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More bank for your IT buck

Asia–Pacific's mature- and emerging-market banks differ in many ways, but most have one thing in common: they urgently need to improve their IT operating models.

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Asia–Pacific is the banking industry's biggest growth engine. The region, when excluding its most mature markets, Japan and Australia, is expected to account for about 39 percent of global banking revenue growth between 2012 and 2020. However, this growth may be accompanied by decreasing profitability, due to increasingly intense competition and because of many banks' operating models reaching their limits in efficient scalability and flexibility in the face of change.[1]

IT is a major catalyst for growth in the banking industry; it supports, for example, scalability, productivity growth, and risk management. Unfortunately, the findings from our annual Asia–Pacific banking IT benchmarking survey among 85 banks across 13 countries[2] suggest that many banks do not invest enough in IT and that others' investments are not effective enough to propel growth and business efficiency. Some banks, however, are generating significant business impact with IT, and they are doing so despite spending less on IT than most of their peers. This article summarizes key findings based on our survey and highlights success factors and characteristics of operating models that can help both mature- and emerging-market banks realize IT's potential as a key enabler of business efficiency and growth.

A tale of two markets

Asia–Pacific's mature-market banks have marginally increased their IT spending since 2010, with the average hovering around 15 percent of operating expense and a wide span ranging from a 7.1 percent share at banks in the bottom quartile of spending to 29.4 percent at banks in the top quartile.

At banks in Asia–Pacific's emerging markets, however, IT spending's relative share of operating expense has decreased from an already-low 9.4 percent in 2010 to 8.1 percent in 2012 and a range across the sample of 3.1 percent at the bottom to 15 percent in the

[1] Postrisk revenues and exchange rates at 2012 levels. For more, see "The search for a sustainable banking model," January 2013, on mckinsey.com.

[2] Since the survey's inception in 2006, we have benchmarked 85 banks across 47 financial-services groups in 13 countries across Asia–Pacific. Mature markets include Australia, Hong Kong, Japan, Singapore, South Korea, and Taiwan. Emerging markets include China, India, Indonesia, Malaysia, Pakistan, the Philippines, and Thailand. In addition, we draw insights from a global set of 295 more banks in 161 countries, as we are conducting this benchmarking outside Asia as well.

Takeaways

IT can drive growth and efficiency for the Asia–Pacific banking industry. But our annual benchmarking survey shows that while some banks are generating impact with IT, the investment by others is either not sufficient or not effective enough, or both.

Performance differs by market; for example, while banks in the region's mature markets use IT to promote customer centricity and new initiatives, those in emerging markets are still playing catch-up rather than spending strategically to prepare for the future.

top quartile (Exhibit 1). This means that the region's emerging-market banks have, on average, not kept their IT spending in line with the overall rise in operating costs. While the data in our report stretch only until financial year 2012 due to the usual reporting time lags, our subsequent work with Asia–Pacific banks has confirmed these spending patterns and the issues raised by our analysis.

Overall, banks in Asia–Pacific are spending significantly less on IT compared with banks elsewhere. In Europe, banks' IT spending averaged about 19 percent of operating expense across mature and emerging markets in 2011 and 2012.

A close look at how the region's mature- and emerging-market banks allocate and focus their overall IT spending reflects similar patterns across mature and emerging markets in other regions. Asia–Pacific's mature-market banks are increasing their spending on enabling strategic change and thus spending less on running the bank. Not surprisingly, they spend more of their IT budget on applications than on IT infrastructure. In contrast, banks in Asia–Pacific's emerging markets continued to increase their focus on running the bank, even if they are now spending more than before on developing and maintaining applications (Exhibit 2).

According to the survey, banks in Asia–Pacific's mature markets have begun to use IT more often to enable growth and business efficiency, promote customer centricity and channel transformation, improve process efficiency and automation in application development, introduce infrastructure upgrades to create scale, and meet the infrastructure demands of new business initiatives. Emerging-market banks, on the other hand, are focusing on getting the fundamentals right and reducing IT complexity through platform renewal, application consolidation, and storage. Given the overall patterns outlined earlier, however, these findings suggest that emerging Asia's banks are using their IT spending more on incrementally catching up with business growth than on spending strategically to prepare for future business growth and change.

Exhibit 1

IT spending as a share of operating expense differs in mature and emerging markets.

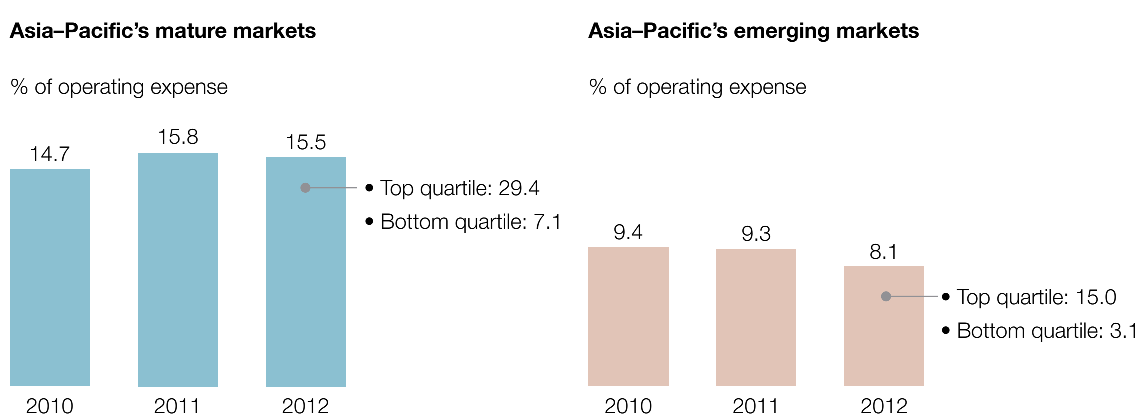
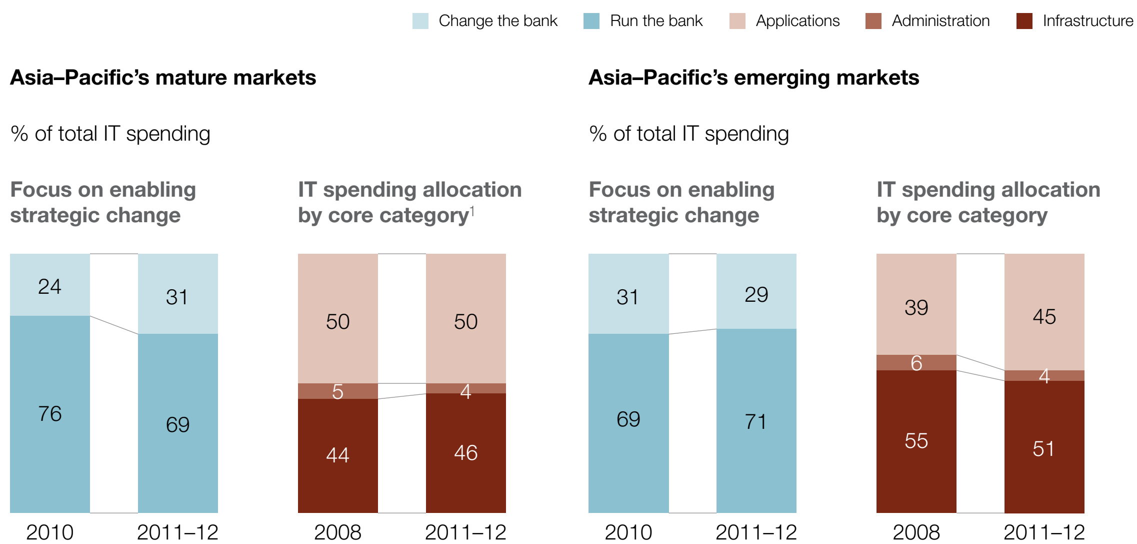


Exhibit 2

Bank IT spending patterns vary across mature and emerging Asia–Pacific.



[1]Figures may not sum to 100%, because of rounding.

In both mature and emerging markets, banks' IT investment priorities do not always maximize long-term synergies and frequently seem to be driven by reactive or short-term decision making. For example, systems for regulatory compliance rank high on the list of priorities, while nonregulatory risk or management information systems and data warehousing rank low, despite being fundamental to integrated, fully functional risk-management capabilities in the long run. If Asian banks, especially in emerging markets, do not develop capabilities to continuously innovate and deliver business value, they may lose market share to nonconventional players. Most emerging customer populations in Asia are younger than in other regions, more comfortable with mobile technologies, and increasingly less dependent on conventional banking infrastructure. Alipay, for instance, a leading Chinese third-party online payment provider, served more than 845 million registered accounts and facilitated transactions worth more than $290 billion in 2012.[3] This shift in customer expectations and behaviors, as well as current and emerging competition from innovative, agile nonbank competitors, mirrors developments in the rest of the world.

The differences in IT spending levels and growth dynamics between Asia–Pacific's mature and emerging markets have practical implications for business-value generation through IT. Even if mature-market banks maintain their current IT spending level, they need to ensure that the investment generates maximum strategic business value by raising the portion spent to enable strategic change from the current level of 31 percent.

Emerging Asia's banks, whose portion spent on enabling change in the business is only 29

[3]According to Analysys International's China third-party payment database, Q1 2013, and McKinsey analysis.

percent of substantially lower spending levels, face an even bigger challenge. Their current total IT spending levels and spending on strategic change imply that, for example, an average bank in the top revenue bracket in Malaysia or Thailand spends less than $100 million a year on strategic change. These numbers are far too small to enable business change and also carry the cost of major systems and programs that provide the capabilities needed to compete in the future. While many emerging-market banks should save costs by evolving leaner IT operating models and architectures, they also need to spend much more on IT to keep up with growth and the resulting complexity of business operations. If they don't, they risk destroying business value and profitability at the margin as they grow. What is more, their current spending levels on strategic change are too low to compete in the intensifying digital "arms race" against incumbents and new competitors.

Getting on a better performance curve

Spending more on IT and enabling strategic change is only one part of the equation. Best-practice banks are able to create more value through a structurally better IT operating model that is more efficient, scalable, and flexible and gives them a head start in digital banking.

As in previous years, our benchmark analysis has classified the IT performance of each bank by comparing its spending levels and relative business performance with the average across Asia–Pacific.[4] There are striking differences that demonstrate that efficiency and effectiveness in the banking sector can be increased significantly across three dimensions[5]:

- Total IT spending. Best-practice banks spend more than 10 percent less on IT than the average bank in Asia–Pacific (based on a comparison of IT spending levels by operating expense). This does not necessarily mean that they could not benefit from spending more; rather, it is an indication of greater efficiency and effectiveness than other banks in the region.

- Business efficiency. Best-practice banks spend 70 cents less in non-IT operating expense for each additional $1 of IT spending than the average bank in Asia–Pacific, which translates to potential savings of up to $32.7 billion a year across the entire banking industry in the region by streamlining operating expense with the help of technology.

- Contribution to business growth. Best-practice banks generate $3.70 more operating income per $1 of IT spending than the average bank in Asia–Pacific. Clearly not all of this difference can be attributed to smart use of technology, but it nevertheless indicates the significant potential of IT to contribute to business growth, from new products to customer experience.

While these benchmarking results reflect the potential currently available to banks in the region, other research estimating the potential economic value of digital-enterprise transformations[6] demonstrates that the value at stake is likely to increase in the future, as will the opportunity cost of falling behind digital leaders.

A more detailed correlation analysis of IT spending and business-value generation (both income and cost efficiency) confirms that best-practice banks are on a different performance curve. They manage to convert

[4] Sai Gopalan et al., "Breakthrough IT banking," *McKinsey on Business Technology*, Spring 2012, Number 26.

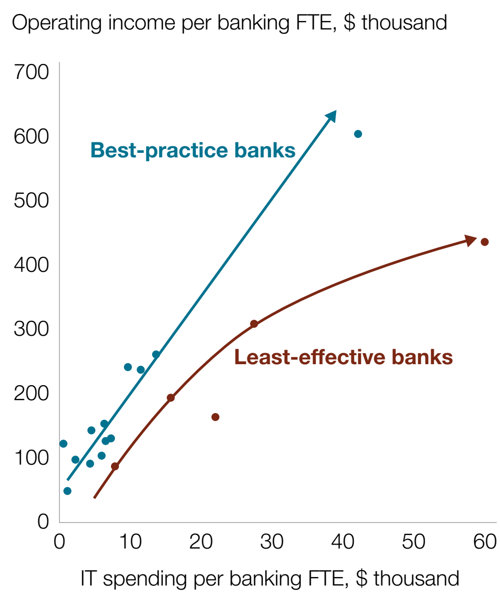
[5] Analysis based on 2011 numbers.

[6] Tunde Olanrewaju and Paul Willmott, "Finding your digital sweet spot," *McKinsey on Business Technology*, November 2013, mckinsey.com; *IT in Digital Banking*, 2012, mckinsey.com.

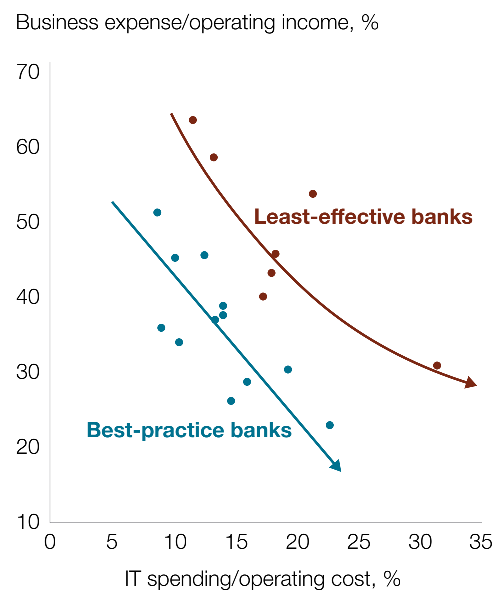
Exhibit 3

Best-practice banks generate more value from incremental IT spending as they grow.

Best-practice banks are better at translating IT spending into income per banking FTE[1]…



…and into overall business cost efficiency, compared with least-effective banks



[1]Full-time equivalent.

every increase in IT spending into at least a proportionate increase in business value while others do not (Exhibit 3).

Our benchmarking of IT operating practices, combining both performance today and health (performance tomorrow), showed what differentiates best-practice banks from the rest:

- Running the bank versus enabling strategic change. Best-practice banks spend much less on running the bank than banks with higher-than-average IT spending. Best-practice banks maintain a strong alignment of IT and business strategies through direct CIO–CEO reporting lines and through regular enterprise-wide IT project prioritization.

- IT capability and IT cost. Best-practice banks achieve more with fewer people and lower average cost per IT employee by building superior project-execution engines with lean and agile continuous-development practices that involve business users much more closely and proactively. They also suffer far less from long maintenance backlogs.

- IT architecture complexity. Best-practice banks have strong central IT governance teams that continuously execute architecture and application rationalization programs, leverage infrastructure economies of scale through strategic asset-management prac-tices, and proactively involve business to design IT for the future. One of the largest

Asian banks, for example, maintained less than 150 applications compared with the regional average of 450 per bank.

- Rightsourcing. Best-practice banks report lower outsourcing levels and higher value realized from outsourcing by measures such as quality and flexibility. Their "secret" is more mature capabilities to manage outsourcing providers, better demand management, and in-house offshoring capabilities, even for core projects.

These practices are the key elements of best-practice IT operating models in general, but the practical implications and value for each bank will differ depending on its starting point and geographic footprint. The path to success differs for emerging- and mature-market banks.

Emerging markets. Many banks in Asia's growth markets need to substantially increase IT investment. Their top-line growth rates require major continued investment, even beyond current levels. At the same time, banks in these markets have an opportunity to build a simpler initial setup (for example, fewer applications and less complex infrastructure architecture) to break down emerging bottlenecks early and avoid increasing complexity that may severely constrain future competitiveness.

Mature markets. Banks here need to continue to invest in simplification efforts to maintain or further reduce IT spending on running the bank. This is similar to mature markets elsewhere but emphasized by the lower degrees of cross-border competition in many of Asia–Pacific's mature markets than in Europe, for example. Consolidation may help to further reduce overall IT spending initially and allow banks in mature markets to maximize spending on enabling strategic change by digitally transforming their business models and delivering a customer experience that lives up to fundamental shifts in customers' expectations.

Furthermore, beyond managing increasing regulatory demands, mature- as well as emerging-market banks also need to urgently invest in improving their risk-management IT and operational capabilities. And regardless of location and market dynamics, banks across the region should continue to invest in improving their IT operating model.

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Adopting best-practice IT operating models remains an imperative for banks across the Asia–Pacific region. In an increasingly digital future, banks need strong and consistent IT leadership to keep building IT engines that act as catalysts for business, rather than as bottlenecks.

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