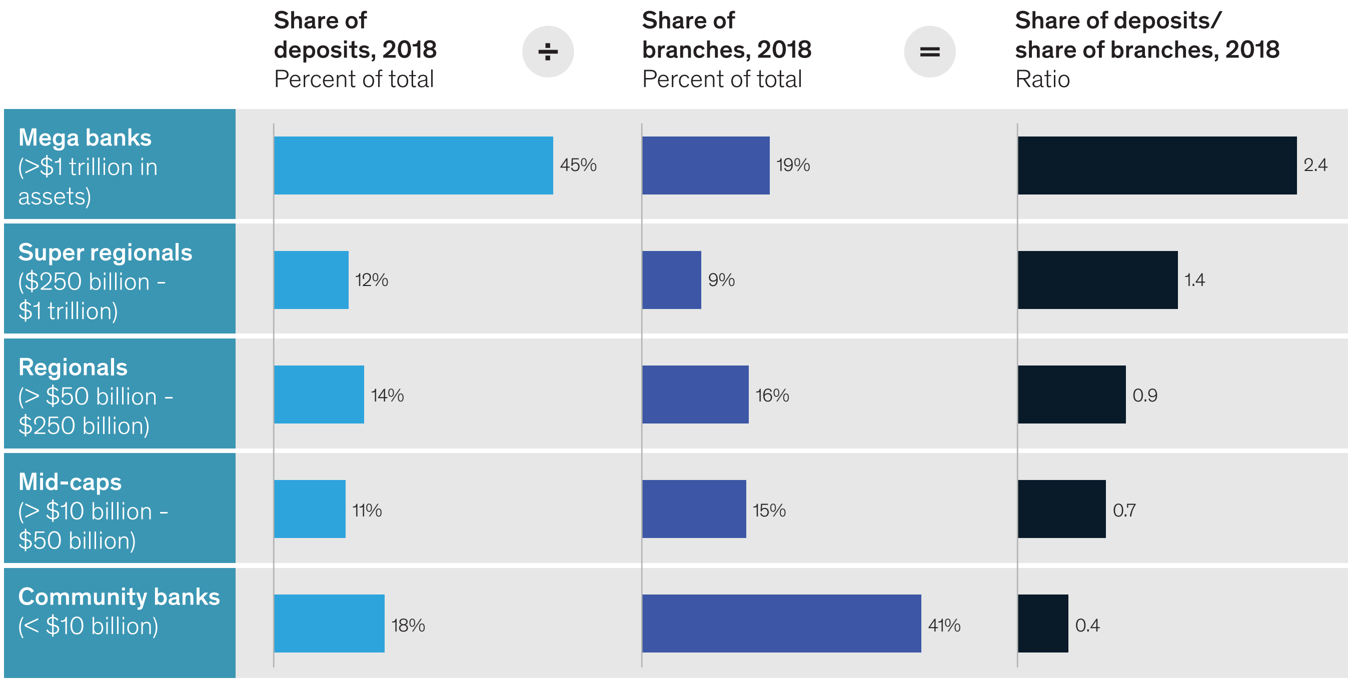
In our experience, successful productivity transformation is less about belt tightening and more about reimagining the organization so it can successfully compete over the next five years. For this reason, it must be led by the CEO and driven by the full executive team. Working with CEOs who have materially changed the performance trajectory of their banks, we observe a few key lessons for success:

Lesson 1: Don't just focus on cost

Costs are important. But no one—apart from a few analysts perhaps—gets excited when a bank announces its next $100 million cost target. In fact, for the majority of people working in banks, these announcements are demotivating—all downside and no upside. As a result, the organization begrudgingly endures the effort until it inevitably runs out of steam. Successful transformations start with an effort to envision what the bank needs to look like to compete in the coming years, including top-of-the-house financial metrics, customer experience goals, and revenue and efficiency targets. We often ask executive teams to write a newspaper "article" describing what they would like to see written about

Exhibit 1

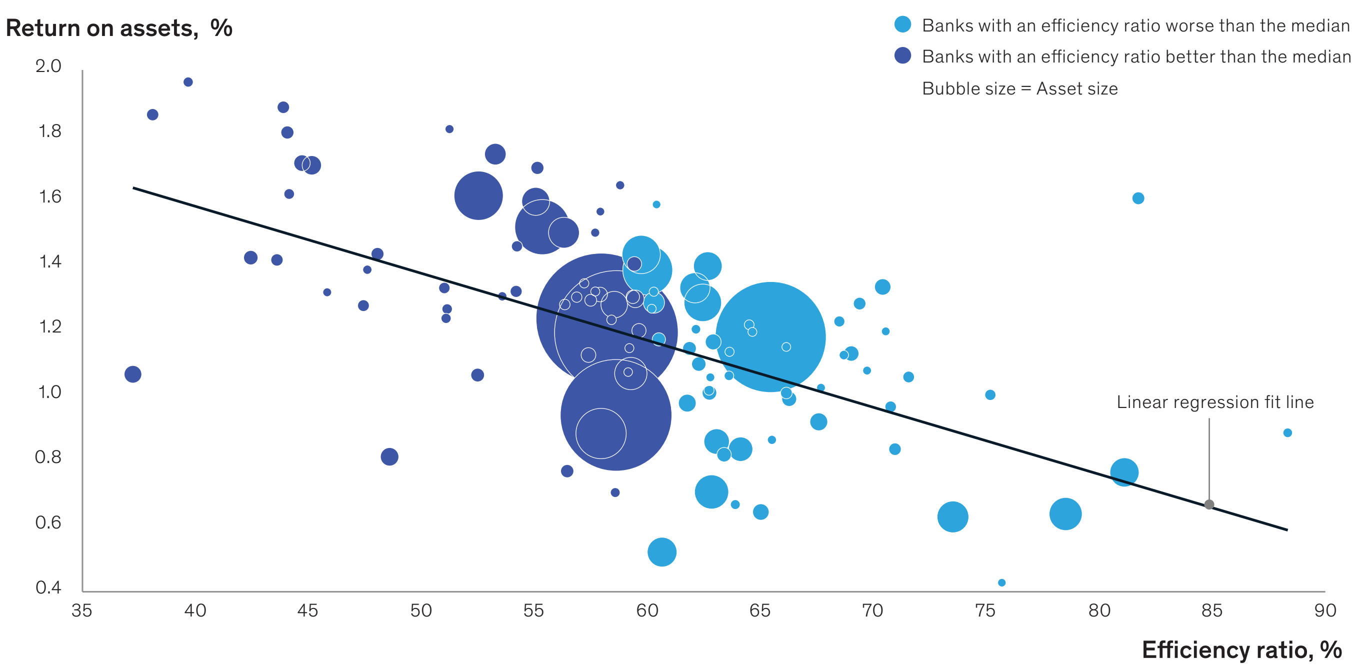
Large US banks are using their scale to gain a disproportionate share of deposits.



Source: SNL; McKinsey analysis

Exhibit 2

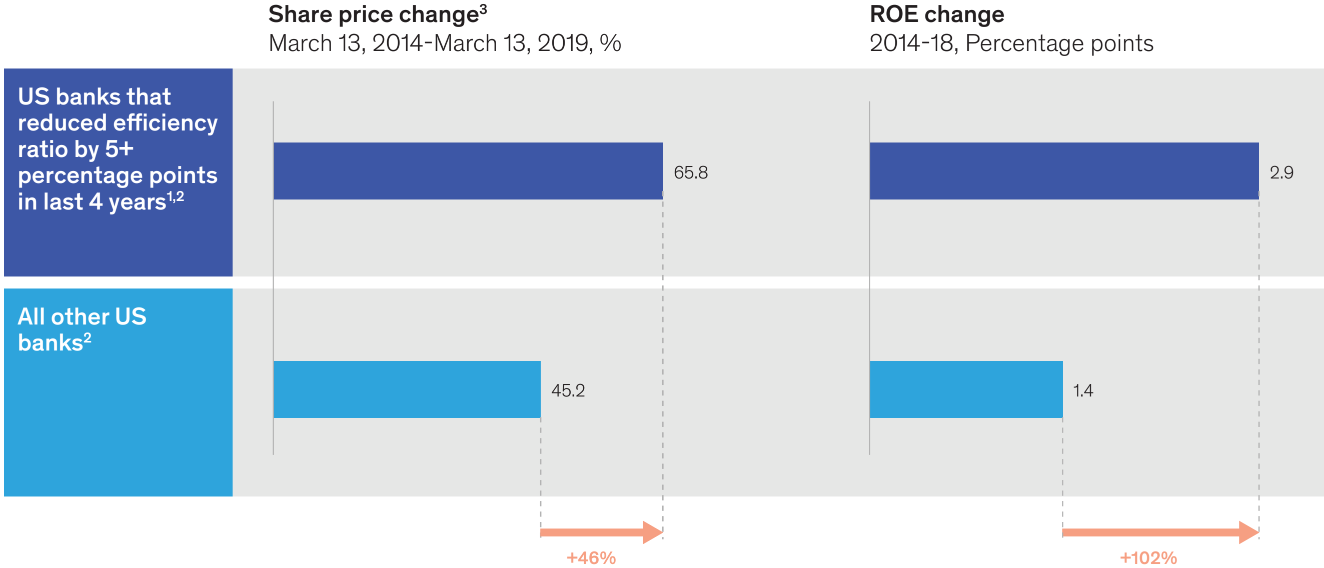
There is a strong correlation between return on assets and efficiency ratio for US banks with more than $10 billion of assets



N = 107
Source: SNL; McKinsey analysis

Exhibit 3

US banks that reduced their efficiency ratio the most over the last four years had considerably better share price and ROE performance.



[1] 26 banks that decreased efficiency ratio by 5 percentage points or more between 2014 and 2018, and ended 2018 with an efficiency ratio below peer median.
[2] Banks with between $10 billion and $250 billion in assets.
[3] Reflecting change in dividend-adjusted close price, adjusted for cash dividends, stock splits, and spin offs.
Source: SNL; McKinsey analysis

their bank in 2022. This gives them an opportunity to step back and think about what they want to achieve. Banks that go through this exercise soon realize that their transformation not only needs to reduce cost, but also needs to include revenue initiatives, digital investments, and customer experience redesign. A wholistic productivity transformation also changes the narrative, from yet another cost-cutting exercise to an exciting vision of what the bank will look like in the future.

Lesson 2: Put yourself in the shoes of an acquirer
Incumbents think about their organizations in a fundamentally different way than external actors, be they activists or acquirers who are not tethered to the decisions of the past. Banks should do the same, and ask “How would someone else think about efficiency and effectiveness in our organization, and what would they do if they acquired us?” While the in-market synergies that come with a real acquisition are absent, this clean-sheet mindset can open the aperture and help leaders identify a broad range of opportunities. Having someone role-play an activist and present their findings to the executive team can be a great catalyst. Looking through a new lens can encourage executives to turn from protecting the status quo—“We’ve already taken everything out of my area”—to facing market realities—“If we don’t do it someone else will.” This mindset change enables a frank discussion of the art of the possible.

Lesson 3: Leave no stone unturned
Executive teams are often tempted to pursue opportunities one department at a time or in a piecemeal fashion rather than in a programmatic way. This is usually because they perceive that with all the projects in flight across the bank they need to prioritize down to a few things. The problem is that this approach almost guarantees an incremental result. Unit leaders will wonder why they were chosen and why other leaders were given a free pass. After a while, enthusiasm will dissipate and the program will lose steam. The reality is that every bank, from the highest performer to the lowest, has multiple projects underway. We have never met a CEO who said, “Actually, we aren’t doing much right now so we have a lot of capacity.” Executive teams aiming for real transformational change must recognize that they need to mobilize their entire organization and move fast to achieve it. Launching a bank-wide effort signals to the organization that

this is a major undertaking and that everyone must participate and contribute.

Lesson 4: Dedicate the "A" team

One of the most critical factors in a successful transformation program is the dedication of "A" players to the effort. These colleagues are often in high demand—which can make freeing their time a challenge—but it also signals to the organization that the executive team "means business." The most important role is that of the chief transformation officer—the full-time executive who will lead the program on behalf of the executive team. If a successful and respected leader is chosen as CTO, the organization is more likely to be energized and excited about the transformation. Conversely, if a journeyman is placed in the role, a collective "sigh" will indicate that staff is bracing for "yet another" corporate initiative. There's no perfect profile for a CTO. Some banks choose a respected regional leader, others choose strong functional executives. The most important factor is that they have a strong track record and command respect from their peers.

Lesson 5: Be bold about making executive changes

CEOs learn a lot about their team through the transformation process. Some executives will not be up for the challenge. Some can't let go of the status quo and are unable to reinvent themselves. Others do not have the skills for their redesigned roles. Making senior leadership changes can be hard, especially if it affects long-tenured executives. However, ensuring you have the right talent to make your vision reality is critical, and a transformation is an excellent opportunity to reassess the bank's talent and make room for dynamic new leaders. These leaders often emerge from unlikely places. One bank, for example, replaced the leader of their ineffective procurement function with a senior sales executive. It was seen as an odd choice at first, as the executive had never worked in procurement, but he brought instant credibility and a practical perspective to the role. And by partnering with the business he significantly reduced procured spending.

Lesson 6: Don't wait for the next technology upgrade

It is quite common for teams to describe technology as an obstacle to successful implementation; as in "We can't improve the credit process until we implement the new technology platform in 2022." While technology investments are of course critical, in our experience the bulk of transformation benefits can be captured with minimal technology spending. Teams should be challenged to devise initiatives that can be fully implemented in one or, in rare cases, two years and business cases should be developed with and without technology investment. One bank that redesigned their commercial credit process achieved impact within four months, not only cutting costs by 25 percent, but also reducing approval time from nine days to fewer than three (with about 80 percent of cases adjudicated same or next day). This, in turn, improved pull-through by 16 percent. All with zero dollars of technology investment.

Lesson 7: Don't let the dollars slip away

It is not uncommon for banks to go through the pain of a transformation and then have the benefits leak away because they lack a robust tracking process. Successfully capturing and retaining program value demands appropriate governance and infrastructure to create accountability to a very granular level. McKinsey recommends going far beyond traditional broad workstreams (e.g., retail, IT, finance) and defining opportunities down to very specific initiatives—potentially up to 100 in a major program. Each initiative has an accountable executive who is responsible for maturing it through a five-stage process from identification (L1), to business case approval by the CFO (L3), all the way to implementation (L5). Every initiative is tracked centrally on a weekly basis through software, so at any point in time program value can be reviewed and appropriate course corrections made. In this way, there are no surprises when the benefits hit the bottom line.

Launching a program

With the seven lessons detailed above in mind, we turn to the question of how to launch the transformation program. While from the outside transformation efforts may seem like complex undertakings that distract the organization for long periods, it does not have to work that way. Productivity transformations should in fact be very tightly orchestrated over a finite time period, with a few clear objectives. In our experience the work falls into three phases:

Phase 1: Agree on the objectives and targets.

Most executive teams agree that change is needed, but usually do not share a collective view of how much change is required and where the opportunity resides. They also usually think the opportunity is a fraction of what is ultimately captured. For this reason, the first step is for the executive team to take time—eight to ten weeks—to get facts on the table (e.g., data, benchmarks) and really understand the full potential. As they review their performance against their peers, they can plot where they need to go and how they can get there. At the end of the process the executive team agrees to a collective vision including targets by function and business. Only when they are in agreement on these elements are they ready to launch the broader program and begin communicating to the broader organization.

Phase 2: Design the new bank. This is the most intense part of the transformation. A team of around 40 people consisting of transformation office staff, workstream owners, and initiative leaders come together to design the initiatives that will make the vision a reality over the next one or two years. Over ten weeks they mature the initiatives through the five-level process we mentioned previously. The process is not linear; ideas are challenged and assumptions pressure tested, resulting in some initiatives being discarded and new ones being launched. Every initiative in L3 has an accountable owner, a business case signed off by the CFO, numbers placed into budgets, a roadmap for implementation and agreed resourcing. It's usually at this point that many CEOs have enough confidence in their plans to begin to make public announcements and visible organizational changes, and capture quick wins.

Phase 3: Capture the value. The final stage is the implementation of the initiatives to capture value. While initiative owners continue to be accountable for success and the transformation office closely tracks progress, the broader line organization is much more integrally involved in implementation. It is through this process that the effort transitions from a program to business as usual. While this phase is generally longer than the previous two, a sense of urgency and the engagement of the executive team remain essential. In our experience, most of the financial benefits can be captured on a run-rate basis within a year.

Of course, no matter how well executed, transformational programs can cause significant anxiety within an organization. Many staff welcome the change and are energized by the prospect of being part of a higher-performing organization. Others, however, worry about job security and an uncertain future. During the first six months of the program the executive team needs to visibly communicate the vision and, to the extent possible, allay concerns. Many banks also have initiatives to reassure high performers. In our experience, after the initial period of uncertainty, morale increases as the vision takes shape and the benefits begin to emerge.

The banking landscape is changing. Digital disruption continues to put pressure on the traditional model, larger banks are gaining an advantage by outspending their smaller rivals on technology, and growth is becoming more difficult as the economy slows. To thrive in this environment, regional banks must become more focused on what they are good at and build highly efficient delivery models. Those that can will be in better position if consolidation continues to increase—and those that fail to transform might find themselves the lesser partner in a "merger of equals."

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