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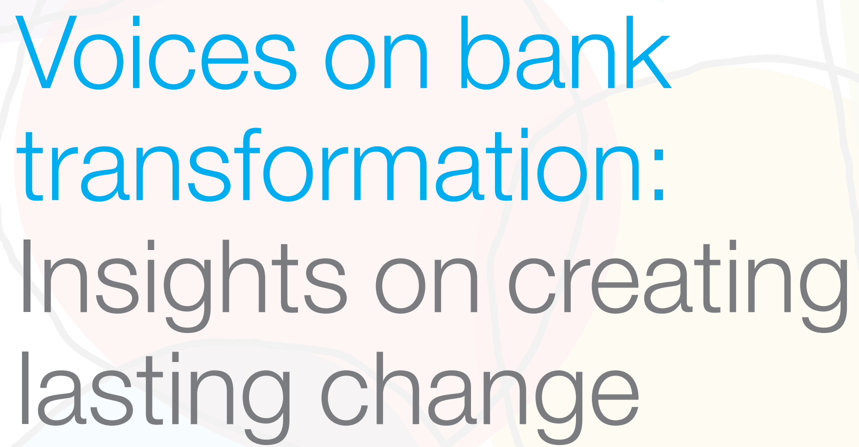

Voices on bank transformation: Insights on creating lasting change

Global Banking March 2015

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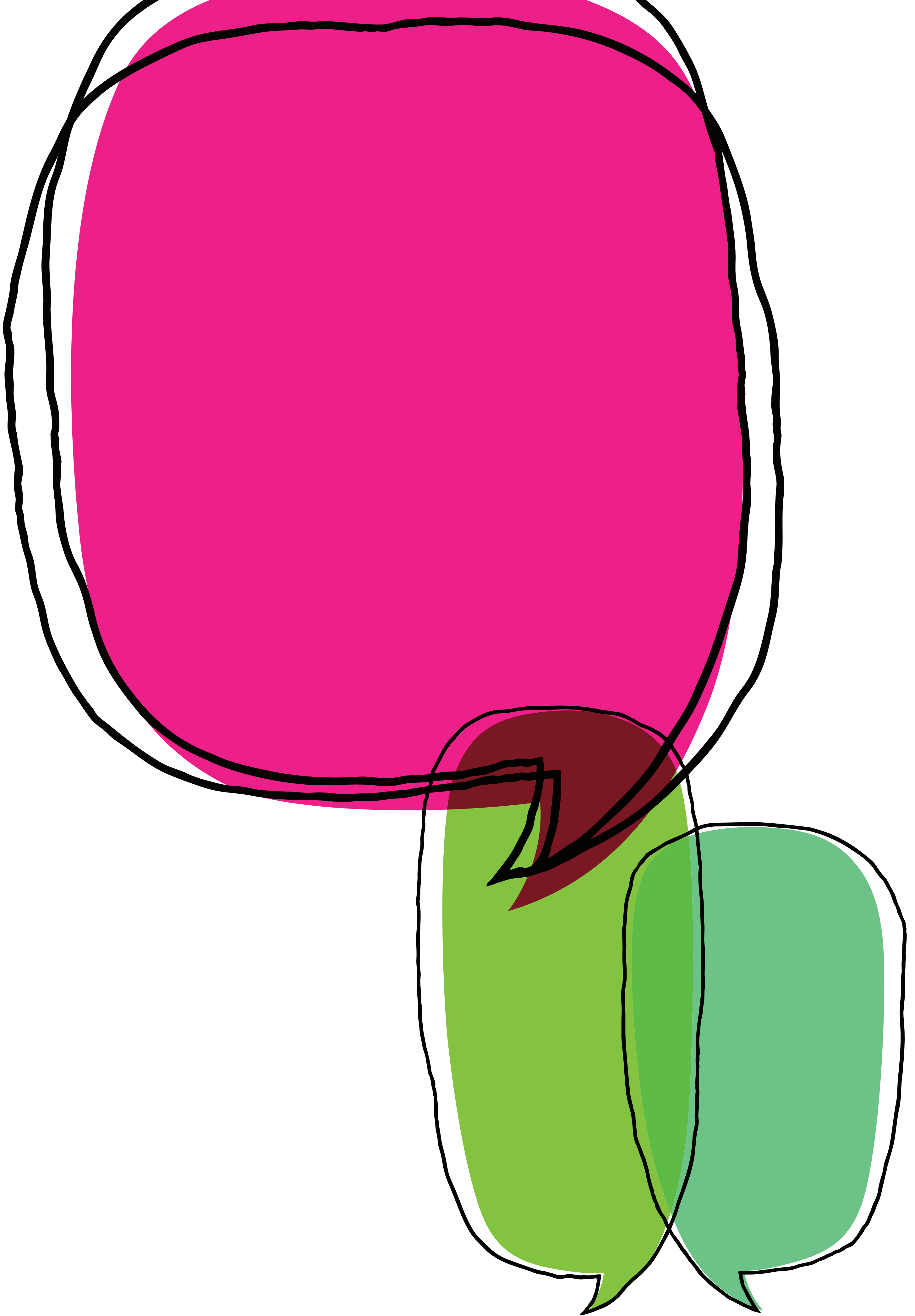

Introduction

Walter Lironi and Frédéric Vandenberghe

The *McKinsey Global Banking Annual Review 2014*[1], shows that a small group of outperforming banks account for all of the value creation in the industry. Within the group of outperforming banks, transformation – operationally, technologically, and, not least, culturally – is a way of life. The return on equity (ROE) such banks record is stronger and their investment appeal as measured by market to book valuation is healthy and growing. Most average and underperformers, by contrast, do not earn their cost of capital, lag in becoming digitally enabled, and are scrambling to adapt to an ever more complex regulatory framework.

The aim of *Voices on bank transformation* is to join the perspective of McKinsey with the experience of five successful CEOs and chairmen to illuminate the changes reshaping banks. By focusing on transformation, we hope to share our insight into what we have seen that works well, and what is not so effective. In particular, we believe that banks need to transform both their ability to manage risk and their capability to adapt and evolve as digital organizations. Building a platform to do both better year after year points to the broader transformation that can help banks experience a step change in growing revenue and profits.

For bank CEOs and other senior leaders, insight about transformation is highly valuable. Transformations are tough to execute and success is not guaranteed. In fact, only about one-third of banks achieve their transformation goals on schedule and with the desired financial impact. What is revealing is that the major reason for the high rate of failure is people – including lack of involvement of top leaders; weak buy-in from teams and senior managers; and a lack of investment in building capabilities and in doing things to change mindsets across an organization.

[1] We found that 90 of the world's 500 largest banks outperformed in 2013 and that this group accounted for the creation of all forward value (defined as market capitalization minus book value). For a copy of *The Road Back: McKinsey Global Banking Annual Review 2014*, please contact any member of your McKinsey client service team.

Working with clients, we've learned that change can be genuinely desired but may often be limited to top-down initiatives. Moreover, cultural and mindset change has been extremely limited. Instead, repetitive cost initiatives have left most employees disillusioned, while a failure to invest in capabilities has left them insufficiently skilled to operate in the new channel roles that digital change will increasingly require.

In this report, Part I features three chapters that respectively focus on: the organizational health of banks, risk culture change, and digital transformation. There are, of course, other areas – customer excellence, for example – where banks have been active with transformation. Yet, with health, the goal is to build for the long term rather than continually react to events and short-term crises. Meanwhile, addressing risk culture proactively and positively can help address the distrust of banks by regulators and consumers. Finally, digital transformation will equip banks with the new skills and ways of working that the competitive landscape will increasingly demand.

1. Transforming the organizational health of banks

Banks that are healthy and "fit for purpose" are often able to outperform peers that lag in this area. Indeed, banks with top quartile organizational health generate three times the total return to shareholders than banks in the bottom quartile. Banks need to prioritize which health actions will drive performance and then design the appropriate interventions. Linking the performance criteria for existing business initiatives with the desired cultural change will help to embed the transformation over time.

2. Managing the people side of things: Instill mindset shifts to foster a good risk culture

Next, with regulators raising the bar on risk and compliance, banks must be proactive in shifting staff mindsets and behaviors regarding risk and compliance. More stringent controls and penalties are not sufficient to prevent banks from failures

like those experienced during the financial crisis, nor do they satisfy present-day requirements of the board, regulators, or clients. We believe that risk culture is made up of several key elements: sufficient transparency of risks, acknowledgement of risks, responsiveness to risks, and respect for rules. CEOs need to be persistent in working across these areas to transform a bank's risk culture and mitigate financial losses.

3. Go on the offensive: Use digital to build the bank of tomorrow

Banks do recognize the urgency of embracing digital transformation to ensure they capture the massive value at stake. A majority of the value will come from the fundamental transformation of working practices by moving towards more agile development and creating an organization structure that is more flexible. Equally important for digital transformation is winning the battle for talent, most likely using a combination of in-house development, buying it in, and partnering. However, the long-term goal must be to foster a culture that is attractive to these skilled people, and helps them to develop and thrive.

In Part II we shift focus to consider the lessons and experience of a number of renowned bankers. Here, we will explore other types of transformation – notably, those involving customer excellence and business model change, among others – to provide a richer overview of how banks are adapting. Five inspirational bank leaders will discuss transformation, and their own progress and challenges. They include:

Richard K. Davis, CEO, President, and Chairman of U.S. Bancorp, who discusses creating a culture based on adapting to continual change.

CEO **António Horta-Osório,** who provides an overview of the balance sheet, business model, and operations transformation of Lloyds Banking Group.

> "Banks do recognize the urgency of embracing digital transformation to ensure they capture the massive value at stake. A majority of the value will come from the fundamental transformation of working practices by moving towards more agile development and creating an organization structure that is more flexible."

From India, ICICI Bank Chairman (and former CEO) **K.V. Kamath,** who discusses the relationship of bank boards and senior leaders during a transformation.

Gerrit Zalm, Chairman of ABN AMRO, who reveals how transforming customer experience helped with that institution's revitalization.

And from Brazil, **Candido Bracher,** CEO and President of Bank Itaú BBA, who explains how transforming the corporate investment banking management model helped to create a top 20 global financial institution.

McKinsey & Company wishes to thank these leaders for sharing their insights in *Voices on bank transformation*.

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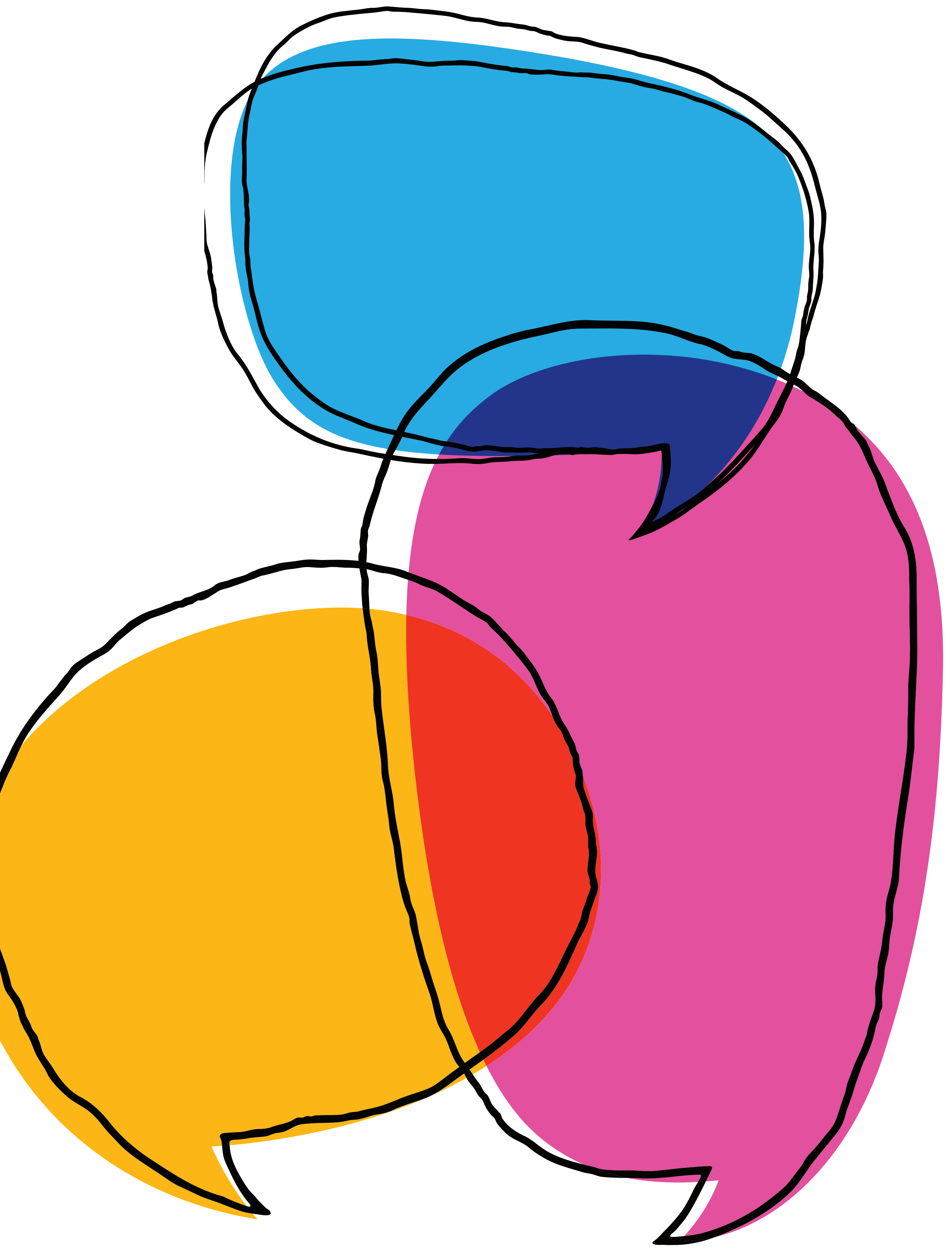
Part I
Key themes in bank transformation



Transforming the organizational health of banks

Walter Lironi, Elizabeth McNally, and Frédéric Vandenberghe

McKinsey research shows how banks that focus on creating healthy organizations significantly outperform their less healthy peers. In fact, banks with top quartile organizational health scores achieve an average total return to shareholders (TRS) that is three times that of banks in the bottom quartile (Exhibit 1). Among banks, the difference between the most and least healthy organizations is greater than that of public companies as a whole.

Defining health

But what do we mean by health? Quite simply, health is defined as the ability of an organization to align on common goals, execute effectively to meet them, and innovate and continually adapt to change more rapidly than competitors. McKinsey's Organizational Health Index (OHI) enables the measurement of health across 37 different management practices. It looks at behaviors, actions, and processes, and how they contribute to nine dimensions of organizational health called "outcomes" (Exhibit 2).

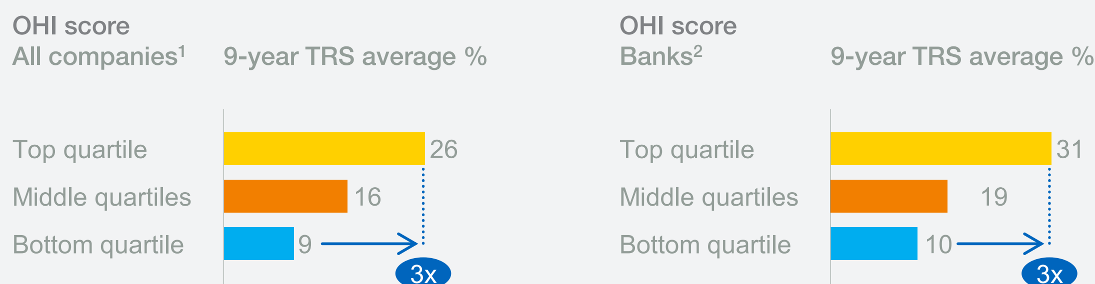
Today, pressure from a number of sources is causing banks to reassess their health and accelerate organizational transformation programs. Customer expectations are shifting rapidly, whereas regulators are increasingly expecting banks to measure organizational health and improve their risk cultures. Competitive threats are forcing banks to rethink business models and become more innovative, while rapid advances in digital are making it necessary to reinvent ways of working and the organizational model. All of these factors mean that the time is ripe for banks to accelerate efforts to improve their health.

Healthy banks share common characteristics

A detailed analysis of the organizational health of 87 banks globally (incorporating 170,000 respondents) provides several important insights about how both healthy and unhealthy banks operate.

Exhibit 1 – The healthiest organizations show TRS three times that of the unhealthiest

Correlation of Organizational Health Index (OHI) scores to TRS in public companies and banks



1 Sample of 272
2 Sample of 42

SOURCE: OHI database for health scores, CPAT database for financial data

Exhibit 2 – The Organizational Health Index

The 9 OHI outcomes...

SOURCE: McKinsey Organization Practice

...driven by 37 management practices

Leadership
- Authoritative leadership
- Consultative leadership
- Supportive leadership
- Challenging leadership

Direction
- Shared vision
- Strategic clarity
- Employee involvement

Culture and Climate
- Open and trusting
- Internally competitive
- Operationally disciplined
- Creative and entrepreneurial

Accountability
- Role clarity
- Performance contracts
- Consequence management
- Personal ownership

Coordination and control
- People performance review
- Operational management
- Financial management
- Professional standards
- Risk management

Capability
- Talent acquisition
- Talent development
- Process based capabilities
- Outsourced expertise

Motivation
- Meaningful values
- Inspirational leaders
- Career opportunities
- Financial incentives
- Rewards and recognition

External orientation
- Customer focus
- Competitive insights
- Business partnerships
- Government and community relations

Innovation and Learning
- Top-down innovation
- Bottom-up innovation
- Knowledge sharing
- Capturing external ideas

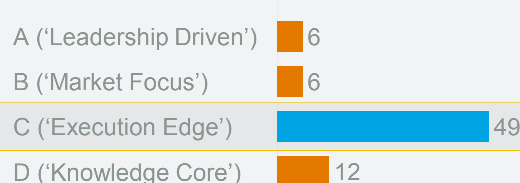
To start, we have found that high-performing banks focus on a handful of practices that work together to create a winning "recipe" – a coherent, effective management system that supports an organization's strategic objectives. Most banks use a specific formula that focuses on superior execution and continuous improvement.

We call this model "execution edge" (Exhibit 3). It is particularly relevant for retail banks where delivering smooth customer interaction is vital. Execution edge emphasizes using people and their know-how at all levels of the organization to outperform the competition through superior execution and continuous improvement.

Exhibit 3 – Healthy banks align disproportionately with "Execution Edge"

Distribution of moderate to very strong recipe alignment[1]

Number of banks by recipe



Top 10 practices for Recipe C, or Execution Edge (Healthy banks' Top 10 practices)

1. Knowledge sharing
2. Employee involvement
3. Creative and entrepreneurial
4. Bottom-up innovation
5. Talent development
6. Internally competitive
7. Personal ownership
8. Top-down innovation
9. Meaningful values
10. Consequence management

With execution edge successful banks "run the place" by using their people and know-how across the organization to outperform competitors through superior execution and continuous improvement

1 Includes all observations with alignment correlations showing moderate, strong and very strong alignment to a recipe from a sample of 73

SOURCE: McKinsey Organization Practice; OHI database

For banks following this recipe, key practices include encouraging knowledge sharing, creativity and entrepreneurship, employee involvement, talent development, personal ownership, and bottom-up innovation.

Just as important as the positive practices observed by healthy banks is the avoidance of so-called pitfall practices. Among unhealthy banks, instead of doing more to motivate people, there is a tendency to focus inward and use authoritative leadership as a crisis management technique. In addition, unhealthy banks tend to rely on outsourced capabilities and compliance with externally imposed behavior standards (such as regulatory codes) rather than building their own procedures and abilities.

Yet, it remains the case that both healthy and unhealthy banks seek to foster internal competition: the OHI database shows that it is the most common of the 37 practices. Internal competition will, of course, be something banks continue to encourage. What's essential is that bank leaders are in control of how internal competition is used and the second-order implications it may have. In particular, they should carefully consider whether it contributes to or detracts from the broader culture being built.

Finally, our research underscores why banks should broaden the methods used to both motivate employees and focus more attention on the external environment. Clearly, financial incentives and recognition will always play a role in motivation. However, inspirational leadership as well as placing greater emphasis on career opportunities and the development of meaningful values will deepen the motivation of employees. Boosting attention on the external environment will also present banks with a valuable opportunity to gain from improved customer and competitor focus.

"Just as important as the positive practices observed by healthy banks is the avoidance of so-called pitfall practices. Among unhealthy banks, instead of doing more to motivate people, there is a tendency to focus inward and use authoritative leadership as a crisis management technique. In addition, unhealthy banks tend to rely on outsourced capabilities and compliance with externally imposed behavior standards (such as regulatory codes) rather than building their own procedures and abilities."

Pick the right battles

The increasing recognition of the impact that health has on performance means that many banks want to improve their organizational cultures. Since banks can only realistically make considerable change in a few management practices during a transformation, our experience has shown that it is critical to carefully pick the right battles.

It is, therefore, important to first clarify which healthy practices will drive business performance in a specific situation. To do so, a bank should build a health baseline that incorporates an assessment of its starting position and creates the ability to track progress.

Exhibit 4 – Four influence levers are pulled to shift mindsets and behaviors in support of desired change

Influence Model

SOURCE: Scott Keller and Colin Price, "Performance and Health: An Evidence-Based Approach to Transforming Your Organization," 2010

From that baseline, a bank can define its health goals, which should include the selection of priority areas that will make the biggest difference to the organization.

The influence model

The next step is to design a set of integrated actions that will influence people to change. Once the direction of travel is clear, the right transformation actions can be designed to inspire lasting and self-sustaining mindset and behavior changes (Exhibit 4).

The influence model incorporates four levers that – when used together – can do just that.

The first focuses on communication: fostering understanding and conviction among employees about the need for change, what the change entails, and why it should matter to them. This can often be done through what is called a change story – a story that describes the change and is cascaded down from senior leaders to the front line, building buy-in through the cascade as one level of leadership discusses it with the next.

The second lever is role modeling the change: seeing formal and informal leaders behave differently will strengthen employees' conviction for change in them and build buy-in across the organization. The third lever is developing programs to build the skills needed to facilitate change. This will help overcome resistance from colleagues who do not have the new skills necessary to succeed.

The final lever is employing reinforcement mechanisms to support the transformation that is being pursued. These can be changes to incentives and metrics, or to performance management systems. Though reinforcement is a critical component, it is important not to overemphasize it relative to the other levers. In our experience, a tightly integrated action plan that engages and aligns the organization in a balanced fashion across these levers is the best way to create self-sustaining momentum for change.

Embedding culture change in the business

It is crucial to link the performance criteria for existing business initiatives with desired cultural changes. This will help reinforce and embed the transformation over time.

For example, consider a bank that has targeted a need for more collaboration and knowledge sharing to improve its health. Suppose that the bank also has a performance initiative focused on improving customer issue management. Rather than create a new program solely focused on collaboration, the performance initiative should be executed in a way that fosters it. This could involve leadership in the form of a cross-functional team, while having the initiative cosponsored by business units that do not typically work together.

A new platform could also be set up to enable cross-silo discussion of customer issues. In each example, deliberate steps are taken to improve collaboration (and health) while also improving customer issue management (and performance).

In sum, banks need to clearly prioritize which health actions will drive performance and then design the interventions using the full set of influence levers (fostering understanding and conviction, role modeling, skill enhancement, and reinforcement mechanisms). Packaging this with a joint rollout of business initiatives should ensure real and lasting impact.

The business and economic challenges that banks face provide a strong imperative for leaders to measure their organization's health, determine the right recipe for future success, and prioritize where management's time and financial capital should be invested. Leaders that take these actions will position their institutions to improve and sustain organizational health – and overall performance – for the long term.

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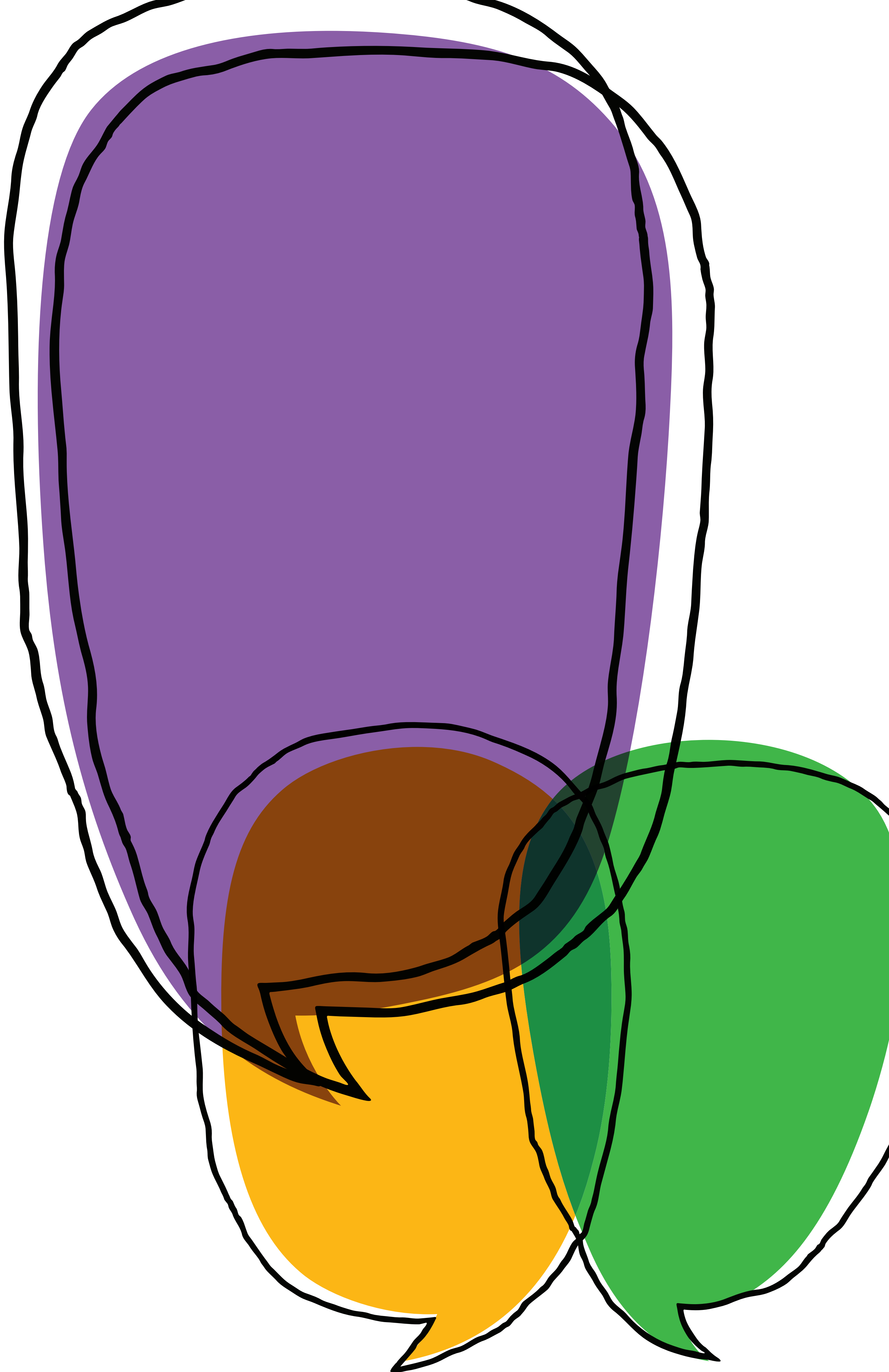

Managing the people side of risk: Risk culture transformation

Julia Graf, Alexis Krivkovich, Cindy Levy and Mehdi El Ouali

Introduction

In the wake of the global financial crisis, banks have invested heavily to improve their risk models and to put in place more thorough processes and oversight structures in order to detect and mitigate potential risk. Yet, models, processes, and oversight structures – albeit essential – are only part of the story. In our experience, most risk incidents tie back to a cultural root cause, fostering inappropriate decisions and actions that result in losses. Crises can continue to emerge when organizations neglect to manage their people's attitudes and behaviors towards risk across all lines of defense.

In April 2014, the Financial Stability Board (FSB) stated that even though risk culture is a very complex issue, "… efforts should be made by financial institutions and by supervisors to understand an institution's culture and how it affects safety and soundness" (FSB report, "Guidance on Supervisory Interaction with Financial Institutions on Risk Culture," April 2014). By now, nearly all national regulators in North America and Western Europe have issued guidelines requiring banks to actively improve and monitor their risk cultures.

In this context, banks find themselves faced with three major questions:

- How should risk culture be defined?
- What is required to transform an organization's risk culture?
- How can an organization rigorously monitor progress on evolving risk culture towards a desired target state?

Traits of strong risk culture

Effectively tackling the issue begins with establishing a common language for how to talk about risk culture. We define risk culture as:

The mindsets and behaviors of individuals and groups within an organization that determine the collective ability to identify and understand, openly discuss, and act on the organization's current and future risks.

This definition is supported by 10 dimensions of risk culture, identified through dozens of in-depth case studies on the cultural root cause of risk incidents at leading institutions, globally coupled with an extensive review of academic literature. Underpinning this framework is a rigorous quantitative assessment of the strength of risk culture, which has now been deployed at over 30 financial institutions globally (Exhibit 1).

Encouraging transparency

The best cultures actively seek information about and insight into risk through appropriate risk models, detailed risk reporting, and the establishment of a shared responsibility to communicate potential issues. A lack of transparency on current and future risk exposures not only hinders early risk mitigation, but can also prevent measured risk taking. The mindset of: "If we don't know, the answer is no," is a common reflex in organizations with low transparency, resulting in foregone opportunities and strife between business and risk functions.
At the same time, it is important to foster a common understanding of the boundaries of individual risk taking. A clear risk tolerance derived from an overall risk appetite statement and expressed in specific guidelines that limit which risks are allowed is one important element of a strong risk culture.

Acknowledging risk

It takes a certain confidence among managers to acknowledge risks. Doing so requires working through issues that could lead to crisis, embarrassment, or loss. The cultural difference between companies that acknowledge risk and those that do not is stark. Consider, for example, the difference between two global financial institutions we surveyed that take similar risks and share a similar risk appetite.

Exhibit 1 – Risk culture elements

The first has built an organizationwide culture that values proactive challenging of decisions, thereby encouraging discussion and learning from risk failures. The stance it takes is: "If we see it, identify it, and size it, then even if it's horrible, we will be able to manage it!" Where risks cannot be sized, they are at least discussed in qualitative terms. This institution has won the respect of regulators and built credibility with investors.

The second institution, in contrast, has evolved into a reactive and protective culture – one focused more on staying out of trouble. Its managers are generally content to run with the pack on risk issues, preferring to wait for regulatory scrutiny or reprimand before upgrading subpar practices. They are afraid of what they don't know and, over time, have instilled in employees a fear that they will "shoot the messenger." This organization's stance is: "Let's wait until we really need to deal with these unpleasant things, because they might turn out to be nothing at all." They've experienced a wave of regulatory fines and now face an overhaul of their risk governance processes.

"It takes a certain confidence among managers to acknowledge risks. Doing so requires working through issues that could lead to crisis, embarrassment, or loss."

Responsiveness

The most effective organizations act quickly to move risk issues up the chain of command as they emerge. This requires well-defined, yet nimble risk escalation processes along with the willingness to break through rigid governance mechanisms to get the right experts involved whether or not, for example, they sit on a formal risk-management committee. Very often, responsiveness is bogged down by the very processes intended to support a strong risk environment – expectations on supporting data and committee protocol can swamp the ability

to engage in productive discussion of emerging risks before they become prominent issues.

Responsiveness also requires instilling a cohesive sense of personal accountability at the individual level for risk management, across all lines of defense. Institutions that stand out in this regard embody a mindset of "every manager is a risk manager," avoiding the trap of positioning the risk function as the "police department" of business behavior.

Ensuring respect for risk

Most executives understand the need for controls that alert them to trends and behaviors they should monitor in order to better to mobilize in response to an evolving risk situation. While too few controls can leave companies in the dark as a situation develops, too many can be equally problematic. More controls are often mistakenly equated with tighter management of risk. In one large hospital system surveyed, managers had implemented so many guidelines and controls for ward procedures that staff saw them as impractical. As a result, they routinely circumvented them, and the culture became increasingly dismissive of all guidelines, to the detriment of patients.

In the best of cases, respect for rules can be a powerful source of competitive advantage. A global investment company that took part in the survey had a comprehensive due diligence process and sign-off requirements for investments. Once these requirements were fulfilled, however, the board was prepared to make large, early investments. Companywide confidence in proceeding resulted from an exhaustive risk debate that reduced fear of failure and encouraged greater boldness relative to competitors.

Risk culture transformation

Banks that want to reshape their risk cultures should be aware that patience and persistence are crucial. Changing the operating environment of a large organization takes at least two to three years.

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In our experience, the keys to a successful risk culture transformation are:

- Reaching a broad consensus on the desired risk culture that is linked to the overall organizational culture.
- Reviewing formal mechanisms to enforce a strong risk culture and developing people capabilities related to dealing with risks.
- Overinvesting in communication and senior leadership role modeling.

Reaching consensus on culture

Improving a company's risk culture is a group exercise. No one executive—or even a dozen—can sufficiently address the challenge. A risk culture transformation must build broad agreement among a bank's top 50 or so leaders.

These leaders must first clearly define the kind of culture they want to build – expressed in four or five core statements of values. For one institution,

this included the statement: “We will always understand the infrastructure implications of the risk decisions we make.” As a consequence, the company needed to change the way it approved activities so that they no longer proceeded if the risk infrastructure did not support them.

A common pitfall is to define a desired risk culture and put in place a transformational program without considering the wider organizational culture. A bank’s overall culture will significantly influence its risk culture. For example, a hierarchical leadership culture may make it difficult to foster openness and challenge across all levels. The link between desired risk culture and the overall organizational culture needs to be actively discussed among leadership. One option to ensure a proper linkage of risk culture to the overall organizational culture is to embed risk culture expectations into the general code of conduct.

Review formal mechanisms and capability building

To make aspirations for risk culture operational, managers must translate them into specific process changes across the organization. This includes changing the way governance committees function, adjusting key operating procedures, and modifying people processes such as training, compensation, and accountability.

While reengineering end-to-end processes takes time, creating a sense of urgency through a few symbolic, but highly visible actions can have a profound impact on a bank’s culture. For example, in one global organization, a simple announcement that certain risk-related data would be incorporated into promotions radiated throughout the organization virtually overnight, encouraging some behaviors and discouraging others.

Beyond pay and promotion structures, the incorporation of risk culture elements in the full HR cycle is critical. An assessment of risk culture attitude should be incorporated into the recruiting process. A targeted, tenure-dependent capability building program for risk and nonrisk employees, based on real risk scenarios, can help reinforce key risk culture messages. Rotation programs are another way to build more extensive risk knowledge, with some institutions even going so far as to make a rotation in risk or compliance mandatory for senior leadership progression.

> “A common pitfall is to define a desired risk culture and put in place a transformational program without considering the wider organizational culture. A bank’s overall culture will significantly influence its risk culture. For example, a hierarchical leadership culture may make it difficult to foster openness and challenge across all levels. The link between desired risk culture and the overall organizational culture needs to be actively discussed among leadership.”

Communication and senior leadership role modeling

Proper communication across all levels is the key to ensuring sufficient awareness of potential risks and an associated good risk culture. Very often, a risk culture narrative that seems obvious to senior leadership is poorly understood by those just a few levels deeper in the organization. Investing the time to clearly articulate and cascade the desired target state can drive measureable impact. This includes finding ways to celebrate examples of good risk

behaviors as well as creating the right "cultural PR" through town halls, different forms of employee communication, and leadership actions.

In our experience, the perception gap can vary dramatically across organizational levels. Even with explicit encouragement, employees often feel wary about stepping out of their comfort zones. Senior leaders at one leading bank were surprised to discover that while they rated their institution very strongly regarding openness to upward challenge on risk issues, those deeper in the organization did not. A behavior they welcomed and thought they were encouraging was, in fact, not perceived as safe. Altering this perception required initiating a dialogue about how challenge is expected and rewarded with mechanisms built into decision making to prompt the explicit discussion of what might be missing/what could go wrong.

From transformation to risk monitoring

Maintaining a strong risk culture requires constant vigilance, which in turn requires regular monitoring. Risk culture can and should be measured. Typically, a mix of different metrics needs to be applied to measure all aspects of risk culture. These often include:

- **Behavioral scores,** e.g., from annual surveys sampling employees about their views on a set of prevailing outcomes and practices along all risk culture dimensions.
- **Risk culture knowledge scores,** e.g., the share of employees that attended a risk culture training module, the frequency of risk-focused communications sent out by management.
- **Outcome-based metrics,** e.g., the amount of operational losses, the number of compliance incidents, the number of audit findings resolved in a timely manner, the number of risk limit breaches.

One bank introduced a "red flag system" in which managers issue red flags to employees for nonadherence to policies and procedures (i.e., not fulfilling mandatory training requirements on time, limit breaches, the use of unapproved models) with the specific number of red flags issued dependent on the frequency and severity of individual breaches ("risk weighting"). Red flags are then considered during performance reviews and constitute one of the criteria for decisions regarding individual promotions and compensation.

For banks, a successful risk culture transformation should result in a lower number of risk/ compliance incidents, lower operational losses, and a reduction in regulatory penalties. It is our contention that risk culture in banks can be defined and measured using a combination of tools. This enables specific interventions to be designed and deployed to shape a bank's risk culture and reduce the likelihood of breeches occurring in the future. Risk taking will remain central to bank operations. It is, therefore, important that management actively shape a risk culture in which these risks are managed and run, and that every employee, in accordance with the organization's risk profile, plays his or her part in protecting the institution from extraneous risks.

For bank leadership teams, understanding and developing risk culture is the key to becoming smarter and more agile. The stronger an institution's risk culture, the less it needs to rely on policies, procedures, and systems to manage and mitigate risk. For banks, a successful risk culture transformation is the first step in developing superiority in risk mitigation.

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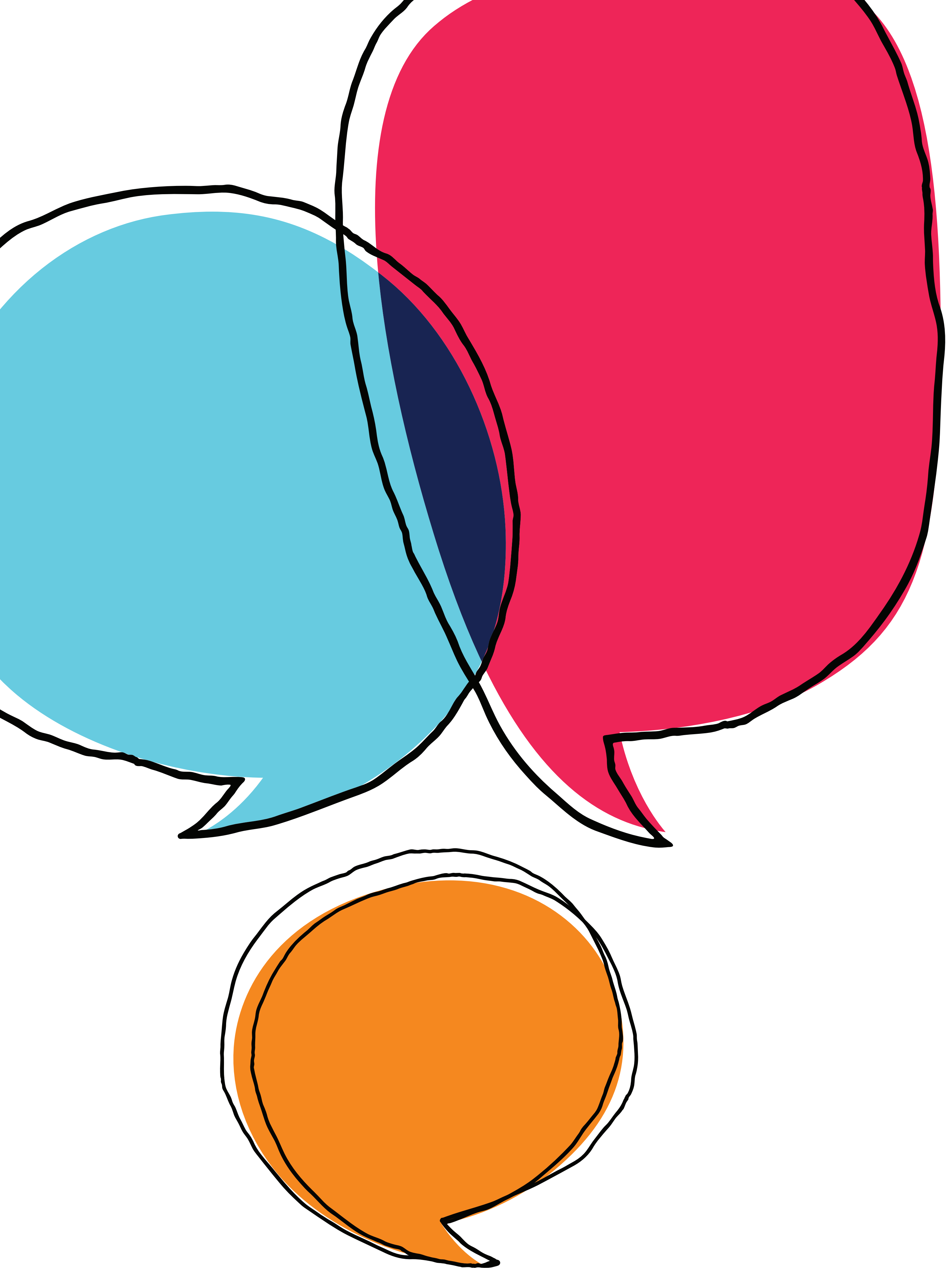

Go on the offensive: Use digital to build the bank of tomorrow[1]

Henk Broeders, Barbara Jeffery, and Somesh Khanna

Changing consumer behavior enabled by digital technologies is revolutionizing retail banking. Today, only about 10 percent of retail banking revenue is captured via online or mobile channels, but this is set to rise to 30 to 60 percent by 2018, in major markets.[1] Incumbents only have a short period to adjust to this new reality or risk becoming obsolete. To go on the offensive, CEOs should focus on building the digital bank of tomorrow.

As the financial crisis recedes, it is increasingly apparent that the new epoch of banking will be defined by digital. In fact, we believe banks have only a few years to become digitally proficient. There is an urgency to act or risk entering a spiral of decline like laggards in industries where digital has already reordered the competitive landscape.

Revenues and profits will move at scale towards banks that successfully use digital technologies to automate processes, create new products, improve regulatory compliance, transform the experiences of their customers, and disrupt key components of the value chain. Institutions that resist digital innovation will be punished by customers, financial markets, and – sometimes – regulators. Indeed, our analysis suggests that digital laggards could see up to 35 percent of net profit eroded, while winners may realize a profit upside of 40 percent or more.

Embracing digital transformation

Innovative bank CEOs are moving rapidly to transform their institutions by embracing digital. Significant progress has already been made with transaction migration. In addition, many banks have invested in Web and mobile technologies and have created innovation and testing centers. Yet, banks have also increasingly realized that to succeed with digital, they must adopt the habits and cultures of digitally native companies: for example, by opening up the banks' application programming interfaces, pursuing agile development, or finding new ways, such as hosting "hackathons," to foster intensive digital collaboration.

The imperative for digital transformation isn't expected to show any letup. Within the next five years, research from McKinsey Solutions shows that digital sales will advance rapidly. Indeed, digital sales could account for 40 percent or more of new inflow revenue in the most progressive geographies such as Western Europe and in product segments such as savings and term deposits.

Although the impact of change may take longer to materialize than expected, evidence suggests that digital transformation is at an inflection point. We believe banks have only a few years to adapt.

Appreciating the magnitude of the opportunity – and the gravity of the threat – is vital, but it is just the first step in formulating and executing a winning digital transformation. Digital will touch every aspect of bank operations, from product development to risk management and human capital management. What's more, CEOs need to have both a clear understanding of how digital creates value and granular perspectives on consumer behavior and market dynamics. They also need to carefully prioritize action among hundreds of potential digital investments.

The urgency of action is underscored by the movement of new entrants into the broader financial services sector in many markets. Alibaba, for example, has captured about USD 100 billion in assets in the second year since its launch of a wealth management platform in China, while online giant Tencent is building a financial ecosystem around a large-scale online platform. The realm of payments, already digitized, is also seeing more innovation from Apple Pay's contactless payment technology.[2] Banks, too, must embark on digital transformations to capture customers migrating to new types of products and services.

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[1] The analysis and data in this article is based on Henk Broeders and Somesh Khanna, "*Strategic choices for banks in the digital age*," January 2015.

[2] Olivier Denecker, Sameer Gulati, and Marc Niederkorn, "*The digital battle that banks must win*," August 2014.

Capturing the value of digital transformation

A digital transformation can create value for banks in four fundamental ways. First, digital technologies increase a bank's *connectivity* – not only with regard to customers, but also with regard to employees and suppliers. This extends from online interactivity and payment solutions to mobile functionality and opportunities to boost the presence of bank brands in social media.

Second, digital draws on big data and advanced analytics to extend and refine *decision making*. Such analytics are being deployed by the most innovative banks in many areas including sales, product design, pricing and underwriting, and the design of truly amazing customer experiences.

A third way that digital transformation creates value is by enabling straight-through processing – that is, *automating* and digitizing a number of repetitive, low-value, and low-risk processes. Process apps, for example, boost productivity and facilitate regulatory compliance, while imaging and straight-through processing lead to paperless, more efficient work flows.

Lastly, digital transformation is a means of fostering *innovation* across products and business models. Examples of this include social marketing and crowd-sourced support as well as "digitally centered" business models.

Capabilities and culture drive digital transformation

The process of developing and driving a digitally focused transformation is complex. For CEOs, the good news is that each of these ways of creating value can be applied to every bank function. Yet, the process requires an unusually high level of coordination of cross-bank initiatives spanning prioritization, resource allocation, and collaboration in execution.

Most banks are only in the early stages of developing the capabilities and culture of digitally native organizations. We would like to highlight a few broad capabilities or ways of working to drive a digital transformation:

User-centered customer-journey design. Customer journeys should be compelling and highly differentiated, combining personalization, speed, and ease of use for all processes including applying and getting approved for a loan, opening and understanding how to make full use of an account, and reconciling payments. To make this leap in the delivery of customer journeys, banks need to act quickly to acquire extensive capabilities in user experience and user interfaces.

> "Appreciating the magnitude of the opportunity – and the gravity of the threat – is vital, but it is just the first step in formulating and executing a winning digital transformation."

Personalization, leveraging data, and advanced analytics. Most data still go unused. Yet, there is significant value in applying advanced analytics to create targeted offerings for up- and cross-selling. This is achieved by making data usable in real time, such as at the point of sale, and combining it with analytical tools to generate insights provided by "next product to buy" models or risk assessments, for example.

Rapid experimentation and agile development. Banks need to learn to rapidly acquire or imitate high-value initiatives, while showing tolerance of failure in trials. Banks often struggle with a culture of trialing and testing. In addition, they need to move away from a "waterfall" approach in which there are months between releases to an "agile delivery" approach with weekly sprints.

They must achieve this agile model at scale but still recognize that agile isn't necessarily the right answer for every development effort.

Developing capabilities is crucial, but an equally critical part of succeeding with digital change is the need to develop a different culture. Here, the aim should be to adopt a mindset similar to that found in successful digital enterprises. This would include everything from establishing a challenging and coherent digital vision to acquiring new data capabilities and adopting a test-and-learn approach with rapid iterations. To be successful, a digital transformation requires instilling habits or traits in a bank's culture.

Getting (and keeping) talent

Sourcing and retaining the right talent is a critical precursor to building the right capabilities and culture. CEOs can mix a number of approaches depending on timelines and existing capabilities.

The best digital companies buy scarce talent en masse. We have seen some banks emulate the high-tech practice of "acqui-hiring," that is, acquiring small companies largely for their employees rather than their products.

An example of this is BBVA, which bought Simple, a fast-growing digital bank with about 100,000 customers in the US. Simple's talent and capabilities acted as a catalyst to enhance BBVA's marketing and digital capabilities and culture. We believe retail banks have the scope to acqui-hire much more regularly. Banking lags industries such as high tech, where this practice is much more common.

Driving and sustaining a digital transformation also requires taking a systematic approach to building in-house talent. Most banks seek to foster relevant technical skills such as mobile development, data and analytics, and cybersecurity skills as well as capabilities for new infrastructure such as cloud technologies. However, we would argue that many banks neglect developing mindsets and core leadership skills – which can be a fatal error. The McKinsey Global Survey[3] suggests that company leaders often think that the success (or failure) of digital transformation ultimately relies on organization and leadership, rather than technology considerations. Since leadership is the most decisive factor for a digital program's success or failure, increase your focus on building the digital capabilities of your senior leaders.

We see an increasing move towards partnering for hard-to-build skills, or skills that are used on a limited basis. Models that seem to work include managed services and open partnerships, among others. However, one model that tends to fail is fully offshoring and outsourcing digital capabilities while trying to undertake a digital transformation. Evidence suggests that this makes the transition even harder.

To retain talent, banks need to help talent develop further, not just through formal training, but also through the use of innovative formats like games or hackathons. An important incentive for digital talent is to let these employees see impact quickly through rapid (daily or weekly) releases of code.

Creating the right organization structure

For larger companies, organizational structures are now judged to be the biggest barrier to achieving digital success, according to the latest McKinsey Global Survey. This has replaced talent shortages as the top challenge. To be successful, banks need to offer digital customers a fully consistent and coordinated experience. Banks, in particular, need to rethink the organization of their governance structures, and their standards for data and systems.

[3] Josh Gottlieb and Paul Willmott, "*The digital tipping point: McKinsey Global Survey results*," June 2014.

Digital organization structures continue to evolve, with no clear winning model emerging, but, typically, we see two main successful characteristics. We recommend that banks consider making both of these moves:

- **"Disorganize" by creating resource pools rather than functions.** Resource pools, rather than siloed functions, encourage agile working modes and collaboration. Rotate colleagues between organizational units and move to project-based resourcing models that utilize a professional-services approach.

- **Build digital shared services.** Creating (or expanding) a unit to manage digital shared services allows digital assets (such as data, algorithms, processes, and other capabilities) to be deployed across businesses. This enables a consistent customer experience and delivers economies of scale.

One choice that all banks face is the degree to which digital business should be kept separate or integrated. We have seen both models work.

Integrating digital operations can quickly provide bank customers with multichannel capabilities. Lloyds Banking Group is keeping digital integrated with its traditional business, but it has also created a digital hub to support the rest of the group in adopting new technologies to improve the customer experience.

Other banks choose to completely separate the digital business in order to foster capability development more rapidly. For example, Millennium bcp set up ActivoBank as an own-brand digital bank with separate commercial and operating functions.

The pace and scale of a bank's digital transformation will depend on its ambition, investment capacity, and management capability. Other key factors include the level of the bank's development including current working practices, how architecture is split between the front and back ends, and the stability of the run environment.

> "Driving and sustaining a digital transformation also requires taking a systematic approach to building in-house talent. Most banks seek to foster relevant technical skills such as mobile development, data and analytics, and cybersecurity skills as well as capabilities for new infrastructure such as cloud technologies. However, we would argue that many banks neglect developing mindsets and core leadership skills – which can be a fatal error."

Failure to adapt in the brief window that is open to banks will risk damaging franchises that have taken decades to build. Conversely, if CEOs manage to address the multiple strategic challenges posed by digital transformation, they can position their institutions to compete effectively and capture a new long-term growth trajectory.

About the authors

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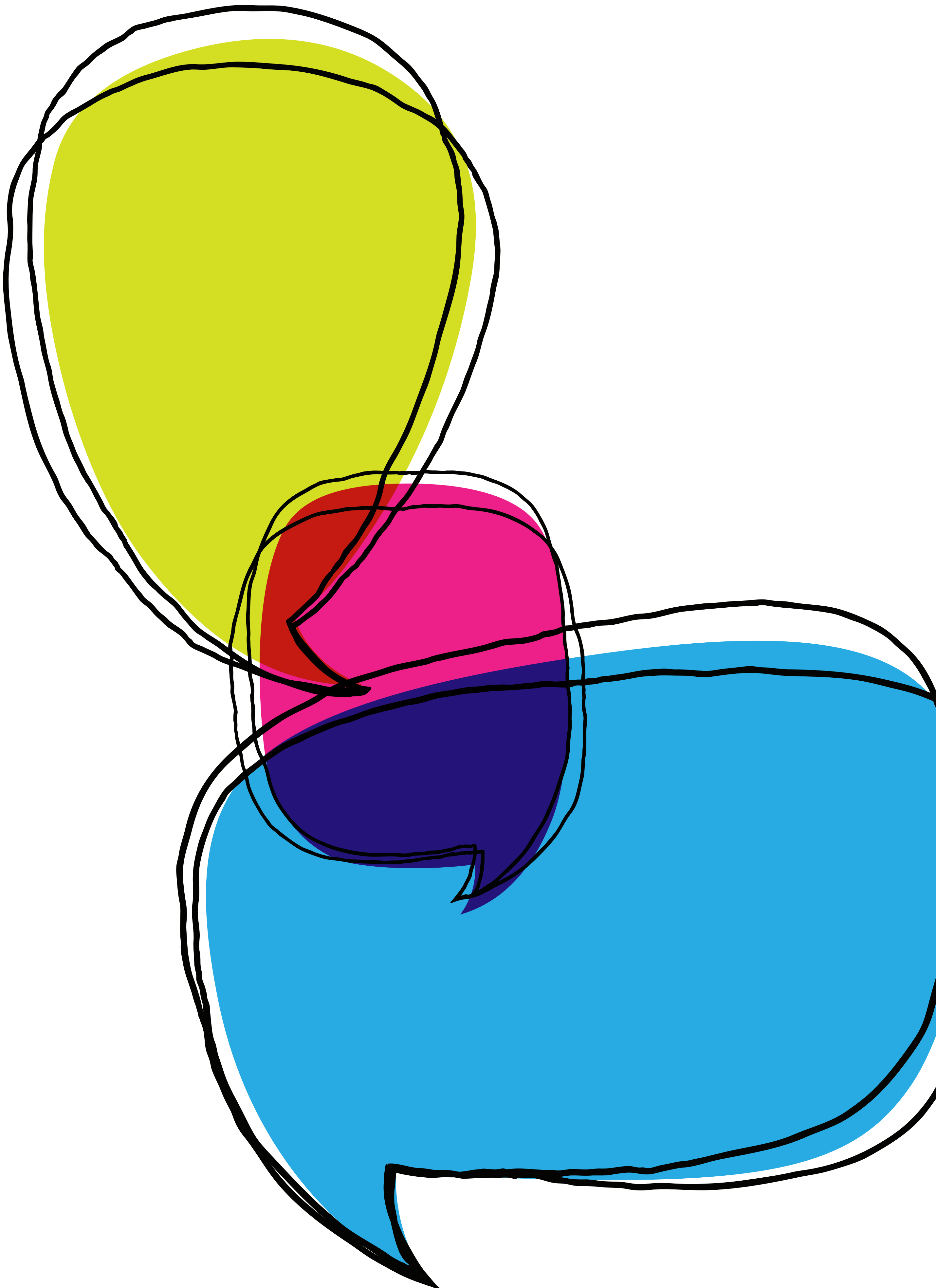
Part II
Leaders on bank transformation



Building an American powerhouse:

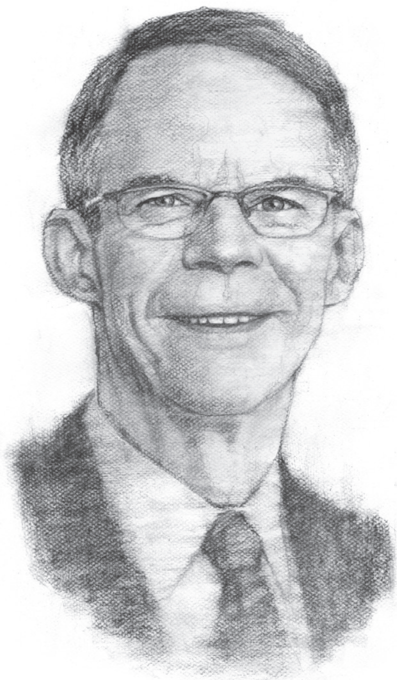
An interview with the CEO, President, and Chairman of U.S. Bancorp

Toos Daruvala

Richard K. Davis describes creating a culture based on adapting to continual change and the importance of engaging employees' vision of the future

Richard K. Davis

CEO, President, and Chairman, U.S. Bancorp



U.S. Bancorp is an American diversified financial services company headquartered in Minneapolis, Minnesota. It is the fifth largest commercial bank in the US with USD 403 billion in assets as of December 31, 2014. The bank was forged during the 1990s from the acquisitions of several major regional banks in the American West and Midwest. The present-day company took shape when the Firstar Corporation completed the acquisition of U.S. Bancorp in early 2001.

Richard K. Davis became CEO of U.S. Bancorp in December 2006, and also serves as Chairman and President. For two years prior to that, he was Chief Operating Officer. When Firstar acquired U.S. Bancorp, Mr. Davis was responsible for consumer banking, including retail payment solutions, and he later assumed additional responsibility for commercial banking. In recent years, U.S. Bancorp has transformed its employee culture, grown strongly, and emerged as one of the leaders in global banking. Mr. Davis recently spoke with Toos Daruvala, a Director in McKinsey's New York office. The following is an edited transcript of their conversation.

McKinsey: You started out in 1976 in a frontline service role. What are the biggest changes you have observed in the world of banking and customer experience over the last three decades?

Richard Davis: In 1976, there was no online banking and if you wanted to conduct a transaction you needed to come to the bank. Obviously that's not true now. However, in some respects we have come full circle in that the front line is going to again be required to provide expertise and information to customers. Many banks are closing lots of branches, but we aren't. We think that branches will increasingly be important for profitable conversations and guidance, rather than transactions and processing. So I think frontline service, rather than being just a transaction, can be a conversation of opportunity. I think the skill sets will rise and people will need to be multicapable. I'm excited to see that we're coming into a world where consultative expertise has value again and where customers, no matter what channel they use for transactions, will still find the need to contact a banker for guidance and information they can't get anywhere else.

McKinsey: How would you describe the U.S. Bancorp story?

Richard Davis: We've grown to become the fifth largest commercial bank in the US. The merger joined two USD 80 billion banks to create a USD 160 billion bank. Now, just 12 years later, we are close to being a USD 400 billion bank with the majority of that growth being organic. Since 2002, there have been a small number of acquisitions and mergers, but the story is mainly one of organic growth. In the first few years after the merger, we went on offense to gain market share and grow the business in markets where we operated. And since 2008, we have enjoyed a "flight to quality," as one of the strongest banks in America. This helped us improve the quality of customers and new businesses we attracted and helped us to further grow the bank. As the economy continues to improve, our reputation for high-quality growth will play perfectly with the recovery.

McKinsey: U.S. Bancorp has always had a very strong expense focus. But you have shifted the bank to being employee and revenue focused. How did that transformation happen?

Richard Davis: We have long "owned" the category as the most efficient bank in America. But while we are focused on expenses, we are also growing revenue better than most. We are mindful of expenses, but not at a cost to top-line revenue. This balance is something few of our peers have managed. We aim to have revenue grow faster than expenses so that the efficiency ratio will continue to improve and keep us at the top of the class.

The culture transformation was different. About ten years ago, we reversed the paradigm and put employees first. We have found that if employees are deeply engaged and excited, customer service improves. The upshot is happy customers and a remarkably strong stock price, which both reward shareholders. So for us, the transformation was about putting employees first.

McKinsey: You describe organic growth as building deeper customer relationships, investing and executing in digital banking channels, and improving customer experience. What connects all this?

Richard Davis: Two things. One is increasing employee engagement. When an employee is motivated, engaged, and enthused, it affects your experience and willingness to listen and learn more. When banks genuinely take the interest of customers to heart, it starts to make a big difference.

The second thing is to emphasize that the transformation to the digital world and higher technology competence is completely about enabling employees to be better service providers. Think of how air travel now operates. When people walk into the airport they print their own ticket. Customers able to handle their own transactions rate the experience positively because they are satisfied by being able to serve themselves and not having to wait for someone else. Yet there are still people there if you really need to speak to them or if you need to check luggage weight, for example. A customer places a higher value on this because it is something he or she can't do for themselves.

"We are mindful of expenses, but not at a cost to top-line revenue. This balance is something few of our peers have managed. We aim to have revenue grow faster than expenses so that the efficiency ratio will continue to improve and keep us at the top of the class."

For us, technology has to allow customers to self-direct efficiently and without interruption or empower employees to help a customer in an efficient and capable fashion. Technology allows us to help customers be self-directed, but use a bank employee when needed. When that happens, the experience has got to be remarkable.

Nine years ago, we created an office of revenue to let investors know that U.S. Bancorp could be as good at growing revenue as at managing costs. We believe that organic revenue growth comes from customer relationships. With the support of technology, it can be become more effective, not just efficient. We describe organic revenue growth as doing more with existing customers: by allowing them to either self-direct or reach out to have a higher level of conversation with and guidance from bank employees.

McKinsey: It has been observed that banking used to be very much about credit risk, but you have said in the current environment it is much more about regulatory risk. How did the bank handle this shift?

Richard Davis: Credit risk is still there and always will be because banks are in the business of making loans. But in the last few years, the focus has shifted to doing things more competently. Now the bar is much higher, and we need to be compliance perfect. Take air travel again. Baggage handlers look to get things done right, but if something goes wrong a bag might be put on another plane and get delivered the next day. Nobody gets hurt too badly in the outcome. But an airline also has pilots – and they must have zero tolerance for errors – zero tolerance for planes that fall out of the sky. In the last few years, bankers have had to adjust from being more like baggage handlers to becoming more like pilots. We're now moving to the same expectation of compliance where it's no longer okay to make a handful of mistakes even if no one really gets hurt. Every transaction needs to be done perfectly, and your support capabilities must be as competent and as good as your origination. It's caused us and a lot of other banks to really rethink compliance. One silver lining of this transition into a compliance-focused industry is that in the aftermath of the credit crunch there weren't a lot of bad loans made. So we are spending our energy improving compliance risk. As the market recovers, banks will emerge with a compliance and credit culture that is better and more capable than the previous one.

McKinsey: What are the key steps you've taken to develop this culture of compliance?

Richard Davis: The first thing to do to modify a culture is to be specific and describe that you're expecting things to change. The second thing is to put it in the context that it's a reasonable – not a remarkable – thing to do. Banking is in the business of trust so it makes sense that we always attempt to do things correctly the first time. People in the bank need to realize it's not a Herculean task for them to move to a compliance culture of seeking perfection, but that it's consistent and in keeping with who we are.

Perhaps the most important thing is that no leader should ever criticize or voice aversion to compliance. Many times I've heard other bank executives publicly discuss how frustrated they are with the time and effort spent on compliance and how much they dislike it. For my part, I value our compliance people because without their expertise and diligence we wouldn't do compliance well.

With compliance, there are effectively three lines of defense. The first line is people who sell and service the products. The second line is the compliance folks in the business lines who make sure everything is done well and accurately. The third line would be the audit department, which confirms everything is done properly. What you want is for everybody to be compliance focused. If for some reason the front line makes a mistake, the compliance group will point this out and guide them to do it better the next time. And if both miss the breach then the audit department will step in and remedy the problem. It's important to celebrate achievement in compliance just like you would high levels of sales.

McKinsey: What demands is digital transformation placing on a bank's human capital, and what are some of the constraints that digital is imposing on banking?

Richard Davis: I think digital transformation is a natural evolution. Our employees and customers see this clearly: the migration of channel choices, mobile banking, and different ways of moving money. It is really about adding channels to the ATMs, call centers, and branches we have already. Our responsibility is to have all the options available to our customers, but to let them choose and not force them into some paradigm that they're not ready for.

We have a group of 250 people who come to work every day to figure out the new best ideas in banking. It's allowed us to have a leading position in innovation when banks typically aren't considered to be innovators. Being in the payments space means we're competing with nonbanks, and they hold us to a higher bar, so that makes us better and smarter. We've also learned that if we can't build something ourselves, we need to find a development partner so that we can market the product to our customers before someone else does. This protects the bank's role in the payments scheme and keeps us the trusted partner for moving money safely.

McKinsey: You have regularly called U.S. Bancorp a business of people. How does the bank look to inculcate its vision and invest in human capital?

Richard Davis: We are a business of people for people. The minute that a bank becomes entirely automated, it becomes a commoditized service. Helping customers learn and become more capable of getting a desired outcome is how bank employees can measure their success.

Technology can make things faster and more efficient, but it will never replace what people do for each other. The banks that are typically the most successful are the ones where customers feel that the bankers are better listeners and better purveyors of information and guidance. Putting the employee first means they're engaged and excited about their role, and they believe in the bank's vision. That translates into a remarkably better customer experience than one where an employee just comes to work every day and is waiting for the next opportunity somewhere else.

McKinsey: Regarding employees, you've noted that training is almost secondary to their ability to convey remarkable experiences. Can you elaborate on that a bit?

Richard Davis: When employees are just employees and told to do certain things in a particular order with a customer, they'll train themselves dull. On the other hand, an employee who is empathetic, capable, smart, talented, and energized to do the right thing no matter what the circumstances will still need to be trained, but the training won't be rote, and the answers won't be the same to every question. That employee will be motivated to find the right answer or seek a slightly different solution based on the circumstances. And if he or she is motivated, engaged and empathetic, he or she will find the answer because someone within the bank will have a solution. Thus, I put engaged employees above perfectly trained employees because perfectly trained employees have no empathy and are not very effective. Highly trained employees with huge amounts of empathy who understand their roles can be amazingly effective.

> "We are a business of people for people. The minute that a bank becomes entirely automated, it becomes a commoditized service. Helping customers learn and become more capable of getting a desired outcome is how bank employees can measure their success."

McKinsey: What are the key distinctive leadership practices that you have followed?

Richard Davis: We aim to keep them simple. The focus is particularly on things like transparency, collaboration, integrity – in short, the key things that help a manager become a leader. A manager spurs people to do what they need to do and conducts them like an orchestra, while a leader uses trust to take people to places they've never been before. Leadership traits are much more aspirational in nature since leaders are

expected to interpret them slightly differently given particular needs and circumstances.

McKinsey: How has the bank's leadership team evolved since you became CEO nine years ago?

Richard Davis: First, it's important to say that they are an amazingly good team and remarkably stable. Of 13 direct reports, only six people have changed in those nine years. I like to think that our leadership team evokes trust and a common sense of purpose for the entire bank. We routinely go into different markets and conduct panels with large bank management teams. We generally find that employees like and trust each other. There is also a focus on what is good for the entire group and little sense of competitiveness between different teams.

I like to think that one of the contributions I've made is to create a transparent and very healthy leadership environment. This has helped with role modeling and building a more productive team of employees.

McKinsey: How have you and your team succeeded in engaging the whole organization and transforming the culture when so many other organizations have come up short in seeking change?

Richard Davis: Once we embark on something, we always think about our strategy as a team. When we determine the strategy, we lock it down and then move forward together as a team. There are two important things to recognize there. First, we spend time debating and agreeing on a strategy; any discord is settled once we move forward. The second thing is that we are totally transparent about the strategy and making it simple, actionable, and transferable. Making strategy simple is very hard but absolutely necessary. If a strategy isn't simple and there is no general sense of the goal being pursued, then an organization has failed in the first step and there is little likelihood of getting the execution right. To avoid this we spend a fair amount of time on getting strategy right, but spend more time making sure that everyone gets it and gets on with it together.

McKinsey: In your experience, what are some key risks that transformations run up against, and what are the mindsets needed to overcome these barriers?

Richard Davis: With a team like ours that's worked together and is very stable, there might be a risk of becoming comfortable and failing to look for new breakout opportunities. But I'd rather know that's a risk and manage it than have the alternative: no stability and no sense of trust. Transformations often run up against a mindset that says: "If it's worked this way so far, why would we need to make a change?" Or, in our case, we continue to be among the best in the industry in almost every category, why fix something that's not broken? That's one way to look at it. However, if you agree that your success came from not sitting still, you can then show that moving forward and innovating are what made you successful. That transforms a group to believe that the only way to remain successful is to keep changing. But it's important to remember that the way you define recent success will determine how an organization is going to be motivated in the future. When we look at the milestones of our success, we characterize them as things we did differently. Thus, it's easier for us to think about how we keep changing rather than considering it a result of new ideas or interruptions of things that are working. For me, complacency and misunderstanding why an organization is doing well in the first place can lead to outcomes that will inhibit growth and a bank's ability to adapt over time.

McKinsey: Finally, what are some of the key leadership lessons that you have learned?

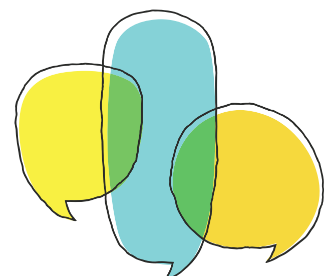
Richard Davis: I've learned that you build a culture one person and one idea at a time. But you don't get to a culture if you don't set that as a goal. It is necessary to decide what the organization needs to be at a certain point in time and frame all of your activities to guide you to that point. With the metamorphic moment of a merger of two companies, there is a once-in-a-lifetime opportunity to keep the best parts of each organization, jettison the weak bits, and add what is missing. It is a rare chance at redefinition. It's when you stop having big transformational moments that you need to create them in order to keep being relevant and remain dynamic. In the first few years after our big merger, the aim was to get to a new culture and one language in one bank. Since then, we have sought to continue to act like we did after the merger. Yet I've learned that transforming a bank after a merger and keeping it exciting beyond that process requires different skills.

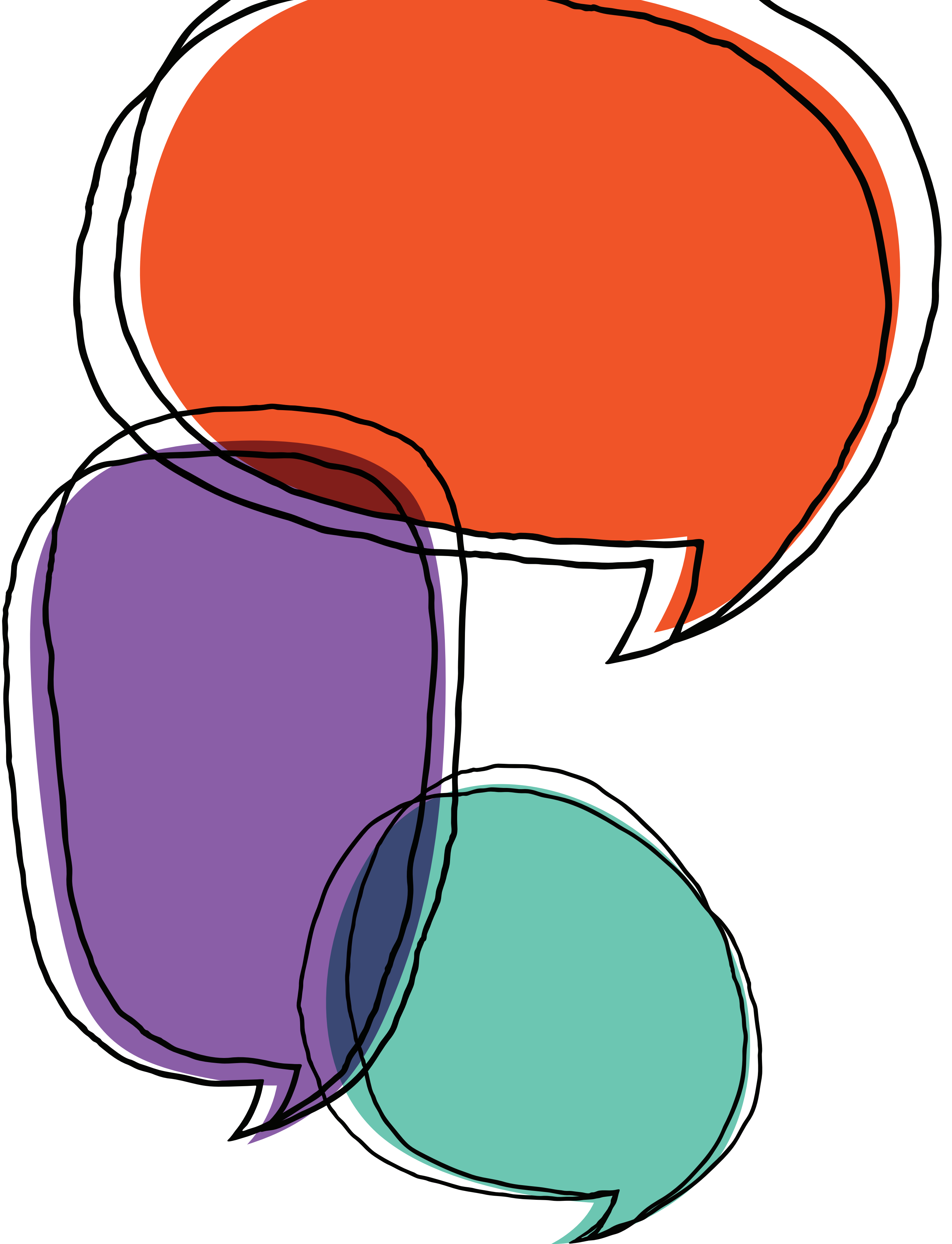
Let me explain. Each year we do an organizationwide survey along with other banks. Typically we are in the top quartile on every measure. Up until 2014, the number one correlation of employee satisfaction and engagement was tied to trust in management. For the first time, that became number two.

What is number one for the first time is the finding that employees are most engaged when they believe in the future vision of the company and see themselves in that future. That's very heady and the best lesson I've learned in many years.

"With the metamorphic moment of a merger of two companies, there is a once-in-a-lifetime opportunity to keep the best parts of each organization, jettison the weak bits, and add what is missing."

I'm proud we did really well on that point. It is completely because we think about it and spend a lot of time talking about the future – we call it "looking around corners." I'm now inclined to put a lot more energy into building up employees directly to get them to feel confident that the bank they work for has a strategic vision and that this is something exciting for them. That is very powerful. Creating this vision is vital: everyone wants to be part of something exciting in the future.





Refocusing and transforming a UK leader:

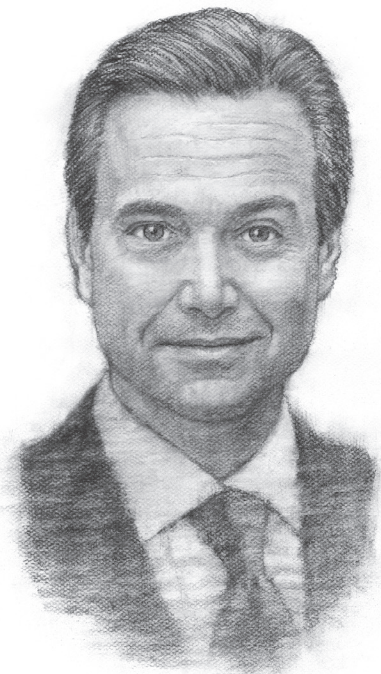
An interview with the Group Chief Executive of Lloyds Banking Group

Pedro Rodeia

António Horta-Osório explains the challenges that emerged during the financial crisis and the changes required to recover and grow

António Horta-Osório

Group Chief Executive, Lloyds Banking Group



Lloyds Banking Group became one of the Big Four banks in the UK and a leading insurance company through a series of acquisitions. The last acquisition, in 2008, of HBOS at the depth of the global financial crisis ultimately led to the need for a government rescue.

To transform the bank, Mr. Horta-Osório became Group Chief Executive of Lloyds on March 1, 2011. He undertook a wide-ranging program that included reshaping the business portfolio through a series of divestitures, simplifying the group to reduce its cost base, growing the core vision to become "the UK's best bank for customers," and strengthening its balance sheet.

These measures returned the bank to profit, facilitated the UK government – whose shareholding was reduced – and allowed taxpayers to begin recouping their investment. McKinsey Director Pedro Rodeia, who coleads the Global Banking Practice, discussed Lloyds' transformation with Mr. Horta-Osório in London. What follows is an edited transcript of their conversation.

McKinsey: What was the situation at Lloyds Banking Group in 2011 when you arrived?

António Horta-Osório: There were three key challenges. First, following the earlier merger with HBOS, Lloyds still faced the complexity of combining different cultures and organizations. A bigger challenge still was that the bank had multiple, very pressing priorities that all had to be addressed in a single timeline, either because they were urgent or they were closely connected. Finally, there was also the quickly deteriorating economic situation and the potential for debt contagion in the Eurozone, which had an impact on Lloyds' ability to access wholesale funding.

McKinsey: What were the top priorities that you had to address as the bank transformation got underway?

António Horta-Osório: The first priority was to address the bank balance sheet where half of the loans were supported by wholesale funding. About half of that was in short-term funding with an average duration of two months, while the average loan was for around five years. It was a huge mismatch.

We also had to deal with GBP 200 billion in toxic loans (one-third of the total portfolio) that had been acquired with HBOS, which were losing value and making creditors more nervous by the day. We needed to sell the loans but to do so in a way that would not destroy capital. These two were the most acute situations among the priorities, and they were interconnected as decreasing the toxic assets would enable us to address the funding situation quickly.

McKinsey: How did regulation affect the transformation priorities?

António Horta-Osório: In a preliminary report, the Independent Commission on Banking (ICB) had proposed that Lloyds make a large divestment, going beyond the EU-mandated divestment of TSB. We had to work very hard to have the report

revised. This was critical to the bank since we wanted to keep a multi-branch strategy. A large divestment would have made it impossible to keep the multibrand granularity of the branch network. Indeed, divesting TSB by the 2014 deadline was a huge project for which few resources were available at the time because the merger of the businesses of HBOS and Lloyds was being completed.

McKinsey: What challenges did you face getting the transformation up and running?

António Horta-Osório: There was little attention paid to costs and efficiency. There was some resistance to change since it was a very slow and collegiate organization in terms of decision making. It was also very silo based, which made cooperation, agility, and change of direction quite difficult.

McKinsey: Given that you didn't have the luxury of time, how did you build the team to address so many changes simultaneously?

António Horta-Osório: There were many changes that needed to be addressed together very quickly and in a deteriorating economic environment. We also had insufficient managerial resources as recruitment in the UK takes time – six to nine months. I believed it was necessary to create huge discomfort internally by announcing a new strategy within 100 days. It wasn't just about having a quick impact, but also about creating organizationwide discomfort that would enable us to decisively address the problems we faced as a team.

I realized that without discomfort the resistance to change would be even greater. We moved quickly. It was clear that a huge amount of effort would be required to carry out this transformation.

McKinsey: Looking at Lloyds three years later, the degree of change in the leadership team was much more radical than that of most other transformations. Tell us about the pace of change and what constraints you faced.

António Horta-Osório: In each of my earlier turnaround roles in Portugal, Brazil, and the UK, I thought I had acted too quickly. But in hindsight, after each turnaround I realized I should have moved even more quickly.

At Lloyds on the day I was appointed Chief Executive, I began reshaping my executive team. I wanted to flatten the organization, remove resistance to change, and give a clear sign to the organization that change was going to come quickly. The change had nothing to do with the people themselves. It had to do with the fact that it was a silo-based organization and had many layers. I wanted to break retail into different brands and insurance into the different business units. Overall, I wanted to delayer the organization, get closer to customers, and make the decision cycle happen more quickly.

"There were many changes that needed to be addressed together very quickly and in a deteriorating economic environment. We also had insufficient managerial resources as recruitment in the UK takes time – six to nine months. I believed it was necessary to create huge discomfort internally by announcing a new strategy within 100 days."

Within a year we had 10 new people on the executive management committee. Of the bank's top 180 leaders, only 35 kept the same job: after 18 months, 50 new senior managers had been

hired from the outside and the rest had new roles. We sought to put the right people into the right positions where we had gaps, based on an external analysis of both "performance" and "competencies." The numbers show the depth of the change.

McKinsey: They do and they raise one question: with so many new people with different backgrounds in new roles, how did you get them to work together and move in the same direction?

António Horta-Osório: Because I wanted people to work together, it was critical to break down the silo-based organization. The first thing we did was to delayer to cut bureaucracy and decision making time and costs. We eliminated three layers of middle management, reducing the number of levels from teller to chief executive from 10 to seven.

The second thing we did was to centralize all control functions and all the central areas of the bank. Up until then, every business area ran its own finance, risk, and human resource functions. I believe that a bank needs to have strong risk and control mechanisms, so that means risk and finance have to report centrally. Centralizing the control functions enabled us to delayer further and make teams work together. Teams needed the support of the control functions in order to make things work in an end-to-end organization that they did not control in its entirety.

The third thing we did was to articulate the strategy through a 100-day campaign to align people with the vision. Although we were still evolving the plans, we wanted to drive people forward and get everyone behind the goals.

McKinsey: What were the main pillars of the transformation?

António Horta-Osório: The first pillar was to address the bank's balance sheet imbalances and refocus it on Lloyds' core businesses. The second was to simplify the bank, particularly from the customer's perspective, and cut costs as a consequence. This enabled us to reinvest part of the cost savings in additional investments for growth opportunities. The third pillar was to have a prudent risk profile and lower the cost of funds as a consequence.

To stabilize the bank we needed to reshape it and, because resources were scarce, concentrate it in the UK. This was contrary to the conventional wisdom to diversify. But it made sense to do the opposite and concentrate Lloyds in the UK where it was strong and where the scarce resources available could be focused. This meant selling international activities as well as getting out of trading, investment banking, international private banking, and other complex activities in order to concentrate on the UK retail and commercial banking markets.

Simplifying the bank allowed costs to come down significantly (18 percent in four years) and provided us with an attractive value proposition for customers. Simplification through the streamlining of end-to-end processes and embracing digital, including mobile channels, helped us improve customer experience and lower cost. We believe that having the lowest cost-to-income ratio in the UK market is a critical competitive advantage.

Finally, we redefined Lloyds' risk appetite. Being a low-risk bank should provide us with the key competitive advantage of having a lower cost of funds and a lower cost of equity in the future.

McKinsey: Each of the pillars has undergone great change. Where have you had the most impact?

António Horta-Osório: First, in the culture of the bank: it became much more customer focused, more prudent in relation to risk, and much more cost conscious. Second, in reshaping the portfolio, which is now 95 percent UK focused in retail and commercial banking. Third, we had a significant, positive outcome with the Independent Commission on Banking (ICB) in avoiding divestiture beyond TSB. In fact, the final outcome of the ICB report was neutral for Lloyds in terms of competition and positive in terms of ring fencing as we were the least affected UK bank.

Finally, we completed the TSB divestiture (which floated in June 2014) with only a brief delay. It marks the first time in Europe that a bank was spun off from another bank and became totally autonomous. All of this shows the breadth and intensity of the transformation.

McKinsey: What are the main metrics that can illustrate the magnitude of the change delivered?

António Horta-Osório: Several metrics show Lloyds' transformation. The GBP 300 billion wholesale debt is now GBP 130 billion, while the GBP 150 billion of short-term funding is now only GBP 20 billion. And the GBP 200 billion of legacy assets are down to around GBP 30 billion. This was achieved in a capital-accretive way and improved our capital ratios. In addition, it created billions of pounds of liquidity that enabled us to repay short-term wholesale funding, together with an increase in deposits through the multibrand strategy.

Our loan-to-deposit ratio is now close to 100 percent, which is a prudent level for any retail and commercial bank and down from 154 percent three years ago. Our capital ratio, on a fully loaded basis, is one of the highest in the UK and Europe, at above 11 percent – up from less than 8 percent three years ago. And from operating in 30 countries we are now operating in nine, and it will be six by year-end, with 95 percent of the assets now in the UK.

We already have the best cost-to-income ratio in the UK bank sector at 51 percent – while our peers range from 53 to 70 percent. This gives us a competitive advantage on cost. Our CDS is now 50 basis points – down from 300 when it was among the highest for a top 50 bank. In addition, we have recently been one of the very few banks upgraded by the ratings agencies since the crisis.

> "Several metrics show Lloyds' transformation. The GBP 300 billion wholesale debt is now GBP 130 billion, while the GBP 150 billion of short-term funding is now only GBP 20 billion. And the GBP 200 billion of legacy assets are down to around GBP 30 billion. This was achieved in a capital-accretive way and improved our capital ratios."

Our costs fell 18 percent in nominal terms in three years with our NPS score going up by 40 percent, while customer complaints more than halved. We were able to decrease costs while improving the customer experience and we haven't closed a single branch in the last three years.

McKinsey: What was your leadership style and how did you adapt it to the transformation at Lloyds?

António Horta-Osório: It is very important that a CEO's leadership style adapts itself to his or her company's position at each moment in time and to the external constraints facing the company. In a turnaround situation with a very weak company and a very difficult external environment, I strongly believe that the leadership style has to be outcome focused and more assertive. At the same time, I tried to hire the best people and work with them as a team to make decisions together. When a company is under severe internal and external stress, a more direct management style – where outcomes are more important than processes – is natural since survival is at stake. But it is important that people understand the rationale.

As the company gets stronger and the external environment gets better – true for both Lloyds and Britain now – the leadership style should evolve to be more inclusive and encourage participation. Debates can last longer and the processes to reach decisions can take longer and are more important because the life of the company is not at stake, and this increases motivation and engagement.

For example, in the beginning I chaired all the bank's internal committees, not only because the bank's condition was critical, but because most of the team had just arrived following the management changes. I don't do that anymore. I no longer chair the asset-liability or risk committees. Instead, I devote much more time to meeting investors, regulators, and customers, while communicating throughout the bank with town hall and off-site meetings, and branch visits.

I also focus much more on internal and external communication, and building leadership teams, while thinking about who we should hire or promote for the future and who we should recruit from university. I communicate more with investors about Lloyds' future. Being a complete and robust CEO is about adopting the right management style for the circumstances as these evolve over time.

McKinsey: What lessons did the transformation teach you, and what would you pass on to bank leaders?

António Horta-Osório: There are three things that I would advise any leader to do. First, set out a direction that is clear to both the leadership team and as many people as possible. Second, act quickly, as speed is of the essence, not only because time is critical when you are in a turnaround situation and an adverse external environment, but also because going quickly stops resistance from forming. Conversely, if you go more slowly, resistance, which may be understandable but is not acceptable, can increase. Going very quickly makes it clear to people what the direction is and encourages people who are undecided to join the transformation rather than the camp of resistance.

The third thing I would emphasize is that CEOs must find a way of taking people with them. It is a matter of communicating, communicating, and communicating. Leaders think they communicate a lot, but people always think they communicate too little. Repeating the message relentlessly at all levels of the organization is the right thing to do so that people see the progress being made and understand why you are making tough decisions. This really helps bring people with you.

Those are the three key things: clear direction, speed in execution, and taking people with you.

McKinsey: With the benefit of hindsight, is there anything you would have done differently?

António Horta-Osório: Looking back, what would I have done differently? It is surprising! Again, like in all my previous turnaround situations – and even though we went very quickly and much quicker than in previous transformations – I now think I could have gone even faster. In addition, I should have moved immediately to have an objective and comprehensive assessment of the performance potential of the top 200 people – something we did 12 months later.

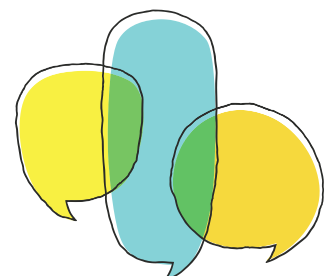
We didn't consider it to begin with as other things got prioritized, but it would have been very useful to move faster.

Also, with hindsight I should have communicated even more throughout the bank with town halls and visits – even writing more memos to all the staff about the reasons for the transformation. Communicating the small successes we were starting to see would have permeated the various levels of the organization faster and broken resistance in certain pockets and areas.

McKinsey: Is there anything else you think is important to understand about the transformation?

António Horta-Osório: The transformation strategy and how we operated was subject to huge political and media scrutiny. Lloyds was the largest bank in the UK and very much in the spotlight because of taxpayer assistance. The political and media dimensions of having a 43 percent government stake meant that the strategy had to be inclusive for a larger number of different stakeholders. This added an additional layer of complexity to an already delicate situation within Lloyds and in the broader financial environment, which had to be incorporated in the strategy.

> "Leaders think they communicate a lot, but people always think they communicate too little. Repeating the message relentlessly at all levels of the organization is the right thing to do so that people see the progress being made and understand why you are making tough decisions. This really helps bring people with you."



The role of boards in transformational change:

An interview with the Chairman of India's ICICI Bank

Arne Gast and Vimal Choudary

K.V. Kamath reflects on the evolving role of bank boards over recent decades and the duties of CEOs and chairmen

K.V. Kamath

Chairman, ICICI Bank

ICICI Bank is an Indian multinational banking and financial services company headquartered in Mumbai. As of 2015, it is the second largest bank (and the largest private sector bank) in India in terms of assets and has a presence in 19 countries with assets of almost USD 99 billion. ICICI Bank was established by the Industrial Credit and Investment Corporation of India Bank as a wholly owned subsidiary in 1994. The holding company was formed in 1955 as a joint venture of the World Bank, India's public sector banks, and public sector insurance companies to provide project financing to Indian industry.

In 1996, Mr. Kamath was appointed CEO of ICICI Bank. Under his leadership, ICICI Bank transformed its business from a development financial institution, which only offered project finance, to a diversified financial services group, which offers a wide variety of products and services. It launched Internet banking operations in 1998, and, in 2000, ICICI Bank become the first Indian bank to list on the New York Stock Exchange. In 2009, Mr. Kamath was appointed Chairman of ICICI Bank. He is also the Chairman of Infosys and an Independent Director on the Board of Directors of Schlumberger Limited. Additionally, Mr. Kamath is a faculty member of McKinsey's Bower Forum for CEOs.

Arne Gast, McKinsey's head of the transformational change service line in Asia, based in Malaysia, and Vimal Choudhary, the COO of the McKinsey Leadership Institute, based in India, met Mr. Kamath in Mumbai in late 2014. They discussed changes in the banking industry and the role of boards of directors in transformations. The following is an edited transcript of their conversation.

McKinsey: Please tell us about the extensive experience you've had in Indian banking, spanning turbulent times, but surviving them, and some of the main changes along the way.

K.V. Kamath: I worked at ICICI for 17 years, beginning in project finance, but left to join the Asian Development Bank where I joined their private sector department, based in Manila. Then in 1996, I returned to ICICI as CEO. By then, India had already started to change rapidly. Until the early 1990s, Indian companies had been protected – but, of course, there was a cost for protection in terms of licensing fees. Being licensed meant that you got all sorts of protection and nobody could compete with you. The result was that businesses would get the wrong scale and cost efficiency was poor. I think everything that can go wrong in a licensing regime did go wrong.

Inevitably, India began to open up, one sector and then another. As a result, Indian industry started to face global competition. There was no retail lending in India at that time, and commercial banks had only one product – a working capital product called cash credit. A company would get a loan, and the bank would keep debiting interest to the loan. That's how the product worked.

McKinsey: As CEO, you led the transformation of ICICI from a conservative public sector project lending institution into India's biggest private sector bank. Since 2009, you have continued to play a leadership role in transformational change, but have done so as Chairman. How would you characterize what a chairman does?

K.V. Kamath: I think two roles come to mind. As chairman of the board, the governance role is somewhat different from what one does as a CEO. One role the chairman plays is to make sure that the organization adheres to sound practices, either as required by law or by aligning with best-practice procedures.

The second role is to be the sounding board to the organization on a variety of things that may be happening in the broader business and economic environment. I think this is a very critical role to play, particularly now, with change happening so quickly. A chairman can be a somewhat passive sounding board, responding to ideas that people in the organization present to him or her and discussing them while providing feedback. Alternatively, the chairman can be a slightly more proactive sounding board – I want to suggest the word challenging – but, in any case, more proactive, particularly in meetings. Taking this approach means throwing challenging ideas out for discussion. Perhaps the chairman sees how some of the dots connect in a particular way, but other colleagues do not. Putting this approach into practice can help push everyone to a higher level.

McKinsey: How can a chairman respond to and embrace a transformation imperative? Furthermore, how do you lead a CEO and management team that might not agree that change is needed?

K.V. Kamath: A chairman and a board can respond to a transformation imperative in a couple of different ways. When the chairman and the board perceive something that the CEO and the organization do not, the board needs to persist. The board should be patient and open with management. Combative situations can happen both ways. It can happen when the board is asking for change, and the company is not ready for change and not willing to accept change. To me, that is a more dangerous situation than one where the CEO is asking for change, and the board is holding back.

In the first situation, the board has to persist; otherwise, they will be derelict in their duty of care to the company.

On the other hand, if the CEO is making a pitch for change, I think, as chairman, your duty is to listen, to counsel, and to ultimately agree on a path with which the CEO is comfortable. After all, in the final analysis, the CEO takes responsibility for driving the company to the agreed destination. So if the CEO strongly believes that something is required for the good of the company, the board must give that a fair shot. The board can specify very clear caveats in terms of time and cost, but then the CEO must have the freedom to act.

"A chairman and a board can respond to a transformation imperative in a couple of different ways. When the chairman and the board perceive something that the CEO and the organization do not, the board needs to persist. The board should be patient and open with management."

McKinsey: What boards do has changed a lot over the years, in particular, the intensity with which they engage – what is your perspective on this?

K.V. Kamath: Going back to 25 years ago, the first board that I was nominated for by ICICI had meetings that only lasted 10 minutes! At that time, I, as a very young person, gently told the chairman that, as the company was not doing particularly well, there were a number of issues that needed to be discussed further at the board meeting. The Chairman was a complete gentleman,

so he readily accepted my proposal. He suggested that we form a committee to look at the various issues and that I be part of that group. The board process didn't change per se, but it had evolved. It turned out that because the company was heading into trouble, we were able to get a lot of things done.

So what was a 10-minute board meeting became one that ran for one hour. Then it grew to two hours and for a long time stayed around that length. But today it is completely different. I think now, with the committee deliberation structures being used, you are looking at two- to three-day board meetings as a given on a quarterly basis. There are also the appropriate intermediate meetings required to focus on the business of the various board committees. In some cases, this could mean several meetings a month and perhaps eight or nine meetings per quarter.

Now, in some instances, boards are spending considerable time dealing with day-to-day operations. This is particularly true in the banking business because regulators now want to encourage much more oversight. With business in other sectors, this will be less the case, but the trend is to meet more frequently and for longer periods. Since 2009, the ICICI Bank board has met much more frequently, but sometimes via a conference call or a video link, and, thus, not necessarily in person. Even though things have stabilized, the number of committee meetings remains higher than before the crisis. An average bank board member attends 30 to 40 committee meetings a year, and I don't see this changing.

McKinsey: How would you characterize the dynamic and function of boards today?

K.V. Kamath: We look to have the most creative leadership team members discuss what they are doing and share the rationale for their development plans. There is then a wide-ranging discussion in which board members probe and challenge the leadership team. It's basically a give-and-take situation to help the leadership team understand what is in the board's collective mind. Essentially, I regard the board as a knowledge place, a repository of collective knowledge. There is an analogy here to the capital markets, which are also places of collective knowledge. When I say that I respect the market, it is because of exactly this type of collective wisdom. This doesn't mean that the board's wisdom will make it a specialist in a particular area. In a situation requiring particular expertise, it is probably best to bring in a specialist. Instead, the board offers collective wisdom. Companies that understand how to dip into it stand to benefit the most. This is how I would conceptualize the role that a board should play today.

McKinsey: What are some of the skill sets that you look to have represented on the board and how has this changed over the years?

K.V. Kamath: Regarding the makeup of boards, we are increasingly looking for people from backgrounds outside of business. I would characterize these as backgrounds in the liberal arts and behavioral sciences. There is a regulatory requirement (in India) to broaden the backgrounds from which board members are drawn. But I think it is also common sense to do so. Someone with a behavioral sciences perspective can bring important insights to our organization and perhaps help us understand behavior in the institution in a way that we might often overlook. Equally, someone from a teaching background, perhaps educated in behavioral science and the liberal arts, will have a completely different approach, which can be extremely valuable when an institution is undergoing transformation – and today we are very much in the process of transforming the bank.

McKinsey: How do you ensure a sound board perspective on technology developments, one of the forces disrupting the industry?

K.V. Kamath: In both the banking and technology sectors today, the technological disruption is very significant, probably as much as it was 15 years ago in the "new economy" boom. In banking,

I think we could be on the cusp of genuinely epochal change that may completely alter how the business operates. Thus, I'm on the lookout to include board members who not only have knowledge of IT, but also have relevant technology experience directly related to banking and finance.

The one advantage many banks have in this landscape of disruption – probably the only one – is that they have a regulator to shield them. Essentially, many banks work in a protected market. But the moment they step out of this protected market they are going to be in trouble. When banks talk about the regulatory challenge they face, it seems to me that they should be thankful there is a regulator; otherwise, they would most likely be out of business. This is something that banks have to understand regardless of where they are operating or their particular business mix. If you look at it from this perspective, it becomes clear that the status quo cannot work. Therefore, it is imperative for my bank to adapt rapidly to become as strong as the competitor at the door who is currently prevented entry to the market by the regulator.

"The one advantage many banks have in this landscape of disruption – probably the only one – is that they have a regulator to shield them. Essentially, many banks work in a protected market. But the moment they step out of this protected market they are going to be in trouble. When banks talk about the regulatory challenge they face, it seems to me that they should be thankful there is a regulator; otherwise, they would most likely be out of business."

McKinsey: That's fascinating. Surely part of ICICI's approach to competing better, both with existing banks and potential new entrants, is by becoming more customer centric. What is the bank doing with respect to customer centricity?

K.V. Kamath: We have a board committee that focuses on customer centricity. It does two things. The first thing it does is look at customer complaints. The time and nature of the complaint is tracked, and the committee considers how to fix it. We use it as an early warning system, and it helps us spot developing trends. If you have ATM complaints or online service complaints, then we know quickly that there is a failure with the network or with an Internet link. Management is then forced to act at speed to resolve the matter and make sure things are righted.

The second thing the committee does is look at in-branch experience. The focus here is on customer experience with regard to back-office processes and the turnaround times for account opening or product applications – these and other processes should be routine. The committee also looks at the use of different technologies, perhaps opening an account on a particular device, or how a rollout may be progressing, and evaluates them with respect to customer expectations. I'm on this committee. I think, to me, it is probably one of the most important committees in the sense that it is where you make a real connection with your customer.

McKinsey: This certainly chimes with the regulatory push in many countries to make banks more customer centric; how difficult is it to be successful?

K.V. Kamath: The most difficult thing with customer centricity is when a bank aims to do it for every customer across all product lines. Let me give you a small example from about 10 years ago. At that time, I asked my team for a quick comparative exercise to understand how others were being customer centric. Within 15 days, we had a rough sample covering banks from Brazil to Australia. We quickly came to the conclusion that nobody had gotten the equation quite right. Given the level of technology in 2004, it wasn't really possible to position the customer at the center of all products in a way that is now fairly common. Fast forward to today with the ubiquity of the Internet, and everyone can analyze big data and put the customer at the center of all products, which can then be pushed to an individual depending on his or her interests, habits, and so on.

So clearly the technology has made it possible. However, I don't think big banks are there yet. At ICICI, we are still scrambling to further our understanding of customer centricity. There is something of an ethical point too, in that the bank needs to avoid selling a product which is not suitable, even if a customer wants it. At the moment, if a bank can understand what someone needs, it can showcase the product and leave the customer to decide whether to proceed or not. Given the state of technology, that's what a bank can do well.

But the question of what constitutes overload in being helpful to customers will arise very soon. Today, if you go to any of the e-commerce Web sites and search for a very simple audio product or piece of furniture, you will get reminders for the next 10 days from sites where the product appears. This amounts to a little bit of overload. I think when there's an overload, there's a backlash, so business has to be very careful with how this data is used. Nevertheless, compared to 10 years ago, the ability to put the customer at the center of a bank's focus is very real.

McKinsey: When you were CEO, you had a tough discussion with the board about wanting to change a large portion of top management. Now that you are Chairman, how extensively do you assess the change capability and agility of the top 100 leaders?

K.V. Kamath: Indeed, as a CEO I pushed for a lot of new blood at the start of ICICI's transformation from a development project finance institution to a retail bank. At that time we had 1,000 people, but we changed about 30 percent of the staff. They were good people, but we needed transformational change. As Chairman, assessing and changing people in a transformation is an extremely delicate issue. Every board consults on this in one way or another. Because of this, I would suggest that boards spend about one quarter of their time assessing people's capabilities and how they fit into the organization. It is important to keep in mind that, ultimately, the organization and the company must be the first order of priority in terms of your duty of care and loyalty as chairman. You need to make sure that the company is healthy, and the first way to do so is by ensuring that its people are healthy. Thus, the organization and the people involved are something that every board needs to scrutinize closely.

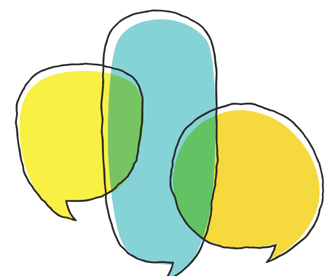
McKinsey: Explain how you engage with CEOs as a mentor and what advice you give them on engaging with their board of directors.

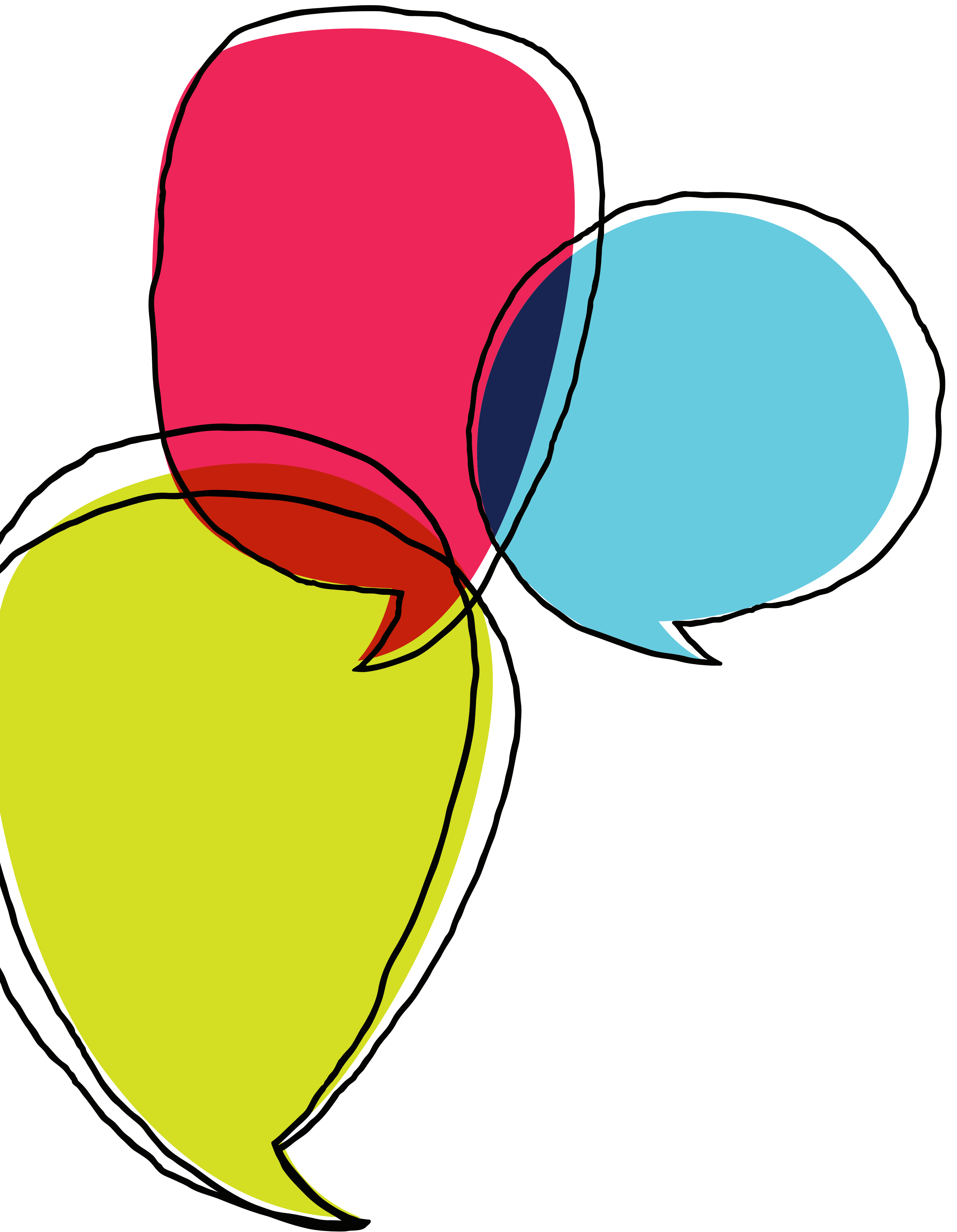
K.V. Kamath: When I'm talking with a CEO, whether I'm mentoring that person or not, the first thing I ask is whether he or she has considered how long the average company lasts at the top. The cycle is usually not more than 15 years. Thus, it is important for a CEO to be deeply humble and understand that this is the situation. The CEO must also know that to take a company to the top and keep it there requires exceptionally hard work.

If you look at the 20 biggest companies in India by market capitalization, there are only two or three that were in this group 25 years ago. It is, therefore, extremely important to understand what it has taken for these companies to prosper. It is very important for the CEO to have an aspiration to remain on top, but this aspiration must be pursued in a dynamic way.

It is also vital for the CEO to continuously scan the business environment and learn from every single source. A CEO needs to engage his or her board, and while not being too combative, make sure that he or she presents a well-reasoned point of view. Above all, as CEO, don't stick to your own mindset. Since we depend more and more on data, it is important to use it; not so much as proof, but as a way to make a persuasive case for the action you want to drive.

> "It is important to keep in mind that, ultimately, the organization and the company must be the first order of priority in terms of your duty of care and loyalty as chairman."





Revitalization through transforming customer experience:

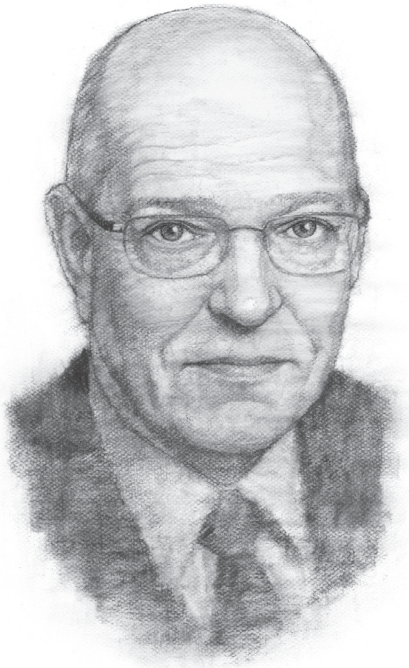
An interview with the Chairman of ABN AMRO

Henk Broeders and Michiel Kruyt

Gerrit Zalm discusses the challenges of rebuilding a Dutch leader ahead of an eventual initial public offering

Gerrit Zalm

Chairman, ABN AMRO



With roots dating back to the founding of R. Mees & Zoonen in 1720, ABN AMRO will soon embark on a fourth century of providing banking service. Over that period, the Dutch banking giant has seen epochal change. ABN AMRO itself has also undergone organizationwide transformations on a number of occasions, not least following the 2008 financial crisis when it was split into pieces, nationalized, and subsequently forced to merge with Fortis Bank Nederland.

Overseeing this latest transformation was Gerrit Zalm, Chairman of the Managing Board of ABN AMRO and a former Dutch Minister of Finance, who served in two government cabinets spanning from 1994 to 2007. McKinsey Director Henk Broeders and Expert Principal Michiel Kruyt visited him earlier this year at the bank's Amsterdam headquarters. What follows is an edited transcript of their conversation.

McKinsey: Let's start at the beginning. What did you find when you joined ABN AMRO in December 2008?

Gerrit Zalm: I found something very unique: a bank that had to be completely carved up into pieces – belonging to RBS, Santander, and the Dutch government – before it could be rebuilt. We had to prepare the bank's relaunch as well as find a new leadership team to operate like a second board of directors. Even though the state-owned part of the old ABN AMRO and the nationalized Fortis Bank Nederland were planned to merge, we were legally unable to consult with each other until the legal split of the old ABN AMRO was completed. It was a very unique situation. To give you an example, at the old ABN AMRO our financial reports had specific versions for each different share class: RBS, Santander, the Dutch state, and a fourth (unallocated) one.

McKinsey: How did you manage such a complex governance and ownership structure?

Gerrit Zalm: I was literally being thrown in at the deep end! Many people asked me, "What is the strategy, Mr. Zalm?" After many discussions and reading vast amounts of paperwork, we put the focus on relaunching ABN AMRO and establishing the leadership team. Although I had already been identified as the future Chairman, over a year passed before I was officially appointed as Chairman of the new ABN AMRO. In the meantime I was on the board of the still undivided old ABN AMRO, and the CFO-to-be was the CEO of Fortis Bank Nederland. The advantage of this was that it gave me time to form a close-knit transition team, which then got off to a fast start.

It was a very unique situation. Many legal issues needed to be settled, while Fortis Bank Nederland had to be extricated from Brussels. The surprising thing is that it was completed in three years.

McKinsey: From your experience in setting up the new ABN AMRO, what advice would you offer others?

Gerrit Zalm: Underpromise and overdeliver. Also, stick to what you're good at and only do things you genuinely understand. I would advise sticking with a few simple principles: be customer oriented with everything focused on sustaining long-term customer relationships. And do not be transaction oriented. Doing a good deal now and again is fantastic, but you must be able to work with clients in a long-term relationship. This is also the best risk management policy. You know the customer and the customer knows the bank. I would advise banks to stick closely to core business strengths and avoid chasing high-risk, high-return transactions. It is very important to exercise a high level of caution.

Another thing we did from the outset of the transition was introduce cost management. The bank had struggled with cost control for 30 years, but the solution turned out to be very simple. We set ceilings for the whole of ABN AMRO as well as for different business units. Cost ceilings were also introduced in variable remuneration to emphasize our approach. We took a direct approach on this by speaking candidly to individual executives about their delivery against these cost ceilings.

Regarding culture and behavior, I became aware of the deadly impact "power-tripping" CEOs can have. We abolished a rule imposed by the previous CEO, which required him to approve every decision. Quite a few failing banks suffered from having a CEO who could not tolerate opposing views. Such attitudes have been a major factor in some banks failing. They are very detrimental to a bank having a healthy operating culture. CEOs need to operate on the basis of being convincing, not on the basis of power.

Finally, I would stress how critical it is to remain in touch. A CEO and his team must listen closely to customers and employees. I started a daily blog to help eliminate barriers and encourage people to e-mail me. Our management board regularly visits important clients and we use customer events to connect as well.

McKinsey: What obstacles are there to your approach of getting back to basics and having more openness?

Gerrit Zalm: Not that many, although in a large organization there is a tendency to be bureaucratic. That is one thing I have worked to change. We have made progress, but it is still easy for bureaucracy to get embedded in customs and habits.

"Underpromise and overdeliver. Also, stick to what you're good at and only do things you genuinely understand. I would advise sticking with a few simple principles: be customer oriented with everything focused on sustaining long-term customer relationships."

Also, because of heavy regulation, banks are complex organizations. Everything has to be documented. The advantage is that everything is done carefully. The disadvantage is that an opening in Shanghai might require the approval of 15 committees, even though it is something that we've already decided to do.

McKinsey: Part of the transformation was a bank-wide program called "Customer Excellence." What were you trying to achieve with that?

Gerrit Zalm: It was clear that we needed to give more responsibility to employees in frontline positions. This helped set the tone, and Customer Excellence is compatible with this approach.

Initially, I envisaged Customer Excellence as quite analytical. We would analyze processes, get everything shipshape, and then create something worthwhile. However, we soon learned that there were big benefits to having managers embrace coaching-based leadership instead of a "command and control" approach. This collaboration with the leadership helped genuinely emancipate our staff. The approach is something I believe in because people now work with greater enthusiasm and ownership.

This enthusiasm meant that the staff worked more efficiently and zeroed in on providing excellent customer service. Even though this has created capacity surpluses and less work, the Customer Excellence focus is broadly supported because no one likes doing unnecessary or unuseful work. Once staff saw how things could be done differently, no one wanted to go back.

The fact that it was a bottom-up initiative that started within the organization helped. It would have never worked if it had been imposed top down. Colleagues got interested and energy was awakened. Now it's a case of: "I also want to participate." In the meantime, more than two-thirds of the employees have been "touched" by the Customer Excellence program. It helped reduce our cost-income ratio and increased customer satisfaction and employee happiness.

With the shop floor having a lot more influence, a major change in culture has ensued. In the retail bank, we had been accustomed to managing things centrally, for example, opening times and staffing, in terms of how many FTEs are assigned in each district. Now the districts and branches have much more responsibility. Overall, the transformation to focusing on Customer Excellence has hugely changed our culture and behavior. There is much more personal responsibility. Frontline staff, for example, can give flowers to customers and have discretion to settle a wide range of issues with customers.

McKinsey: Given that ABN AMRO started with simple principles – and not with a complete program – it sounds like an organic process. What major issues remain?

Gerrit Zalm: Thankfully, instead of major issues, it is a matter of more small issues: becoming even more efficient, further improving customer service, and delivering even better quality. What I'd call continuous improvement. We also need to ensure that the cost-income ratio decreases further, although a helping hand from the economy would be welcome.

McKinsey: What's the next step for Customer Excellence?

Gerrit Zalm: We need to address end-to-end processes and ensure that upper-level management is able to balance the complexity arising from the interaction of a complex organization, complicated issues, and conflicting interests across the end-to-end chain. Many things can be done to improve efficiency and cross-functionality for customers, but it is still necessary to assign ownership to a ranking executive. With the mortgage chain, for example, we assigned it to members of the board of directors.

Leadership duties will become more important in the next stage of Customer Excellence as different managers assume new roles. It is encouraging that as more and more colleagues work with Customer Excellence programs, there is more belief in it. But excitement still has to be generated for each new phase of the program.

In this regard, simplification is a key goal of our ongoing reorganization. Making things a little simpler and identifying an owner of a process or product should be possible. Simplification is also important to IT. One aim is to make it more modular; another is to incorporate straight-through

processing. Paradoxically, simplification is one of the most complicated things around.

McKinsey: How has the leadership style changed?

Gerrit Zalm: It's less authoritarian. We use training sessions to promote the values of accessible leadership, which is starting to bear fruit. But personnel changes were also required, and managers who couldn't cope with this new style of leadership were replaced. We have also put more emphasis on the social skills of managers. The employee engagement survey provides good insight into this. In general, there is more data about leadership style and it is actively used to make decisions on management positions.

McKinsey: Are you beginning to see changes in employee attitudes and in the bank's DNA?

Gerrit Zalm: It is a balancing act. We have eliminated the arrogance of the precrisis era, while seeking to retain the professional focus.

McKinsey: Looking back over the past four years, what is heading in the right direction and what needs to be adjusted?

Gerrit Zalm: We have made huge strides in behavior and culture – things which were not always taken seriously by bankers. We also have Caroline Princen on the Managing Board. As a former consultant, Caroline has experience in this field, and while a lot of people have helped our transformation to be successful, she is certainly a key contributor.

We need to keep focusing on simplification as everything is interrelated. There is a lot to be gained, and it is a potential goldmine. The key is to present it in a positive manner because that generates greater motivation among staff.

McKinsey: Among the lessons you have learned during the transformation, which stand out the most?

> "Leadership duties will become more important in the next stage of Customer Excellence as different managers assume new roles."

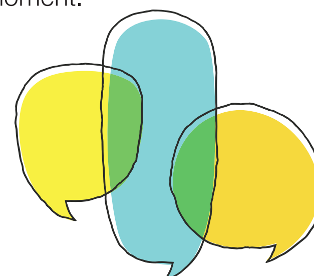
Gerrit Zalm: It is really important to think carefully about the things the bank doesn't want to do – whether it is products, services, or customer segments. This sometimes means making difficult decisions about what the bank won't do. Conversely, a bank must focus on things that it is good at to drive success. We have been successful by placing a great deal of focus on the Netherlands and on international activities where we have capabilities and a proven track record.

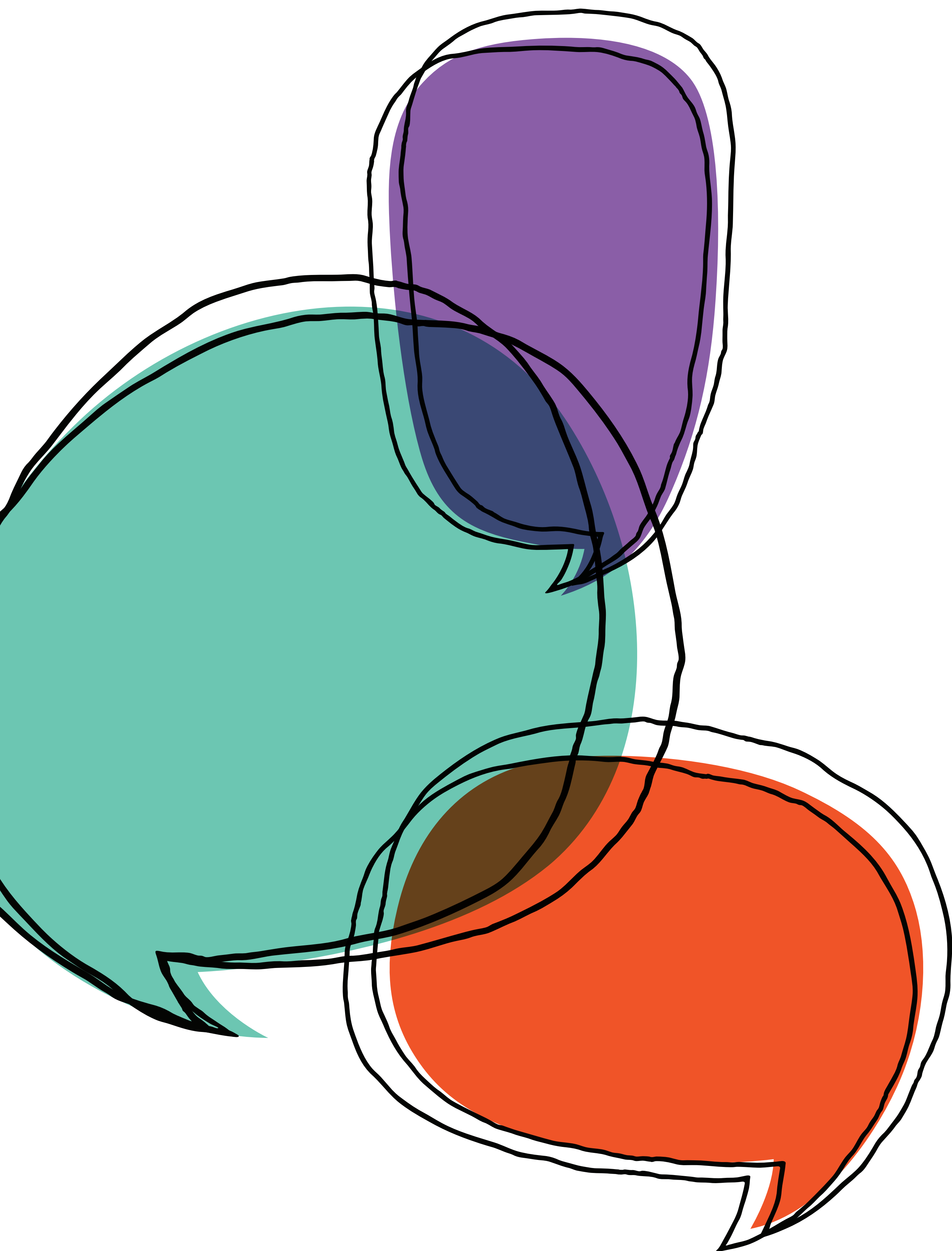
McKinsey: How does the upcoming privatization fit into your story?

Gerrit Zalm: It's not a choice; it's the only way to move forward. The government cannot continue to own a bank. We plan to continue the current strategy and not get forced into short-term thinking. It will require determination. Moving to a listing on Euronext Amsterdam means that I will spend more time working on investor relations.

McKinsey: How is the IPO being received?

Gerrit Zalm: Our focus on the Netherlands is attractive and investors view the IPO as an opportunity to diversify. Investors are interested in ABN AMRO as a value stock. We will not be a growth stock any time soon, but that isn't really a problem at the moment.





Transforming the corporate and investment banking business model:

An interview with the President and CEO of Bank Itaú BBA

Heitor Martins and Rogerio Mascarenhas

Candido Bracher discusses the moves that led to the creation of a top 20 global financial institution

Candido Bracher

President and CEO, Bank Itaú BBA

Itaú BBA originated in 1988 as BBA-Creditanstalt, a boutique corporate bank jointly owned by an Austrian bank and a small group of Brazilian banking executives. It then went on to become a leader in the local corporate banking market and merged with Bank Itaú, a leading Brazilian financial conglomerate, in 2003.

Itaú subsequently acquired Bank Boston's operations in Brazil and then merged with Unibanco, creating a top 20 global financial institution. The bank has successfully expanded into capital markets as well as investment and corporate banking, moving beyond Brazil to Latin America, the US, and Europe. Candido Bracher, who was part of the original group of executives in 1988, became CEO of Bank Itaú BBA in 2005.

He spoke with Heitor Martins, a McKinsey Director in São Paulo, and Rogerio Mascarenhas, a Principal in the same office. The following is an edited transcript of their conversation.

McKinsey: What are the key features of the "Bank Itaú BBA model" and which factors have been most important for its success?

Candido Bracher: The elements that are fundamental to the Itaú BBA model relate to a set of principles that have remained relatively unchanged throughout our journey, almost going back to the origins of BBA in 1988.

I believe sustainability for a corporate bank requires that clients regard it as the best partner. For a bank, that means in-depth knowledge of clients and their needs. This focus on clients is essential. It must be real; it has to go beyond the words themselves. That's very important. Our model is to focus the relationship with the client in a single person, an account officer. We make sure that this person has an excellent education as well as experience with credit and other bank products.

A wholesale bank is essentially a people business, a meritocracy, and people need to feel valued. Diversity must also be respected. The aim must be to keep different people working together in harmony. Even within a given segment of the bank, say corporate and investment banking, you have at least three groups that are very different: capital markets, the back office, and the commercial and investment bankers. It is necessary to respect each group's unique characteristics and avoid any one-size-fits-all solutions. These are some of our oldest, most long-standing principles.

Regarding the second part of your question, I'm extremely reluctant to use the world "success." In fact, it's a word I normally avoid. If you define it as making progress over time, learning from experience, renewing the institution, and remaining competitive, then I will accept the use of the term success. But if by success you mean "Hey, we've arrived!" – then I don't. After all, if there is something I have learned over the years, it is that the current challenge is always the toughest one. Since we always have a new challenge, deep down, I believe this keeps us motivated as an institution.

McKinsey: In the transformations that Bank Itaú BBA has undergone, what were some of the main challenges you have faced?

Candido Bracher: We have certainly had many challenges. However, if I were to list the top three challenges after 2003, I would say they were: first, to effectively manage the merger of the bank into a large corporation; second, to manage the growth of the bank's activities; and finally, to address the changes in the regulatory environment.

Early on, the challenges faced by BBA-Creditanstalt were typical for a small bank in an extremely volatile market. Funding was quite concentrated and given the very volatile market, that posed a significant risk. Although the evolution to an enlarged ownership structure brought about huge changes, it did provide more security for the bank and made it stronger.

Initially the focus was on integration, taking a small bank and transforming it into a mid-sized one. Then the challenge became learning how to grow. We were a small, stand-alone operation functioning inside a large conglomerate. The challenge was to learn how to leverage the strength and qualities of a conglomerate – such as liquidity, brand, methods, controls, and processes, all of which were excellent at Itaú-Unibanco – without losing our client focus or our flexibility to serve specific client needs. Growth is something that happens in phases, and it raises new questions every step of the way.

McKinsey: How did you manage transformation and change in the Brazilian financial system?

Candido Bracher: The best way to look at transformation challenges is to consider them as permanently ongoing. They evolve and take on new forms. You must maintain principles, but always be ready and willing to review and improve practices. Our integration into Itaú-Unibanco introduced us to a world where a lot had been invested in process excellence. We had to learn how to use and apply these processes as part of a bigger wholesale bank, but without losing our agility.

McKinsey: How have you sought to serve clients in a unique market like Brazil which has, on occasion, experienced upheaval and unexpected change?

Candido Bracher: The focus on clients means being quick to identify needs and creative in responding to them. Being viewed as a constant and reliable partner over time is especially important given the numerous major crises Brazil has experienced. I have seen many of our competitors take a stop-and-go approach towards their clients; this gave us a chance to broaden our presence in the market. The idea is to know your client so well that you are willing to make a truly long-term commitment – amid crises that come and go – rather than waver in response to market trends. That's very important.

"The best way to look at transformation challenges is to consider them as permanently ongoing. They evolve and take on new forms. You must maintain principles, but always be ready and willing to review and improve practices."

McKinsey: How has Bank Itaú BBA worked to develop its organization during its evolution, and what are some of the key challenges you have faced?

Candido Bracher: Flexibility, valuing people, being meritocratic, accepting diversity, and encouraging questioning are the fundamental components of the Itaú BBA culture. Over the years, I think the Itaú BBA and Itaú Unibanco cultures have been converging and are much closer. This accelerated after the Itaú-Unibanco merger. There are obviously some big challenges in making these cultures compatible. The role of the leader is to head the change process, to restate principles, but in a flexible way that allows change to happen. Change is always a source of uncertainty, but handled properly it can strengthen the culture of a business and enhance an organization's resilience. The culture of one business may be unique from that of a broader conglomerate of which it is a part, but it can never be incompatible with the culture of the broader organizational environment.

McKinsey: What are some of the more important features of how the bank was transformed by expanding to Latin America, and then the US and Europe?

Candido Bracher: The corporate investment banking model is easy to export. It works well and is much easier to apply to smaller operations than to larger ones. Since we are smaller abroad than in Brazil, it is fairly easy to export the model. But the pillars, one of which is the people, can pose challenges. Clearly, a bank's culture needs to encompass the characteristics of its people and the way it does business. But close attention must also be paid to local markets where it does business.

Having always competed with foreign banks in Brazil, I have often seen how they lose competitiveness by making decisions based on a way of thinking that is foreign and completely different to how things are done in Brazil. As a result, they can't understand the specific characteristics of the Brazilian market and the unique aspects of their Brazilian clients. When we moved into other Latin American markets, I took great care not to repeat this mistake. I feel it is important to delegate and work in a local context, while maintaining your established, universal principles. This is much easier said than done. In reality, it is a continuous effort to behave like a local bank in the different Latin American markets in which we do business.

In the developed markets, I would say that we are still learning. The first aim is to have a distribution function to support the Latin American investment bank activities so that we can match the capabilities of our international competitors. This will allow us to become an established player in Latin American investment banking. It means that we will have a distribution force stronger than that of our international competitors dedicated to Latin America. The second aim is to address the links to the head offices of the multinationals with operations in Latin America and the subsidiaries of Latin American multinationals in developed nations.

McKinsey: What have you learned from the transformation of Bank Itaú BBA and how has it changed you as a leader and as an individual?

Candido Bracher: I truly believe that working in corporate investment banking is a privilege. I'm constantly learning from the people at BBA as well as people in the broader Itaú Unibanco universe. Working with clients from all sorts of companies across many industries is a great learning experience and the personal growth is tremendous.

I have people around me with strong opinions, who are not afraid of sharing their thoughts or asking questions. This makes for a rather intense coexistence. I find the challenge stimulating and I like that.

With a growing organization there are many challenges arising from the need for implementation, processes, and improvement. I have seen processes which we did well on a small scale – like HR policy, for instance – adopted and applied by the conglomerate on a much larger scale, with more method and control, end up

being much more effective than I thought was possible. During this phase of growth I paid pay more attention to processes and governance, and relied less on initiative and improvisation. Since much of what I learn comes from interacting with clients, I continue to meet with them very regularly.

McKinsey: How many clients do you see each week?

Candido Bracher: An average of ten. I really make an effort to keep this up. The tendency is to be immersed in operations and dedicate myself to IT, systems, and to creating a network of connections with the holding company. But I do like to see clients. For me it's a real pleasure, so I have tried to continue doing so.

McKinsey: With the benefit of hindsight, what would you have done differently?

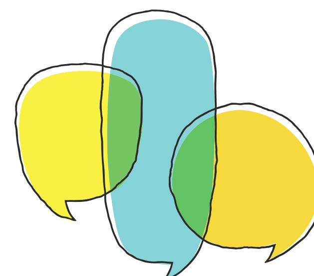
Candido Bracher: I think we could have been faster at adapting the bank to a larger environment. Today when I look back, I think that sometimes we lost time. We saw threats where there were none and we were too defensive.

McKinsey: During the next three to five years, what do you think will be your main priorities?

Candido Bracher: One of our priorities is to transform the corporate investment bank management model. The challenge will be to carry out the transformation to comply with the new regulatory reality, but, at the same time, remain agile and maintain a strong client focus. In addition, it is very important to work on simplifying our organization. Today, we have a number of processes going on within the conglomerate that I believe will enable significant efficiency gains when they are applied to the wholesale bank. I believe that's an important focus.

> "The corporate investment banking model is easy to export. It works well and is much easier to apply to smaller operations than to larger ones. Since we are smaller abroad than in Brazil, it is fairly easy to export the model."

Additionally, we have a big opportunity with new clients in the middle market. When I look at how we and our competitors serve these companies, I get the impression that nobody has developed a specific model to address them. I have the impression that middle market is always seen as an extension of retail or as an extension of wholesale. We are trying to create a specific model for this market, which from a banking point of view is a very attractive and engrossing challenge.



What is McKinsey Leadership Development?

McKinsey Leadership Development (MLD) is McKinsey's response to meeting the growing needs of our clients to develop the leadership capabilities and capacity required to deliver significant and sustained performance results. Our philosophy is centered on co-creating a leadership journey, from leading self as a starting point to leading others and successfully leading business. Ours is a comprehensive approach using a suite of open enrolment, client-specific and organization-wide programs, delivered via a field and forum method that provides long-term client support and stimulates continuous reflection and transformation.

Our value proposition is our distinctive ability to provide practical business insights integrated with proven leadership development methodologies. We offer experiential leadership development programs customized to clients' business context, personal needs and development, embedded in participants' real lives.

Our leadership development programs are based on seven core principles stemming from our deep global experience:

Leadership development …

- … is contextual, and therefore needs to be tailored to the client's specific business context and development challenges to achieve the greatest impact.
- … needs to be closely tied to the business: only then will the development be relevant and the behavioral changes stick.
- … must address all aspects of leadership – leading self, leading the team, and leading the organization.
- … begins with personal mastery, and builds authentic leaders through cycles of action and reflection.
- … must be owned and driven from the top: when developing and deploying leadership programs, we work with the top management team right from the start.
- … only lasts when a new habit is formed: we therefore help to sustain new behaviors until they are engrained.
- Its impact can and must be tracked rigorously over time.

Our core multi-client programs

Program	Content and value-added	Audience
Board Academy	■ Enhance the skills of non-executive directors of large organizations through exclusive round-table discussions facilitated by McKinsey and renowned professional legal, auditing, and headhunting firms. ■ Explore multiple relevant topics, including boardroom dynamics, effectiveness and good governance. ■ Each Academy is tailored to experienced or new directors.	■ Non-executive board members in the private and public sectors
The Bower Forum	■ Join fellow CEOs in candid and confidential discussions with each other and experts on topics including driving organizational performance and health, developing strategy while building your team, strengthening governance, transforming the top team and managing stakeholders. ■ Work with McKinsey partners before and after the forum for continued leadership coaching.	■ CEOs ■ Prospective CEOs
Change Leaders Forum	■ Learn a structured approach to guide you through the difficult steps of integrating master change programs by using McKinsey's proprietary knowledge and tailoring it to your organization. ■ Accelerate and scale up transformational dynamics and capabilities at the start and during a change journey.	■ Executives ■ Transformation leaders ■ Business unit managers
Centered Leadership Forum	■ Learn how to personally influence and effectively lead transformational change. ■ Participate in a highly experiential field and forum program rich in reflection and dialogue.	■ Executives ■ Business unit managers
Remarkable Women Forum	■ Similar to the Centered Leadership Forum, this is tailored to and focused on women. ■ Learn how to personally influence and effectively lead transformational change. ■ Participate in a highly experiential field and forum program rich in reflection and dialogue.	■ Female executives

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Customized programs for individual leaders

Program	Content and value-added	Audience
Leadership Effectiveness Dialogue	■ Provide a platform for senior leaders to take honest stock of themselves in a safe and confidential setting. ■ Identify personal objectives and start changing their behavior accordingly, building on emerging insights. ■ Draw on both McKinsey's business expertise and developmental psychology as practiced by Mind at Work, and embark on a process of thorough self-examination and gradual behavioral change.	■ Executives and management
Leadership Transitions	■ Take stock and take action. ■ Answer the questions "how, what, who, and when" as necessary steps to a successful transition. ■ Tackle real-life business challenges using experiential learning.	■ Executives moving into senior leadership positions

Customized programs for top teams

Program	Content and value-added	Audience
Top Team Effectiveness	■ Enables teams to improve their team dynamics and decision making. ■ Consists of capability- and team-building forums and field coaching. ■ Covers topics including strategy refinement, alignment of roles and responsibilities, building trust, giving and receiving feedback, and managing difficult conversations. ■ Combines business and behavioral coaching to support implementation and sustainability of improvements.	■ Top management teams

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Customized programs for leaders and their teams

Program	Content and value-added	Audience
Leadership Engine	■ Discover who you need to be and what you need to do to become a more effective leader via a field and forum approach. ■ Learn how to lead self using meaning, energy and self-mastery, to lead others via motivation, coaching and trust, and lead an organization through inspiration, vision and rigor. Leading change builds on all those three, using role modeling and capability building.	■ Executives and senior leaders with their teams
Change Accelerator	■ Access knowledge on how to drive and sustain transformational change by balancing performance with organizational health. ■ Learn about the latest thinking on change in an experiential and interactive setting. ■ Work on and align your individual change strategies and implementation plans. ■ Identify key risks and challenges, and develop courses of action to overcome them.	■ Executives and senior leaders with their teams
Capability for Performance	■ Gain a deeper understanding of how to balance general leadership skills with functional expertise and industry experience. ■ Teams learn actively based on experiences, real-life tasks, and immediate problems.	■ Executives and senior leaders with their teams

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