# Europe's low-cost path to high-

**Management feature**

*"There is an optimal path to value creation."*

*Philippe De Backer*
*Director and head of European Financial Services practice*
*Bain & Company*

*"Cost and revenue leaders are disproportionately rewarded by the market."*

*François Goffinet*
*Manager*
*Bain & Company*

When HSBC Holding's widely scrutinized plan to buy a 20 percent 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 time, Hong Kong chairman David Eldon made himself clear: HSBC had no intention of targeting a stake in China's state-owned Big Four banks.

There's more to that strategy than simply caution. It's a reflection of HSBC's cost-effective approach to expansion, which avoids a rigid universal banking model. In various markets, the company cherry-picks its acquisitions, buying only 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 profit-conscious banks are asking themselves where to push first: expanding revenue or trimming costs? When we looked at 150 of the world's largest banks, we found, surprisingly, that banks like HSBC that contain costs first do more for their stock price than those that prioritize growth.

"A cost focus remains the best path to achieving performance leadership."

Banks with the lowest cost-to-income ratios—those that ranked in the best third of our study—but annual revenue growth that put them in the worst third still produced annual shareholder returns 14 percent higher than the local stock market indices. However, banks that ranked in the top third for growth—but in the bottom third when it came to efficiency—returned just 3.5 percent more than their country indices. In other words, efficient banks with slow growth still manage to outperform their less efficient, higher-growth peers—by a factor of four to one (see Figure 1).

**Figure 1:**

Efficient banks with slow growth outperform their less efficient, higher-growth peers by a factor of 4 to 1.

| Revenue growth ↓ / Cost efficiency** → | Low | | High |
|---|---|---|---|
| High | Average TSR premium*: 3,5% (Growth culture) | Average TSR premium*: 13,7% | Average TSR premium*: 22% (Performance culture) |
| | Average TSR premium*: 4,8% | Average TSR premium*: 9,1% | Average TSR premium*: 17,3% |
| Low | Average TSR premium*: 2,6% | Average TSR premium*: 8,4% | Average TSR premium*: 14% (Cost culture) |

*Average total shareholder return premium over the country index.

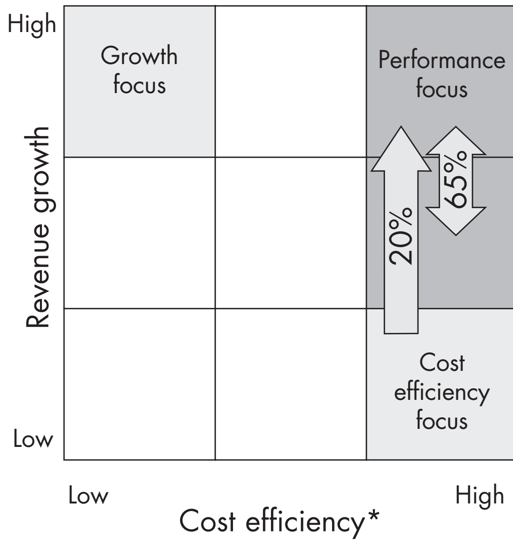
** Cost plus net loan provision divided by income.

Achieving the magic combination of high growth and low costs isn't easy, and the ways banks can address that challenge vary greatly. For example, European banks cannot always take their cues from top American banks—the markets' dynamics are too different.

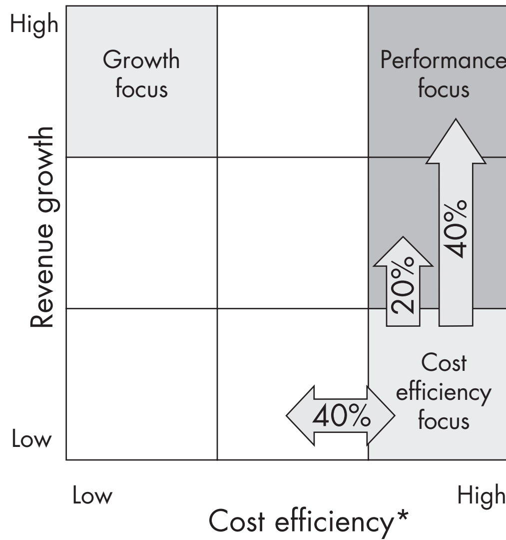
Take the level of consolidation. Despite a recent run of mergers, the top five banks still control only around a quarter of the US market, which means American banks can still generate growth by taking over their peers. Those that do it best tackle costs first: Bank of America, for example, which recently acquired FleetBoston, has maintained a cost-to-income ratio of 60 percent, compared with 67 percent for the industry as a whole.

In Europe, opportunities for consolidation are less evenly distributed. In the UK and France, five banks already control about 80 percent of the market in each country. That makes acquisition-based growth possible only on a cross-border basis—something few European banks besides HSBC have done successfully. In some countries as fragmented as the US, ownership structures limit consolidation opportunities. In Germany, consolidation tends to take place within ownership tiers that include public banks, cooperatives and private banks. If the Big Four shareholder-owned banks—Deutsche Bank, Dresdner, Commerzbank and HVB—were to consolidate, they still would hold only 16 percent of the retail market, with the lion's share held by the public savings banks.

And keeping costs down is even more difficult in continental Europe because of labor restrictions. Once banks have capitalized on




85% of global performance leaders in 2002 were previously cost leaders




60% of global cost leaders in 1998 had evolved towards performance focus by 2002

**Figure 2:**

Building a cost-focused organisation is the best path to achieving performance leadership.

Note: % shows the proportion of banks in this box that moved into other boxes from 1998 to 2002.

* Cost plus net loan provision divided by income.

such low-hanging fruit as purchasing, they hit a wall. Going after technology savings is rarely an option because it usually requires outsourcing or offshoring. 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 the difficulties, a cost focus remains the best path to achieving performance leadership for banks, in our experience (see Figure 2). Most banks can still gain efficiency by improving operations by simplifying processes or adjusting incentive structures to speed good ideas into action. But banks that have exhausted cost-cutting potential should not forget part two of high performance: increasing income. They can approach this cost-consciously, by focusing on increasing their business with existing customers rather than forays into new businesses.

The big UK banks that have pruned overlaps resulting from consolidation are now seeking to boost revenue growth. The UK's HSBC and HBOS serve as prime examples of how to go about it cost-consciously.

HBOS has expanded impressively—attracting 1.2 million new bank accounts and one million new credit card customers in 2003, as well as carving out a 23 percent 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 platform to process all its mortgages, regardless of which customer segment it's targeting. Its cost-to-income ratio fell from 45.2 percent in 2002 to 41.6 percent in 2003. Result: In 2003 the bank's profits jumped 27 percent. 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 helped HSBC's profits attributable to shareholders to jump from $5.4 billion in 1999 to $8.8 billion in 2003.

While the ability to manage costs varies by country, it's 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.

"Achieving the magic combination of growth and low costs is no easy feat, and the means by which banks can address that challenge vary greatly by region, country and player."