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# The Seven Deadly Sins of Cost Reduction



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## EXECUTIVE SUMMARY

*Banks of all sizes are struggling to sustainably reduce costs while maintaining their ability to grow. There are a number of pitfalls in cost-cutting initiatives, from paralyzing indecision to undue haste. To overcome these challenges, banks need to define a programmatic approach, choose the right team, and properly engage the organization. This Perspective paper addresses the best way to do so and looks at the organizational strategies that can make sure costs stay cut.*

# COST CUTTING IN A CRISIS

The wave of consolidations and bankruptcies that hit the banking industry in late September and early October 2008 have made clear the magnitude of the current financial crisis. The next year or so will see a massive deleveraging of the global economy, a deep recession, and a fundamental restructuring of the financial services landscape. In the short term, a combination of constrained credit availability, anemic demand, and intense deposit competition will result in significant earnings pressures for banks.

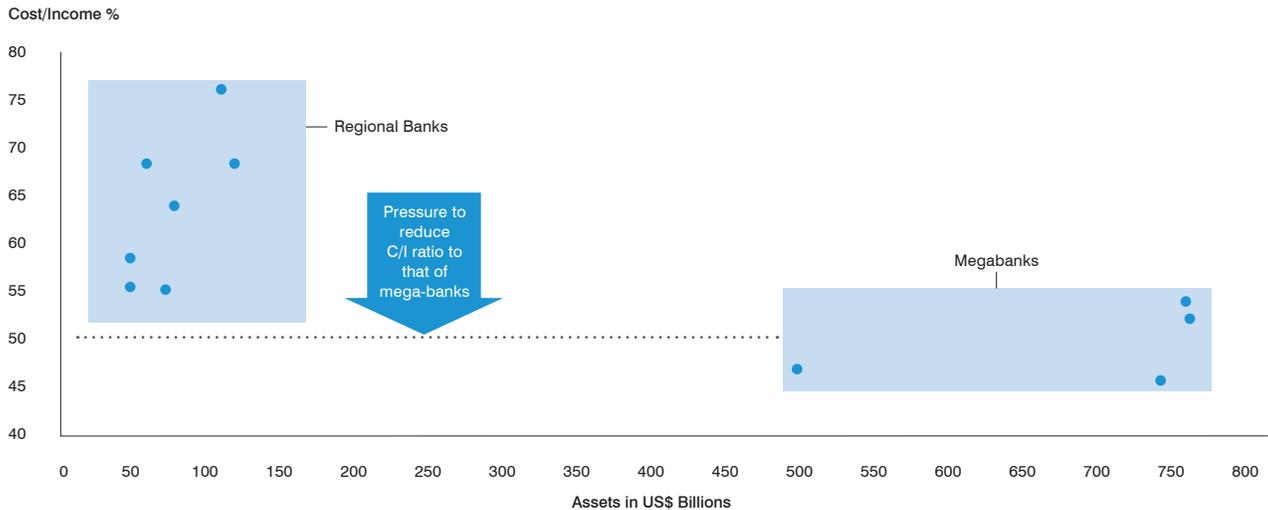
The four megabanks that have emerged in the crisis—Wells Fargo (with the addition of Wachovia), Bank of America, Citigroup, and JPMorgan Chase (with the addition of Washington Mutual)—will drive to improve their cost/income (C/I) ratios

in a shrinking national market by uncovering the synergies and benefits of scale in their consolidations—for instance, in technology platforms and branch networks. And as they sort out their own businesses, they will put significant cost pressure on the regional banks that remain. In order to compete, regional banks will need to reduce their C/I ratios by 5 or even 10 percentage points, which equals hundreds of millions of dollars in cost reduction (see Exhibit 1).

Against this stark backdrop, the industry's near-term priorities have never been clearer. Bank CEOs know they need to take out costs rapidly; in most cases, they even know roughly where the opportunities are. The problem they are struggling with is how to sustainably reduce costs while maintaining their ability to grow.

**Exhibit 1**  
*Efficiency Ratio by Asset Size for Major Banks (2007)*

Includes U.S. Retail & Commercial Banking Business



Source: Company financial statements; Booz & Company

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## COMMON PITFALLS OF COST CUTTING

In the past decade, most banks have embarked on cost reduction programs, only to see costs creep back over time. In our experience, the biggest mistake companies make when faced with a significant cost challenge is to treat the effort like business as usual. Typically, a small team will perform a cost analysis, set targets, and distribute them to various business and functional heads to meet in the course of normal business. Despite some initial enthusiasm, most teams will find no shortage of reasons for the biggest cost-saving opportunities to be found in other parts of the bank. With everyone operating in their own silos, tactical cost savings are identified—but more transformative opportunities that require cross-organization collaboration are overlooked. The result is a 5 to 10 percent reduction in costs that lasts only until everyone goes back to their old ways.

In our work with hundreds of companies over the last two decades, we have identified the biggest mistakes that companies make when they set out to reduce costs. We call them the seven deadly sins.

### *Silence: Where Is the CEO?*

The CEO is reluctant to make the case for cost reduction because he or she has not hammered out all the details and is unwilling to present a “half-baked” plan.

### *Indecision: What’s the Big Picture?*

Leaders fail to agree on the strategic agenda that drives the program; they

employ an incremental approach and delay moving forward until they’ve created a bottom-up analysis, rather than starting with an overarching vision.

### *Detachment: A Message from Corporate*

Management portrays transformation as a corporate project, without explicitly laying out why it is integral to the success of the business units, geographies, and functions.

### *Haste: Why Wait? We’re Ready!*

The organization skips directly from articulating the overall vision to rolling it out, without preparing a detailed plan for design and execution. In these cases, the transformation program office is usually dismantled too soon.

### *Arrogance: Cost Issues Are for Little People*

Leaders delegate cost reduction activities to someone lower in their organization so they can focus on running their business.

### *Vanity: What Customers?*

Banks identify cost reduction opportunities in an introspective manner, without any market-back or customer perspective.

### *Ignorance: Any Results Out There?*

The program is not measured comprehensively or consistently throughout the organization. No one is accountable for realizing benefits, and management is unaware of the status.

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## GETTING COSTS OUT

Taking out significant costs in a sustainable way can't be done piecemeal. Instead, it requires a fundamental redesign of the way the bank operates. Banks must reevaluate the businesses they are in, the manner in which they engage customers, and the way they organize. A successful program has three elements:

*Approach:* A small team of rising stars from throughout the corporation—for greater effectiveness in looking across the organization—is deployed to quantify the size of the cost-reduction prize and understand what must be done to capture it. They conduct a series of bottom-up and top-down analyses to develop aggressive goals that will necessitate creative thinking and transformative solutions. Once top management has agreed on cost-reduction targets, a broader-based team including business and functional heads designs pragmatic steps necessary to achieve these targets. These steps typically include process changes, technology renewal, and organization and people changes. Finally, changes are implemented throughout the organization.

*Team:* During the entire process, the bank's leadership team must visibly lead the effort, not as representatives of their individual business units but from the perspective of the broader organization. They must illustrate both their vision for short-term changes and their long-term view of how the bank will compete in the future. Some effective methods for communicating the importance of the change, and the steps that will be necessary to achieve it, are town hall meetings, electronic newsletters, social-networking sites, and Q&A sessions for small groups.

*Organizational Engagement:* Finally, the entire organization must be mobilized throughout the process. Initially the focus is on ensuring that top management is aligned with the changes required, but in later phases the focus is on mobilizing the organization and transitioning initiatives to the businesses. This requires a systematic change program that ensures the right amount of information is communicated to the right people at the right time.

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## SUSTAINING THE CHANGE

Once costs have been cut, sustaining the benefits over the long term inevitably requires organizational changes. Every organization has four fundamental building blocks—its DNA, if you will—that determine how it will respond to change and whether it will be able to effectively execute strategy:

- *Decision rights* are the underlying mechanics of how and by whom decisions are truly made, beyond the lines and boxes of the organization chart.
- *Information flow* determines how activities are coordinated and how knowledge is transferred.
- *Motivators* are the objectives, incentives, and career alternatives available in the organization.
- *Structure* is the overall organization model, including the lines and boxes of the organization chart.

Most executives instinctively believe that the most effective way to implement change is by changing the bank's structure. Such efforts can quickly generate short-term efficiencies—but they are addressing the symptoms of the problem, not its

root causes. Our research shows that actions having to do with decision rights and information flow are far more important—about twice as effective—as improvements made to structure and motivators.

Decision rights can be adjusted to broaden spans of control, resulting in greater accountability throughout the organization. They are also the basis of governance mechanisms, which can ensure efficiency across the corporation—for instance, in the use of shared services.

Naturally, the mechanisms created by strong decision rights could not exist without timely, relevant information. Banks need to implement marketlike mechanisms that make costs transparent to help manage or reduce demand—again, shared services is a good example. The use of relevant metrics can also promote ongoing cost-consciousness.

Only after banks have realigned their decision rights and information flow should they address structure and motivators. The overall goal is to create a mutually reinforcing system of organizational levers that can sustain significant cost savings over the long term. If senior executives look beyond standard structure-based remedies and examine the other three organizational elements, they can more effectively diagnose the root causes of high costs and keep them down permanently.

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## CONCLUSION

The current economic crisis has redefined the financial services industry. The new industry structure will be characterized by intensely competitive, large-scale, low-cost competitors. By taking an approach to cost cutting that recognizes the significance of the effort and applies resources accordingly, banks can achieve a fundamentally lower cost position and sustain the benefits of their cost-cutting efforts beyond the short term.

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