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Financial Services: **Banking**Tools 

## Smart IT spending: Insights from European banks

Those that get the most value from information technology might be the ones that spend the least on it.

**Kanika Bahadur, Driek Desmet, and Edwin van Bommel**

*Web exclusive, January 2006*

**A small number** of European banks get more business value from information technology—including faster, more flexible support of business objectives—than do their peers, and at a far lower cost. How? Our research found that this select group combines superior IT management with a tight focus on using IT to help improve business performance.

We surveyed 37 retail and wholesale banks to understand how they manage technology and to identify the IT-management practices of the top performers. In the course of the effort, more than 70 variables of management practice—ranging from the management of data centers and application portfolios to IT governance models and outsourcing contract provisions—were examined. We collected quantitative and qualitative data on the banks' IT spending and on their staffing levels for internal personnel and contractors.

The survey found that IT spending varied widely—from 10 to 30 percent of operating costs, or 4 to 18 percent of operating income. Higher levels of IT spending didn't increase the effectiveness or efficiency of the business. Indeed, the banks that appear to get the most business value from IT spend up to 40 percent less than the weakest performers.

We discovered that the best performers were separated from the rest by fewer than 20 statistically meaningful variables associated with two factors: the quality of a bank's IT management and the ways the bank uses IT to support the needs of the business. There was no correlation between the performance of a bank and either its size (as measured by revenues or head counts) or its mix of retail and wholesale business. Taken together, these results strongly suggest that the way banks use and manage IT will continue to be a crucial factor in their performance.

### Four kinds of banks

Each bank was assigned to one of four categories (Exhibit 1). The top performers, which we dubbed "effective business enablers," achieve the greatest business efficiency and effectiveness, from a relatively low level of IT spending (8 percent of operating income, compared with an average of 12 percent for all other respondents). Of the 37 banks, 14—including all of the Spanish institutions surveyed (see sidebar, "[The IT operating edge of Spanish banks](#)")—fell into this category.

At the other end of the scale were the "high IT spenders," which pay out almost 13 percent of their operating income on IT but are not yet seeing the desired impact on business efficiency and effectiveness. Thirteen banks were in this group.

The banks in the third category, "heavy IT transformers," spend almost 15 percent of their operating income on IT, largely for specific business transformation projects. These tend to be one-time but multiyear efforts, such as a major IT consolidation, standardization and postmerger integration efforts, or support for business expansion into new product lines, markets, or channels. Only three banks fell into this category.

Finally, seven banks spend just 10 percent of their operating income on IT but haven't achieved a high level of operating efficiency. We dubbed these banks "efficient IT executors."

### IT management makes the difference

The effective business enablers, we found, have a distinctive way of managing IT operations. Most striking was the way these banks handled applications, infrastructure, outsourcing, and vendor management (Exhibit 2, part 1).

Typically, the effective business enabler has a more centralized and consolidated application portfolio than the typical high IT spender—380 applications, on

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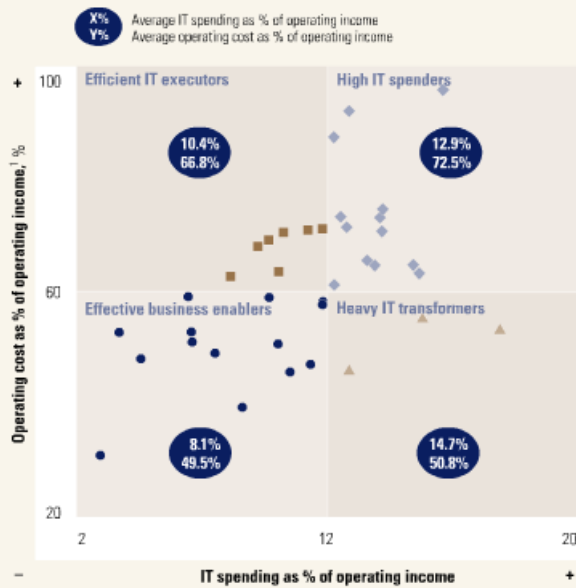
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EXHIBIT 1

**How do you use IT?**



<sup>1</sup> Derived cost-to-income ratio (cash flow equivalent).  
Source: McKinsey 2006 survey of IT costs in 37 European banks

[enlarge exhibit](#)

EXHIBIT 2

**Managing IT better**

Part 1	Differentiating factor	Effective business enablers	High IT spenders	
<b>IT management</b>	<b>Managing assets</b>			
	<ul style="list-style-type: none"> <li>Applications                             <ul style="list-style-type: none"> <li>Number of applications</li> <li>Maintenance spending per application</li> <li>Degree of fragmentation (ie, number of applications used in end-to-end business transactions)</li> </ul> </li> <li>Data centers                             <ul style="list-style-type: none"> <li>Number of data centers</li> <li>Spending per data center</li> </ul> </li> <li>Desktop infrastructure/help desk spending per full-time equivalent (FTE)</li> </ul>	<ul style="list-style-type: none"> <li>380</li> <li>&lt;€60,000</li> <li>A few well-integrated applications</li> </ul>	<ul style="list-style-type: none"> <li>500</li> <li>€135,000</li> <li>Many poorly integrated applications, creating potential for redundant data</li> </ul>	
	<b>Managing vendors</b>	<ul style="list-style-type: none"> <li>Outsourcing                             <ul style="list-style-type: none"> <li>% of banks in sample that outsource</li> <li>Outsourced spending as % of IT spending</li> </ul> </li> <li>Vendor management                             <ul style="list-style-type: none"> <li>Frequency of vendor negotiations</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>30%</li> <li>7%</li> <li>Continuous monitoring</li> </ul>	<ul style="list-style-type: none"> <li>45%</li> <li>25%</li> <li>Every 6 months</li> </ul>
<b>Part 2</b>	<b>Business enablement</b>			
	<b>Responsiveness to business change</b>	<ul style="list-style-type: none"> <li>Flexibility of applications, % of applications with difficult-to-change features</li> <li>Availability of customer profile information, number of systems user must obtain access to</li> </ul>	<ul style="list-style-type: none"> <li>&lt;40%</li> <li>1</li> </ul>	<ul style="list-style-type: none"> <li>40–60%</li> <li>2–3</li> </ul>
	<b>Focus on business productivity</b>	<ul style="list-style-type: none"> <li>Focus on core banking, % of application spending on support functions (eg, finance, HR)</li> <li>Use of work-flow-management systems in high-volume transactions</li> </ul>	<ul style="list-style-type: none"> <li>13%</li> <li>Used in all</li> </ul>	<ul style="list-style-type: none"> <li>21%</li> <li>Used in few</li> </ul>

Source: McKinsey 2006 survey of IT costs in 37 European banks

[enlarge exhibit](#)

average, compared with 500 for high IT spenders and as many as 1,200 at some other banks. Effective business enablers also spend €75,000 less per application than do high IT spenders. Moreover, the applications associated with complicated business transactions are less fragmented at the top-performing banks than at others. Take a typical mortgage transaction that consists of various stages, from submitting the application and prequalifying the borrower to underwriting and financing the loan. To complete such processes, banks lower down on the performance scale use numerous applications that draw on data from many different systems. Since these applications often require manual data transfers from system to system, they generate more errors and slow down processing. The best banks, by contrast, use fewer, more integrated applications.

Effective business enablers also manage their IT infrastructure tightly. They have half as many data centers (one or two, on average) as the high IT spenders do,

for example. They also spend less on each one—some €22 million a year, compared with €29 million for the highest spenders.<sup>1</sup> The difference partly reflects the fact that many high IT spenders haven't yet rationalized the data centers they accumulated through acquisitions. Most top banks have done so but still seek to reduce costs further by setting up data centers in regions with lower real-estate costs and by automating operations so that fewer employees are needed to run them. Top banks also keep a close grip on procurement contracts for hardware and services.

As for desktops and help desks, effective business enablers have standardized these assets to reduce their cost and increase their scalability and to make it possible to manage them remotely. As a result, such banks spend only €1,600 a year per employee on desktop and help desk services, compared with €2,500 for high IT spenders.

Another way this group of banks differs from the rest is its approach to outsourcing IT and managing vendors. Only 30 percent outsource at all, compared with 45 percent of the high IT spenders. Moreover, effective business enablers do so sparingly—outsourcing represents only 7 percent of their IT spending, compared with 25 percent for high spenders. In our experience, the reason for the difference is that the top banks have stronger in-house IT skills and can thus outsource more selectively than the others, carefully choosing those areas where third-party providers would add value rather than outsourcing to "fix" IT-management problems.

Finally, top banks negotiate flexible vendor contracts and monitor them continually to allow for timely renegotiation when opportunities arise. Other banks tend to be constrained by inflexible contract terms and conditions, which make renegotiation more difficult and less rewarding.

### More support for business

In addition, effective business enablers excel in the way they use IT to support the business. They make applications flexible, centralize important customer data, and use IT to support core banking processes and business productivity.

Because these banks use applications that are more standardized and fairly easily modified, they are better able to respond to changing business needs (Exhibit 2, part 2). By contrast, high IT spenders report that 40 to 60 percent of their applications have customized features that are difficult to change or enhance, as compared with less than 40 percent of those at the top banks. Moreover, the top performers tend to keep customer profiles in a centralized, integrated data file. As a result, back-office processes are more efficient and contact information about existing customers need not be reentered each time one of them applies for a new loan or opens an account.

Another key difference is that the effective business enablers spend more of their application budgets on primary processes such as executing payments, processing mortgages, or handling securities—applications that deliver direct value to the business. They spend only 13 percent on support processes such as HR, risk, and finance. By contrast, the high IT spenders dedicate an average of 21 percent of their spending on applications to such support processes rather than to customer-facing or core-banking processes.

Effective business enablers also enhance their business productivity by spending more on work-flow-management systems that automate a wider range of processes and ensure that the most appropriate people perform the right process steps in a timely fashion. In addition, these companies provide customers with easier access by making all services available through all channels: branch offices, ATMs, the Web, and the telephone. Other banks offer only limited services on certain channels—for instance, by narrowing the customers' telephone-banking options to checking account balances.

### Strategies for improving performance

Taking the top performers' practices as a starting point, any bank can improve its efficiency and effectiveness. Each, however, faces specific challenges. High IT spenders need to invest more selectively and to align their spending more closely with business aims. As Exhibit 3 shows, these banks lag well behind the effective business enablers on overall operating efficiency. Business as usual is not an option: the high IT spenders must fundamentally rethink how they manage and integrate IT into the business.

Efficient IT executors might need to increase their investment and use more of it to enable their business processes. The IT transformers should closely monitor multiyear investments to ensure that they stay aligned with changing business needs and, at the same time, run day-to-day IT operations efficiently. The challenge for these banks will be to cut back on IT spending as their transformation projects draw to a close and to redirect those funds toward further innovation and efficiency.


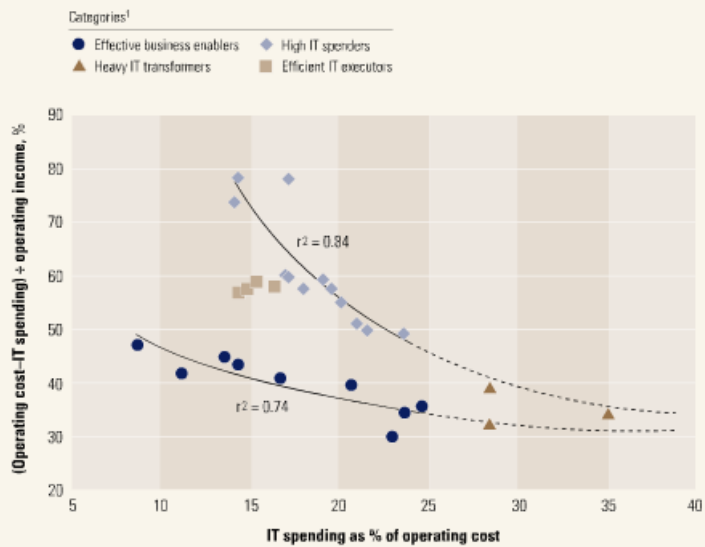
The top performers can make advances too. They have an opportunity to extend their advantage by further automating their already lean back-office processes. And when integrating a merger or acquisition, they can use their own tried and tested applications, data centers, and capabilities as a starting point for the new IT organization. 

EXHIBIT 3

## The learning curve



<sup>1</sup> $r^2$  is the proportion or percentage of variance explained by a regression.

<sup>2</sup>Excludes participants within  $\pm 3\%$  of category's median cost-to-income ratio and/or within 0.2% of category's median IT spending as % of operating income.

Source: McKinsey 2005 survey of IT costs in 37 European banks

[enlarge exhibit](#)

The IT operating edge of Spanish banks

Why were all four Spanish banks in our survey among the top performers? The answer is competition and leadership. Spain's banking market was for many years more fragmented than that of other European countries, sparking fierce competition. In this climate, bankers maintained extraordinary discipline over IT costs and at the same time looked for IT solutions that could provide a competitive edge. As a result, the country's banks were early adopters of many IT-management best practices identified in our research.

We found the use of technology to be especially effective in three areas:

- *Servicing.* Spanish banks were quicker than other European institutions to adopt ATMs and to establish call centers and Internet channels. Being ahead of the curve, they reaped the cost savings from each of these moves early on—and garnered a reputation among customers for being innovative and technologically savvy.
- *Transactional products.* Spanish banks quickly embraced paperless transactions in the payments arena through the use of ATM networks, wire transfers, and direct debits (a direct, automated charge to an open account for a service provided by a company). Moreover, the country's regulatory bodies drove efficiency within the industry by fostering the development of centralized, consolidated, and well-run exchanges for processing payments, bonds, and equities. By eliminating paper-based transactions, the banking sector lowered its processing costs and increased its efficiency.
- *Back-office operations.* IT and operations are closely linked and managed at most Spanish banks and are frequently run by the same person—often the chief operating officer. The result: more consolidated and automated back-office functions, which in turn lowers costs.

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