The McKinsey Quarterly

HIGH TECH

JULY 2007

Better **IT management** for banks

McKinsey research shows that the IT investments of banks are most fruitful when they match technology strategy with business strategy, implement systems in a disciplined way, and balance value creation with increased IT capabilities.

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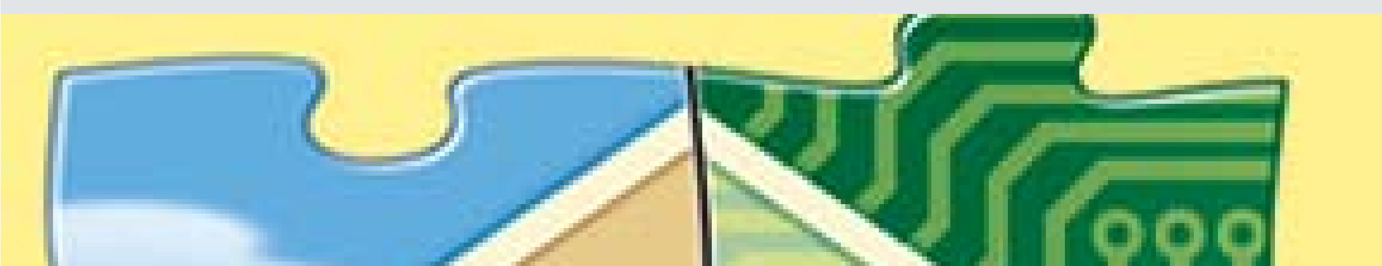
Article at a glance

McKinsey research into the IT operations of banks in Europe, Asia, and Latin America identifies practices that help leading institutions get the most out of their technology investments.

Some measures that bank managers assume are important, such as scale and levels of IT investment, turn out to be less critical.

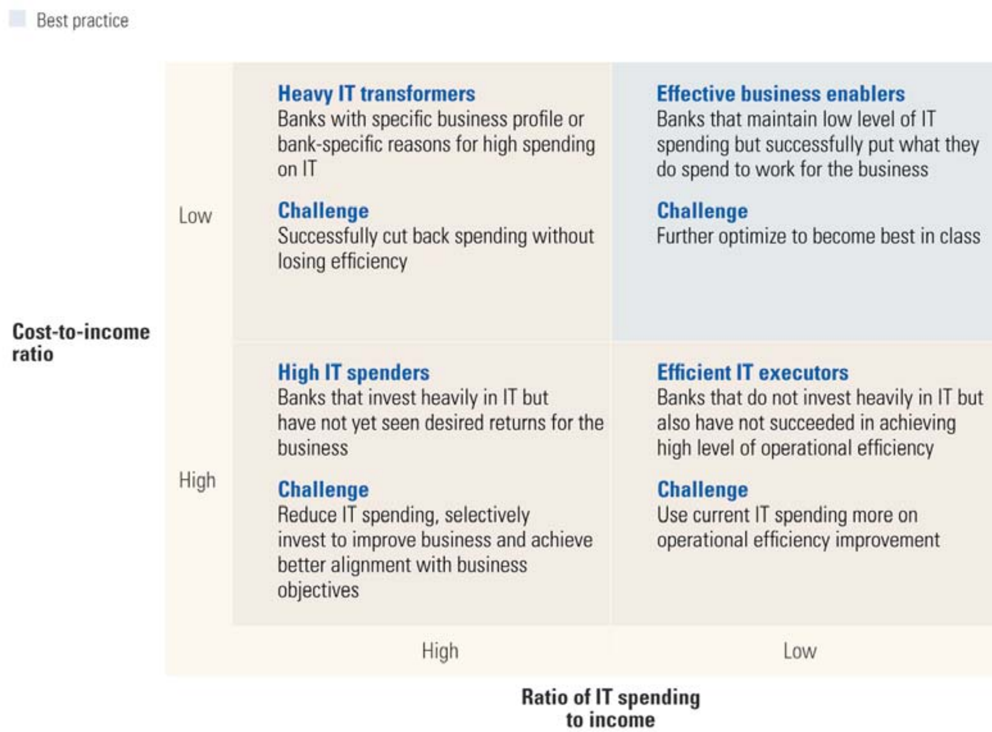
Far more important is the way a bank's IT unit forms its technology strategy together with the business. Leading banks also take a more disciplined approach to IT architecture, create standardized platforms, and wring more business value from technology investments.



Bank executives who manage information technology often share misconceptions about how to get the best value from IT investments. Some have long believed that in this sector, operating scale is a critical competitive factor because it creates cost advantages; others think that spending more on IT to improve operating efficiency directly yields better performance. Many feel that newer platforms are more likely to generate value; others hold that what really matters is the country where a bank operates, because certain places deliver factor-cost and market advantages.

EXHIBIT 1

Bank performance and relative IT spending



McKinsey research shows that these commonly held beliefs fall apart under close scrutiny. As part of an annual effort aimed at understanding what really matters in IT for banks,[1] we studied the financial performance and underlying IT practices of 105 of them in Europe, Asia, and Latin America. Our research examined many facets of the banks' IT performance, including governance and organization, outsourcing and offshoring practices, the complexity of the application architecture, and the utilization rate of hardware.[2] We then looked at the key financial metrics of the banks, cross-referencing their operational effectiveness (using cost-to-income—and in Asia, growth as well—ratios against their spending in IT as a percentage of income). These metrics helped us identify a set of leading banks that spend carefully on IT and successfully apply those investments to the business (Exhibit 1).

Examining the IT practices of banks in the top quartile highlights the link between certain IT practices and financial results, strongly confirming our experience that operational and other practices can substantially affect the performance of financial institutions.

Our findings show that some conventional wisdom isn't so wise after all. Spending more on IT, for example, doesn't necessarily translate into higher profitability. Banks with above-average IT expenditures have higher cost-to-income ratios and, in Asia, where we measured growth, a below-average increase in revenues. One reason is that many banks spend too much on running their daily operations and too little on innovations that would set them apart from competitors. Also, many banks have difficulty translating their IT investments into real business value; they may invest in new technology—an enhanced customer-relationship management (CRM) system, for example—that the business doesn't adopt. The top-performing banks in our study tend to invest more in innovation and differentiation and do a better job of getting the business to engage with IT investments.

We also found that scale does not guarantee cost benefits. Many big banks in our study have yet to see sustainable cost advantages from their vast IT operations, because they have difficulty managing the complexity of these large environments—particularly when their size results from cross-border mergers, which create integration challenges. Although some banks have addressed them and are beginning to reap the benefits, certain recently merged or regional banks may have to continue their efforts for years before seeing the combined platforms deliver strong performance.

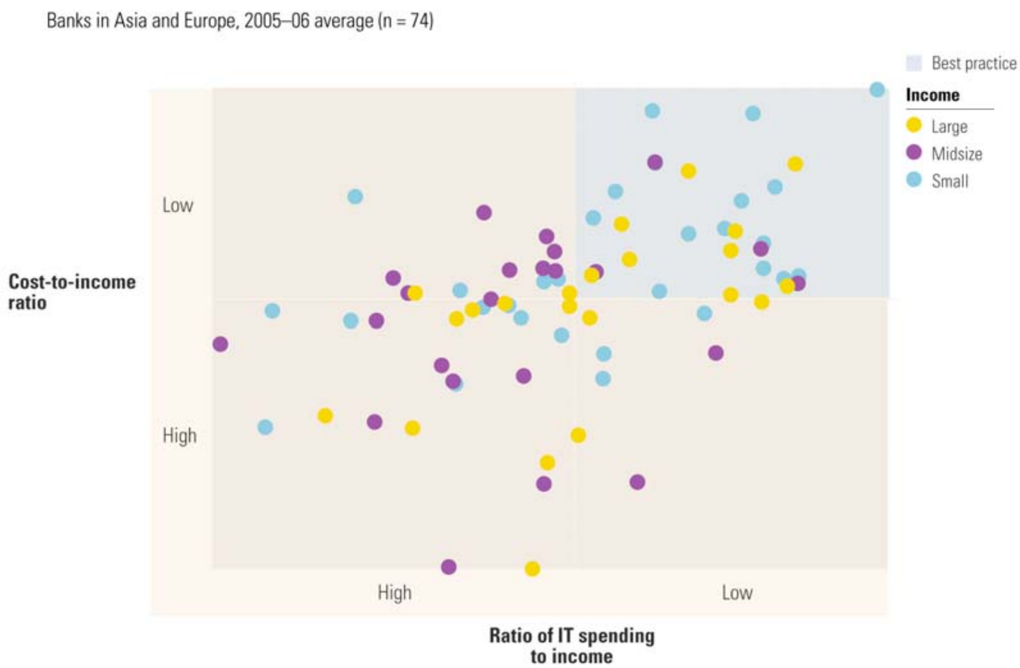
Indeed, having a large organization is no longer a prerequisite for gaining scale benefits (Exhibit 2). Smaller local players can get them by "smart sourcing" carefully chosen services (for instance, outsourcing the help desk rather than IT operations generally); adding capacity as needed; and adopting new, more scalable technologies, such as servers that allow companies to scale up or down more flexibly.

A third bit of conventional wisdom blames poor cost performance on location—specifically, national or regional regulations and the resulting costs of doing business. But with a few exceptions (see sidebar, "How are Indian private-sector banks leveraging IT for their businesses?"), we found no significant correlation between a bank's home country and the efficiency or effectiveness of IT operations. Labor cost and skill advantages can now increasingly be leveraged across countries and continents.

Finally, our study in Asia found no correlation between the age of the core banking platform—that is, the IT hardware and software that process transactions, deposits, loans, interest, accounting, and customer information—and the efficiency of IT.[3] Half of the high-performing banks in our survey have platforms that are less than five years old, while the other half have older platforms, many of which evolved into complex and rigid systems. Banks that replace their core banking systems may be disappointed by poor returns unless they drive additional business initiatives in parallel.

EXHIBIT 2

Scale doesn't guarantee cost advantages

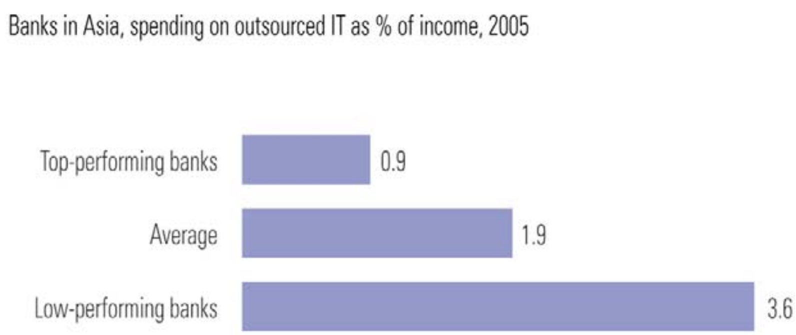


What matters more is the way banks manage IT and integrate it with business functions. One key finding, for example, is that strong management and good governance of IT have a greater impact on its performance than many other factors that conventional wisdom deems important, including the scale of IT operations, a bank's home country, the age of the IT platform, and the amount of money spent on IT. The banks that performed best on our IT benchmarks for governance have higher profit-to-earnings ratios (13.0 among our European banks, for example) than those that scored lower (11.7), suggesting that well-run banks do a good job of managing their information technology.

Top-performing banks tend to form their IT strategies in close cooperation with the business by using formal governance processes and engaging the business to focus on value creation levers that are influenced by IT. What's more, high-performing banks see IT as more strategic, and they drive more of their IT agenda directly; that is, they outsource less (Exhibit 3). When they outsource, they closely manage their vendors. Indian banks provide a good example, as they do outsource and otherwise leverage external services, though in a targeted way, with active management to ensure that they get value from deals. Some Asian banks that have pursued wholesale outsourcing—for example, of infrastructure, application development and maintenance, and, in several cases, large parts of IT management—are struggling to use IT to drive value and have limited strategic flexibility as the business context evolves and hardware prices plummet.

EXHIBIT 3

Selective outsourcing



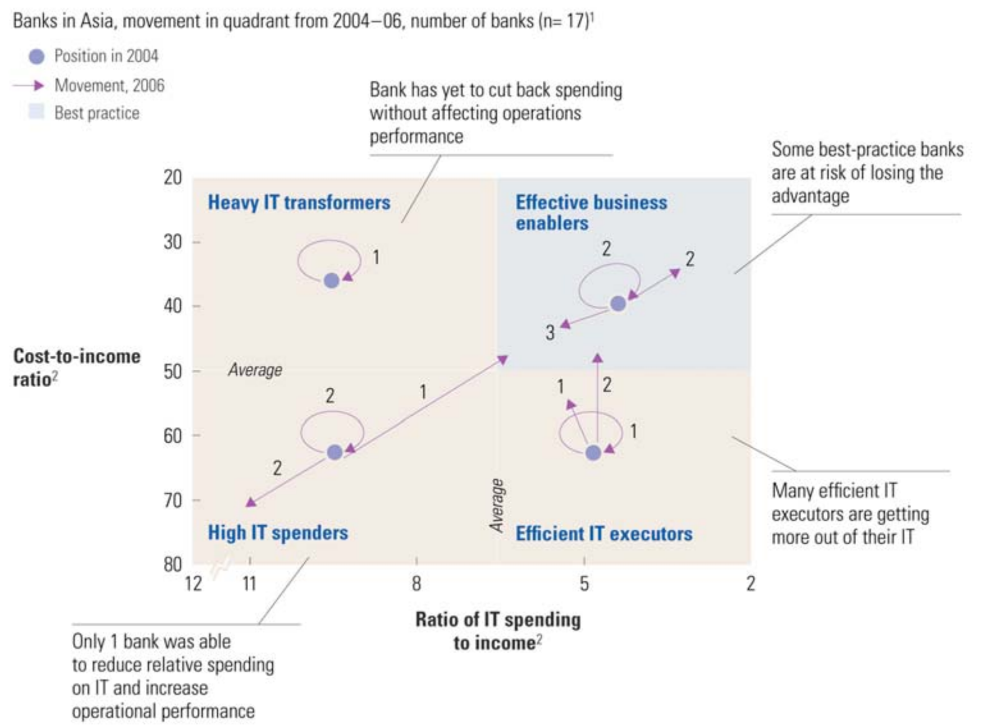
We also found that leading IT performers do a better job of applying their technology investments to create new business value and spend less on daily operations. Top performers spend 45 percent of their IT budgets on innovation (new services or capabilities); lower-ranked banks only 29 percent. Best-practice banks also introduce new products in only three to six months, compared with six to nine for less well-run banks.

Leading banks follow a more disciplined approach to application architecture, particularly in Europe, where leaders run the business on an average of only 300 applications, compared with 1,250 for other banks. Asian banks, most of which are still building their application platforms, can benefit from the experience of their European counterparts by investing in flexible application architectures now, so they won't have to simplify a complicated legacy platform in the future. Top performers also use more standard interfaces, as well as more middleware that makes connections among applications less complex and ultimately reduces labor costs. Leading banks say that custom features make 20 to 40 percent of their applications difficult to change, other banks 40 to 60 percent.

Finally, leading performers standardize their IT operations on a limited set of platforms and use infrastructure such as machines more effectively than others do. In Asia, for example, leading banks achieve utilization rates of 30 to 40 percent on their Unix servers, compared with less than 30 percent for lower achievers.

EXHIBIT 4

Improvement isn't guaranteed



[1]2006 data based on banks' forecasts; though small, this sample of 17 banks represent 80% of leading banks in the countries studied.
[2]Adjusted for country differences based on banks' home countries and regional footprints.

Comparing the results of our 2006 benchmark study with those from previous years shows that most top performers managed to stay at the top, improving their performance or at least holding steady (Exhibit 4). Certain banks that earlier ranked lower down have begun to focus more on improving the performance of IT, and some have made good progress; others are stalled, spending more on IT without improving their profitability. In our experience, a sustained commitment from top leadership makes all the difference. Leading banks tend to follow clearly established patterns: a two- to four-year transformational journey that reduces IT spending and selectively reinvests some of the savings in new platforms and capabilities. They follow several principles, including transparency (giving managers a clear view of all IT costs and related benefits, even those falling outside the IT department), performance management (clearly defined metrics), and a balance between short-term performance gains (such as reducing costs) and long-term investments (simpler architectures).

The most important thing is attention and engagement from the highest ranks of the organization. Senior managers at the best-performing banks tend to cite technology as one of their three most important strategic capabilities. Direction comes from the top, and the governance model prioritizes and encourages alignment with the business agenda. IT leaders are business savvy, earning and justifying their seats at the table where IT savvy senior management makes strategic decision

How are Indian private-sector banks leveraging IT for their businesses?

Indian banks score well in our study, spending less on IT than other banks and effectively leveraging investments for competitive advantage. Specifically, all participating private-sector Indian banks are among the most effective performers, using IT to promote growth while remaining relatively efficient operationally. One explanation lays in their origins: India opened banking to the private sector less than 15 years ago. To compete with established public and foreign institutions, these banks used low-cost IT and operations to gain a competitive edge by addressing the urban mass market.[1]

Three key characteristics contribute to the effective use of IT by Indian banks:

1. Factor cost advantage. The IT labor costs of India's private-sector banks are typically 40 and 60 percent lower than those of banks in the Asia-Pacific region and Europe, respectively. As a result, internal staff costs amount to roughly 10 percent of total IT expenses for these Indian banks, as opposed to 20 percent for Asia-Pacific banks and more than 30 percent for European ones.

2. Distribution strategy. Indian banks have established a unique business model, acquiring customers rapidly with minimal IT investments by relying on low-cost, third-party direct-selling agents. To serve this rapidly growing customer base, Indian private-sector banks also moved quickly into alternative delivery channels (such as ATMs, call centers, and online banking), thus establishing a reputation for being more technologically savvy than their state-owned competitors while providing better service. The market leaders, including HDFC Bank and ICICI Bank, have successfully migrated as much as two-thirds of their transactions to these channels.

3. IT governance. All the Indian banks surveyed emphasize IT governance, with a strong in-house IT division and a CIO who reports directly to the CEO in most cases. With stronger in-house IT skills, these banks can outsource selectively, and they get greater value by using IT vendors that charge lower rates while maintaining the quality of their infrastructure and application development.

A low-cost, India-based servicing platform could provide a competitive edge for Indian banks seeking to do business outside the country, by enabling them to play the attacker role and capture market share from incumbents.

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[1] Leo Puri, "The CEO as CIO: An interview with the head of India's top private bank," *The McKinsey Quarterly*, Web exclusive, March 2007.

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[1] Kanika Bahadur, Driek Desmet, and Edwin van Bommel, "Smart IT spending: Insights from European banks," *The McKinsey Quarterly*, Web exclusive, January 2006.

[2] We measured these factors using share of spending or qualitative best-practice calibration: for example, how the IT demand and supply functions were split between business units and central IT units; whether the chief information officer reports to the business unit head, the chief operating officer, or the CEO; what key performance indicators (KPIs) are used to measure IT performance; the compensation of the IT staff; and at what point IT is involved in investment decisions. The elements we studied differed by region.

[3] We measured the age of platforms only in the Asian part of our study, because core banking-system replacement to support business growth is one of the top issues facing the CIOs of the Asian banks.

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