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VIEWPOINTS

Maximizing Operating Leverage at Your Bank

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As the current economic cycle matures and financial institutions attempt to hold the line on costs amid revenues pressure, investors are increasingly asking whether bigger is better.

In 2005 over 60% of bank assets and more than 65% of bank income was concentrated in a handful of institutions with more than $50 billion of revenue, yet analysis of industry trends from 1995 to 2005 suggests investors have reason to question whether scale yields the returns they expect.

Net income growth isn't significantly different between the large and the small banks. In fact, normalized growth at the smallest banks (those with under $5 billion of revenue) has kept pace with growth at the very largest (those with over $50 billion).

There is no significant difference in returns on assets or equity among banks in the $5 billion-$15 billion, $15 billion-$50 billion, and over-$50 billion revenue categories. However, banks with revenue of under $5 billion consistently underperform the larger ones on these measures.

Small banks have much better efficiency ratios, though there is also greater variability in those ratios. Among banks $5 billion or more of revenue, there is little difference in efficiency ratios, even among those with over $50 billion, whose strategies have incorporated acquisitions to drive the scale that, in theory, could be leveraged efficiently.

Considering that investors continue to value large banks, particularly those in the over-$50 billion category, more than small ones (in terms of average price per share as well as market capitalization), the implications of these findings are profound. Since scale does not appear to justify the higher value, one can speculate that investors are paying a premium to obtain either the diversification offered by the large institutions or the promise of acquisition-related increases in operating leverage.

In either case, this situation should give managers and investors pause and spur a renewed focus on increasing operating leverage at the large institutions.

In our view, transparency is a core enabler for operating leverage at leading financial institutions. We work with clients to identify opportunities by focusing on a number of key questions.

Do you understand all elements of your cost structure? Shared infrastructures and their corporate costs, for example, often are allocated with little regard for transparency about the businesses receiving these costs. There is often little understanding not only of the breakdown of these costs, but also, more importantly, of the business drivers (or lack thereof).

Do you foster business ownership and accountability for revenue and costs? Business leaders have been compensated largely in accordance with top-line growth, thus limiting incentive to consider the costs of their actions.

This setup, coupled with the challenges in managing and allocating shared costs, an area where many managers have little influence, makes it harder for executives to manage their true P&L. It sacrifices cost control and prevents executives from understanding a business line's contribution to the company's profitability.

Have you derived all the operating leverage and growth from past acquisitions? Managers can use mergers and acquisitions as tools, in short cycles, to boost performance. However, in many cases additional capital is necessary, on top of the acquisition cost, to complete the integration. Typically this involves consolidations and conversions that produce more sustainable cost reductions.

Are your models appropriate for today's environment? It is important to challenge periodically whether long-established designs or procedures are responsive to current market needs.

On the revenue side, clients' buying patterns have changed over time, but many financial institutions have not adjusted their approach and are vulnerable to more customer-attuned competitors with integrated offerings.

On the cost side, stand-alone risk functions created to deal with a particular set of regulations and implemented as one-time efforts can create unnecessary cost and complexity while limiting insight into and management of enterprise risks.

Do you manage shared service infrastructures? Whether onshore or off, whether outsourced or not, these services require comprehensive oversight as well as ongoing management, so their impact is consistent, fair, and manageable for internal clients.

This oversight, in turn, requires transparency in terms of services provided, costs for the services, and governance of the shared services organization itself.

Transforming an organization to produce a better run, more transparent, and cost-efficient support structure starts with a comprehensive understanding of all aspects of the organization: the functions, human capital, technologies, and infrastructures.

The next step is to construct a target operating environment, including governance and management reporting frameworks, and to analyze gaps between current and target structures. The outcome is an implementation plan. In our experience, this plan is best executed in a phased manner, with clear milestones.

The future growth and consolidation of the financial services industry depends largely on institutions' ability to capitalize on opportunities to extract more leverage from the scale of a particular business and the synergies among businesses. If financial institutions can assert their capacity to do this, managers will be rewarded with more operating freedom, and shareholders will be rewarded with ample returns.

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