Closing the performance gap: Back to basics for the U.S. banking industry

Banking institutions across America show a striking dichotomy in terms of stock performance. Those that remain at the top of the charts display strategies and attributes that consistently garner shareholder value. A recent study by the IBM Institute for Business Value suggests that while their methods may vary, these leaders share three distinct characteristics.

By Vikram Lund and Christy Maver
Introduction

In an economy now stymied by recession, a string of corporate failures and the September 11 attacks, banking firms across the United States are finding themselves at either end of the spectrum in terms of achieving and sustaining shareholder value (see Figure 1). Although the U.S. banking industry has generally prospered over the past decade, institutions weigh in very differently on the performance scale. This fact may be comforting to firms on the high end of the curve—typically those with a diverse portfolio of value-based initiatives—but protects none from the challenges brought about by constant rate changes, stock devaluation, loan charge-offs and newly anxious, often debt-burdened customers.

Figure 1. The dichotomy between high and low performers, which reached its peak in 2000, has managed to sustain itself.

Notes: (1) Banks were examined using a market cap to asset ratio to compare performance, regardless of size. (2) High and low performers were determined by looking at all public banks over two-year, five-year and ten-year periods to determine which banks had performed well and which had performed poorly across all three time periods. (3) S&P Banking Index did not exist until May 1993.

Source: FDIC Quarterly Banking Profile, 9/01; IBM Institute for Business Value analysis.
“For the last decade at least, many banks have been so absorbed in their own internal issues, particularly merger-driven cost cutting and reengineering, that customer service often received short shrift. The industry’s propensity to raise fees to boost noninterest income hasn’t helped either. Getting an accurate read on customers is becoming more important as evidence accumulates of a growing disconnect between banks and their customers.”

What’s more, there is extra scrutiny to assure business continuity and produce realtime proof of operational integrity and stability. While security and trust remain fundamental to the banking industry, those expectations are now higher. Add to these concerns a growing list of new contenders: other financial institutions that can now compete directly with banks, as well as nonbanking entities that are using the strength of their brands and customer base to enter the banking domain.

Although the dot-com frenzy fizzled, it uncovered monumental inefficiencies among traditional firms, who typically underutilize Web-based technologies. Granted, this is only one piece of the puzzle; yet it reinforces the fact that U.S. banking institutions are going to have to work harder at sustaining their value and growing profits in an essentially commodity-based industry. This will require close examination of all the factors impacting the business and a willingness to build value from the outside in—from the customer’s perspective. While players across the industry continue to pursue strategies for increasing and sustaining shareholder worth, firms that are succeeding exhibit three distinct characteristics, as identified by IBM: a tenacious customer focus; a viable, executable strategy that is both tactical and strategic; and a portfolio approach that reflects the strength of the institution and the requirements of the customer.

Confronting the performance gap

The flood of mergers and acquisitions has slowed, compelling banks to leverage their core competencies. Although capabilities vary from business to business, most institutions are expanding their portfolios with noninterest income offerings in an attempt to open new revenue streams and steady the income statement (with initiatives such as financial advisory services, venture capital revenue, service fees, securitization, insurance commissions, loans and real estate).

Account aggregation is a natural fit for banks; the trust and security associated with banking institutions make this service appealing to customers. Yet, too often, banks view aggregation simply as a way to retain customers and remain competitive, ignoring the chance to extend their value. For the bank, the data gleaned from this service—information gathered from the customer through a growing assortment of channels—can be put to use in any number of ways: to confirm customer preferences, assign appropriate fees and develop new and innovative offerings, for example. Still, many firms fail to capitalize on this opportunity—focusing on the needs of the business rather than those of the customer.
In the age of e-business, banks can use the Web and the volumes of information it generates to transform how they design and deploy services, reinvent relationships, forge new connections, and align processes throughout the enterprise and across the value chain. Yet, while electronic connections continue to afford huge opportunities for banking institutions to expand their capabilities, lower costs, grow revenue and attach more value, those same technologies are making it easier for nontraditional competitors to enter and compete in the banking industry. Many of the unexpected rivals, like retailers and grocers, are new to the banking arena but have other advantages: they know their local marketplace, they know how to manage supply chains and they've become experts at delivering the right product to the right customer at the right time.

Connecting the dots
In the banking industry, every customer counts—and every satisfied customer spends more. Now, thanks to the Web and its technologies, more banks can reach more customers anytime, in realtime and customers can do likewise with their bank. Both can profit. But while banks have invested more than most other industries in technology (the banking industry will spend US$33 million on IT in 2002 alone), many are saddled with older, frequently isolated systems that regard customers as consumers of products, rather than purveyors of rich information. Many banks are ill equipped to analyze ROI from these technologies or integrate those assets with other business elements to get closer to customers. For example, although the ATM, the teller’s counter and the Internet offer convenient choices for customers, these avenues add little value for the bank or the customer if they can’t “talk” to one another.

Also, banks typically categorize customers according to age and net worth—leaving many opportunities untapped. At the same time, companies must be sensitive when making changes that could affect customers’ services or banking habits. Current technologies make it possible to interpret customer data at a highly granular level, summarize the present value of the consumer, then turn that information into opportunities for building lifetime value. By using their IT assets to gather, consolidate and distribute customer-related data, institutions can segment customers appropriately, develop and price products accordingly, and assign resources in the most prudent and profitable ways over the course of the relationship.
For example, if a customer historically relies on low-end transactions, online banking probably makes the most sense. On the other hand, consumers looking for advice and long-range planning (buying a home, saving for emergencies, college, new business ventures or retirement) will most likely appreciate direct communications, either face-to-face or on the phone, with a trusted and knowledgeable source. The key is to have strategies and tools that map to a customer’s present needs, balance them with the goals and capabilities of the business and draw customers naturally to the most economical channel.

**Pursuing shareholder value: What banks are doing**

Across the industry, banks are deploying common initiatives to stake their claim and strengthen their value proposition. These include:

**Acquisitions and mergers**

Historically, banks have deployed this strategy to extend their presence, achieve new economies of scale and augment their product line with new and value-added services. IBM studies reveal that institutions will narrow this focus—opting for more strategic unions that fill a gap in the bank’s overall strategy. It’s no longer about being bigger; it’s about creating value for customers and shareholders.

**Customer segmentation**

Institutions continue to invest in technologies to help gather, sort and analyze customer data. If deployed correctly, these initiatives can offer valuable insight into customers’ preferences. Banks can then develop products and services around what customers want, at the price they are willing to pay. If and when the customer’s requirements change, the bank can respond dynamically.
Closing the performance gap

Optimizing the IT infrastructure
Banks have found that investing in a more stable, more efficient technology infrastructure can dramatically lower the cost of serving customers and strengthen the value of the business in terms of enhanced security features and improved continuity. This last factor has added importance when one considers the repercussions of September 11 and ensuing government pressures.

Outsourcing
While traditional outsourcing remains a viable strategy, a number of institutions are exploring more process-based outsourcing – turning over noncore operations to best-of-breed service providers who provide IT services on demand. These types of services allow businesses to scale as needed while focusing on core business concerns. On-demand services can also result in significant savings – turning fixed costs into variable expenditures that better align with business and customer needs.

Technology leadership
A number of banking institutions are turning to new technologies to capitalize on growth opportunities and lower the costs associated with front- and back-end processes. While these efforts might not offer a quick payback (customers are just starting to adopt some of these tools – wireless being one example), IBM studies have shown that banks who are embracing this strategy early on can generate significant value once critical mass is achieved. (This is especially noteworthy when one considers that consumers’ adoption of online services is far outpacing what the industry observed with ATMs.) It is the intersection of business and technology that contributes value to the marketplace.

Fee-based offerings
In an effort to shield themselves from market volatility, many banks are turning to non-interest income. Banks that profit from this approach see it as an opportunity to develop products and services that add real value for the customer, rather than simply a way to attach fees to services already in existence. By providing extra value that the customer is willing to pay for, banks can create a win-win situation that benefits both the business and the consumer.
In spite of these efforts, many businesses are falling short—relegating themselves to the low end of the performance matrix. IBM studies indicate that high-performing institutions carry out the above strategies in the context of a clear and executable value proposition, and that there are striking discrepancies between high and low performers.

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<thead>
<tr>
<th>Strategy</th>
<th>High performers</th>
<th>Low performers</th>
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<tr>
<td>Acquisitions</td>
<td>This U.S. bank’s acquisition of a large foreign banking institution has had positive financial results and is likely to be just one of many such moves the company will make. The deal, which kept the foreign bank’s brand intact and leveraged a joint venture that the latter had with another institution, enabled the company to add a compelling new value proposition for the foreign bank’s customers, extend its footprint and heighten its ranking as a global leader. The secret to success in this case was the U.S. bank’s adherence to a strategy of growth and world leadership, diligence in presenting a better value proposition to newly acquired customers, and an intelligent mix of products and service.</td>
<td>Blindsided by a “follow the leader” mentality, this U.S. bank undertook too many acquisitions—with no clear strategy to support those actions. The firms the company acquired had little or no synergy. In its haste to gobble up businesses, the bank lost sight of its customers and how its direction would affect them. By concentrating primarily on acquisitions, the bank missed other opportunities to broaden its portfolio.</td>
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<td>Customer segmentation</td>
<td>This U.S.-based institution is a leader in customer segmentation. The bank adopted a needs-based approach and employed data-mining techniques to accurately identify individual customer requirements and align offerings accordingly. The firm also launched a branch strategy combining one-stop service and financial analysis needs and planning. This represents a shift from selling products to identifying solutions—and a commitment to stay on strategy.</td>
<td>This bank paid a hefty sum to merge with another U.S. bank in hopes of building regional market share and cutting costs. In an attempt to recoup its high acquisition expenses, the bank shaved operating costs at the other firm’s branches. This involved replacing face-to-face customer services with automated tellers, phone banks and Internet sites, and raising fees across the board. Such cost-cutting measures alienated customers and highlighted the bank’s simplistic segmentation.</td>
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<td>Efficient infrastructure</td>
<td>With branches across the U.S., this bank has garnered an impressive efficiency record, despite aggressive acquisitions. One of the reasons is the company’s unique, decentralized business model, which enables its affiliate banks to share a common back office. Both the business and its customers benefit from the decentralized approach: Each of the affiliates retains the look and feel of a small community bank where branch employees nourish customer relationships. Additionally, efficiencies gained through common back-office processing result in potentially lower costs across the company.</td>
<td>This institution’s strategy to increase operational efficiencies through mergers and acquisitions—although admirable—did not work. As the bank started to realize efficiencies from its merger with another large firm, it lost sight of customer needs; the merger forced headcount reductions and branch consolidation. Customer satisfaction fell as local branches disappeared, and customer attrition grew—negatively impacting shareholder value. The firm’s constant, isolated use of mergers and acquisitions to increase efficiency proved costly over the long term.</td>
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## Closing the performance gap

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<tr>
<th>Strategy continued</th>
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<th>Low performers</th>
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<tbody>
<tr>
<td><strong>Alliances and outsourcing</strong></td>
<td>To capitalize on its core strengths, this U.S. bank decided to offer its known abilities in processing and custodial services to other institutions. The key to the company's strategy was its focus on what to outsource, what to abandon and what to provide in house. The bank confirmed its core capabilities, then leveraged these services by offering them to others. When outsourcing was appropriate, the firm did not hesitate to seize this option. And whenever the bank expanded through acquisitions or mergers, it pursued additional services that it might outsource.</td>
<td>Though its intentions were good, this bank's outsourcing deal with another financial institution took unexpected — and unwanted — turns. The firm that the bank chose to help increase its financial clout was not experienced in servicing high net-worth clients. As a result, many highly profitable customers left the bank. In an attempt to reconcile the misstep, the company took aggressive measures that included acquiring another company, hiring portfolio and fund managers, and adding new mutual funds specifically targeted at high net-worth customers. What went wrong? The bank had no clear strategy for outsourcing, and many of its major outsourcing initiatives occurred only because of failed acquisitions. By alienating several high-end customers, the company also demonstrated its lack of customer focus. Adding new staff was not enough to bring back customers; alliances and outsourcing were more of an afterthought.</td>
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<td><strong>New technology</strong></td>
<td>By making technology its core competency, this innovative U.S. bank created a solid source of noninterest income. While many banks outsource electronic and credit card payments, this institution handles payments for itself, other banks and merchants through its subdivision. The latter serves as one of the few full-service processors in the U.S. — serving clients with ATM, point of service (POS) and e-commerce transactions. Rigorous cost controls have kept technology expenses low — resulting in an impressive efficiency ratio. Although the company was fortunate to be at the front of the electronic payment wave, it is balancing its strategy with other IT initiatives and using the income from its subdivision to cushion the effects of interest rate shifts.</td>
<td>This U.S. bank targets middle- to lower-income demographics and small businesses. In only one year, the firm acquired branches from another institution — doubling its size and making it one of the largest banks in the region. Although the conversion has been relatively smooth (losing very few customers), the market has discounted the bank's efforts to attempt such a large branch acquisition. And although the company has taken steps (outsourcing systems integration responsibilities, for example) to allay market trepidation, it has paid little attention to creating innovative IT solutions for its customer set. Also, acquisition expenses have left the company with little left over for technology investments — opening the way for competitors to take the upper hand.</td>
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<td><strong>Fees</strong></td>
<td>Customers of this bank rarely dispute the company's fees; the value that they receive from the institution's fee-based offerings is clearly stated and appreciated. The firm specializes in fiduciary, asset custody and investment management services for high net-worth clients. Although its fees are actually above the industry average, the bank consistently exceeds its customers' expectations and fee levels are rarely questioned. Why? The bank regularly demonstrates an intense customer focus. Rather than branches, it has opted for well-decorated &quot;offices&quot; in which clients can discuss their financial goals and concerns. The bank also makes a habit of hosting seminars. The business stays on strategy by limiting acquisitions and concentrating on its core value proposition — fee-based operations. It is also careful to maintain a highly-diversified portfolio of businesses and offerings.</td>
<td>An aggressive merger strategy compelled this bank to raise fees as a way to relieve acquisition expenses. The institution's plan was to increase its fee-related services and split the business equally among traditional banking services and fee-based offerings. Not surprisingly, customers balked — repeatedly thanking the bank's fee initiatives, including the decision to charge for using other banks' ATMs. The firm lost a large percentage of a newly acquired customer base that was angered by branch closings and higher fees. While the goal to improve the balance sheet was sound, the aggressive pace of execution might have doomed the strategy. The bank’s strategy to balance its business with traditional and fee-based offerings indicates its attempt at developing an equalized portfolio. However, the strategy will take time to integrate and execute.</td>
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Closing the performance gap

**Follow the leaders**
An analysis by the IBM Institute for Business Value verified that institutions at the top of the performance curve exhibit specific traits, each of which uses both human and technological resources to balance cost and value. It is important to note that low performers lack one or more of these characteristics.

**Focus first on the customer**
Understand that real value is perceived and driven by the consumer, not the business, and technologies and services should be developed and delivered accordingly. Design and deploy all strategies with the customer in mind, and consider how these actions will impact the customer. View every customer relationship as an opportunity to embellish your competitive advantage. IBM studies of U.S. banking trends indicate that market leaders who adopted this approach in mergers and acquisitions, technology adoption or other initiatives—sometimes even by increasing fees—placed the customer at the heart of these efforts.

**Develop a viable strategy and execute it effectively**
Think of every strategy in terms of shareholder value and ROI. Seek to develop initiatives that are achievable, concrete, comprehensive and well articulated. You can look at other, similar institutions to identify best practices and lessons learned. And remember, execution counts just as much as design. While numerous banks have expressed noble intentions of revamping their cost structures and reinventing their businesses, much of what they envisioned simply was not viable, much less executable. The best strategies are driven from the top down and across every channel—from the chairman’s office to the ATM machine to the Web site.

**Maintain a balanced portfolio that aligns with both short- and long-term business expectations**
When developing offerings and services, think tactically and strategically. Develop a mix of products that is designed to meet both current and future customer demands, and that also takes into account the capabilities of the institution. Most leaders have used this approach to balance short-term financial performance with long-term growth. The crux of this strategy is to stay on course—to remain diligent about proportioning strategies, products and services in a way that continues to render value and takes into account all the factors that impact shareholder worth: revenue, cost, assets and risk. This may require abandoning certain initiatives that fail to live up to expectations or skew the product mix.
Aligning goals with actions

Banking institutions typically use four methods to increase shareholder value. IBM research revealed that banks positioning these techniques as part of an integrated, value-focused portfolio will stand to realize the most gains.

**Objective: Grow revenue**

**Action:** Refine customer information to develop and tailor offerings that target individual needs, furnish value and increase profits.

Perfecting one’s view of the customer and shaping offerings from that perspective not only affords more value for the consumer; it also opens opportunities for cross-selling, up-selling and cementing one’s brand. Yet achieving this state requires working around vertical organizational structures and disparate systems to create a holistic view of the customer and, for the customer, a like view of the banking institution. This way, banks can begin to understand what customer preferences drive profits, price products accordingly and equate cost and value. As offerings continue to assume commodity status, institutions will have to renew their efforts to develop new products and services to differentiate themselves, whether through superior service delivery, financial advice, innovation—or all of these competencies.

**Objective: Reduce costs**

**Action:** Employ technology to heighten channel efficiency, align services with the most appropriate channel and optimize core strengths.

Banks can take several actions to reduce costs. One is to learn to utilize technology more effectively to reduce process costs across the enterprise. For example, by implementing wireless solutions, institutions can afford remote workers easy access to vital information, raise efficiency levels and trim expenditures. Another step is to migrate customer activity to the most cost-effective channel. Many transactions that are carried out in cost-consuming channels could be performed just as well using less-expensive mechanisms. (One cautionary note: Banking institutions that take on this task must articulate a strong proposition for moving customers to another channel. This requires a fundamental shift—from penalizing customers for unprofitable actions to rewarding them for conduct that adds value for both the business and the buyer.) The third action that banks can take is to look at outsourcing noncore processes—those that do not contribute directly to the enterprise.
Objective: Leverage physical assets

Action: Work from the “ground up” to integrate and deploy strategies at every level through every channel.

Most bank branches are transaction-focused, paying little attention to enriching sales efforts or enhancing relationships. This is changing, however. Institutions are ramping up efforts to heighten the efficiency of their branches, call centers and ATMs, and add more value to these channels. Banks will use technology to achieve this goal. Enterprise portals are just one way that firms can do this. Organizations should also take time to rationalize their number and mix of branch offices. Institutions can also consider providing core capabilities to complementary businesses.

Objective: Lower operational and credit risk

Action: Leverage IT assets to improve communications, promote a security-rich environment, monitor assets and bolster the infrastructure.

Now more than ever, banks need to work at fostering credit quality. Today’s technologies make it possible for firms to better assess risk from all angles. Forward-thinking institutions will use these tools to manage, monitor and evaluate volumes of data in realtime and arm themselves for market fluctuations. Another critical action for guarding against risk is to build an IT environment that enables business continuity—a concern that now has more serious implications.
## Closing the Performance Gap

**Test your value proposition**

Take the challenge! Assess your bank’s abilities in the following areas.

<table>
<thead>
<tr>
<th>Capability</th>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>Not sure</th>
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<tbody>
<tr>
<td>Correctly determine customers’ needs</td>
<td>Do you have the data, IT resources and staff necessary to determine individual customers’ financial goals and concerns? Can you quantify results?</td>
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<tr>
<td>Create an all-encompassing view of the customer</td>
<td>Do you have the ability to capture customer interactions across channels to gain a comprehensive understanding of each customer?</td>
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<tr>
<td>Accurately assess customers’ profit potential</td>
<td>Are you able to analyze customer data to determine an individual customer’s current profitability, as well as their future profit potential?</td>
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<tr>
<td>Balance IT investments</td>
<td>With your IT infrastructure, are you balancing expenses for mandatory upgrades with investments in new technologies?</td>
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<tr>
<td>Leverage technology</td>
<td>Can your bank integrate and deploy technologies seamlessly, across processes, without disrupting your institution’s day-to-day operations?</td>
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<tr>
<td>Extend customer channels</td>
<td>Has your institution extended its portfolio to include value-added services that will differentiate your business and generate new revenue streams?</td>
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<tr>
<td>Define core strengths</td>
<td>Has your bank determined its central competencies? If so, are you prepared to outsource noncore activities?</td>
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<tr>
<td>Focus more on relationships</td>
<td>Are you providing incentives that encourage your employees to focus less on transactions and more on building relationships?</td>
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<tr>
<td>Rationalize assets</td>
<td>Has your bank evaluated its distribution environment to determine the optimal balance of channels? Has it optimized the efficiency of each channel?</td>
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<tr>
<td>Supervise and control credit risk</td>
<td>Are new technologies part of your bank’s strategy to more accurately assess and control credit risk?</td>
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<tr>
<td>Extend technology to the field</td>
<td>Are your branch offices and external sales force equipped with new technologies that extend their reach and enhance their value?</td>
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<tr>
<td>Migrate customers to lower-cost channels</td>
<td>Are you providing your customers with clear and appealing incentives to switch to lower-cost channels?</td>
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<tr>
<td>Assure business continuity with a reliable and resilient infrastructure</td>
<td>Have you taken steps to safeguard your IT environment and replicate those systems across regions to help assure business continuity?</td>
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Get started now
At IBM, we have gathered a team of seasoned, industry-focused consultants who are ready to help banking institutions build and sustain value—not only from their customer relationships, but also from their business and IT assets as well. We know the importance of blending strategies and technologies with the practicalities of day-to-day operations, and are today helping banks across the U.S. reap the rewards of sustained shareholder value. To explore how we can help your organization, contact us at bva@us.ibm.com. To browse other resources for business executives, visit our Web site at ibm.com/services/insights
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