

White Paper

Responding to the New Reality in Banking: Containing Costs Amid High Inflation

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Financial institutions (FIs) around the world continue to face multiple challenges: an inflationary environment not witnessed for more than 20 years; volatile interest rates; a significant increase in market uncertainty across asset classes; geopolitical instability intensified by the protracted war in Ukraine; a severe shock on the bond market; less-abundant liquidity; and workforce challenges that include managing employee expectations, hybrid working models, and critical skills shortages simultaneously.

Most recently, the **Silicon Valley Bank (SVB) crisis** in the United States has served as a wake-up call for banks to improve balance-sheet modeling, to pressure-test their contingency playbooks and communication plans, and to better understand risk silos and asset-monetization capabilities. The SVB event has highlighted flaws in the typical bank risk-management approach that other institutions should mobilize to address. And in Europe, sudden fears over the long-term solvency of Cr dit Suisse, since calmed, placed more scrutiny on the global banking sector.



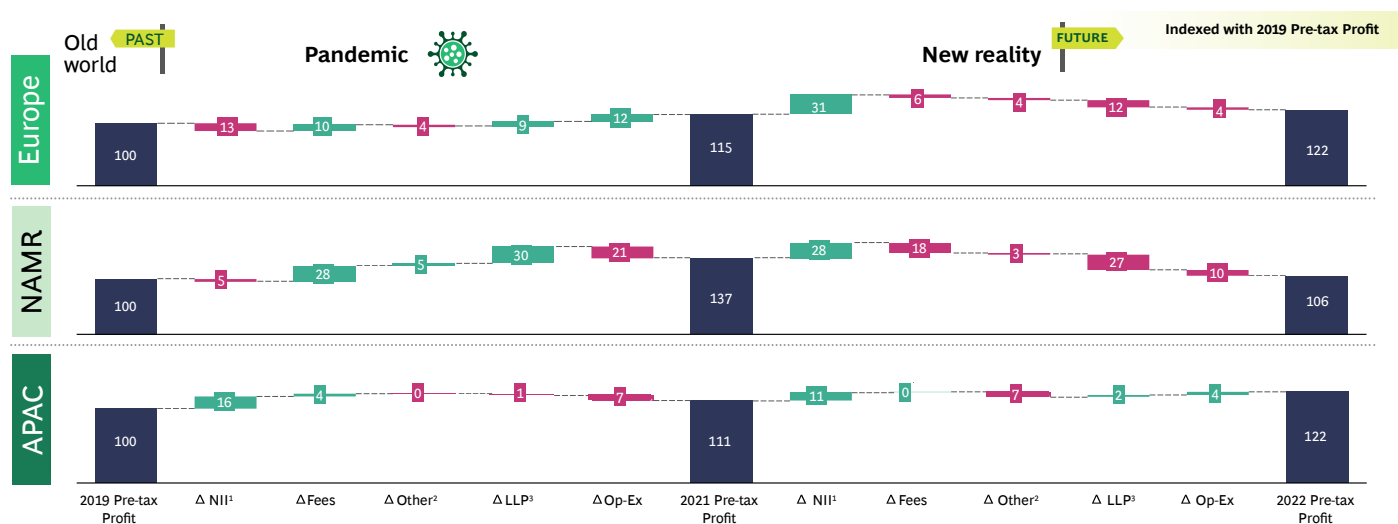
Tailwinds in interest rates, headwinds in fees and costs

The year 2022 ended well enough for banks in general, with the positive profitability trends observed in the first half prevailing through the rest of the year. (See Exhibit 1). European banks saw steady improvement, as the lift in net interest income stemming from higher interest rates offset the headwinds in fees, cost of risk, and overall costs — the exception being some UK banks whose results were sub-par. The outcome was worse for US banks, which witnessed a steep deterioration in fee income (influenced by lower advisory activity

for bulge-bracket banks) and a rise in costs, including a full reversal of the cost-of-risk improvement seen during the pandemic. The end result for many FIs was a decline in pre-tax profit over the full year.

Overall, headwinds can be observed through a number of early-warning indicators, signaling that banks must act in order to face the upcoming challenges — not wait for the full-blown effect of inflation on costs, which could catch some FIs off-guard.

Exhibit 1: Profitability | Drivers of profitability reversing course in new reality



1. Net interest income 2. Other income 3. Loan loss provisions

Source: BCG expertise and analysis. Minor differences in aggregated numbers owing to rounding off.



Operational expenses, particularly labor costs, are on the rise

The effects of inflation have only begun to show up on banks' financial statements around the world. Given the natural lag in labor-cost growth following an increase in consumer prices, these effects will be more visible in the months to come. Even if overall inflation normalizes — under an optimistic scenario — wages will likely remain on the rise, and historically low unemployment will lead to even higher wage pressure as FIs compete for top talent.

More specifically, in Europe, overall operating expenses (OpEx) for FIs increased by 1.6% on average in 2022 (compared with 2021), following many years of general containment. This surge was driven mostly by a rise in personnel costs, reflecting the more competitive talent environment. The effect on North American banks was more profound, with a 5.1% OpEx increase in 2022, although this rise was driven by non-personnel costs, which jumped by 10.4% in one year.

Labor cost increases will likely become stronger, partly due to the decrease in global workforce participation — at 59% in 2020-2022, compared with 62% in 2000-2019. In the US, businesses are struggling to find the right talent, as evidenced by the doubling of monthly US job openings between 2019 and 2022, with technology roles being particularly challenging

to fill. Additionally, banks need to adapt to a world in which employees are much more prone to change jobs, given the right incentives. In 2022, according to a recent BCG survey¹, 55% of knowledge workers were open to considering other positions within the next 12 months, with 20% actively looking for a new role.

Furthermore, technology accounts for a substantial share of the cost increase across geographies, although the underlying drivers of technology spend vary. US and EU banks, for example, spend more of their tech budgets on the remediation of legacy systems and on M&A activity, while banks in APAC generally have simpler legacy architectures and can focus on building new revenue capabilities and developing advanced tech systems. Yet in all regions, given the scarcity of high-level technology staff, significant cost increases can be observed.

1. Job switch data from Future Forum Pulse Survey, conducted January 27 through February 12, 2022. Number of respondents = 10,818 knowledge workers across US, Australia, Germany, Japan, France, and the UK

Loan-loss provisions are an ongoing concern

Beyond operational expenses, loan-loss provisions have emerged as a substantial cost driver, especially in North America. The 27 basis points allocated is in anticipation of potential defaults caused by increased interest rates in loans. This trend is almost certain to materialize in European banks as well — the current 12 basis points allocation is likely to grow in the following quarters, as ECB deposit rates climb from the current 2.5% level to the anticipated 3+% level later in 2023.

While a rise in profitability has been achieved with the help of higher net interest income, the slowdown in new loans generation — owing to the increased interest-rate environment — will be a concern for banks. Initial warning signs can be seen through the decline in loan growth in North America, or indeed through the decrease in total gross loans in Europe in Q4 2022. It is important to note that the slowdown started in Q3 in the US, and was not observed until Q4 in Europe. This can be explained by the fact that the US Federal Reserve Board increased interest rates earlier in 2022 than the European Central Bank did.

The new reality will require tenacity and velocity

Over the previous decade, many banks undertook large transformation programs aimed at making their business and operating models more digital and agile, boosting client centricity, and unlocking substantial cost efficiencies along the way. The low-interest-rate environment applied constant pressure to margins, which resulted in many FIs undertaking multiple waves of cost containment — sometimes losing some of their appetite for further transformation along the way.

Yet banks cannot let their guard down when it comes to cost containment. While many have made significant progress, they must still avoid costs creeping back into the P&L. FIs need to view inflation not only as a challenge but as a chance to gain competitive advantage, because playing the inflation game right is all about capturing top-line opportunities while being rapidly effective in containing OpEx and capital expenditures.

It's worth noting that banks have historically demonstrated fast reflexes when it comes to cost reduction in inflationary times. Consider the targeted efforts to contain operating costs during the high-inflation period of the early 1980s: the introduction of ATMs, digitization of back-office activities, and consolidation of branches in several large American banks, notably Citibank, led the way. Such initiatives were tactical moves geared to contain rising wages, and signaled the savoir faire of some banks as they entered the new decade.



Four levers to attaining cost excellence amid high inflation

Many banks, despite having achieved creditable results with cost-cutting programs during less trying times, will face ongoing hurdles under high-pressure scenarios. A key example is the COVID crisis, when virtually every major player regretted not being more digitally prepared. The current situation offers a chance to learn from the previous crisis.

Having analyzed numerous cost-reduction efforts carried out by banks, we believe there are four levers that FIs can deploy to not only weather a high-inflation environment but to thrive and deliver sustained cost excellence. These levers are: simplification, accelerated digitization, agile delivery models, and efficient procurement.

Simplification. Pursuing the continued simplification of processes and organization is a necessity for all banks. Using approaches such as zero-based budgeting, lean, value-stream mapping, and delayering, banks can ensure that existing processes are radically streamlined, that new processes are designed to a hit high standard with low manual effort, and that organizational structures are kept flat with minimal hierarchy. Such benefits not only enable a lower cost base, but also provide an advantage in agility, which is critical in highly uncertain times such as the present. In our client work focused on simplification, we have observed a 6% reduction in operating costs through an organizational redesign effort.

Accelerated digitization. Digitization efforts need to be accelerated further. First, in terms of client and employee interfaces (with a renewed push toward digital channels), optimization of branch networks, and end-to-end digitization of key customer journeys in lending and transaction banking. Then, second, in terms of modernizing underlying IT infrastructure. This type of update is particularly relevant for European and US banks, where parts of the IT architecture (such as the core banking system) are often home-grown and not ideal for the implementation of transformational business initiatives. Deeper digitization can lead to savings in the range of 20% to 40% of operating costs in selected processes (including personnel costs), based on our client experience.

Agile delivery models. There are very few changes in a bank that do not require some type of IT support. Therefore, evolving the IT delivery model is a key to unlocking the next level of efficiency. Shifting from a traditional waterfall model to an agile approach yields substantial benefits for banks in terms of cost efficiency, time to market, and ability to attract and retain high-quality tech talent.

Efficient procurement. Banks need to reinforce discipline in procurement, adopting a zero-based approach to non-personnel budgets, putting in place sound rules and governance in decision-making, and promoting frequent supplier reviews and contract renegotiations. In our experience, savings of 5% to 15%, especially in technology-related spend, are very feasible using a rigorous zero-based-budget approach. Thinking more broadly, such an approach also emphasizes the critical role that procurement has to play in the new reality, as high inflation dictates the need for a strategic review of what is done in-house and what is outsourced.

Ultimately, a holistic transformation along these traditional levers can bring tangible and long-lasting benefits. One such effort with one of our clients in 2016-2017 resulted in improved and sustained cost-to-income ratio until the COVID crisis, with the bank retaining a stable cost basis into the current environment as well.

Why things are different in the new reality

The new reality also creates opportunities for banks to use a fresh set of levers to address costs, building on the latest trends. These trends include the changing nature of globalization, the increase in the availability and quality of artificial intelligence (AI), shifting employee expectations for hybrid working models, and multiple opportunities for value-chain decoupling through outsourcing and nearshoring.

Change in globalization. The scaling down of globalization — essentially the way in which many countries, in a post-pandemic form of economic protectionism, are placing more emphasis on their home markets without cutting international ties — is prompting banks to look at their geographic footprint through a return-on-equity (ROE) lens. Many are considering revisiting their presence in foreign countries, making trade-offs on size versus profitability, and nearshoring instead of offshoring certain activities to reduce their exposure to geopolitical risk.

Increasing rise of AI. With AI being increasingly abundant and accurate, banks can now rely on it for various use cases, among them efforts to lower costs. Perhaps the most impactful use case of AI is in credit, where predictive analytics can be used to lower default risk, while also potentially reducing provisions. AI-enabled credit models have already come into play, with neo-banks making their way into traditional banking models. Such enablement can have a positive impact on cost efficiencies, with up to 45% in OpEx reduction for relevant functionalities. Additional use cases for generative AI can be in the form of chatbots (either client facing or internal, such as for knowledge management), fraud detection software, and synthetic data generation.

Hybrid working. Banks can positively leverage shifting employee expectations on remote working and the role of the physical office on multiple fronts. Clearly-scheduled working models can allow for more accurate space planning, potentially resulting in a scaled-down need for real estate. Additionally, banks should strive to make new ways of working a core part of their employee value proposition, further strengthening their potential for talent acquisition and retention. We estimate that optimization of locations for the workforce can have an impact of 20% to 30% on costs related to office space.

Outsourcing and nearshoring. Finally, banks can think even more disruptively about carve-outs, including outsourcing and nearshoring opportunities. Many banks could consider spinning off parts of their activities, especially those that can be automated or scaled down in the future. Banks have already used this lever in non-core areas such as real-estate management, but in the new reality core activities such as IT and loan administration should be on the table. And given that the changing nature of globalization does not strictly mean “local-only” focus, new regional opportunities may appear.



Making it happen

For banks, the profitability stresses and increased customer demands brought about by a prolonged period of high inflation leave little room for error and experimentation. Banks need to be decisive, fast-moving, and precise, which can only be achieved through a disciplined cost-management program that includes full transparency, ambitious targets, clear accountabilities, and worthwhile incentives. No one silver bullet can solve all of the challenges, and it is crucial for

each bank to identify the right steps to take for its own specific situation.

As we have discussed in our two previous **“New Reality in Banking”** articles, the current inflationary environment presents numerous challenges. However, for banks that find the right approach, correctly identify and execute key initiatives, and navigate the journey strategically, the new reality can also unlock numerous opportunities.

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