

How can European banks sustain long-term growth while keeping the costs of expansion under control? Bain & Company's Philippe De Backer, Tim Wright, Cornel Wisskirchen and Scott Tanner explain.

# Europe's low-cost path to high-performance banking

When HSBC Holdings widely scrutinised plan to buy a 20% stake in China's Bank of Communications closed in August, the UK bank succeeded in making the largest Western investment to date in the mainland's retail banking sector. At the same time, Hong Kong Chairman David Eldon has been clear about the bank's strategy: HSBC has no intention of buying a stake in China's big four state-owned banks.

There's more to this strategy than simply treading lightly into China. It's a reflection of HSBC's cost-effective approach to expansion, which avoids a rigid universal banking model. In one market after the next, the company cherry-picks its acquisitions, buying only those business lines where its managers see value. It can operate as a retail bank in one market and an investment bank in another. As a result, it has been able to grow rapidly without letting costs spiral.

It's an approach that should please HSBC shareholders at a time when many banks concerned about profitable growth are asking themselves where to push first: expanding revenue or trimming costs? When we looked at 150 of the largest banks in the world, we found that, surprisingly, banks that contain costs first, as HSBC does,

appear to do far more for their stock price than those putting growth before costs.

Those banks with the lowest cost-to-income ratios, in the best third of our study, but annual revenue growth in the worst third, still produced average annual shareholder returns 14% higher than the local stock market indices. However, banks with robust top-line growth in the top third of our study, but in the bottom third in terms of efficiency, returned just 3.5% more than their country indices annually. In other words, efficient banks with slow revenue growth still manage to outperform their less-efficient, higher-growth peers by a 4:1 ratio.

Achieving this magic combination of high growth and low costs is no easy feat, and the means by which banks can address these dual challenges vary greatly by region, country and player. For example, European banks cannot always take their cues from the top American banks on this count. The markets' dynamics are simply too different.

Start with the level of consolidation. Despite a run of mergers and acquisitions over the past decade, the top five banks still control only around a quarter of the US market. That makes it possible for American banks

to continue to generate growth by taking over their peers. Those that do it best tackle costs first: Bank of America, for example, which recently acquired FleetBoston, has maintained a cost-to-income ratio of 60%, including non-performing loans as a cost, compared to 67% for the industry as a whole.

In Europe, by contrast, opportunities for consolidation are less evenly distributed. In the UK and France, five banks already control about 80% of the market in each country. That makes meaningful, acquisition-based growth possible only on a cross-border basis, which is something very few European banks besides HSBC have done successfully. In some countries that appear to be as fragmented as the US, opportunity for consolidation is limited by ownership structure. In Germany, for example, consolidation tends to take place within ownership tiers that include public banks (either savings and loans or *Landesbanken*), cooperatives and private banks. Indeed, if the big four shareholder-owned banks – Deutsche Bank, Dresdner, Commerzbank and HVB – were to consolidate, they still would hold only 16% of the retail market, with the lion's share held by the public savings banks.

Next, take social contracts. Keeping costs down is even more difficult in continental Europe because of labour restrictions. Once banks have capitalised on such low-hanging fruit as purchasing, they hit a wall. Going after technology savings is rarely an option because this usually requires outsourcing and/or offshoring, which implies job migration. Similarly, branch reconfiguration generally results in job losses, or at least requires shifting employees to another area. In most of Europe, except for the UK, such transfers go down like sludge.

Despite these difficulties, most banks that take a clear-eyed look will find some opportunities to gain efficiency: cost cuts that focus on operational improvements like simplifying and clarifying processes or adjusting incentive structures to speed good ideas into action.

At the same time, banks that have exhausted cost-cutting potential should not forget part two of the high-performance equation: increasing income. They can approach this cost-consciously, by focusing on increasing business with current customers rather than forays into new businesses, while avoiding duplication of costs, particularly those associated with adding new products and channels.

The big UK banks that have pruned overlaps resulting from consolidation are in this space today, now seeking to boost revenue growth. The UK's HSBC and HBOS, the result of the September 2001 merger between Halifax and Bank of Scotland, serve as prime examples of how to go about it cost-consciously.

HBOS has accomplished impressive organic expansion, attracting 1.2 million new bank accounts and one million new credit card customers in 2003, as well as carving out a 23% share of the mortgage market, by running multiple brands off the same low-cost platform. In mortgages, for example, HBOS is the lowest-cost provider among the UK's big five, and it uses that low-cost platform to process all of its mortgages, regardless of which customer segment it is targeting. Its cost-to-income ratio fell from 45.2% in 2002 to 41.6% in 2003. Result: In 2003, the first full reporting year since the merger, the combined bank's profits jumped 27% over the previous year, and in some units (insurance and investment, for example) by as much as 51%.

On the other hand, HSBC in Europe, as in China, illustrates how to acquire growth cost-consciously across borders. For example, in 2000, HSBC purchased *Crédit Commercial de*

France, a medium-sized French bank, which gave it a foothold in the retail market in continental Europe. With 650 branches, CCF had only the eighth-largest retail branch network in France, but it was the country's most profitable retail operation. This acquisition and others helped HSBC's profits attributable to shareholders jump from \$5.4 billion in 1999 to \$8.8 billion in 2003. All the while, HSBC kept its cost-to-income ratio close to 50%, versus an average of 67% for banks in our study.

While the ability to manage costs varies by country, it is possible for European banks to take a cost-conscious approach to expansion, without resorting to layoffs. Ultimately, banks that keep costs in the foreground, even when targeting revenue expansion, will find the path cleared for sustainable, long-term growth. **IQ**

 Endnote

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