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An efficient operating model for US regional banks

Over the past four years, US regional banks, on the whole, have continued their recovery from the Great Recession. Return on equity (ROE) is at long-term levels of around 10 percent, credit quality appears to be strong, and some businesses are posting solid growth. Industry performance averages, however, mask the wide variation of performance at the individual bank level. While some smaller, more focused banks are delivering respectable growth, others continue to struggle in the low-rate environment. Many that have not already fallen victim to industry consolidation teeter on the edge of being acquired.

The view ahead is no easier. Interest rates are expected to stay low and only rise gradually, continuing to squeeze net interest margins. Regulatory costs are expected to stay flat or grow over the long term, digital innovation will continue to raise the bar for incumbents, and competition will remain intense. Even with modest interest-rate rises in the short term, regional banks need to change their performance trajectory by generating more growth and becoming more efficient. We estimate that to stay relevant, regional banks will need to lower efficiency ratios over the next few years to the mid-50s from the current mid-60s (for some banks) and raise ROEs to the mid-teens from current levels of around 10 percent.

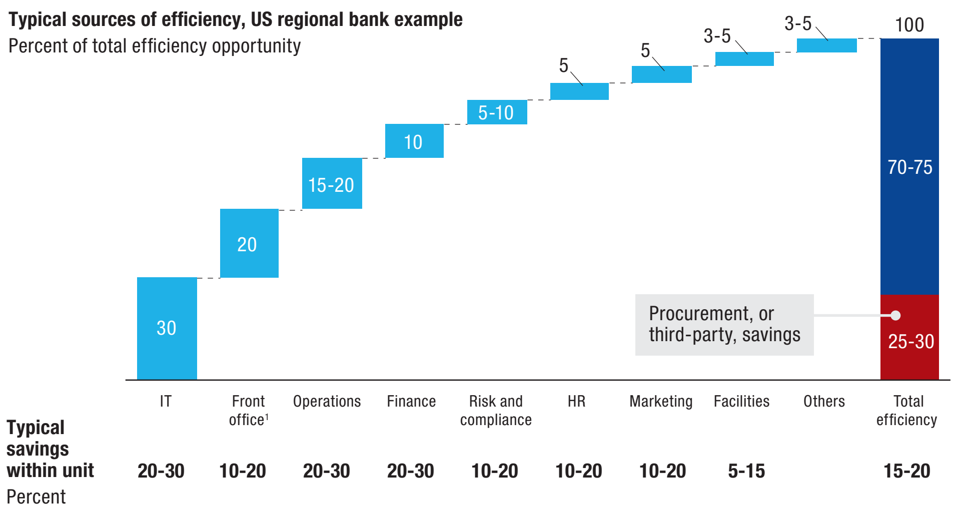
To return to healthier ROEs, more regional banks are contemplating fundamental changes to their operating models, particularly in the area of costs. Our experience with holistic operating model transformations at regional banks suggests that operating model transformations that focus on both performance and organizational health can yield improvements in efficiency of up to 20 percent (Exhibit 1).

Performance: Simplifying the operating model

Most regional banks have operating models that have become increasingly siloed and complex over the years, and are slowed down by inefficient processes, struggle to share knowledge across business lines, and deliver a subpar customer experience. To

Exhibit 1

Efficiency gains across the banking model



[1] Front office includes a sustained branch rationalization and staffing optimization effort

Source: McKinsey & Company

break out of these ruts, regional banks must fundamentally redesign their operating model by addressing five major areas.

1. Segmentation and channel strategy

From a customer segmentation perspective, banks must re-examine how they distinguish between small and medium-size enterprises (SMEs) and commercial customers, ensuring that their service offering addresses the unique needs of companies in each group.

From a channel perspective, the strategic elements have grown more complex. In the past, banks simply had to consider the number and location of branches. Today, changing consumer preferences and technological innovation have reduced the average number of branch interactions. Regional banks now must consider removing some branches in favor of developing more robust web sites and strategically locating ATMs. This shift is particularly difficult for regional banks, as they view customer service as a core differentiator and have built expertise in their branches.

2. Customer journey

By digitizing some of the primary end-to-end customer journeys, such as deposit account opening and mortgage origination, banks can significantly improve the customer and employee experience and reduce costs. For example, recently a bank redesigned its mortgage-origination journey, reducing costs by 40 percent while improving loan-closing time to fewer than 30 days from more than 50. They achieved these improvements by redesigning and digitizing processes and introducing a stronger focus on performance throughout the operations.

3. Project spending

As they reorganize support functions to align with a new operating model, banks often find it challenging to control project demand and track spending against a budget. Some might have a strong hold on their capital expenditure but struggle to create transparency in operational expenditure. These institutions benefit from setting up an independent demand-management organization with an end-to-end mandate that ranges from project intake to cross-business-unit prioritization, capacity planning, execution oversight, and spending and value-delivery tracking.

4. Organization

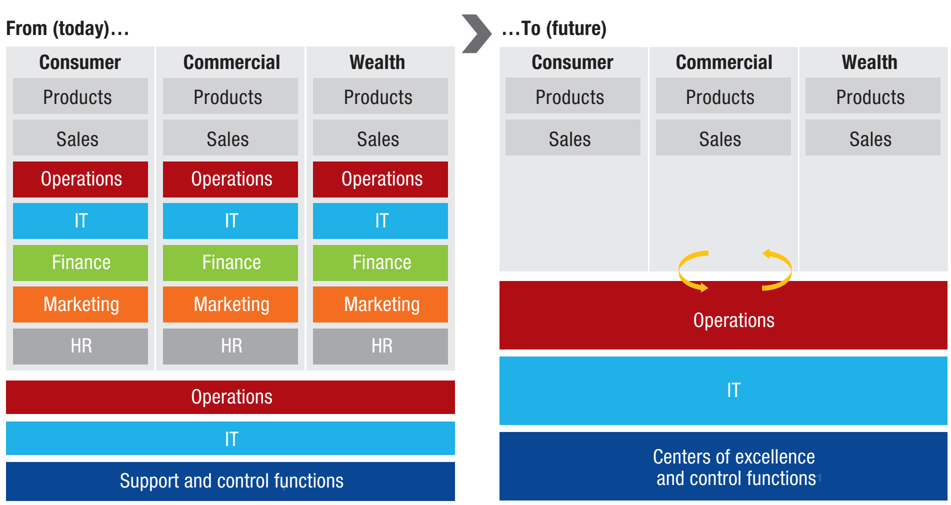
A natural inclination among many business unit leaders is to want to control all the resources required to run their businesses. This inclination often results in each business unit creating its own support teams, and it is particularly common with IT, finance, and HR personnel. Aside from obvious cost considerations, fragmented spending on multiple IT departments, for example, leads to inefficient and sometimes inconsistent service delivery.

It is possible to cut costs by consolidating these support functions (Exhibit 2). In addition to cutting costs, consolidation can also lead to more effective demand management, often delivering 10 percent or more in efficiency improvements. Consolidating support functions also enables banks to hire the right talent, ensuring the bank can meet best-practice cost and service goals. Perhaps most important, it also sets the stage for banks to create centers of excellence and control functions that are critical to continuously driving down costs.

That said, banks should not always consolidate functional capabilities. In fact, without addressing the other necessary elements—for instance, redesigning decision-making processes and other interactions between functions and businesses—a consolidated organization will not deliver efficiency over time. In one instance, we saw duplicative activities creep back into a bank's organization. The bank in his case had not developed service-level agreements between the functions and business, and business unit leaders became frustrated with the lack of transparency.

Exhibit 2

Consolidation of support functions can deliver 10 percent or more in efficiency gains



[1] Support and control functions include marketing, communications, finance, HR, legal, risk, compliance, corporate development, and others

Source: McKinsey & Company

5. Centers of excellence

Delivering the next level of efficiency increasingly involves bringing new specialist capabilities to bear that are hard to acquire and need to be managed by highly skilled executives. To be effective, these capabilities need to be managed centrally but have an organization-wide remit to partner with businesses and deliver value. In McKinsey's view, four centers of excellence are most important to banks' efforts to reduce costs, primarily in the middle and back office.

- **Procurement:** Most bank executives believe that they can effectively manage external spending. In our experience, however, management of external spending is one of the single-biggest opportunities to improve costs for regional banks today. As vendor complexity has increased, many banks have not kept pace. Areas such as IT, operations, finance, and HR all require category-specific vendor-management expertise which varies across business areas. Because procurement generalists tend to lack this specific expertise, business units and support functions end up dealing directly with vendors, and the bank-wide procurement capability atrophies over time. Rarely have we seen central-procurement teams set up with the right level of access to businesses, decision rights, control processes, and category expertise to capture the value on the table, which usually stands between 15 and 20 percent of spending.[1]

- **Automation:** Recently, banks have successfully embraced robotic process automation (RPA) to reduce costs. There are immediate applications in functions such as HR (résumé screening), finance (standard-report production), and IT (code debugging). Although robotics in banking is in its infancy, it has the potential to dramatically reduce the need for aggressive offshoring while still delivering efficiencies of 40 percent or higher in the specific process.

  One bank, for example, used robotics transformation at-scale across functions to fully automate home-loan progress-payments processes and automate semiannual audit reports, pulling data from tens of different systems. As a result, it has reduced its costs and delivery time per process by 40 percent. Another bank used robotics transformations in several processes, reducing costs in excess queue processes by 80 percent and shrinking its clearing house automated payment system process time from 10 minutes to 20 seconds.

- **Offshoring:** Regional banks can generate efficiencies between 20 and 40 percent (of full-time equivalent costs under consideration) by setting up a shared-services utility in a low-cost location—either locally or offshore. Many of larger banks have been pursuing shared-services strategies over the past 10 to 15 years. Within these more mature strategies, transactional activities, such as application development, application maintenance, accounts payable, and payroll, are commonly housed in a shared-services center.

- **Agile and lean:** The rapid software-development technique known as "agile" has been, admittedly, overused. Still, US regional banks would do well to embrace much of the methodology. In fact, to remain competitive in the face of the much larger product-development budgets of bigger banks, US regional banks will need to dramatically speed their time to market. Instilling an agile approach and mind-set in the context of banking can also make banks a much more attractive proposition for today's top talent.

[1] For more, see "A Winning Partnership: Financial Institutions and Strategic Suppliers," McKinsey & Company, October 2016.

Improving the odds: Dedication to health and talent

Even with the constant introduction of disruptive technologies and business models, banks have been slow to break from their traditionally risk-averse cultures. Rather than making step changes, many banks fall into the trap of making incremental improvements. They ask questions such as, “Can we take another 15 percent out of the human resources function?” The better question, based on the tools available today, should be “Do we need this function at all?” A transformation is a great opportunity to make those bold operating model decisions.

Major programs, however, are risky. They consume significant organizational time and resources and, according to McKinsey research, have only about a 30 percent chance of long-term, sustainable success. Through decades of work and research, we have identified important lessons from companies that consistently beat those odds—and their efforts revolve around a focus on organizational health and talent. By both taking a closer look at their operational models and employing the strategies below, banks can put themselves on the path to increased efficiency and vastly improved ROEs.

Monitor and drive organizational health

Organizational health is often overlooked as companies embark on large-scale efficiency and growth initiatives. Too often, banks pursue financial and operational performance transformations and relegate health to HR-led “culture programs” that are disconnected from the details of the actual strategic initiatives. Health, however, is a crucial performance enabler: banks with top-quartile health scores—as measured by McKinsey’s Organizational Health Index—are three times more likely to experience and sustain successful performance, as measured by total return to shareholders.

Based on responses from 170,000 employees at more than 85 banks globally, the heathiest banks converge on a common recipe for success—developing a superior “execution edge” and unleashing a continuous improvement engine. Of course, traditional change-management practices, such as leading from the top and developing strict budgeting practices, are fundamental to success. But our survey found that healthy banks also focus on a discrete set of management practices that go beyond this baseline, including breaking down organizational silos to encourage knowledge sharing, fostering bottom-up innovation, and supporting talent development. To truly transform the bank’s culture, it is critical that leaders take five actions:

- *Agree on a clear and quantified organizational health baseline and health goals that are rooted in identified healthy practices.* For instance, a bank may pursue better innovation and learning outcomes based on their understanding of the importance of knowledge sharing.
- *Design the portfolio of actions that will influence the desired mind-set and behavior changes.* These actions may include visible role-modeling of new behaviors by senior leaders or highlighting success stories of teams working in fundamentally new ways.
- *Ensure that performance initiatives and core redesigned processes reinforce desired culture.* Measure and manage the initiative, through ongoing surveys and open communication, to track its impact.
- *Communicate a clear case for change.* In a recent McKinsey survey, when asked what they would do differently in a transformation, nearly half of executives wished

they had spent more time communicating a clear change story.[2] At regional banks, we commonly hear employees in the middle of the organization saying, "We thought we were doing well." With leaders only communicating positive feedback that doesn't reflect reality, employees can be caught off guard when a bank launches a transformation. Executives should not shy away from providing their employee base with an understanding of their areas for improvement.

- *Inspire the leadership team to act as a "united front" for change.* Some of the biggest opportunities often come from changing the engagement model of the executive team—breaking down the silos and building cross-unit collaboration. Without this collaboration, for example, finance might spread savings across the entire bank in an "equitable" manner, not taking into account operating nuances such as current growth projections for different businesses. For effective and lasting change, leaders need to work together toward a common goal.

By following this proven set of interventions, banks can increase the odds of success by more than 10 times.[3] By putting health front and center, banks not only improve their financial performance but build an organization that can sustain performance over the long term.

Build capabilities and dedicate talent to driving the program

In addition to taking the actions toward organizational health, the most successful banks build appropriate management capabilities at all levels of the organization. Major performance programs need a respected senior leader to be dedicated full time and supported by appropriate working teams. And these teams need clear performance metrics and targets.

Moreover, as the work changes, teams will need to focus on developing new skills and ways of working (e.g., working in agile teams). Leaders will then need to ensure employees at all levels—from vice presidents to front-line service operators—have the right training and skill set to manage their new tasks and work approach.

To ensure that the right approaches are adopted and that changes stick, banks should establish a robust transformation oversight office with responsibilities that extend beyond basic program governance. The project management office should focus on continuously reviewing the transformation strategy and building the capabilities necessary to drive the effort over the long term.

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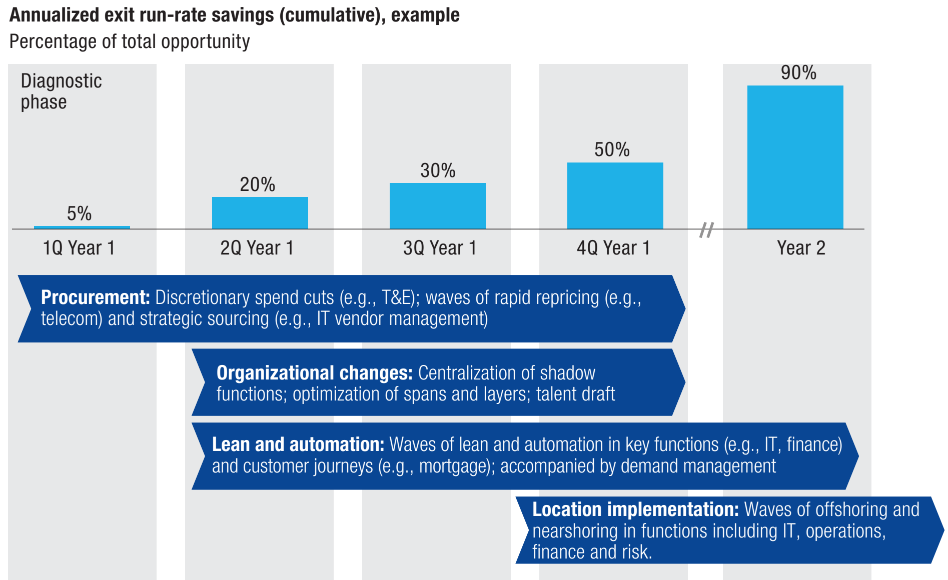
US regional banks are facing severe bottom-line pressure driven by low interest rates, high regulatory costs, and intense competition. Against this backdrop, banks must reduce costs in order to restore ROE to historical levels. When done right, a cost transformation can unlock 15 to 20 percent of bank-wide operating expenses, which can be used to fund investments in growth. Bottom-line benefits from this transformation start to be realized after six months. Nearly 50 percent of the value can be realized by the end of the first year and 90 percent by the end of the second on a run-rate basis (Exhibit 3).

2 "How to beat the transformation odds," McKinsey & Company, April 2015, https://www.mckinsey.com/business-functions/organization/our-insights/how-to-beat-the-transformation-odds.

3 McKinsey Organization Practice research.

Exhibit 3

Nearly 50% of value can be realized by end of first year, and 90% by end of second year on a run-rate basis



Source: McKinsey & Company

Banks that beat the odds, delivering sustainable, structural cost reduction, commit to the transformation across the organization. They set a clear aspiration, pursue structural (not just tactical) levers, engage business and function leaders, set up an empowered transformation program office, and maintain a dedicated focus on organizational health.

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