The Boston Consulting Group

Retail Banking

Winning Strategies and Business Models Revisited

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Throughout more than two years of financial crisis and economic turmoil, the retail business has proved to be an irreplaceable source of stability for most banks. What this sector lacks in explosive performance it makes up for by providing a cushion against sharp downturns. But like all other parts of the financial services industry, it has been strained by the turmoil. As a result, most retail banks have taken steps to reinforce their fundamentals by cutting costs and reaching out to customers.

As important as it has been for banks to respond to the immediate challenges posed by the crisis, it has become just as important to take a strategic view of how the industry is changing. Retail banks were buffeted by challenges before the crisis—as described in our last major report on this sector—and now they are dealing with a shifting landscape.[1] The changes range from short-term to semipermanent, depending on the market. Together, they will have a major impact on profitability and growth over the next few years.

This paper aims to help banks reassess their strategies, business models, and plans for emerging from the crisis faster and in a stronger position than their peers. It includes insights into the performance of retail banks from 2001 through 2008 and in the first three quarters of 2009, based on data from more than 140 banks around the globe. (For more on our approach, see the sidebar "The BCG Retail Banking Database.") Specifically, we explore the following issues:

- The inherent strengths of the retail banking sector, as well as the challenges it is facing owing to both the crisis and several trends that predated the turmoil.
- The performance of retail banks in five major regions: the Americas, Europe, the Middle East, Asia, and Australia. Each of these regions has been affected differently by the crisis, and even within regions, banking performance has varied widely.
- How different business models have fared over the long term as well as during the crisis. The drivers of performance vary among the models, but our analysis identified a set of levers essential to ensuring growth and profitability for all retail banks, regardless of type.

A Stabilizing Force

In the wake of the crisis, banks have come to rely on their retail operations as an invaluable source of funding for the asset side of the balance sheet. Some banks have also developed a greater appreciation for the retail business—in particular, for its sheer size and relative stability, both of which can help steady performance in times of crisis.

A Sizable, Resilient Business

With group profits and revenues decreasing because of the credit crunch, the retail business has assumed a bigger share of total banking revenues. In 2008, retail banking activities accounted for 55 percent of the revenues generated by the 140 banks in our database, up from 45 percent in 2006.

Retail banking revenues actually continued to increase in the first half of 2008 but have since fallen, driven by the "flight to safety" triggered by the crisis. Stung by losses and shocked by high-profile financial scandals, investors have shifted their liquidity and savings toward products they perceive to be safer, such

1. See *Retail Banking: Facing the Future,* BCG report, November 2007.

The BCG Retail Banking Database

The BCG Retail Banking Database comprises retail and group data for more than 140 banks worldwide. These banks represented 55 percent of global retail-banking revenues in 2008. The retail banking data are as stated by the individual banks for their retail-banking divisions.

The definition of retail banking activities and the application of accounting standards vary among banks. To ensure comparability, we adjusted the data for mergers and divestments and scrutinized data that were above normal thresholds.

as deposits. The subsequent competition for deposits has put pressure on margins.

Higher savings rates have increased the flow of new funds, which has only partially offset the effects of lower margins. In addition, consumers have shifted some of their money to retail banks considered to be stable and reliable, either because of government guarantees or because these institutions are not associated with highly complex, risky activities. This trend has led to gains for some banks and losses for others.

Still, with their revenues holding up relatively well, retail banks in 2008 posted better cost-to-income ratios (CIRs) than did banking groups. (CIR is the core measure of efficiency for banks: it compares operating costs with revenues.) In Europe, the average CIR of retail banks was 14 percentage points lower than the group ratio. This disparity was due, in large part, to the decline in group revenues, especially in investment banking.

Retail banks also outperformed banking groups in return on assets (ROA) in 2008, as they did across all regions before the crisis.[2] In most places, this performance gap widened as group performance fell more steeply than retail performance. In the Americas, for example, the average retail-banking ROA was 162 percent higher than the average group ROA in 2008. From 2001 through 2006, it was 51 percent higher. (See Exhibit 1.)

Stable but Not Immune

Retail-focused banks are less likely than more diversified banks to experience wild swings in performance. As resilient as they have been, however, retail banks were far from insulated from the crisis. In fact, banks have lost some or all of the gains in efficiency and productivity made during the precrisis boom. The average retail-banking CIR improved by seven percentage points from 2001 through 2006, falling to 55 percent. But from 2006 through 2008, the ratio increased by three percentage points. Likewise, the average ROA improved from 1.1 percent in 2001 to 1.3 percent in 2006. From 2006 through 2008, it fell by nearly half, to 0.7 percent.

Dampened performance can be seen as a symptom of the global economic downturn, but retail banks also made their share of bad decisions and miscalculations in the run-up to the crisis. Their exposure to unsustainable levels of consumer and small-business debt led to a sharp rise in loan loss provisions, along with a string of bank failures.

Familiar and New Challenges

BCG's 2007 report on retail banking outlined two major challenges stemming from long-term trends: intensifying competition and increasing pressure on margins.

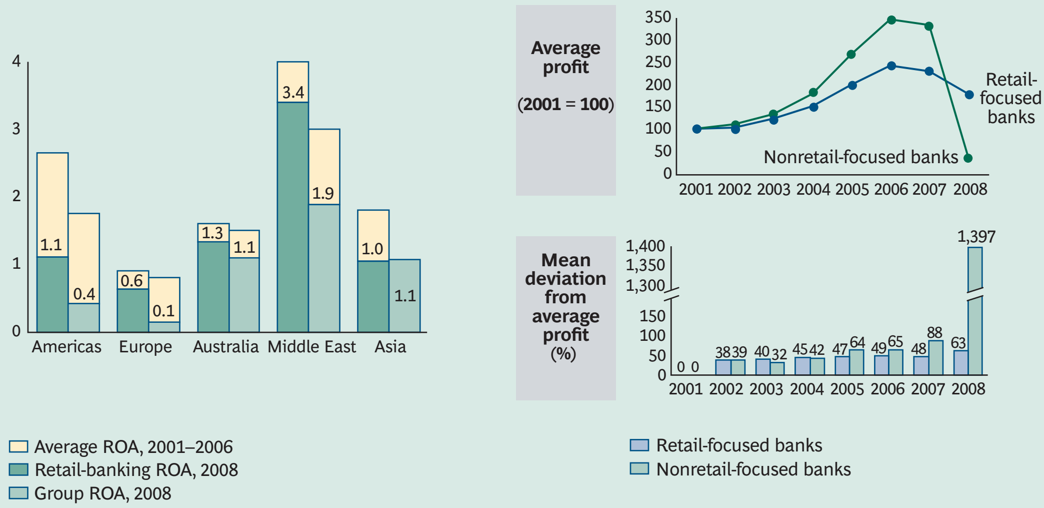
Long before the crisis sent banks scrambling for deposits, the retail banking sector was growing more competitive. The reasons included the deregulation and opening of international markets, the ongoing regional expansion and globalization of many banks, the expansion of direct and online banking, and

2. Because only a limited number of the banks in our database reported accurate equity ratios (which are used to calculate return on equity and return on risk-adjusted capital) for their retail divisions, we used the more widely available measure of ROA to gauge profitability.

Exhibit 1. Retail Banking Is Relatively Profitable and Stable

Average retail-banking versus group ROA, 2001–2006 and 2008 (%)[a]

Profit of retail-focused versus nonretail-focused banks, 2001–2008[b]



Source: BCG Retail Banking Database.
[a]Weighted average.
[b]Unweighted average. Retail-focused banks are defined as those that derived more than 80 percent of their income from retail activities in 2005; nonretail-focused banks are defined as those that derived less than 50 percent of their income from retail activities in 2005.

rising customer expectations.

To some extent, the financial crisis has lessened the competitive intensity in retail banking, but only temporarily. Banks that are struggling with equity losses have been forced to trim their balance sheets and, as a result, are curtailing international activities. The sale of overseas retail-banking units, often to local incumbents, will reduce competitive pressure in the short term (especially since these units often have an “attacker” mindset). But new attackers, some of which emerged as winners during the crisis, are going on the offensive.

Other trends that led to greater competition before the crisis—such as the rise of online banking—have persisted. In a recent survey by the American Bankers Association, 25 percent of customers named Internet banking as their preferred channel, compared with 21 percent for branch banking and 17 percent for ATMs. This trend is not confined to developed markets. In China, Ping An Insurance launched an online account-aggregation and financial-management tool that provides access to other service providers, including banks, insurers, travel agents, and social-media sites.

Margin pressure was evident before the onset of the crisis. The margins of our benchmarking participants declined by an average of about 21 percent from 2001 through 2006. It was clear that the industry was moving toward a new structural equilibrium characterized by lower margins and lower cost levels. Both were the result of the industry’s competitive intensity, the overall decline in interest rates, and a sustained focus on cost efficiency through industrialization and lower-cost channels. We see the financial crisis, with its negative impact on CIRs, as largely a cyclical interruption of this trend.

In addition to the long-term trends of greater competition and lower margins, retail banks face several changes stemming directly from the crisis. These changes will come to define a new normal in retail banking, in which profitable growth will be more elusive.

- *Deregulation will yield to regulation.* In the coming years, government regulation and public demand for ethical pricing and advice will continue to put pressure on margins. Banks in several markets, such as the United States, the United Kingdom, and Australia, have already reduced some of their fees on overdrafts, checking accounts, and credit cards. Regulators are also expected to eliminate certain product features while imposing stricter requirements on how some products are sold.

Pending regulations pose a threat to some of the biggest profit pools. In deposits, significant structural changes are expected in overdraft fees, which have fueled the no-fee-checking-account business model. In the United States, these fees generate $25 billion in marginal profit per year but are imposed on only about one-quarter of all banking customers. Leading banks have started changing their fee policies in an effort to comply with the anticipated regulations. These initial changes alone will likely reduce overdraft revenues by 25 percent. Revenues from these fees could be reduced by another 25 to 50 percent once the regulations come into effect.

- *Capital requirements will increase.* Regulators will require banks to hold more capital in all asset classes. This requirement will further depress the profitability of credit products and credit-focused business models. As a result, most retail banks will be forced to steer their business models toward collecting deposits and generating fees.

- *Loans will grow at a slower pace as loan loss provisions rise.* The last 20 years in retail banking were characterized by an ever-growing share of revenues generated through loans. In many markets, however, retail banks have become more cautious. This supply-driven trend dovetails with weaker demand for consumer finance—the rise in the savings rate will persist until consumers feel more confident about their financial health, job security, and the economic climate.

  In most countries, loan loss provisions in retail credit have soared, in part because of the high level of household debt. The International Monetary Fund claims that up to 7 percent of Europe's total consumer debt of about €1.65 trillion may go sour as a result of the economic downturn. This would equate to €115 billion in losses. In the United States, total write-offs are expected to be one and a half times European write-offs.

  There is a clear correlation between the indebtedness of households and the level of loan loss provisions in a particular country. Countries with the highest household indebtedness experienced the largest increase in loan loss provisions. This correlation was evident in the United States, as well as in some parts of Europe, particularly Ireland, the United Kingdom, and the Nordic countries, where banks were weighed down by their loan books in the Baltic nations.

- *Consumers will remain cautious.* For a period that is likely to outlast the crisis, savings rates may stay relatively high, while demand for complex products will remain sluggish. Consumers are insecure about their financial well-being. They will need more attentive service when it comes to choosing products, and they are likely to be wary of financial institutions in general. The crisis prompted many consumers to distribute their deposits across several banks in order to stay below the threshold of government guarantees.

As daunting as the new normal is, it should not overshadow the inherent strengths of retail banking. This sector will remain as vital and indispensable to consumers as it is to banking groups. Consistently strong growth and profitability will be more difficult to achieve, but retail banks will continue to prosper, provided they can find the right business model to suit their capabilities and local market conditions, which vary among regions and countries.

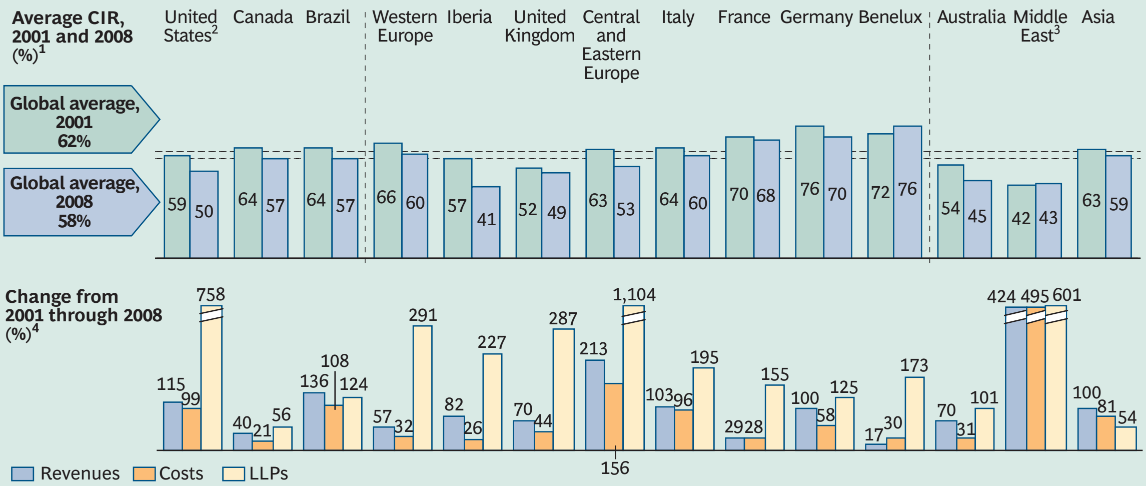
Performance by Region

Comparisons of banks in different markets should be taken with a grain of salt. Margins and cost levels can be heavily influenced by local regulations, the competitive landscape, local banking habits, and socioeconomic factors. Banks in most countries were more efficient in 2008 than in 2001, measured by CIR. (See Exhibit 2.) The strongest improvements over this period were achieved by Spanish and Portuguese banks, followed by banks in Central and Eastern Europe, Australia, and the United States.

Revenues grew at a strong rate from 2001 through 2007 before stagnating in 2008 and falling in 2009,

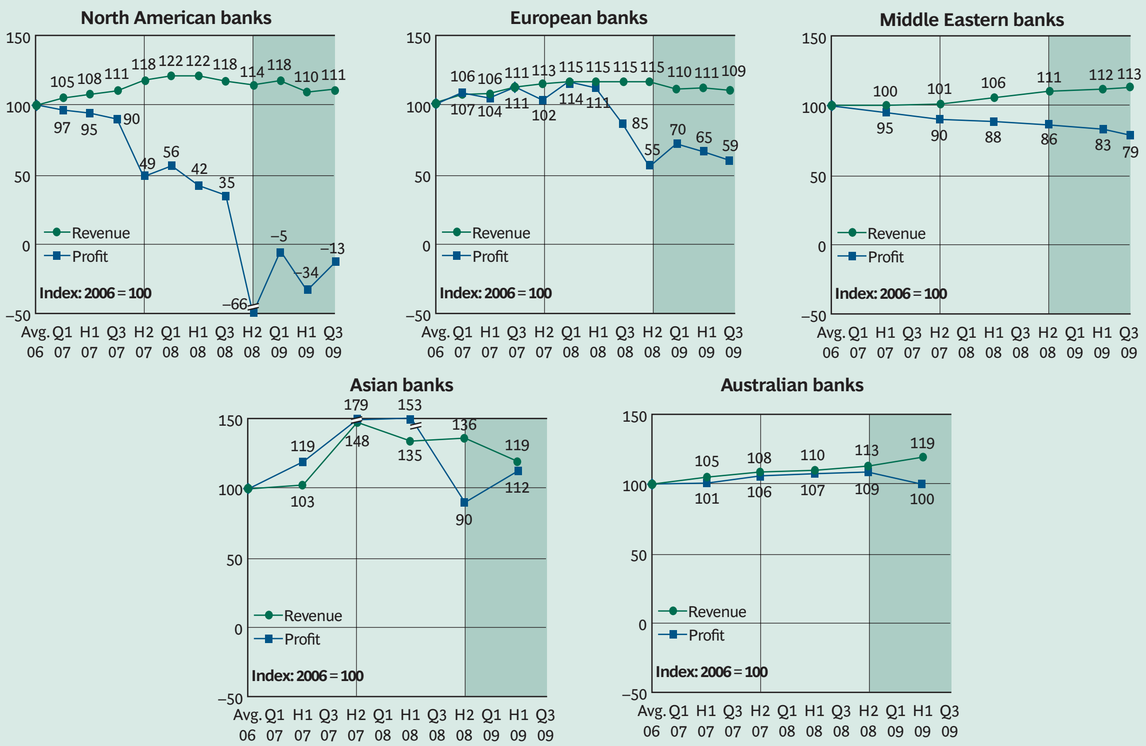
Exhibit 2. Cost-to-Income Ratios Declined in Most Markets from 2001 through 2008, While Loan Loss Provisions Surged

Average retail-banking CIRs and change in revenues, costs, and LLPs, 2001–2008



Source: BCG Retail Banking Database.
Note: Where CIR data were not available for 2001, we used 2002 data; some banks were excluded because of major distortions caused by reporting changes or merger activities.
[1]Weighted average.
[2]Citigroup was excluded because of significant changes in its segment-reporting structure; the deviation between year-on-year changes and CIR changes was driven by the significant weight of Bank of America, JPMorgan Chase, and Wells Fargo; data for JPMorgan Chase were available only after the 2004 merger.
[3]LLP data were not available for many banks; for strong outliers, we used longer-term averages.
[4]Based on year-on-year changes and unweighted averages.

Exhibit 3. Profits Plummeted in North America but Stayed at or Above 2006 Levels in Asia and Australia



Source: BCG Retail Banking Performance Index.
Note: Asian and Australian banks do not publish quarterly figures.

particularly in Europe and North America. (See Exhibit 3.) The crisis had a more immediate and severe impact on retail banking profits, which fell well below their 2006 level in both regions. Banks in the Middle East, Asia, and Australia have been much less affected. Their profitability has not dropped more than about 20 percent below where it stood in 2006; in some cases, it was higher in 2008 than it was two years before.

The Americas

Our analysis of the Americas focused on three major banking markets: the United States, Canada, and Brazil.

The United States. The crisis sharpened the contrast between strong and weak banks. Many banks were devastated by the crisis, but the market leaders still managed to improve their CIRs from 2001 through 2008. In addition, the market became more concentrated as a result of mergers and acquisitions (M&A). Three banks—Wells Fargo, JPMorgan Chase, and Bank of America—now account for about 34 percent of U.S. deposits, as well as a large portion of the market's retail-lending capacity. For a time, these banks will be focused on integrating their acquisitions of distressed banks and stabilizing their businesses.

U.S. banks are facing persistent losses and reduced demand: consumers' capacity to borrow has been constrained by unemployment and deleveraging. Structural changes in funding and regulation of banking deposits and credit card fees are forcing banks to reexamine their strategies and business models. The free-checking-account model will have to change radically, and the repricing model in the credit card industry is defunct. Banks need to rethink how to maintain profitability in their fixed-cost branch networks through innovation in products and asset generation, as well as new formats and rationalization of the existing network.

Lending practices will remain cautious rather than aggressive: banks will need to charge off toxic assets over many years while rebuilding positive book value. Surviving credit providers will focus on their specific segments and areas of expertise.

At the same time, the shift in consumer sentiment toward deleveraging has led to demonstrable decreases in credit spending, increases in debit spending, and a noticeably lower appetite for risk. The illusory affluence created by inflated real-estate prices may be a lasting drag on consumer spending: the savings rate could remain high well after the turmoil subsides.

Canada. The Canadian banking sector fared well during the crisis. Canadian banks improved their CIRs by seven percentage points from 2001 through 2008. Good financial fundamentals, tight restrictions on leverage ratios, and conservative credit policies helped, but there are concerns about credit card defaults and the country's high debt-to-disposable-income ratio.

Brazil. Some Brazilian banks have long been technology savvy and are using automation to optimize end-to-end processes. This explains, in part, how they managed to improve their CIRs by seven percentage points from 2001 through 2008. With the country's large population becoming more bankable, the outlook for retail banking is good. From 2001 through 2008, the number of Brazilians classified as poor fell by more than 40 percent.

To reach to a broader range of customers, Brazilian retail banks have found innovative ways to expand their networks of correspondents. By utilizing supermarkets, bakeries, corner shops, and drugstores to provide services, these banks have found faster, more cost-effective alternatives to building branches.

Europe

Retail banks in almost all European countries were more efficient in 2008 than in 2001, having lowered their CIRs by an average of six percentage points. Still, European banks face challenges. Loan loss provisions have risen significantly owing to the exaggerated growth of consumer loans and credit cards. In some countries, such as the United Kingdom and Spain, the precrisis growth of mortgages was built on the back of credit processes that lacked rigor and discipline.

The banking landscape has changed significantly in some markets, with governments having taken a stake in banks in the United Kingdom, the Benelux countries, and Germany. Major mergers increased scale for banks in Germany and the United Kingdom. In addition, some high-flying retail-oriented attackers were or will be taken over.

Southern European banks led the pack in terms of efficiency, with CIRs ranging from 40 to 55 percent in 2008. Their ratios were low ten years ago, thanks to a combination of high margins and low costs. More recently, these banks have shown an outstanding drive for efficiency and international expansion. Italian banks have built a presence in Eastern Europe, for example, while Spanish banks have expanded into Latin America, the United States, and parts of Europe. The international Spanish banks have developed a broader portfolio and have benefited from the strong growth of emerging markets. Their CIRs have shown the greatest improvement, declining from 58 percent in 2001 to 41 percent in 2008. Spain's domestically oriented savings banks, by comparison, had ratios of about 60 percent in 2008.

The Middle East

Middle Eastern banks continued to have some of the lowest CIRs. They also had the highest average ROAs and ROEs among all retail-banking sectors. The reason is simple: they still have comparatively high margins as well as low costs and loan loss provisions. At the same time, Middle Eastern banks have enjoyed outstanding growth in revenues, owing not only to loans but also to brokerage activity. Margins, however, have come under pressure in recent years, and the main engine of growth, consumer loans, is slowing down in several countries. Moreover, loan loss provisions are rising.

Asia

The outlook in Asia is relatively optimistic. In some countries, banks were largely untouched by the crisis. State-owned banks benefited from the flight to safety, but well-managed, low-risk banks in the private sector also managed to increase retail deposits. In countries that were at the epicenter of the Asian financial crisis in the late 1990s, government and industry responses this time around were swift and decisive. Their banking industries have weathered the storm.

Still, the effects of the crisis were apparent in some Asian markets. In 2008, operating income from retail banking operations declined in South Korea, Hong Kong, and Taiwan, while Japan and Singapore registered almost flat growth. Retail banks in China and India were largely shielded from the financial crisis.

Australia

Australian retail banks have maintained their high profitability; some have even improved their performance. The average CIR of the four largest banks, which had fallen from 54 percent in 2001 to 50 percent in 2006, declined to 45 percent in 2008.

The Big Four banks account for more than 80 percent of the retail banking market in terms of mortgages and deposits. Margins in retail banking, in general, stayed high in 2008 and 2009, and lending margins recently rose for the first time in ten years because of more risk-oriented pricing. In the third quarter of 2009, however, several banks simplified account fee structures. They also cut various exception fees—which include late-payment and default charges—applicable to transaction accounts and credit cards, mainly in an effort to strengthen customer relationships.

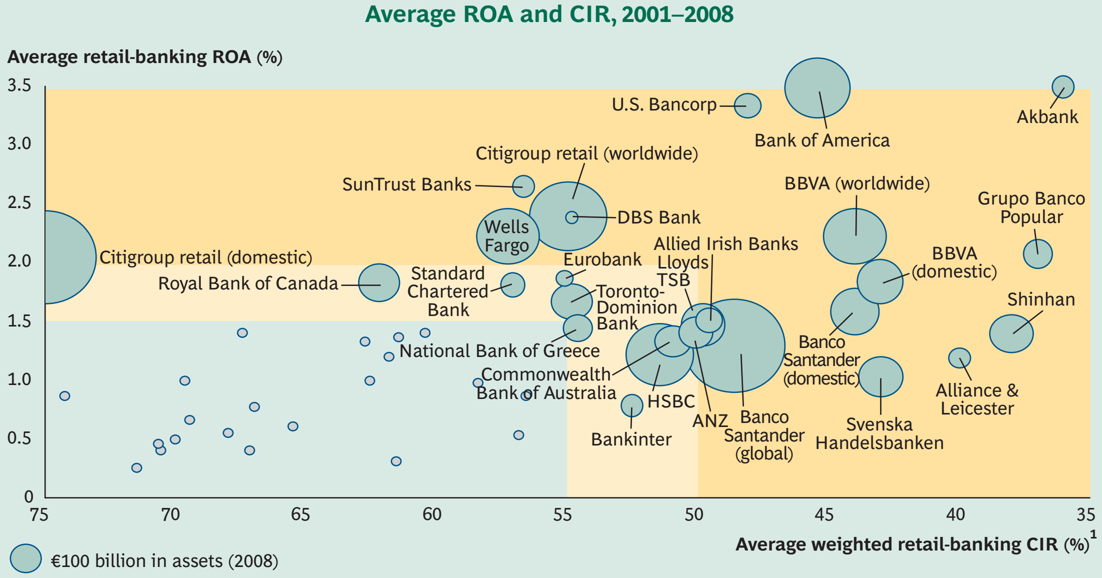
In the coming years, retail banking should continue to be a very healthy business in Australia, primarily because unemployment is expected to remain relatively low. The growth of loans, however, may slow.

Winning Banks and Business Models

A view of banking performance from 2001 through 2008 highlights different kinds of top performers. Some banks did consistently well over the entire period. Others improved over the long term or thrived during the crisis years.

A wide range of banks achieved ROAs above 1.5 percent and CIRs below 55 percent from 2001 through 2008. (See Exhibit 4.) To some extent, the results achieved by these "star performers" were driven by the prevailing conditions in specific markets.

Exhibit 4. A Range of Banks Managed to Achieve Strong ROAs and Low Cost-to-Income Ratios



Source: BCG Retail Banking Database.
Note: Green bubbles are banks with superior performance; gray bubbles represent other banks in the BCG database (assets not specified).
[1]Data for 2002 were used when data for 2001 were not available; CIRs were given linearly increasing weight to emphasize more recent performance.

Some banks improved their performance during this period regardless of their starting point. This group of "long-term improvers" included banks that operate in markets characterized by narrower margins and limits on cost reduction options, such as Germany and the United Kingdom.

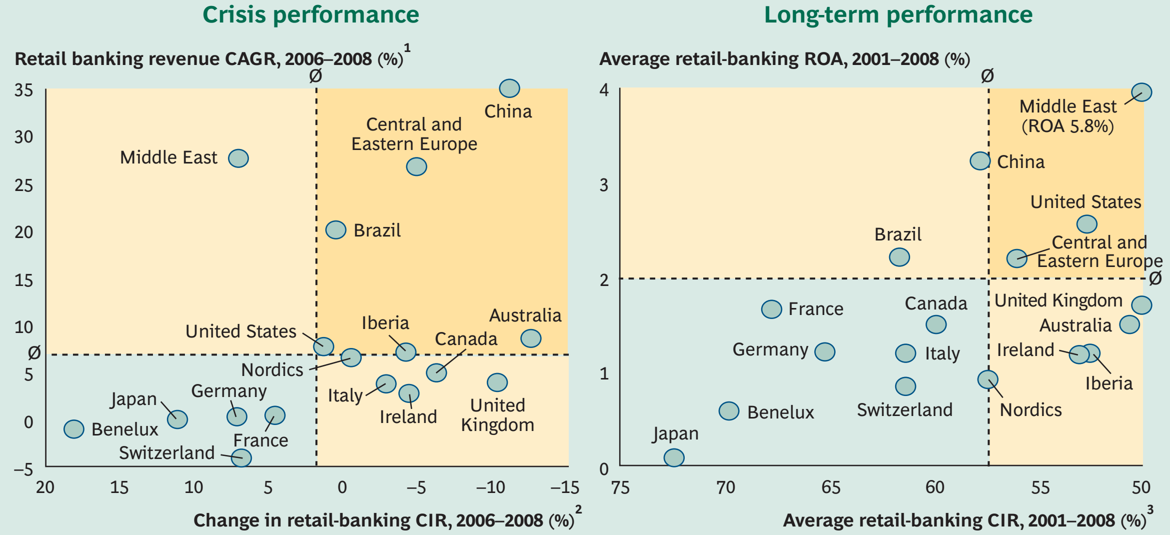
A smaller number of banks achieved particularly strong performance from 2006 through 2008 and are in good shape to emerge from the recession in a strong position. These "crisis champions" managed to improve their CIRs and profits at above-average rates while maintaining positive revenue growth. Again, country developments played a major role in their performance. Canadian banks—despite their proximity to the epicenter of the crisis—fared well, as did Spanish and Australian banks. A number of banks in Europe also managed to improve their performance during the crisis.

Some markets lent themselves to strong performance by banks, both over the long term and during the crisis. (See Exhibit 5.) Retail banks in China, Central and Eastern Europe, Brazil, and Australia stood out as crisis champions. The retail banking sector in the Middle East, China, and the United States outperformed that of other regions from 2001 through 2008.

It is important to note, however, that every market has its own champions—banks that outperformed their peers over the long term or during the crisis. Banks that are striving for better performance should look first and foremost at the top performers in their own markets. These local peers provide the best lessons for tackling challenges that are endemic to the local market. Their second reference point should be banks that share a similar business model, irrespective of the market. For as much as banking performance depends on the prevailing conditions in a specific market, it also reflects the strengths and weaknesses of different business models. And the characteristics of these business models remain fairly constant across markets.

Most of the top-performing banks follow—to varying degrees—one of the six business models that were described in our 2007 report. These were models that had done very well in the period from 2001 through 2006 and that we considered promising for the future. The six models—global titans and regional expansionists, domestic champions, retail-oriented attackers, direct banks, specialists, and trading-up players—were clearly exemplified in a group of about 30 banks that were the focus of our report.

Exhibit 5. Retail Banks in Emerging Markets Have Been Less Affected by the Crisis



Source: BCG Retail Banking Database.
Note: All averages are unweighted unless otherwise stated and are averages of all retail-banking segments in the specific region.
[1]Compound annual growth rate.
[2]Total percent change in CIR (not percentage points).
[3]CIRs were given linearly increasing weight to emphasize more recent performance; where not all data points were available, the weighting was adjusted so that the remaining data points matched the linear weighting.

We reexamined this group of banks to see how they fared during the crisis. About half of them managed to improve their CIRs from 2006 through 2008. By comparison, of the 110 banks that were not included in this group, only about 35 percent lowered their CIRs.

- Most of the *global titans and regional expansionists* did very well. These banks, typically the largest institutions, are characterized by their acquisition strategies, which are either global or centered on certain regions. Some global titans and regional expansionists suffered from an intense focus on consumer loans and credit cards, but others—particularly Spanish banks—were able to improve their CIRs. They reaped the benefits of having broad portfolios that covered high-growth countries, as well as the benefits of scale.

- The fate of *domestic champions* was tied to local economies. Most of these banks earn more than 95 percent of their revenues in their home markets. Despite this narrow focus, they manage to be among the winners year after year, having mastered core retail-banking skills such as superior sales and service. These skills often result in higher cross-selling ratios as well as more stringent cost discipline. One of the U.S. banks in this group was taken over, but several domestic champions in Australia and Spain improved their performance during the crisis.

- *Retail-oriented attackers* experienced a sharp reversal of fortune. The defining characteristics of these banks are their attacking mindset and tenacious pursuit of customers, market share, and profitability. Because of their winning streaks, some attackers—such as Commerce Bank and Deutsche Postbank—became takeover targets. Standalone attackers that relied too heavily on mortgages had to be rescued. Still, as a whole, this group kept increasing revenues, albeit at a slower pace. A handful of retail attackers even managed to improve their CIRs.

- *Direct banks* rely on marketing, simplicity, and flawless execution to grow and thrive. These banks, which achieved the highest revenue growth in the precrisis period, suffered a heavy slowdown in growth during the crisis but managed to persevere. Still, challenges remain. In many markets, incumbents have learned from their battles with direct banks and have improved their multichannel offerings. Of the six models, direct banks, along with retail-oriented attackers, will need to make the biggest adjustments to the way they approach customers. After years of expanding the customer base, these banks need to concentrate on deepening customer relationships.

- *Specialists* pursue niche markets that are not dominated by major banks, aiming to excel in a small number of products or services. In the years leading up to the crisis, many specialists concentrated on some form of loans. Their CIRs have since deteriorated, largely because of reduced revenue growth.

- *Trading-up players*—banks that have up-market brands, premium offerings, or a high share of the affluent segment—experienced a severe reduction in revenue growth during the crisis but were able to reduce their CIRs, thanks to strict cost discipline. They also maintained their inherently higher return on equity owing to their minimal reliance on loans.

Not surprisingly, banks that follow the most established and broad-based business models fared best during the crisis. They proved to be more resilient, although sometimes this was driven by favorable economic conditions rather than by the strength of their model. Nevertheless, the best and most resilient banks are still going strong.

Taking Action

Virtually every bank responded to the financial crisis, often by reducing costs or repricing loans and other products. As important as these immediate responses have been, however, the key to emerging from the crisis in a stronger position—primed for growth and profitability over the long run—is to know which actions will make the most profound difference to performance, since it is virtually impossible to make significant, continuous improvements across all dimensions. To this end, banks should identify the factors that have played a pivotal role in the success of top performers.

Our research into retail banking performance from 2001 through 2008 highlights several important levers for driving growth and profitability on a lasting basis for all retail banks, regardless of type.

Upgrade Credit Policies and Risk Management Skills

The crisis highlighted the importance of credit policies and skills. What a bank may gain by pushing the threshold of its credit policies—and taking on excessive risk—it can easily lose when market conditions deteriorate. In the run-up to the crisis, a surprisingly large number of banks exceeded this threshold. Some came close to failure. Others collapsed or became dependent on government support.

To achieve strong performance, banks need to strike a balance between growth and risk. Some of the most competitive banks have invested in advanced risk-assessment and portfolio-structuring capabilities, allowing their credit policies to deftly combine prudence with sophistication. At the same time, these banks have been careful not to become overly dependent on mathematical models. By regrounding their risk-management models on the basis of richer information from customer relationships—reflecting new behaviors shaped by the crisis—these top performers are using risk management to drive the business.

All banks have been mobilized to upgrade their risk-management skills while getting ready to deal with a rising tide of defaults. Early-warning systems, product flexibility (the ability to restructure a product to reflect a customer's changed circumstances), collection departments, and debt-restructuring skills are being strengthened to meet the requirements of a far more demanding, stressful environment. In the most affected markets, banks will have to expand their capabilities in the workout and default area, either internally or through outsourcing.

The crisis also highlighted a lack of rigor regarding liquidity risk management and, in particular, the allocation of liquidity costs. In theory, liquidity costs were available for product calculations. In practice, however, most banks paid little attention to these costs, which were quite low in the run-up to the crisis. Cost-of-funds calculations have since become critical. In many banks, however, funds transfer pricing is not state of the art.

Liquidity costs should be calculated on the basis of the bank's real funding costs. Stress scenarios should be used to determine the amount of liquid assets that the treasury must hold in order to meet regulatory or internal requirements. The return on these assets will be lower than the bank's benchmark cost of funds and divisional transfer price. This cost of carry should be allocated to the business lines that consume liquidity. The liquidity cost in many markets ranges from 50 to 100 basis points.

Finally, banks need to build resilience. Risk management is a major contributor, but resilience also requires strong capital and profit buffers, a balanced portfolio of revenue streams and countries, and a strong customer base. Mature business models proved to be most resilient during the crisis. Most top-performing global titans, for example, benefited from the breadth of their portfolios, which were spread across several regions.

The long upswing that preceded the crisis, fueled by the excessive growth of lending, came far too easily in many markets—and for many banks. Banks can and should ride such growth waves, but a resilient bank will not rely on them. Now the challenge is to reignite the growth of deposits and fee income.

Solve the Growth Problem

In the period leading up to the crisis, from 2001 through 2007, many banks settled on a relatively simple growth model. Revenue growth came from acquiring more customers—often through competitively priced products, such as mortgages or free-of-charge checking accounts—rather than deepening existing relationships. More than half the banks in our study achieved customer growth at the expense of revenue per customer. Only a quarter were able to noticeably expand their customer relationships—and many of these banks are known for making an extra effort to understand their customers and invest in relationships.

With revenues in most markets expected to remain flat for the next few years, the dominant precrisis growth model simply will not work. Instead, banks need to sharpen their focus on the customer. Moreover, in the postcrisis world—where customers are insecure and new regulations are certain to change how and to whom certain products are sold—banks will need to take much greater care in aligning their service models with customer needs.

Few banks have transformed the avalanche of customer data available to them into superior knowledge. Too often, banks use this information not to reposition the service model but to develop centralized campaigns—to drive sales of a specific product or to acquire new customers, for example—according to broad generalizations regarding consumer behavior. This approach leaves the relationship manager in charge of figuring out how best to serve the customer. Banks should aim to develop a more integrated way of looking at customers—one that aligns central marketing, product development, and frontline staff around an offering that suits the overall growth strategy.

World-class banks listen to their customers in order to understand what they want. Rather than segmenting and serving customers strictly according to their financial worth (the revenues they generate, both real and potential), these banks also categorize customers on the basis of the kinds of services and interactions they value. This knowledge can then be used to develop a more appropriate level of service, redirecting resources toward customers who value attentive service, for example. Such a nuanced perspective typically allows a bank to lower its cost to serve without sacrificing revenues. The best banks use this approach to boost revenues—better service can lead to a higher share of wallet—while lowering service costs.

Some banks set out to become customer service champions. To excel in service, banks need an offering that makes a true difference for customers. This model requires a dedicated commitment to service excellence, which needs to be conveyed to—and embodied by—thousands of employees. Banks also need to study service champions outside of financial services, such as Amazon, Ritz-Carlton, and Southwest Airlines, where every employee understands and acts in the true spirit of the company.

Other banks have developed superior online and multichannel platforms that have allowed them to achieve a disproportionately high market share in nontraditional channels, such as online banking. The benefits of optimizing the multichannel experience are significant. It can lower costs by migrating transactions to more economical channels. It can also improve service by providing seamless information and service across channels. The most advanced multichannel systems can boost revenues while increasing customer acquisition and share of wallet.

Another avenue for growth—M&A—remains relevant, but not for all banks. Since the crisis began, M&A has provided unparalleled opportunities for growth, with resilient banks targeting struggling competitors. But banks need strong balance sheets and refinancing capabilities to compete in this game. Similar growth opportunities will continue to emerge but will be available only to banks that have proven M&A skills—in particular, the ability to plan and execute postmerger integration.

Embed Cost Efficiency in Processes and Platforms

With revenue growth constrained in most markets, it is obvious that retail banks must continue improving their efficiency. It will become increasingly important for banks not simply to cut costs but to do so intelligently. To take out costs in the right places, banks must have a clear view of their overall strategy, their business model, and their sources of profitability.

Banks should also take steps to ingrain cost efficiency by industrializing processes, establishing central or regional processing centers, and developing IT and operations platforms. Banks such as Santander have successfully industrialized their operations, having tackled the formidable challenge of optimizing processes across products and countries. In addition, a small number of leading banks have transformed IT into a strategic weapon by building regional or global platforms, which not only lead to much better cost efficiency but also speed the introduction of new products. Superior IT and operations platforms are also prerequisites for the fast and efficient integration of acquisitions.

All banks will be forced to improve their process efficiency in the coming years, not only to reduce costs but also to improve customer service. The two objectives are far from mutually exclusive. Many banks, however, will find that simplifying products and processes is no mean feat. Banks will need to design and implement banking processes that are carefully engineered. Some direct banks and retail-oriented attackers have taken the lead by choosing to work with a simplified and standardized product offering—and to develop processes accordingly. But few banks have managed to create efficient processes that could lead to more significant cost reductions and scalability.

For some banks, it will take at least three to five years to create more efficient, disciplined processes. Indeed, the gap between average and advanced banks—in terms of process efficiency—is very wide. Some of the most efficient banks break down processes into dozens of steps and are able to allocate direct costs to each one. This enables them to apply a manufacturing-style, continuous-improvement approach to specific process steps.

Prioritize Performance Capabilities

The capabilities associated with risk management, growth, and cost efficiency are paramount, but the list of factors that influence performance is long. For example, leadership skills—and the role they play in establishing a performance culture—are essential to ensuring success over the long term. But while leadership is one of the greatest assets a bank can possess, it is also the hardest to acquire or build. Other critical elements include marketing and sales as well as distribution excellence. (See Exhibit 6.)

On the whole, the factors underpinning performance are no mystery, and most banks are working to improve the full spectrum of capabilities. But the secret to success for each institution is not to excel equally across all capabilities: some capabilities will matter more than others.

A bank's priorities over the short, medium, and long term should depend on its strategic starting position, its ideal business model, and the gap between its current capabilities and those it can realistically develop into sources of competitive advantage. There should be absolute clarity about these factors. Some capability gaps will come to the fore, depending on their severity and their importance to the target business model, while others can be addressed over time.

A retail-oriented attacker, for example, needs to excel in marketing and sales, be it through products and pricing—also the domain of direct banks—or through superior sales and service skills. Above all, the attacking mindset must be part of the institution's DNA. A domestic champion, in contrast, usually has a strong retail orientation and performance culture and a firm grip on costs. It also excels in certain areas of

Exhibit 6. To Design an Action Program, Banks Should Identify Capability Gaps Relative to Best Practice

- Vision, strategy, and market positioning
- Top-management leadership
- Organizational structure
- Performance culture and HR development
- Performance-oriented compensation
- Management information systems

- Credit culture, policies, organization, and competence
- Use of decision support models
- Risk-based pricing
- Credit portfolio management
- Credit monitoring and workouts

- Customer knowledge and segmentation
- Product offering and development
- Pricing
- Branding and marketing-spend effectiveness
- Database marketing and customer relationship management
- Sales power
- Customer service

- Cost control culture
- Process design for key products
- Back-office centralization and processing factories
- Outsourcing and offshoring
- IT portfolio and software development, efficient data-center management

- Segment-adapted distribution
- Efficient branch network
- Effective use of alternative channels
- Multichannel setup and management

Source: Reinhold Leichtfuss, *Achieving Excellence in Retail Banking* (Hoboken, N.J.: Wiley, 2003).

marketing and distribution. The global or regional expansionist needs committed and courageous leadership to pursue a series of acquisitions, usually at home first and then abroad. The acquisitions must be built on the foundation of a superior business model and be supported by a core set of M&A skills.

Fulfilling such strategic aspirations is a tall challenge for many institutions. Regardless of the base business model, it requires the following:

- A clear strategy that takes into account recent changes caused by the crisis and that reorders accordingly the initiatives and ideas that are competing for critical resources

- An aligned and extremely committed leadership team capable of steering the organization in the right direction and holding the course over a long period

- An intense level of management attention to ensure that change is driven all the way to the frontline

- Measuring, evaluation, and incentive systems that ensure that the organization is holding the course

- Change management capabilities and processes that motivate and enable a big workforce to meet new standards

In our experience, most retail banks do not achieve outstanding performance by making incremental improvements across a number of dimensions. Rather, they do so by fundamentally transforming their management and operating processes—guided by a well-defined strategy and business model—while also motivating a large percentage of the workforce to embrace change. The journey toward a better business model can be arduous, but it has never been more important. The crisis has underscored—with alarming clarity—the value of having a resilient business model.

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