Financial Services

Value in Focus

Achieving cost-efficiency in the European banking sector

Contents

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Foreword

In the Autumn of 2007 Arthur D. Little examined some of Europe's largest retail banks in terms of cost-efficiency – work resulting in this report. We hope this study will be useful in two ways:

- As a reference work to help industry practitioners, analysts, public policymakers and scholars compare relative levels of cost-efficiency; and
- As a source of inspiration for European banks looking for new ways to increase efficiency.

There are, as the reader will soon discover, many ways to increase cost-efficiency. A flat hierarchy that avoids unnecessary bureaucracy, clever use of technology and a cost-conscious culture are just a few. Indeed, cost-efficiency is not so much a game of avoiding costs per se, but rather a focus on embracing the right (revenue-creating) costs whilst shunning costs that bring little or no value to the customer.

But why is cost-efficiency important? In short, cost-efficiency gives a bank freedom to manoeuvre. Strong, free cash flow gives a bank the means to invest in new markets, products or technologies, to reward its shareholders and, if it chooses, to channel value back to its customers in terms of better service or lower prices. Conversely, low relative cost-efficiency limits a bank's options in the marketplace, and makes it vulnerable in times of financial crisis. For shareholders, high cost-efficiency is an indicator of a well-run bank.

There are a number of ways in which cost-efficiency can be measured. In this report Arthur D. Little has chosen the cost-income ratio, a fairly standardized measure suitable for cross-border analysis. It is worth noting that, over time, this ratio seems to be decreasing. Senior executives at banks with a cost-income ratio over the European average of 59,2% should think hard about what they can do to make their companies more efficient. The inspiration can be found in this paper.

Gerrit Seidel	Erik Almqvist
Managing Director	Director

Executive summary

This survey by Arthur D. Little ranks 51 major European banks on cost-efficiency measured by their cost-income ratio and takes a closer look at the strategies adopted by the top performers to achieve their high-ranking positions.

Arthur D. Little has ranked 51 major European banks on their efficiency level, as measured by their cost-income ratio.

Europe's most efficient bank is the Spanish bank, Banco Popular, followed by Kaupthing from Iceland. On a country level, Iceland is the most efficient country, followed by Spain and the UK. Sweden, Norway, Finland and Denmark are also above the European average. The least efficient country among the 15 examined is Germany, just behind Portugal and the Netherlands.

The top performing banks have some characteristics in common:

- A will always to improve through hard work and innovation in order to maximize value for customers.
- Very cost-conscious cultures where cost-efficiency and operational excellence are continuously encouraged. Cost-cutting is focused to unproductive and non-value-adding activities.
- A high degree of straight-through processes and automation and heavy investment in IT.
- Flat hierarchies with short communication channels and a high degree of decentralization, with decision-making taking place primarily at a local branch level.
- The use of a pragmatic list of key performance indicators and mostly numerical objectives for costs and efficiency.

Introduction

Arthur D. Little has consolidated data from the major banks in 15 different European countries identifying the most efficient. In the ranking produced by the survey, banks from three regions dominate the top ten.

This study, conducted by Arthur D. Little's Global Financial Services Practice in December 2007, aims to identify the most efficient commercial banks in Europe. To this end, Arthur D. Little has consolidated data from 51 major banks all over Europe and established a ranking based on the information gathered.

The survey covers the largest banks, as measured by total assets, from each of 15 countries in western Europe and the Nordic region. This means that the banks in the study are not necessarily the 51 largest in Europe; some banks that are the biggest in their own market might be relatively small in the European context. A full list of the 51 banks included in the survey and details of their total assets can be found at Appendix I.

"The CIR is calculated by dividing operational cost by total income and indicates how much a company spends for every unit of income it earns."

Measuring efficiency

The survey uses the cost-income ratio (CIR) to measure efficiency. The CIR is calculated by dividing operational cost by total income and indicates how much a company spends for every unit of income it earns. An efficient company uses fewer resources than an inefficient one to earn the same amount of money.

Achieving efficiency

The study also includes case studies of several banks that appear at the top of the survey ranking and gives an indication as to how they have become so efficient.

Sources

All data is drawn from the banks' annual reports and Arthur D. Little's own analysis, except where specified below.

Cost-efficiency ranking

The survey highlights a wide variation in cost-efficiency among Europe's large banks. The bank at the top of the cost-efficiency ranking achieves a cost-income ratio less than half that of the lowest-ranking bank.

Methodology

The banks included in the survey have been ranked according to their cost-income ratio (CIR), obtained by dividing operational cost, including amortization and depreciation, by total income.

The data has been gathered directly from each company's official annual reports and the ratio has been calculated by Arthur D. Little to obtain maximum comparability. To make the ranking less vulnerable to extraordinary events, the CIR used is an average of the ratios from three years: 2004-2006.

Most efficient banks

Arthur D. Little's calculations show that the average cost-income ratio of the 51 banks in the survey is 59,2%. The most efficient bank, with a CIR of 37,8%, is the Spanish bank, Banco Popular. Second most efficient, with a CIR of 39,3%, is Kaupthing (Iceland) and third most efficient, Svenska Handelsbanken (Sweden), with a CIR of 42,1% (see figure 1).

All of the ten top banks in the ranking are from three regions: the United Kingdom (four banks in the top ten), the Nordics (three banks) and Spain (three banks).

Figure 1: Banks ranked by average cost-income ratio 2004-2006

	Rank	Bank	Country	CIR %
Above*	1	Banco Popular	Spain	37,8
	2	Kaupthing	Iceland	39,3
	3	Sv. Handelsbanken	Sweden	42,1
	4	Glitnir	Iceland	43,7
	5	HBOS	UK	44,7
	6	RBS	UK	45,0
	7	BBVA	Spain	46,4
	8	HSBC	UK	51,4
	9	Lloyds TSB	UK	51,5
	10	Caja Madrid	Spain	51,7
	11	Swedbank	Sweden	51,7
	12	Dexia	Belgium	52,7
	13	Sampo Group	Finland	53,1
	14	Danske Bank	Denmark	53,7
	15	DnB Nor	Norway	54,0
	16	Nordea	Sweden	55,8
	17	OP Bank	Finland	55,8
	18	Raiffeisenbanken Switzerland	Switzerland	55,9
	19	UBI Banca	Italy	56,4
	20	Banco Santander	Spain	57,6
	21	KBC Bank	Belgium	58,5
	22	Banco Sabadell	Spain	58,8
	23	Unicredit Group	Italy	58,8

	Rank	Bank	Country	CIR %
Below*	24	San Paolo IMI	Italy	59,4
	25	Jyske Bank	Denmark	59,9
	26	Barclays PLC	UK	60,0
	27	Zürcher Kantonalbank	Switzerland	60,3
	28	Raiffeisenbanken International	Austria	60,5
	29	Bank Austria Creditanstalt	Austria	61,2
	30	Banca Intesa	Italy	61,4
	31	BNP Paribas	France	61,7
	32	SNS Bank	Netherlands	61,8
	33	Capitalia	Italy	62,3
	34	Erste Bank	Austria	62,3
	35	Credit Mutuel	France	62,3
	36	SEB	Sweden	62,5
	37	Société Générale	France	64,0
	38	EFG International	Switzerland	64,6
	39	Caixa Geral de Depositos	Portugal	65,0
	40	ING Bank	Netherlands	65,8
	41	Commerzbank	Germany	65,9
	42	Credit Agricole	France	67,1
	43	Rabobank	Netherlands	67,4
	44	HVB Group	Germany	67,6
	45	Fortis Bank	Belgium	68,4
	46	Credit Suisse	Switzerland	70,6
	47	UBS	Switzerland	70,9
	48	Banco Comercial Portugues	Portugal	71,1
	49	Deutsche Bank	Germany	74,9
	50	ABN Amro	Netherlands	76,2
	51	Dresdner Bank	Germany	85,7

Source: Annual Reports, Arthur. D Little analysis
Note: *Versus average (59,2%)

Cost-efficiency ranking

Some of the banks found in the lower end of the overall ranking are nevertheless stars in their respective market (see figure 2).

Figure 2: Banks ranked by efficiency in their own market

Austria
1. Raiffeisenbanken International
2. Bank Austria Creditanstalt
3. Erste Bank

Belgium
1. Dexia
2. KBC Bank
3. Fortis Bank

Denmark
1. Danske Bank
2. Jyske Bank

Finland
1. Sampo Group
2. OP Bank

France
1. BNP Paribas
2. Credit Mutuel
3. Société Générale
4. Crédit Agricole

Germany
1. Commerzbank
2. HVB Group
3. Deutsche Bank
4. Dresdner Bank

Iceland
1. Kaupthing
2. Glitnir

Italy
1. UBI Banca
2. Unicredit Group
3. San Paolo IMI
4. Banca Intesa
5. Capitalia

Netherlands
1. SNS Bank
2. ING Bank
3. Rabobank
4. ABN Amro

Norway
1. DNB Nor

Portugal
1. Caixa Geral de Depositos
2. Banco Comercial Portugues

Spain
1. Banco Popular
2. BBVA
3. Caja Madrid
4. Banco Santander
5. Banco Sabadell

Sweden
1. Handelsbanken
2. Swedbank
3. Nordea
4. SEB

Switzerland
1. Raiffeisenbanken Swi.
2. Zürcher Kantonalbank
3. EFG International
4. Credit Suisse
5. UBS

UK
1. HBOS
2. RBS
3. HSBC
4. Lloyds TSB
5. Barclays PLC

Source: Arthur D. Little analysis

“The data has been gathered directly from each company’s official annual reports and the ratio has been calculated by Arthur D. Little to obtain maximum comparability.”

Cost-efficiency ranking

Most efficient countries

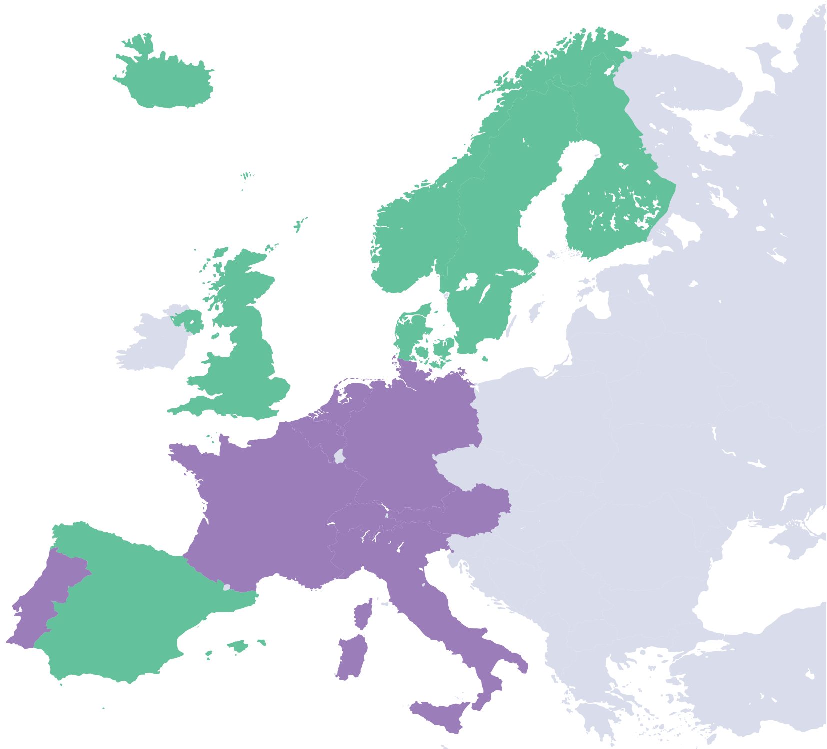
Arthur D. Little has taken the average CIR of the banks from each market to rank each country according to the cost-efficiency of its banks (see figure 3). This ranking shows that Europe's most efficient banks are concentrated in three regions: the Nordics, the United Kingdom and Spain.

Overall, banks in central European countries, such as Austria, Switzerland and Germany, perform worse than banks from the north and south of Europe. Banks from the Mediterranean countries appear at all levels in the ranking, with Spain at the top, Italy in the middle and France at the bottom.

The average cost-income ratio for each country included in the survey, based on the performance of their banks, is 58,6%.

"Overall, banks in central European countries, such as Austria, Switzerland and Germany, perform worse than banks from the north and south of Europe."

Figure 3: Countries ranked according to the efficiency of their banks



	Rank	Country	Average CIR %
Above*	1	Iceland	41,5
	2	Spain	50,5
	3	UK	50,5
	4	Sweden	53,0
	5	Norway	54,0
	6	Finland	54,4
	7	Denmark	56,8
Below*	8	Italy	59,6
	9	Belgium	59,9
	10	Austria	61,3
	11	France	63,8
	12	Switzerland	64,5
	13	Netherlands	67,8
	14	Portugal	68,0
	15	Germany	73,5

Source: Arthur. D Little analysis
Note: *Versus European average (58,6%)

External factors

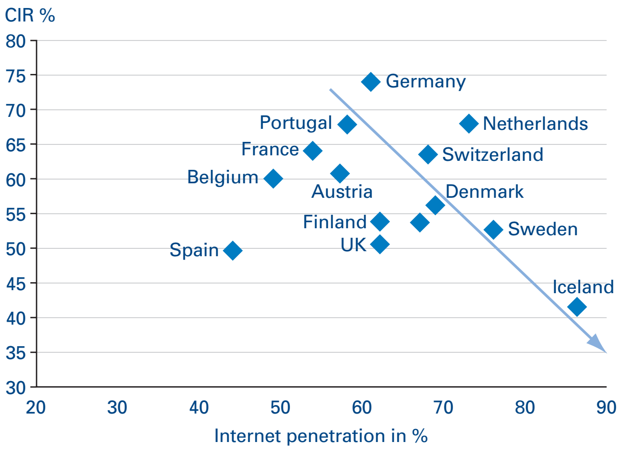
The strategies adopted by banks play a key role in their success, but external factors also have an important impact on each bank's performance.

The survey identifies a number of external factors that have an impact on cost-efficiency.

Internet penetration

The Nordic countries, particularly Iceland and Sweden, lead the world in internet usage (see figure 4). High internet penetration in these markets has put the banks under pressure to use the internet as a sales and transaction channel. Conversely, it has made it possible for the Nordic banks to service a large share of their customers over the internet and to make significant reductions in costly administration and human involvement as a result.

Figure 4: Internet penetration vs. CIR



Source: internetworldstats.com, globaltechforum.eiu.com, interviews, Arthur D. Little analysis

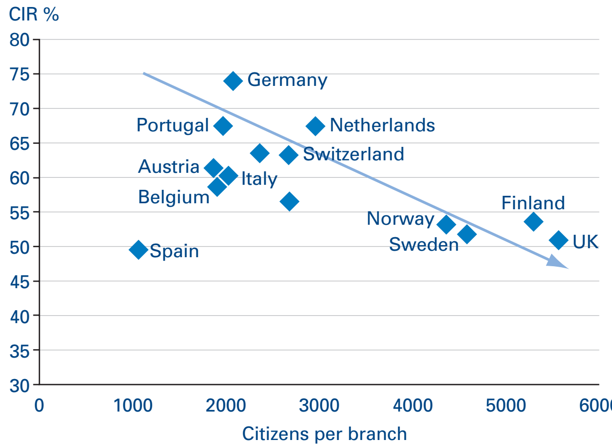
Outlet density

The number of citizens per branch differs significantly between markets and this affects the cost-income ratio (See figure 5). In general, countries with relatively few outlets perform better in the cost-efficiency ranking than countries with a high density of branches.

Branches are an expensive distribution channel and in countries with high branch density, such as Germany and France, sales volumes per branch become too small to make each outlet really efficient, causing CIR to increase.

In Spain, banks compensate for high branch density with an extremely efficient outlet network with a high degree of automation. This has made it possible for Banco Popular, for example, to run its new branches with only three employees in each.

Figure 5: Citizens per banking outlet vs. CIR



Source: internetworldstats.com, globaltechforum.eiu.com, interviews, Arthur D. Little analysis

External factors

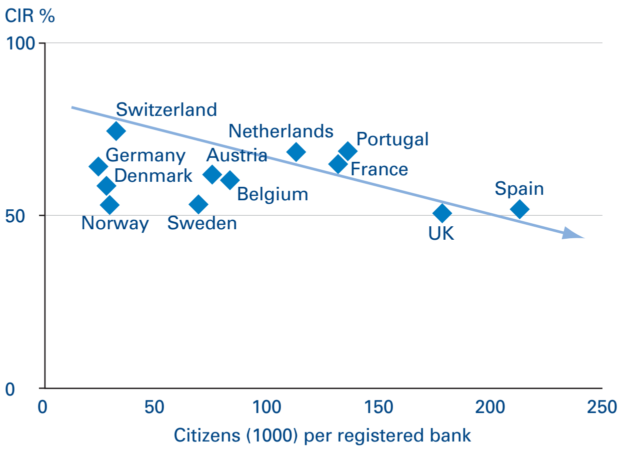
Consolidation

There are large differences in the degree of consolidation in European banking markets and this affects cost-efficiency.

Germany, for example, has an extremely fragmented market with a high number of regional and non-commercial banks. As a result, the country has one registered bank per 34,000 inhabitants. By contrast, the markets in the UK and Spain are highly consolidated, with 178,000 and 213,000 citizens per authorized bank respectively.

Figure 6 below shows a negative (although weak) correlation between the degree of consolidation and the cost-income ratio.

Figure 6: Banking consolidation vs. CIR



Source: Association of German banks, Svenska Bank föreningen, Financial Services Authorities UK, Danish Bankers' Association, Association Française des Banques, Norwegian Financial Services Association, Swissbanking, Banco de Espana, Banco de Portugal, Österreichische Nationalbank, Arthur D. Little analysis

Simulation

Lowering the CIR of the largest German banks to the average European level through increased consolidation and internet penetration could mean potential lay-offs of every fifth employee.

If the German banks were to reach the European average CIR, operational costs would have to be cut by at least 18%. Since the operational costs in the largest German banks are, to a large extent (61,5%), made up of staff expenses, most of the cost reduction would have to be achieved through lay-offs.

Assuming that 61,5% of the total cost reduction would have to come from staff expenses, the four largest banks in Germany would have to cut their personnel costs by around €3,8 billion which corresponds to more than 30,000 jobs or 20% of the total workforce. This would probably be a conservative estimate since other costs such as IT would have to increase some to compensate for the reduction in staff.

Another way out would be for the German banks to increase their productivity and generate more revenue with the existing workforce. The most realistic solution is probably a combination of staff reductions and productivity improvements.

"Germany, for example, has an extremely fragmented market with a high number of regional and non-commercial banks. As a result, the country has one registered bank per 34,000 inhabitants."

The top ten

Some of the best perfomers in the survey share a home market – the top ten are all based in either Spain, the UK or the Nordic region – yet each has a distinctive vision and approach.

Spain

No less than three Spanish banks appear in the top ten of the survey's cost-efficiency ranking: Banco Popular (1), BBVA (7) and Caja Madrid (10). Three factors give rise to this result:

- All the Spanish banks invest heavily in innovative IT to improve customer service and internal efficiency.
- In Spain, it is common for commercial units to secure resources by using business cases to prove profitability and efficiency.
- The Spanish banks motivate and develop their staff with performance-based salaries and comprehensive training.

The Spanish banks improvements in efficiency go hand in hand with the transformation of the Spanish financial sector during recent decades. In the 1970s, the Spanish banking crisis led to a restructuring of the banking sector and reform of the Spanish central bank. New regulations and conditions led to a consolidation of the previously extremely fragmented Spanish financial sector. This in turn made it possible for the banks to exploit in-country economies of scale and increase profitability.

Following the deregulation of the financial sector, foreign banks started to enter the Spanish market in the mid 1970s, forcing Spanish banks to start improving efficiency sooner than many other countries. They began investing heavily in state-of-the-art technology which enabled them to increase the size of the business with less staff.

"Following the deregulation of the financial sector, foreign banks started to enter the Spanish market in the mid 1970s, forcing Spanish banks to start improving efficiency sooner than many other countries."

Banco Popular

Founded in 1926, Banco Popular is a pure retail bank operating in Spain and Portugal, with 4.3% and 2% of the market respectively. It also has five regional banks in Spain. Its total assets in 2006 were €91,5 billion. Net profit in 2006 was €1 billion.

Business approach

The bank's main focus is SMEs, professionals and cards, with recent expansion into mortgages.

Banco Popular has always been a client-driven bank and it focuses on customer satisfaction to win customer loyalty. Its individual banking model was designed with personal banking, affinity groups and other segments with potential for strong loyalty in mind.

Achieving efficiency

Banco Popular has a strong strategic focus on efficiency. In fact, one of its three key management criteria is "systematic enhancement of efficiency". State-of-the-art technology, staff development and organizational structure contribute to its performance:

- **State-of-the-art technology:** Banco Popular has improved cost-efficiency through the use of state-of-the-art IT solutions. For example, in 2006 the bank signed an agreement for a new IT platform with IBM and large savings in IT are expected as a result.

  The bank has also signed an agreement with Telefónica for the joint development of the "Branch 2010" concept. 12,000 workstations are covered by an outsourcing contract and technological evolution is guaranteed.
- **Developing and motivating staff:** The bank has an incentive structure that links compensation to performance, with a large part of salaries being variable. Every employee is required to complete at least 53 hours of training annually. Roberto Higuera, CFO Banco Popular, has said: "Because people move around, we want even our technology people to understand selling."
- **Organizational structure:** The bank has a flat hierarchy that minimizes bureaucracy.

The top ten

BBVA (Spain)

BBVA was formed in 1999 through the merger of Banco Bilbao Vizcaya and Argentaria. Recently the bank has focused on overseas expansion and now operates in 40 countries.

Like many other Spanish companies, it enjoys a dominant position in Spanish-speaking Latin American countries. It also has a presence in many Mediterranean countries, especially Portugal and Italy, and has announced its intention to expand into the United States and Asia. Its total assets in 2006 were €412 billion. Net profit in 2006 was €4,7 billion.

Business approach

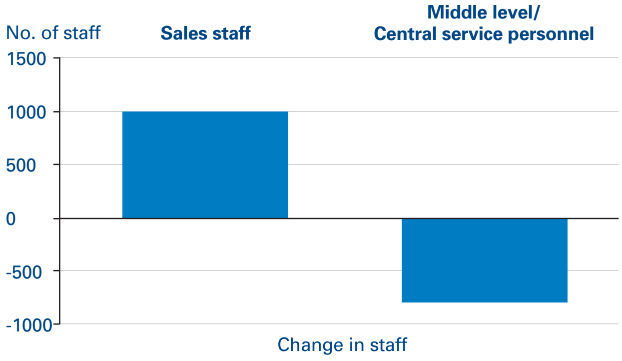
BBVA is one of Spain's largest banks and operates under the universal banking model, although focusing on retail and global wholesale banking.

Achieving efficiency

BBVA uses a number of strategies to maximize efficiency:

- **Operational units own budgets:** Operational units such as IT, Operations, HR and Facilities Management are the owners of the budget. Commercial units must ask for resources and present a business case to show how the resources will be used and the expected return on investment. Operational units have challenging cost-reduction targets. For example, IT currently aims to reduce costs by 20% in five years.
- **Low costs in Latin America:** BBVA has a strong presence in Latin America, with low costs and relatively efficient operations.
- **Salaries linked to efficiency:** By linking salary to efficiency targets, BBVA motivates its staff to work to achieve cost reductions. Up to 50% of an employee's salary may be variable. The variable part depends on individual performance but also on unit and company results, producing a strong impact of efficiency objectives.
- **Share ownership:** The bank offers incentives for employees to purchase stock so as to increase the sense of ownership in the company.
- **Redesign of branches:** There has been a strong effort to redesign bank branches. As a result, BBVA branches have no back office (regional centres carry out the back-office function).
- **Rapid integration of new businesses:** When the bank acquires a new business, the back office, IT and processes are all changed quickly to BBVA´s own. The bank provides global support for all countries.
- **Transformation of staff composition:** In 2006, BBVA reduced the number of personnel in unproductive middle-level and central-service roles by 750 (see figure 7). At the same time, it hired 1,000 new sales personnel to increase revenue. Although BBVA ended up with 250 more employees, moving staff from unproductive to productive positions improved cost-efficiency.

Figure 7: Transformation of staff composition during 2006



Source: Western Europe: Spain – Spanish Bulls On A Run – Can Greater Efficiency Gains Be Made By Spain's Cost-effective Banks – And Will Their Forays Into Anglo-Saxon Markets Succeed? – Karina Robinson 1 April 2007 The Banker, Arthur D. Little analysis

The top ten

Caja Madrid (Spain)

The origins of Caja Madrid can be traced back to 1702 and a pawn-broking institution founded by a priest named Francisco Piquer to help the poor get interest-free loans.

Caja Madrid has one of the largest distribution networks in the Spanish financial system with over 1,900 branches and 4,600 kiosks all over the country. Its main market is the Madrid area, with over 1,000 branches.

Caja Madrid is the fourth largest financial institution in Spain measured by total assets and employs around 13,000 professionals, servicing approximately 7 million customers. Its total assets in 2006 were €136,9 billion. Net profit in 2006 was €1 billion.

Business approach[1]

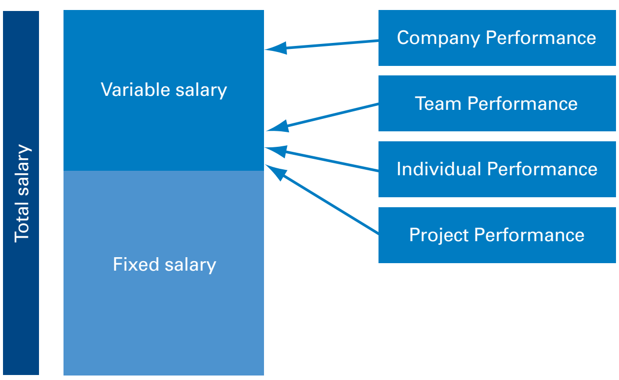
Caja Madrid offers a comprehensive range of products and services in retail, investment and private banking. It has a well-developed internet banking business with more than 2 million private customers and 128,000 businesses doing their banking on-line.

Achieving efficiency

Over the past decade Caja Madrid has taken a number of important steps to improve efficiency:

- **Strategic planning:** The bank's "Project 2006" aimed to increase profitability, market share, quality and efficiency. As a result of the project, during the three years to 2006, Caja Madrid succeeded in lowering its CIR by 6%. The bank's new "Project 2010" aims to see Caja Madrid outperforming the other top Spanish banks in terms of efficiency by 2010.
- **Investment in technology:** A technology transformation process launched in 1998 has improved efficiency significantly. For example:
  - In 2006, the bank introduced a commercial planning system to help managers make recommendations to customers.
  - A new pricing system has improved the coordination of pricing across the group.
  - By automating the mortgage loan admission process, the bank has cut total processing time by 70%.
  - By using its intranet to manage tasks such as applications for staff leave and requests for transactions, the bank has reduced internal administration.
  - The bank has implemented the concept of a mobile office for employees, giving remote access to corporate applications via PDAs and smartphones.
- **Reduced administration:** Through its "Zero Paper Project", Caja Madrid aims to eliminate the physical handling of documentation in order to reduce administration.
- **Employee involvement:** Through its "Improvement Ideas" programme and a survey of the performance of central services, Caja Madrid encourages its staff to come up with proposals and ideas on how to improve business and efficiency.
- **Performance-related pay:** By linking part of employees' remuneration to performance, Caja Madrid motivates staff to work towards higher cost-efficiency and profitability. Staff compensation is divided into two parts: a fixed salary and a performance-related salary including bonuses. Caja Madrid uses a results-evaluation system that takes account of performance at a number of levels (company, team, individual and project) to calculate each employee's variable salary (see figure 8).

Figure 8: Factors affecting the variable salary



Source: Company webpage, Arthur D. Little analysis

[1] Source: Annual reports, company data

The top ten

The Nordic region

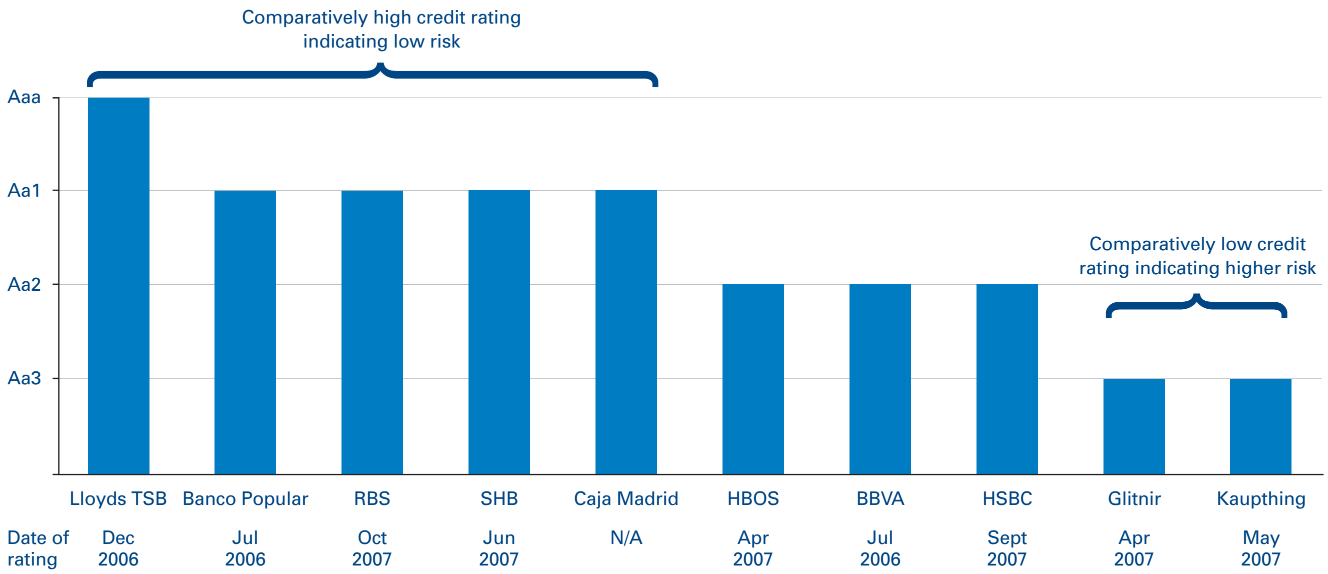
Three banks from the Nordic region appear in the top ten of the survey's cost-efficiency ranking: Kaupthing (2) and Glitnir (4), both from Iceland, and Svenska Handelsbanken (3) from Sweden. A number of factors give rise to this result:

- Icelandic banks are, in general, very flexible and dynamic with quick and efficient decision-making.
- The Icelandic banks are helped by a few additional factors:
  - high internet penetration;
  - a favorable business mix, with a low share of retail banking and a large fraction of income coming from trading gains; and
  - a geographical concentration of population in the home market.
- All the Scandinavian banks are characterized by short communication channels, a flat hierarchy and minimum bureaucracy which allows them to respond quickly to market changes.

The two Icelandic banks have a relatively high risk profile compared with other banks in the top ten (see figure 9). This could explain how they have managed to combine rapid growth with low cost-income ratios. The future will tell if this is a sustainable strategy

"The two Icelandic banks have a relatively high risk profile compared with other banks in the top ten. This could explain how they have managed to combine rapid growth with low cost-income ratios."

Figure 9: Moody's current credit rating



Source: Company data, Arthur D. Little analysis

The top ten

Kaupthing

Established in 1982 in Reykjavik, Kaupthing is Iceland's leading bank and has businesses and branches all over northern Europe, as well as in the US and Middle East. The bank has been growing rapidly in recent years, both organically and through acquisitions, and now has 2,700 employees, of which about 40% work in Iceland. Its total assets in 2006 were €43 billion. Net earnings in 2006 were €0,98 billion.

Business approach

Kaupthing's strategic focus is on investment banking and corporate banking, complemented by capital markets, asset management and private banking. It also provides retail banking, mainly in Iceland.

Achieving efficiency

Kaupthing has lowered its CIR by being dynamic and flexible, with short communication channels and a flat hierarchy. It prides itself on "trumping bureaucracy" in order to make decisions quickly and efficiently. Characteristics of the bank that encourage cost-efficiency include:

- **Short communication channels:** Short communication channels lead to fast and efficient processes and lower administration costs.
- **Flat organization and a culture of empowerment:** These encourage fast and efficient decision-making. According to Kaupthing, slow and cumbersome decision-making actually creates more risk because it results in missed opportunities.
- **Cross-selling to maximize profitability:** By cross-selling both between business units and countries the bank maximizes the profitability of every client contact.
- **Profit before growth:** Although the bank is growing rapidly, investment is always focused on profitability. The bank's target is to achieve a return on equity of at least 15% within 18 months of an acquisition.
- **Effective risk management:** Risk is controlled centrally but is based on reports from local risk managers in every market. This strategy has helped Kaupthing to reduce the ratio of non-performing loans to loans to customers by more than 70%.
- **Efficient sharing of information:** Consolidated IT for the entire company allows information to be shared efficiently. Functional systems are adjusted to fit the business and not the reverse.
- **Clear targets for profitability:** These exist for every business and form the core of each business's development.

"Kaupthing is Iceland's leading bank and has businesses and branches all over northern Europe, as well as in the US and Middle East."

Svenska Handelsbanken

Svenska Handelsbanken (SHB) was established in 1871 in Stockholm and became a public company as early as 1873, making it the oldest company on the Stockholm Stock Exchange.

Today SHB is one of the four biggest banks in Sweden, with a strong presence in the rest of the Nordic countries and the UK. It has 615 offices around the globe and over 10,000 employees. Its total assets in 2006 were €198 billion. Net profit in 2006 was €1,43 billion.

Business approach

Svenska Handelsbanken provides services across the entire banking spectrum: retail, corporate, investment and private banking. Its financial goal is to achieve higher profitability than the average among its competitors. To do so, it focuses on satisfying customers and keeping costs down.

Svenska Handelsbanken emphasizes decentralization. Its local offices are the primary business units, which are responsible for customers. The offices are supported by central specialist functions.

The top ten

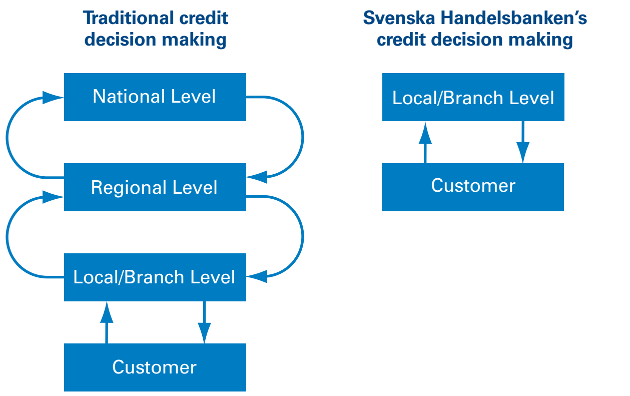
Achieving efficiency

Cost-efficiency is the dominant concept in SHB's corporate culture and cost-consciousness is encouraged throughout the whole organization. The bank aims to build long-term relationships between bank and customer to save money in the long run. It is much more expensive to attract new customers than to keep old ones.

The bank adopts a number of other strategies to support cost-efficiency:

- **Performance-based compensation:** Through its profit-sharing program, "Oktogonen", SHB sets aside a portion of its profit every year to be shared equally among staff on the condition that the bank has reached its financial goals.
- **Well-established strategy for growth:** As far as possible SHB uses the same strategy and methods as it does in Sweden when entering a new market. It prefers to grow organically in well-known mature markets to avoid high macro-risks. It doesn't enter cities with less than 10,000 inhabitants.
- **IT increases time for customers:** The bank uses IT to minimize unnecessary administration and back-office work and this increases time available for customers and revenue generation.
- **Decentralized structure:** SHB's decentralized structure is built to achieve the highest possible level of efficiency for each branch. Features of the organization include:
  - efficient decision-making that keeps central involvement in business to a minimum;
  - full empowerment of local executives to build their branches in a way that fits the local market;
  - closeness to customers resulting in short lead-time between the identification of a market need and the implementation of a solution;
  - ranking of cost-income ratios between branches to increase internal competitiveness; and
  - local marketing keeps the customers' expectations in line with the capacity of each branch, resulting in more satisfied customers.
- **Credit decisions made locally:** By taking credit decisions on a local level (see figure 10), where the customer is known, SHB has succeeded both in minimizing administration and reducing its credit losses to an exceptionally low level:
  - Administration costs are lowered since each credit inquiry is handled in a single location, instead of being sent around the organization, taking up time and resources.
  - Credit losses are cut since local staff who are most knowledgeable about the customer and have the best insight into local market conditions take credit decisions.

Figure 10: Credit decision-making



Source: "Beyond budgeting" – Jürgen H. Daum 2002, Arthur D. Little analysis

"By taking credit decisions on a local level, where the customer is known, SHB has succeeded both in minimizing administration and reducing its credit losses to an exceptionally low level."

The top ten

Glitnir

Islandsbanki changed its brand name to Glitnir in 2006. The bank was formed in 2000 through the merger of Islandsbanki and FBA – The Icelandic Investment Bank.

Glitnir is the second largest financial group in Iceland with almost 1,400 employees. It defines its home market as Iceland and Norway, and also has a presence in Canada, Denmark, China, Canada, the US, the UK, Finland, Luxembourg and Sweden. The bank's total assets in 2006 were €24 billion. Net profit in 2006 was €0,43 billion.

Business approach

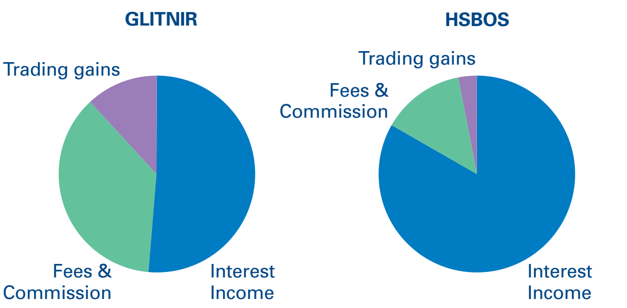
Glitnir's strengths are its capital markets business, investment management and corporate finance. It has unique expertise in the food industry (seafood), sustainable energy (geothermal energy) and offshore supply shipping. It is currently expanding outside Iceland in order to diversify its business and reduce risk.

Achieving efficiency

Glitnir has an explicit target of a CIR below 45% which helps the company to keep its focus on cost-efficiency. It achieves this through a range of strategies:

- **Focus on revenue and profit, not cost:** The bank is less concerned with the size of a cost than with its efficiency in terms of revenue-generating activities. B. Kamallakharan, Glitnir's executive director strategic growth, has said: "We know we need to spend money to make money…but we are extremely disciplined about ensuring that what we invest in generates the maximum return for our investment."
- **Niche knowledge:** Glitnir's business strategy is built around three niche areas: the seafood industry, geothermal energy and offshore supply vessels, in which it is the world's leading financial services provider. Because of its enormous knowledge and experience in these areas, business processing has become extremely efficient.
- **Value of time:** Glitnir is focused on providing services to customers faster than competitors. In addition to satisfying customers, this improves overall cost-efficiency.
- **Income from trading gains:** A large part of income is related to trading gains (see figure 11) which do not drive costs to the same extent as interest or commission income. However, analyst Miguel Pintado of Standard & Poor has recently said: "The very high level of profitability has been driven partly by trading gains… which are not sustainable over the long term."
- **Acquisition of cost-efficient targets:** Growth is driven by the acquisition of cost-efficient niche banks, such as Finnish FIM Group and Norwegian BN Bank, which has made it possible for Glitnir to grow without losing cost-efficiency.

Figure 11: Income sources



Source: Annual report, interviews, Standard&Poor, Arthur D. Little analysis

United Kingdom

Four banks from the United Kingdom appear in the top ten of the survey's cost-efficiency ranking: HBOS (5), RBS (6), HSBC (8) and Lloyds TSB (9). A number of factors contribute to this result:

- The British banks have improved their efficiency through a high degree of automation and large investments in state-of-the-art IT systems.
- In recent years, both HBOS and Lloyds TSB have launched ambitious cost-reduction programmes, aiming to improve cost-efficiency by cutting non-value-adding costs, such as administration and back-office.
- HBOS, RBS and Lloyds TSB are all the result of relatively recent mergers. These have opened up opportunities for reducing costs and exploiting synergy, both of which have helped improve cost-efficiency.

The top ten

HBOS (UK)

HBOS was established in 2001 through the merger of two of the UK's best-known and oldest banks: Halifax (formed in 1852) and Bank of Scotland (founded in 1695). Now one of the largest financial services providers in the UK, HBOS has 73,500 employees worldwide and is a serious competitor to the UK's "Big Four": RBS, HSBC, Barclays and Lloyds TSB. Its total assets in 2006 were €877 billion. Net profit in 2006 was €5,6 billion.

Business approach

HBOS provides services in retail, corporate and business banking as well as insurance and investment services. It focuses on five key strategic elements to create value, the most important of which is to grow its UK business, where the bank aims to achieve a market share of around 15-20%. The other four elements are: targeted international growth, colleague development, capital discipline and cost leadership.

Achieving efficiency

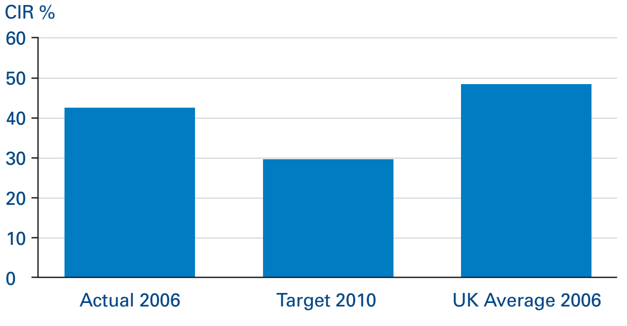
HBOS focuses strongly on cost-efficiency and aims to outperform its UK peers in this field. The bank's target is to achieve a cost-income ratio of around 30% by 2010. To reach this target, the bank will have to reduce its CIR by almost 13% in three years – a real challenge for an already efficient bank (see figure 12).

Central to the bank's quest to reduce costs is its commitment to remain focused on profitability and not to engage in cost reductions that damage core businesses and service levels.

HBOS adopts a number of strategies in pursuit of its cost-efficiency goals:

- **Reduce unproductive costs:** A programme launched in 2006 aims to reduce process and support costs by €430 million annually. The bank expects to do this by increasing bulk buying and streamlining IT systems, and not by reducing the workforce or moving business to low-cost countries.
- **Set cost targets for each division:** Every division has explicit targets for how much costs are allowed to grow during the year. In 2007, overall costs increased by 7%.
- **Exploit synergy:** Strong synergy benefits arising from the merger between Halifax and Bank of Scotland have enabled HBOS to lower its cost base significantly.
- **Replicate success:** The bank uses the same formula it uses to achieve success in the UK when growing internationally.
- **Invest in IT:** The bank appeared in eighth place in the CIO100 list of the biggest users of IT in the UK, largely as a result of its comprehensive investment in IT for back office, communications and storage. This has reduced administration and storage costs and led to large cost savings.
- **Link pay and performance:** Employees will play an important role in helping the bank achieve its CIR target and, as a result, the reward system is strongly connected to performance.

Figure 12: Actual outcome vs. target and UK average



Source: Annual reports, Arthur D. Little analysis

"Central to the bank's quest to reduce costs is its commitment to remain focused on profitability and not to engage in cost reductions that damage core businesses and service levels."

The top ten

RBS

Established 1727 in Edinburgh, RBS (The Royal Bank of Scotland) became one of the largest banks in the UK following its merger with National Westminster Bank in 2000. It is now one of the largest financial services groups in the world, with more than 135,000 employees worldwide. The bank's total assets in 2006 were €1293 billion. Net income in 2006 was €9,3 billion.

Business approach

RBS provides services in all areas of banking through its various divisions: retail markets, corporate markets, RBS Insurance, Ulster Bank and Citizens. It is a truly international bank with 42% of its operating profit coming from outside the UK.

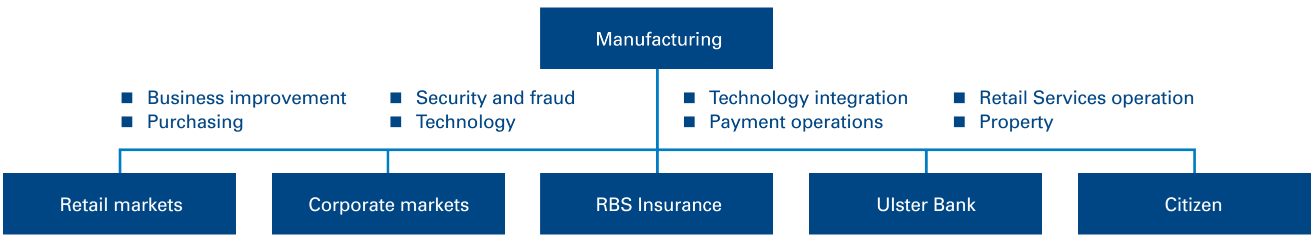
Key aspects of its business approach include avoiding sub-prime lending to reduce impairment losses and credit risk, and developing a strategic partnership with Bank of China to get access to the rapidly growing Chinese market.

Achieving efficiency

Key components contributing to the bank's impressive cost-efficiency ratio include:

- **Centralized support functions:** All support functions are gathered in the manufacturing division (see figure 13). By using the same platform and standardized processes in all divisions, the bank holds down costs and leverages the company's purchasing power (see diagram).
- **State-of-the-art IT systems:** The bank's functions and divisions are connected by advanced IT systems which enable information to flow efficiently between different parts of the group, and provide new ways of collecting and distributing data. For example:
  - advanced HR systems collect data on all employees and gather it in one central database. This gives local managers easy access to information for quality improvement and benchmarking purposes;
  - the bank's productivity and performance-management reporting tool (PIMMS) enables managers to compare the operational performance of different business units, get forecasts of workload demand for the coming months and access reports on the current situation in different operational units. This improves efficiency by allowing managers to make more-informed decisions on the deployment of people to meet work demands; and
  - modern marketing technology has allowed RBS to automate its B-to-C communications in all the traditional channels: direct mail, call centres, advertising and events. This has led to a better overview of marketing operations, lower operational costs and more personalized marketing, all contributing to higher efficiency and greater customer satisfaction.
- **Sound risk control:** In 2006, the bank's effective risk control policies allowed it to increase lending by 14%, while impairment losses increased by just 10%.

Figure 13: Centralized support functions



By having all support functions in one place, large economies of scale can be achieved. The different functions and divisions are connected through advanced IT-systems which enables information to flow efficiently between different parts of the group.

Source: Annual report, interviews, Standard&Poor, Arthur D. Little analysis

The top ten

HSBC

The Hong Kong and Shanghai Banking Corporation (HSBC) was founded in 1835 to help finance the growing trade between China and Europe. HSBC is one of the world's largest financial institutions, with more than 10,000 offices and 312,000 employees in 83 countries. Its total assets in 2006 were €1409 billion. Net profit was €15,7 billion.

Business approach

HSBC provides a comprehensive range of financial services including: personal financial services, commercial banking, corporate banking, investment banking and markets, and private banking. The group operates in five regions: Europe, Hong Kong, the rest of Asia Pacific including the Middle East and Africa, North America and South America.

Achieving efficiency

HSBC's business follows five core principles, two of which are closely linked to cost-efficiency: effective and efficient operations, and strict expense discipline. Others strategies to promote cost-efficiency include:

- **Exploit international presence:** HSBC uses its size and worldwide presence to gain a competitive advantage over purely domestic players. For example, HSBC improves cost-efficiency and shortens time to market by taking best-practice solutions and innovation from different parts of the bank and transferring them to the whole group.
- **Streamline processes and increase automation:** There are many examples of the bank's commitment to streamlining processes and increasing automation:
  - The introduction of self-service terminals means many of the services previously done by branch staff can now be done by customers themselves, reducing unnecessary administration.
  - The Mexican entity is the first bank in the world to offer pre-approved online mortgages, enabling customers to apply and receive loan details in just a couple of minutes using the internet.
  - The use of one common strategic internet platform for business clients worldwide gives economies of scale.
  - The retail division in the UK has reduced its range of products by two thirds in two years, increasing efficiency in sales and distribution.

Lloyds TSB

Lloyds TSB was created in 1996 through the merger of Lloyds Bank, founded in 1765, and TSB Bank, established in 1810. It is one of the "Big Four" banks in the UK with more than 63,000 employees. Its total assets in 2006 were €509 billion. Net profit in 2006 was €4,2 billion.

Business approach

Lloyds TSB is organized into three businesses; retail banking, insurance and investments, and wholesale and international banking. Its business model is built around the creation of long-term relationships with customers.

Achieving efficiency

- Lloyds TSB is currently in the middle of a group-wide productivity program to make structural reductions to its cost base. Already, efficiency improvements in back-office operations and increased automation of administration have made it possible for the bank to reduce staff numbers by more than 4,000 (or 6% of all staff) in 2006. In the retail banking division costs were reduced by 2% during 2006 while income grew by 4%. The program is expected to yield net benefits of more than €350 million annually in the coming years.

Other strategies adopted by the bank to ensure cost-efficiency include:

- **Focus on core markets:** The bank leaves markets where it has no competitive advantages or profitability is too low.
- **Focus on building long-term relationships with customers:** The bank aims to maximize profit from every client meeting.
- **Use efficiency to permit investment:** Lloyds TSB sees efficiency as a means to create room for further revenue-generating and growth-enhancing investments.
- **Reduce telephone support costs:** The use of speech-recognition technology has reduced the need for human involvement in some areas and administration costs for telephone support have decreased as a result.

Secrets of success

What are the key factors affecting cost-efficiency among Europe's banks? Analysis of the survey's top performers shows they all share five vital characteristics.

Analysis of the survey's top performers shows that there are five key factors affecting cost-efficiency:

- corporate culture
- IT
- organizational structure
- cost-cutting
- targets

Corporate culture

In order to achieve a corporate culture where cost-efficiency undergoes continuous improvement, cost-consciousness must be deeply integrated in strategy and encouraged throughout the whole business.

- **A priority for top management:** Top management has to show that cost-efficiency is a priority. Examples are evident among a number of top performers:
  - At HBOS, achieving cost leadership over its competitors is one of five strategic key elements that act as a guide for day-to-day business.
  - Svenska Handelsbanken's financial goal is to have higher profitability than competitors, which is to be achieved through greater customer satisfaction and lower costs.
  - Banco Popular has "systematic enhancing of efficiency" as one of its three management criteria. .
- **Encouraging cost-consciousness:** In order to turn strategy into reality, cost-consciousness has to be encouraged throughout the organization. So, for example:
  - In BBVA and Caja Madrid, large parts of salary are variable and depend on staff achieving different performance targets, many of them based on efficiency.
  - Svenska Handelsbanken puts a part of its profit into a profit-sharing programme for distribution on condition that the bank's profitability target (which is to be reached through low costs) is achieved.

IT

Advanced IT systems have an important role to play in improving efficiency. Their impact is on two fronts: they help reduce human involvement and they support faster and more accurate processes.

- **Automation:** A high degree of automation makes it possible to lower costs by reducing expensive human involvement. This is seen in action in a number of the top performers:
  - Lloyds TSB was able to reduce total staff numbers by 6% by increasing the automation of administration and back-office functions.
  - At Svenska Handelsbanken, an increased use of IT allows staff to focus on revenue-generating activities and makes more time for customers.
  - RBS has been able to lower operational costs by automating marketing functions, such as direct mail and call centers.
- **Speed and accuracy:** IT makes it possible to distribute information through a large organization and helps in maintaining control over a multinational company with several divisions and operations worldwide.
  - With its advanced productivity and performance-management reporting tool, RBS managers can access benchmarking data from the whole group, forecasts of future workload and status on current projects, allowing them to make more-informed decisions in a shorter period of time.
  - With the help of virtualization technology HBOS expects major cost savings due to more efficient allocation of storage.

Organizational structure

The way a company is organized is crucial for its cost-efficiency: a flat hierarchy, shared support functions and decentralization are common characteristics among the top performers.

Secrets of success

- A flat hierarchy with short communication channels reduces bureaucracy and administration.
  - At Kaupthing, slow and cumbersome decision-making is seen as more risky than fast decision-making, since slow decision-making creates the risk of missed opportunities.
  - With its dynamic and flexible organization, Glitnir aims to provide services faster than its competitors, both to satisfy customers and to lower its own costs.
- **Shared support functions:** By centralizing support functions such as IT, HR and other expertise the company can gain large economies of scale.
  - At RBS, all support functions are gathered in the manufacturing division. This gives the bank increased purchasing power and improves efficiency by avoiding sub-optimal performance at a divisional level which would hurt the group as a whole.
- **Decentralized organization:** A decentralized structure means that business decisions are taken as close to the market as possible.
  - By taking all credit decisions on a branch level Svenska Handelsbanken has managed to decrease its credit losses and speed up processing at the same time. By letting the local manager design the branch, SHB makes sure that every branch has the optimum fit with its own market.

Cost-cutting

When it comes to cost-cutting, it is crucial to cut the right costs; there has to be a balance between reducing the cost base and retaining revenue generation.

- **Focus on profitability:** Focus should not be on cost-cutting but on profitability.
  - At Glitnir, the size of the cost is not as important as how efficient the cost is in generating revenue. The idea is that it costs money to make money and as long as the return is sufficient one should not be afraid of taking on costs.
- **Cut the cost of unproductive activities:** When cutting costs, the focus should be on unproductive and non-value-generating activities.
  - Newly launched cost-saving and productivity program at HBOS and Lloyds TSB focus on reducing costs for non-value-adding administrative and support functions.

Targets

Explicit targets help a company to focus its efforts and motivate staff to work towards cost-efficiency. Among the top performers three types of targets are used:

- **Profitability targets:** By adopting a profitability target such as ROE, the company indirectly sets targets for cost-efficiency:
  - Svenska Handelsbanken's financial goal is to be more profitable than its competitors. It aims to reach by having more satisfied customers and lower costs. Although not explicit, the profitability target works as a cost-efficiency target in the end.
- **Cost-income ratio targets:** A CIR target focuses the business on getting as many units of income as possible out of every unit of cost, and provides the incentive to cut unproductive costs as a result.
  - At HBOS, the CIR target for 2010 is the goal for the bank's newly launched cost-reduction program.
  - Glitnir's standing target for CIR tells management whether costs and income are in line with plan or not.
- **Cost growth targets:** A cost growth target focuses the business solely on the cost side of efficiency and gives a clear signal to staff to hold down costs as much as possible.
  - HBOS uses cost growth targets as a complement to its CIR target, which also emphasizes the income side. By having an explicit cost target, everybody knows how much costs are expected to grow and it leaves no room for unnecessary cost increases just because income is unexpectedly high in certain periods.

Appendices

Appendix I: Banks included in the survey, by total assets

Rank	Bank	Country	Total assets
1	UBS	Switzerland	1,486,575
2	Barclays PLC	United Kingdom	1,478,327
3	BNP Paribas	France	1,438,826
4	HSBC	United Kingdom	1,408,818
5	Royal Bank of Scotland	United Kingdom	1,293,174
6	Credit Agricole	France	1,260,252
7	ING Group	Netherlands	1,226,000
8	Deutsche Bank	Germany	1,122,587
9	ABN AMRO Bank	Netherlands	987,100
10	Societe Generale	France	956,201
11	HBOS Group	United Kingdom	877,223
12	Banco Santander	Spain	833,873
13	UniCredit Group	Italy	823,284
14	Credit Suisse	Switzerland	776,977
15	Fortis Bank	Belgium	773,235
16	Commerzbank	Germany	603,293
17	Dexia Bank	Belgium	566,700
18	Rabobank	Netherlands	556,455
19	Lloyds TSB	United Kingdom	509,978
20	HVB Group	Germany	508,000
21	Dresdner Bank	Germany	497,287
22	Banco Bilbao Vizcaya Argentaria	Spain	411,916
23	Danske Bank	Denmark	367,423
24	Nordea Bank	Sweden	346,828
25	Credit Mutuel	France	339,025

Rank	Bank	Country	Total assets
26	KBC Bank	Belgium	325,400
27	Banca Intesa	Italy	291,781
28	San Paolo IMI Group	Italy	288,551
29	SEB Bank	Sweden	214,257
30	Sv. Handelsbanken	Sweden	198,345
31	Erste Bank	Austria	181,703
32	DNB Nor Bank	Norway	160,799
33	Bank Austria Creditanstalt	Austria	153,355
34	Swedbank	Sweden	149,942
35	Capitalia	Italy	137,132
36	Caja Madrid	Spain	136,952
37	Caixa Geral de Depositos	Portugal	96,246
38	Banco Popular Spain	Spain	91,650
39	SNS Bank	Netherlands	79,742
40	Banco Comercial Portuges	Portugal	78,707
41	UBI Banca	Italy	73,873
42	Banco Sabadell	Spain	72,069
43	Raiffeisenbanken Switzerland	Switzerland	70,865
44	Zürcher Kantonalbank	Switzerland	59,182
45	Raiffeisenbanken International	Austria	55,867
46	Sampo Group	Finland	46,946
47	Kaupthing Bank	Iceland	43,200
48	OP Bank Group	Finland	24,192
49	Glitnir Bank	Iceland	23,960
50	Jyske Bank	Denmark	21,470

Source: Annual reports, Arthur D. Little analysis

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CAP Reader (Chip Authentication Program)

For use with banking smartcards for authenticating users and transactions in online and telephone banking. There are two major benefits to moving to smart card based credit card payment systems: improved security (with associated fraud reduction), and the possibility for finer control of "offline" credit card transaction approvals. It reduces the cost and time interval of software development.

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