Can banks grow beyond M&A?

US banks will need to look beyond mergers for growth. Better earnings will have to be won from improved value propositions and productivity.

Kevin P. Coyne, Lenny T. Mendonca, and Gregory Wilson

During the 1990s, the economic rationale for mergers in the banking industry was indisputable. Enormous gaps in efficiency between the acquirer and the acquired often created cost and revenue synergies ranging from 30 to 100 percent of a seller's net income.[1] New technology made many of these gains possible by facilitating the consolidation of branches. In addition, the Riegle-Neal Act of 1994, which allowed bank holding companies to acquire banks in any state, opened the door to pairings—such as Bank of America and NationsBank or Norwest and Wells Fargo—that previously would have been difficult or impossible.

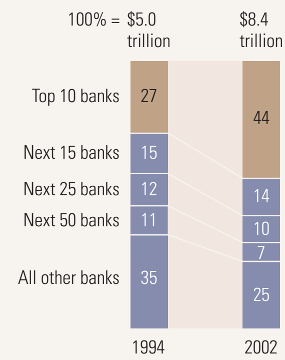
So successful was this wave of mergers that the industry progressed toward a natural endgame in which a handful of nationwide banks began to emerge. Although curbed by a regulation limiting an individual bank's share of US deposits to 10 percent of the total, the top ten institutions increased their share of US deposits from 27 percent in 1994 to 44 percent in 2002 (Exhibit 1). The result? For most large banks, further expansion won't necessarily yield dramatic scale-based savings in systems and product-development costs. What potential combinations remain among the larger institutions present fewer geographic overlaps, and while scale economies are always helpful, most leading banks are already big enough to support the systems, branding, and product-development costs of the next few years. Instead, executives of large banks must look for new ways to increase earnings.

Like the best retailers, banks must differentiate themselves by understanding the needs of their customers and giving them a distinctive experience. Banks should also boost their performance the old-fashioned way, by improving productivity—something that will become vital as their payments businesses, which represent a substantial share of industry profits and operating expenses, shrink with the falling use of checks. To succeed in these tasks, banks must innovate in their formats, their customer targeting, their approach to lending and asset management, their operations, and their use of electronic payments. This agenda is challenging, and it

EXHIBIT 1

Consolidation continues

Share of total assets held by US commercial/savings banks by size, %



Source: FDIC; Sheshunoff Information Services; SNL Financial calls for skills beyond those—such as identifying and valuing acquisition targets and driving integration—that have served executives so well in the recent past. Significant changes lie ahead for managers who are working toward a new set of performance priorities.

In pursuit of growth

In other industries, particularly retailing, value-oriented companies have spent the past two decades developing new formats and relieving customers of the need to balance price and selection, quality and convenience. Banks should now do the same by reinventing the experience they offer and improving their customer service. Opportunities can be found in both retail and wholesale banking, and the current branch-building boom makes this a good time to act.

Reinventing the customer experience

Banks have invested heavily in efforts to keep their customers more satisfied, and all of them want strong relationships with their clients. Yet some leading institutions are poorly differentiated. What should big banks do? Our research suggests that three factors are particularly important to customers. The first is ease of use. A few years ago, a bank could stand out by having a number of points of access—plenty of branches and ATMs as well as online services. But consumers now take these amenities for granted and are more interested in what happens at the service point: they want banks to get them in and out quickly, with exactly the products and services they want. The second important factor is the accurate opening and fulfillment of accounts, both of which frequently give rise to errors. The third is the ability to correct these errors. Perhaps surprisingly, our research shows that customers are willing to forgive occasional mistakes if banks fix them quickly and transparently. When banks don't, the level of satisfaction plummets.

Providing the right experience goes hand in hand with redefining relationships. Our research shows that customers want a bank that understands their needs and provides timely, tailored solutions.

Many transactions—taking out a mortgage, arranging a small-business loan, buying an automobile—occur infrequently. Without deep knowledge of customers, banks are no more likely to win such business than are specialist competitors. One problem with customer relationship management and other cross-selling techniques, however, is that, for all the data they collect, they don't necessarily get at the most important pieces of information (such as the age of children destined for college, for whom financial planning might soon be necessary).

Some of this information still comes from personal interaction. Technology, although no substitute for it, can help by facilitating the capture and recording of vital data, by routing leads to the agents best equipped to help, and by improving the performance of back-office analytics. Such measures have helped some large banks make substantial branch and call-center sales breakthroughs.

Serving the underserved

In addition to upgrading the experience they offer, banks should simultaneously reevaluate the customers they are—and are not—serving. Underserved segments exist in the retail and wholesale businesses of many banks because for years they have focused on bigger clients, wealthier clients, or both. One important challenge for CEOs is persuading their organizations to look far enough ahead to allow new customer segments to become growth engines.

The payments business, accounting for 25 to 40 percent of the profits of most institutions, is the 'stealth industry' of commercial banking. But the business, with its underlying costs and complexities, is also an expensive one.

One area that banks could consider is cheaper retirement advisory services at the lower end of the mass-affluent market. As the baby boomers retire and government and private-sector retirement programs come under strain, the accumulation of assets will slow and investors will shift the weighting of their portfolios from equities to fixed-income securities. Banks are well positioned in this respect because they have long provided certificates of deposit and money market investment vehicles; they are also skilled at serving the smaller customers some money managers shun. Further, many people place more trust in banks than in Wall Street brokerages or mutual funds.

Less affluent market segments beckon too. The US Federal Deposit Insurance Corporation estimates that 10 percent of the US population is "unbanked." Yet many relatively unsophisticated vendors earn attractive returns by focusing on transactions—ATM withdrawals at supermarkets, wire transfers, payday loans, tax-refund loans, check cashing, prepaid credit cards, used-car loans, and appliance loans—for which unbanked customers are willing to pay above-average interest rates. Leading banks that leverage their scale, technology, risk-management systems, and delivery channels should be able to provide this group with simple transaction, savings, and credit products and to earn a profit.[2]

Meanwhile, the large and rapidly growing Hispanic segment, currently numbering about 40 million, works with fewer financial intermediaries (1.5), on average, than does the population as a whole (2.4). Some banks, including Bank of America, Citibank, U.S. Bancorp, and Wells Fargo, have been targeting Hispanic people, but it is not yet clear what approaches will be successful.

Opportunities for experimentation abound

In wholesale banking, the corporate middle market merits attention. Despite relatively low revenues per relationship, the market as a whole represents a $20 billion pool of potential profit and is growing by 8 percent a year—twice the rate for lending to large corporations. Over the next few years, big volumes of this business may be up for grabs because of a proposed Basel II provision that requires certain banks to hold substantially more regulatory capital against loans to companies with lower risk ratings.

Boosting productivity

To finance these customer initiatives, banks must wring more value from operations. Opportunities remain to generate revenues and cut costs by improving productivity. The payments business deserves special examination.

Upheaval in payments

The payments business, accounting for 25 to 40 percent of the profits of most institutions, is commercial banking's stealth industry. But the business is also an expensive one, with banks spending

$50 billion a year servicing consumer and corporate accounts through a growing array of channels (branches, ATMs, telephones, the Internet, and point-of-sale devices) and of payment instruments (checks, cards, electronic fund transfers, bill-payment services, and account-to-account transfers). As the variety of channels, transactions, and payment types multiplied, so too did the underlying costs and complexities of servicing direct-deposit accounts.

The economics of payments are under pressure on several fronts. Customers' cash balances have migrated to higher-yielding (and so, for banks, lower-margin) savings and investment vehicles. Rock-bottom interest rates have compressed banks' spreads from lending. Finally, the fee income from demand-deposit accounts has come under attack. Debit card fees fell by a third following the success of a recent class-action lawsuit brought by retail merchants against Visa and MasterCard, and in several states overdraft and other account-based fees have attracted regulatory scrutiny.

A glimmer of hope is held out by the Check 21 legislation passed in October 2003, which will allow banks to provide check images with their customers' monthly statements rather than sort and return the actual checks. Truncating the process in this way could knock $2 billion to $3 billion off the estimated annual cost—$8 billion—of processing checks. Check 21 does, however, have potential drawbacks. Electronic migration will alter the strategic dynamics in payments by making today's value drivers in checks—geographic proximity, efficient manual labor, and the ability to maximize clearing balances—increasingly irrelevant. Furthermore, the unit costs of processing paper checks will escalate rapidly as the electronic shift progresses, leaving behind large fixed infrastructure costs.

The shift to electronic payments creates opportunities for banks to develop new payment propositions with economics superior to those of cash and checks. Low-balance customers, traditionally unprofitable to serve, might look more attractive if their cash and check usage could be moved to debit or credit cards or to ATMs. As with credit cards, competitors will probably develop new products and services, from prepaid cards for the unbanked to sophisticated payables-processing algorithms for large corporations.

Broader productivity opportunities

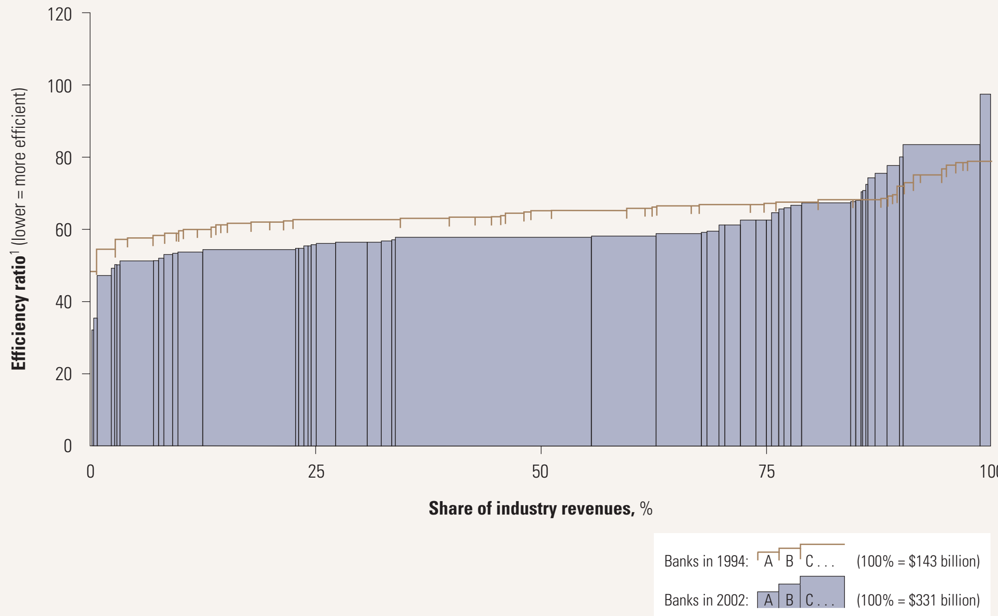
In the absence of "big-bang" opportunities such as back-office automation, more banks will need to pursue the kind of lean techniques that pioneering institutions have employed to enhance service quality and efficiency ratios. Working both the numerator and the denominator of the efficiency ratio, banks could improve the performance of their operations more quickly than they have in recent years (Exhibit 2). Initial improvements would be on the order of 2 to 5 percent, with the potential for more if systems were fully developed.[3]

Productivity gains can also be had from reducing the number of wasted customer leads, refining treasury management and custody controls, and speeding up the processing of applications for credit or insurance. To capture such gains, banks must continue to strike the right balance between cost efficiency and revenue generation in their branches and call

EXHIBIT 2

How low can banks go?

Distribution of top 50 US banks by revenues



[1]Common operational-efficiency measure defined as noninterest expense ÷ (net interest income + noninterest income).
Source: SNL Financial; McKinsey analysis

centers. A few companies, such as the main credit card players, are moving in the right direction, but it's not easy. Key challenges include redefining the roles of frontline sales, service, and supervisory jobs and redesigning processes and the supporting infrastructure so that decisions can be made on the spot.

These opportunities are not new. But realizing value from them has been extremely difficult because the cost base of most banks is highly fragmented, which makes leveraging improvements across the organization tricky and time-consuming. Broad-based progress requires changes in the outlook and behavior of employees at all levels.[4] Many programs have so far failed to realize these kinds of changes because the banks adopting them haven't created pressure to perform at all levels, addressed capabilities in areas such as capacity management, or changed the way frontline managers and employees are hired, motivated, and rewarded.

Productivity initiatives interact in important ways with banks' offshoring efforts. The wage savings made possible by moving jobs to countries such as India are so attractive that offshoring is a competitive necessity; over time, many financial institutions will offshore 20 to 40 percent of their cost base, thereby saving as much as 15 percent of their total noninterest expenses. Yet as banks evaluate offshore options, they will have to recognize the relationship between what they move abroad and the productivity of their operations at home. Banks often send easier, base-load calls offshore, for example, reserving domestic call centers to handle more complex requests and to cope with surges in demand. This approach can help domestic call centers improve the way they meet the needs of customers, but it also demands first-rate management of capacity.[5] In fact, sending functions to low-wage countries does not relieve banks of the need to make their operations back home truly hum.

M&A among smaller banks

Although the banking industry's structure and regulatory framework will permit more mergers in the future, the reduced potential for synergies means that the results could disappoint CEOs who make deals their primary strategic focus. Some obvious pairings will realize worthwhile cost savings, especially among second- and third-tier banks, but for most large institutions the opportunities for consolidation are not what they were a few years ago.

Nonetheless, announcements of recent mergers of second-tier institutions bear witness to the continuing consolidation among banks that aspire to be truly national in scope. Many developed markets have such institutions, four or five of which might command a market share of 75 to 80 percent. We expect this trend to continue as long as management believes that mergers can generate value through costs savings or through new offerings for customers.

Banking consolidation will continue, but growth and productivity initiatives will replace megadeals as the cornerstone of most strategies to create value—thus producing a more diverse and complex agenda for executives. Increasingly, CEOs will be orchestrating a number of initiatives that cut across businesses and involve frontline employees throughout the organization instead of making a few big portfolio decisions and then driving their execution. MoF

The authors wish to thank Andrew Appel, Andy Eichfeld, Jack Stephenson, and Corey Yulinsky for their contributions to this article.

Kevin Coyne (Kevin_Coyne@McKinsey.com) *is a director in McKinsey's Atlanta office,* ***Lenny Mendonca*** (Lenny_Mendonca@McKinsey.com) *is a director in the San Francisco office, and* ***Greg Wilson*** (Greg_Wilson@McKinsey.com) *is a principal in the Washington, DC, office. This is an excerpt from their article "Can banks grow beyond M&A?"* The McKinsey Quarterly, *2004 Number 1, pp. 72–81 (www.mckinseyquarterly.com/links/13467).*

---

1 Madeleine James, Lenny T. Mendonca, Jeffrey Peters, and Gregory Wilson, "Playing to the endgame in financial services," *The McKinsey Quarterly*, 1997 Number 4, pp. 170–85 (www.mckinseyquarterly.com/links/13461).

2 For an international perspective, see David Moore, "Financial services for everyone," *The McKinsey Quarterly*, 2000 Number 1, pp. 124–31 (www.mckinseyquarterly.com/links/13462).

3 Anthony R. Goland, John Hall, and Devereaux A. Clifford, "First National Toyota," *The McKinsey Quarterly*, 1998 Number 4, pp. 58–68 (www.mckinseyquarterly.com/links/13463).

4 For details on how to effect changes of this kind, see Emily Lawson and Colin Price, "The psychology of change management," *The McKinsey Quarterly*, 2003 special edition: The value in organization, pp. 30–41 (www.mckinseyquarterly.com/links/13464).

5 For details on offshoring models, see Gautam Kumra and Jayant Sinha, "The next hurdle for Indian IT," *The McKinsey Quarterly*, 2003 special edition: Global directions, pp. 42–53, particularly Noshir Kaka's sidebar, "A choice of models" (www.mckinseyquarterly.com/links/13465).

McKinsey on Finance is a quarterly publication written by experts and practitioners in McKinsey & Company's Corporate Finance & Strategy Practice. It offers readers insights into value-creating strategies and the translation of those strategies into performance. This and archive issues of *McKinsey on Finance* are available online at http://www.corporatefinance.mckinsey.com.

McKinsey & Company is an international management-consulting firm serving corporate and government institutions from 85 offices in 47 countries.

Editorial Contact: McKinsey_on_Finance@McKinsey.com
Editor: Dennis Swinford
External Relations Director: Joan Horrvich
Design and Layout: Kim Bartko
Circulation: Kimberly Davenport (United States), Susan Cocker (Europe), Jialan Guo (Asia)

Cover images, left to right: © Alberto Ruggieri/Image Bank/Getty Images; Digital Vision/Getty Images; Bruno Budrovic/Spots Illustration/Images.com; Kurt Vargö/Stock Illustration Source/Images.com; Todd Davidson/ Illustration Works/Getty Images