Innovative Destruction and Banking without Banks

A vibrant and effective commercial banking system is a pre-requisite for economic development in general and in emerging economies in particular. One of the key challenges facing the banking sector in general and in emerging economies in particular is the declining net interest income and redirection of resources and efforts from superfluous activities to shareholder value-adding activities. Net Interest Margin will continue to be a key problem. The consolidation of the banking sector, in some countries, has also increased the costs while reducing profits partly due to the regulatory burden and other additional costs. As competition intensifies economies of scale becomes a pre-requisite for sustainable competitive advantage and resulting profitability. Against this background banks must find ways of implementing lean management strategies not only in back office processes but also in front office. They need to invest in lean approaches to data, analytics and processes which align strategy, all business capabilities, people, processes and technology to deliver faster, cheaper and customer friendly products and services at a profit. This requires a quantum leap. While lean management originating at Toyota Corporation in Japan (an approach that eliminates waste) has been used in some financial institutions, the approach may have been known by other names like Continuous Process Improvement (CPI) in other institutions in the past. Six Sigma; a methodology which aims to continuously improve the organisation's processes and products, has been used as a complement to lean management, leading to the term Lean Six Sigma. This has been actively implemented in the banking sector to improve customer service, reduce operational costs, reduce cycle time and improve accuracy including Vanguard in the USA and also China Merchants Bank in China.

There are opportunities and challenges to embrace lean management in banks. Lean management can be instrumental in transforming banks to sustain profitability, by identifying some root causes and potential solutions. And, as a result, increase shareholder wealth in a declining net interest income environment. UBS of Switzerland is an excellent case in point - they started the Lean for Growth program in 2011, and a key focus of their program is to shorten throughput times. Furthermore, their Lean Management program has focussed on sustainability and overall quality improvement.

In some emerging economies, lean management is said to gain traction and deliver cost recovery within 12 to 15 months and increase profits by up to 20 per cent. Moreover, lean banks adopting transformative approaches to innovation and delivery of products may also be able to profitably deliver products and services to the "unbanked" segment of the population who depend on pawn-brokers and other informal channels for their borrowing and pay prohibitive interest rates. Narendra Modi, Indian PM has a financial inclusion plan to reach this segment of the population (Over 100 million Indian households do not have a bank account). This plan includes giving bank accounts to all of the “unbanked”, offering a debit card and offering an overdraft facility after six months. The opportunities to mobilise savings and deliver lending products in the rural sector should not be underestimated. Furthermore, Modi has encouraged ICICI Bank to create a “Digital Village” which will enable the previously “unbanked” to make cashless transactions via the internet. Lean management, therefore, can dramatically improve quality, increase speed and reduce waste. New methods and associated efficiencies needed to be implemented in order to grow the Microfinance industry. It should be emphasised that even the “unbanked” segment has a strong need for financial services; in a 2003-2004 survey of households in South Africa, even the lower income households used 17 different financial instruments over the year. But, one must note that this is not the case in all emerging economies.

Often senior executives do not think lean until some calamitous event compels them to do so. This is often the case with poor acquisition decisions driven by future hope of synergistic benefits. In the process of growing, corporations add “fat” and wastage and this could go on for decades until that calamitous event takes place This also occurs when financial institutions implement an external growth strategy by acquisition. In UK Royal Bank of Scotland’s acquisition of NatWest and later ABN AMRO is a good example of such activities; both acquired companies failed to perform well in the post-acquisition phase. Such challenges warrant the special skill of envisioning the post-acquisition future within the lean context well before the acquisition.

In the absence of lean thinking before the acquisition, contemplated synergies that drive acquisitions are unlikely to eventuate. In New Zealand, a major bank merged with a government-owned bank with nearly 1000 outlets. The large number of outlets was seen as a strategic advantage over competitors before the acquisition but soon that became a liability – excessive cost per transaction and low value accounts. Even a radical low value customer strategy did not help to bring the acquired bank to profitability. Where post-acquisition strategy is clear with detailed knowledge of the target bank, the lean thinking is likely to bring about expected synergies. For example, in Australia where the CEO of the target bank joined the acquirer bank before the acquisition lean initiatives were successful. Therefore, the in-depth knowledge of the target company often helps to derive benefits from the lean approach.

One of the key challenges is realising the potential balance sheet and P&L impact of lean initiatives. The reduction of waste (and additional activities) and delivering a better service/product to market faster are the key drivers of success. Banks in emerging economies in particular have opportunities to implement lean approaches to compensate for reducing net interest income by increasing fee income. Often proposed lean initiatives do not get the approval of the senior leadership because of the poor illustration of tangible benefits by the project managers. Using methodologies used in corporate finance. For e.g. NPV, tangible benefits of a lean initiative undertaken by a bank can be measured. While the benefits calculated may not be very accurate and subject to vagaries of the business environment, it is important to consider what-if scenarios and estimate the potential future benefits. This is particularly important for M & A activity promoted on the premise of synergies.

M & A benefits should be established even before the proposed acquisition. In fact it should become an integral part of the pre-acquisition plan.

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