Management Online REview

CEOs as Leaders and Strategy Designers: Explaining the Success of Spanish Banks

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Abstract

Much management discussion has taken place on whether strategy is centrally designed or emergent-based on the bottom up process, whether motivated management teams can replace the leadership of top executives, whether MBA-trained corporate planners make up for the absence of strategically-minded CEOs, and whether operational factory management techniques such as the Kaizen movement have an effect on strategy, and so on.

Spain and some of its industries appear to offer answers to these discussions since from a relatively small economy such world-class competitors have come to prominence in recent times, as Grupo Santander, BBVA, Telefonica, Zara and others.

Based on our research on Spanish retail banks we conclude that their success is owed essentially to excellent CEOs aided by adequate deregulatory measures and well-defined business models, etc., which confirm the necessity for leadership figures, whilst not excluding necessary support from other management levels to implement strategy.

Keywords: Spanish banks, Leadership, Strategy, CEOs

Introduction

No-one would deny surprise at the emergence of Spain in different walks of life in the last two decades; Telefonica, Zara, Mango, Iberia, Lladró, Chupa Chups and others, have almost become household names. Foremost in this phenomenon is the Spanish banking industry. Grupo Santander and BBVA, two of its leading organisations, are prominent in the ranking of Eurozone banks in terms of market capitalisation. Santander's acquistion of Abbey National showed the world that its strategic orientation points to Anglo Saxon countries, its final objective possibly being penetration in the US. BBVA followed suit acquiring some banks in Florida and Texas.

This article is based principally on Kase and Jacopin (forthcoming). It contends that the Spanish retail banks' success is due to (1) a general framework combining three factors (regulatory environment change, the existence of excellent CEOs, and support from outstanding management teams including COOs) and (2) a basic business model based on three elements (operational efficiency, the strategic use of IT systems, and a penchant for seeking growth through economies of scale).

We elaborate on this general framework and the basic business model below.

The General Framework

Figure 1 illustrates these three factors in the general framework.

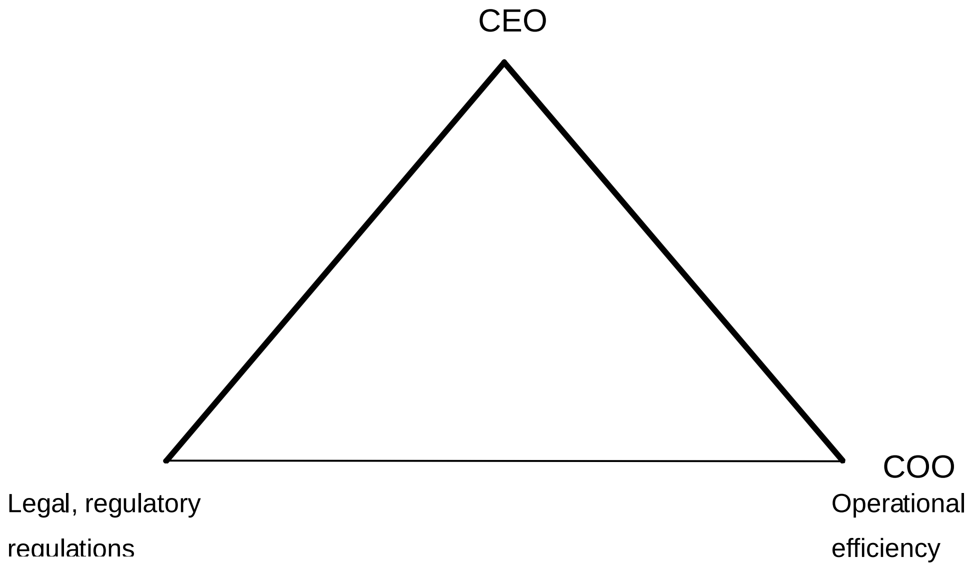

Figure 1. Three Factors in the General Framework of Spanish Banks' Success
Source: Kase and Jacopin (forthcoming)

Regulatory and Legal Framework in Historical Perspective

A major spurt in the rate of change of the Spanish banking industry came about in 1971 when branch opening restrictions were lifted. Some facts are relevant: (1) a radical difference appeared in the percentage of market share held by the banks; some like Santander increased thanks to their aggressive expansion strategy, while others disappeared as independent entities, (2) the concentration of market-share held by the ten largest banks increased from 49 per cent to 92 per cent, and especially (3) the increased concentration of market-share held by the two largest banks which by 2005 controlled as much as 70 per cent of the Spanish market.

During the aftermath of the crisis in the 1980s that followed these liberalisation measures some of the most significant players disappeared, while others managed to position themselves amongst leading global banks in terms of market capitalisation. Due to active merger and acquisition polices, out of the large banks formerly known as the "Seven Big Players", Banesto (originally the largest bank), Banco Central, and Banco Hispanoamericano disappeared as independent entities, whereas those that had held a lower market-share originally, in particular, Santander, Bilbao, and Vizcaya, began to figure as leading banks thanks to their belief that innovation would succeed, and their search for profitability and operational efficiency.

Thanks to a sea change that took place after a series of dynamic regulatory measures, the Spanish banking sector developed from inefficient and backward to a European leader in its sector. Spanish banks benefited from the new international banking regulations, Basel II, Solvency II and IAS. This aside, some prudential measures, such as their obligation to cover credit at a higher percentage than their competitors and the unequal treatment of banks and savings banks, were to constitute barriers to their development.

CEOs and COOs

Deregulation of the sector nurtured competition between the banks, giving rise to a significant improvement in efficiency and profitability.

However, perhaps most relevant to the development of the Spanish banks is the role played by their leading executives; the chairmen, CEOs, and COOs, whose decision-making made the most of the regulatory environment and actually influenced regulatory conditions to enable a radical transformation of their sector. Failure to consider these different leaders, would make it difficult to offer a convincing explanation of the diverging paths taken by different banks facing the same business and regulatory environment – such is the case with Banco Popular and Bankinter on the one hand, and Santander and BBVA on the other.

The relevance given to the CEO's knowledge and skills relates to trends in strategic thinking – the cognitive approach to strategic decisions.

Kase, Sáez-Martínez, and Riquelme's (2005) framework, on which this analysis draws, considers the cognitive perspective, analysing top executives.

In their four case studies on some of Japan's highly successful CEOs, Kase *et al* (2005) identified two differing strategic approaches based on two different cognitive processes. They are the value-laden, culture-bound, long-term oriented Proto-Image of the Firm (PIF) and the cash-flow generation, matter-of-fact, and rather short-term surviving Profit-Arithmetic (PA) processes.

While Sony's Mr Ohga has a clear image of what the essence of Sony is, or should be, Shin-Etsu's Mr Kanagawa acts in accordance with his extraordinary business acumen which allows him to discern what levers should be pulled to produce profit.

If we call Mr Ohga's way of basing his judgment on a specific image of a firm the *proto-image of the firm (PIF) approach* then, by contrast, Mr Kanagawa operates on the basis of processing data and information through a mental model enabling him to discern which options are profit levers and which are not. This we call the *profit arithmetic (PA)* approach.

Kase *et al* (2005) stress that neither approach is superior. In each situation it depends on the business environment and skills and experience of the executives concerned. As a rule, the faster the pace of change in the business and technology environment, the better the firm does if PIF is adopted (provided the firm's financial position is solid). In a more mature business environment or with a predictable pace of change, the better the PA-approach particularly, when the firm is in jeopardy and its survival questionable.

Our theory is that the strategic approach taken by Spanish banks shows clear traits of being PA; their emphasis on daily operations rather than a grand long-term vision, their focus on the continuous improvement of operational cost efficiency, their stress on the creation of value for shareholders as the primary concern, and so on.

The adoption or perhaps emergence of the PA approach may find its origin in the banking crisis and consequent transformation in the 1970s and 1980s in Spain.

Firstly, overcoming the crisis required more focus on profit and cash flow generation. Secondly, the PA approach favoured such focus and helped to foster the improvement of operations management and thirdly, even though in the process the retail banks lost their market share in favour of savings banks, the approach helped some of the bank CEOs to discover that the fostering of a penchant for growth in size was essential to outmanoeuvre their competitors. The competition for size encouraged mergers and acquisitions, which ultimately shrank the number of major players in Spain from seven to four by the turn of the century and to three (Santander, BBVA and Popular) by 2007. These mergers also highlighted the need to integrate and improve IT systems if the resulting banks wanted to compete strongly in the competitive arena[1]. Therefore, the penchant for growth, begun around the time when the PA approach was put in place by top management at the banks,

[1] JI Goirigolzarri, BBVA's Presidential COO, refers back to the keen need they felt to integrate and improve IT systems when Banco de Bilbao and Banco de Vizcaya merged in 1988.

gave rise to excellent IT systems, which combined with other strategic components such as the powerful pursuit of operational excellence, contributed to the emergence of a world-class generic business model.

The Basic Business Model

The second element in the Spanish retail banks' strategy is founded on a basic business model. It comprises (1) bias towards size resulting in focus on the dual strategy levels – business/competitive, and corporate-level strategies, (2) pursuit of operational efficiency (ratio of efficiency), and (3) strategic use of IT systems, and open and modular product architecture. (See Figure 2).

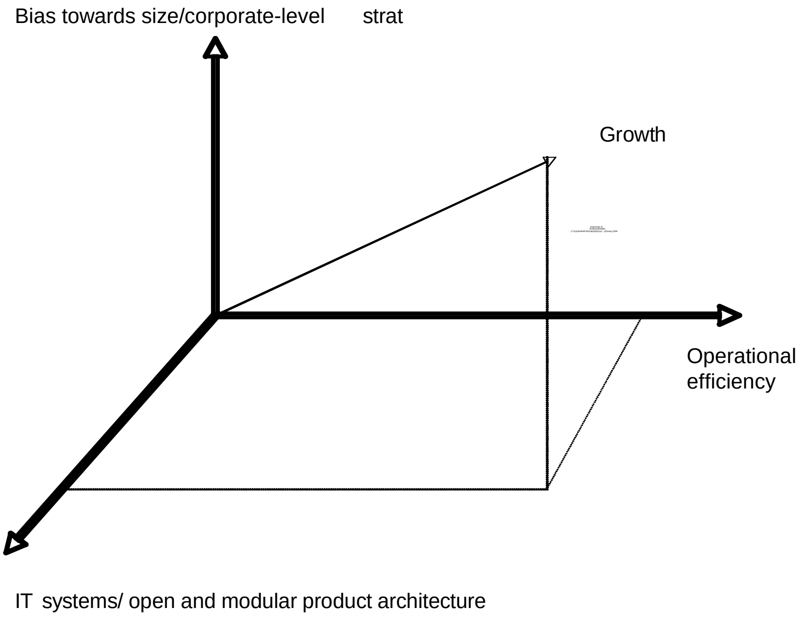

Figure 2. IT Systems, Pursuit of Efficiency and Bias Towards Size and Growth
Source: Kase and Jacopin (forthcoming)

Bias Towards Size Based on Dual Focus on Business and Corporate-level Strategies

For-profit organisations fight their battles on the basis of business or competitive strategy either by cost leadership or differentiation. Banks are no exception.

In a world characterised by diminishing financial spreads, that is a decrease in the difference between the yield on lending and interest paid to deposit holders, cost efficiency is essential for prosperity, if not survival.

The Spanish retail banks are well-known to have been successful in lowering costs, as can be seen from their efficiency ratios (operational costs incurred divided by income). In worldwide and European efficiency ratio rankings they hold the highest positions.

However, in many industries the prevailing key to success has been quietly shifting to corporate-level strategy, defined as "domain selection" in contrast to "domain navigation". The purpose of corporate-level strategy is the creation of value at the level of the corporate centre or parent organisation, in pursuit of profit maximisation for the company as a whole.

The careful combination of business areas allowing the corporation to generate higher profits is one of the main issues at this level of strategy.

Size of the corporation in terms of market capitalisation has become more important in the banking industry, as it has in other industries such as cement (dominated by Lafarge, Cemex, etc.) and steel (where Mittal is the clear market leader). Globalisation giving rise to an increased need to invest in research and development, above all in Information Technology, plays an important part in bringing this about.

Where the fight for market share takes place over years or decades, effective and continual effort on the business or competitive strategy level may be successful. However, for banking entities that stay focused on their domestic local markets, the time for effective competition is running out. In our interviews with top management of both Santander and BBVA, they emphasised the importance of growth in size, using phrases such as "growth is in our genes[2]" and "we are like the Romans[3]" in planning growth and implementing their business plan.

The discussion of economies of scale in the academic forum is a moot point. However, considering the behaviour pattern of the large Spanish banks, there seems to be an underlying belief in the need to create economies of scale that simultaneously guides and obfuscates the banks.

Regardless of whether it is grounded in actual economic benefit or not, the growth in size and the attainment of presence in multiple national markets and geographic regions have become of utmost importance for the major players in the banking industry. Mergers and acquisitions to take over local banks and run local operations are deployed with dexterity and form the core of corporate-level strategy. Thus, in order for banks to compete and become world-players, it is not sufficient for them to have effective competitive or business strategies; they must also design a winning corporate-level strategy.

From observation of the strategy employed by the Spanish banks, it can be concluded that they combine business and corporate-level strategy very well.

Operational Efficiency

Why is efficiency one of the cornerstones of the Spanish banks' strategy? What role does IT play in increasing operational efficiency? And how does the replicability of the business model fit in?

Efficiency gain is the quintessential challenge for all retail banking. The commoditisation and securitisation processes in the financial sector are taking heavy tolls on the financial institutions' coffers, as "improving technology and the continuing decline in transaction costs has added to the intensity of the competition" (Merton, 1995: 26).

"When banks take deposits, they are essentially combining the payment and pooling functions. Lending combines a transfer of resources with risk management" (Crane & Bodie, 1996: 112).

These functions can be discharged by non-bank financial institutions such as money market mutual funds against which the only way to compete is "by cutting costs and striving to be

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[2] Interview with Alfredo Sáenz, Santander's CEO, on 3rd July 2006 at the bank's headquarters in Santander.
[3] Interview with José Ignacio Goirgolzarri, BBVA's presidential COO, on 16th April 2007 at the bank's headquarters in Madrid.

more efficient" (Crane & Bodie, 1996: 114). From this, it follows that, in order to survive, banks have to pursue the maximum efficiency gain in their operations.

Have the Spanish banks attained efficiency? Spain has certainly positioned itself as the top runner in this ratio with 53.87 as compared to the UK with 54.98 and Ireland's 55.12.

Santander's data shows constant improvement — from 62.1 in 1998 to 42. in 2005. Its Portuguese operation, Santander Totta, reached 43.7 as early as 2003, better than the 49.3 which Santander achieved that year.

So how do they attain efficiency? To a large extent, the answer can be found in IT systems and product architecture. First, let's have a look at IT systems and their strategic use to see how they contribute to the Spanish banks' operational excellence and cost efficiency. Open and modular architecture facilitates efficiency using IT systems, so we will review and analyse this type of product architecture and the way in which Spanish banks achieve this.

IT Systems, and the Modular and Open Product Architecture Triangle[4]

IT systems

Three reasons tend to be given for the importance of IT systems in the banking industry. Firstly, due to better access to information across different geographical areas and time zones, the reduction in dissemination time, and a larger capacity to store and process information.

Secondly, in light of the fact that banking fundamentally concerns the handling and management of risk, IT systems can bring about better customer relations and therefore improve the chance of customers buying more products and services. IT systems can also improve operational efficiency and may give rise to better decision-making. Given the huge amount of investment in research and development required, banking is really one of the pioneering industries.

Thirdly, in the event of a takeover, a strong IT system can allow the acquisition of a target bank with a less developed one. Banco Sabadell's José Oliu (Oliu 2006: 12) validates the Spanish banks' acquisition of other European ones, since the latter tend to lag behind the former in their use of IT systems. This translates to 6 to 15 points difference in efficiency ratio. Oliu alleges that the improvement to the acquired bank's operation efficiency thanks to the use of better IT systems alone can offset the acquisition cost.

Spanish retail banks stand out in their use of IT systems. 60 per cent of banking experts consulted by the Conference of European Banks believe that the Spanish banking industry is equipped with the best technology base. The Spanish banks' core system, namely, the set of basic applications that support standard banking operations, is recognised as functioning perfectly. Spanish banks show the highest efficiency indicators in the use of IT systems. Thanks to the efficient use of IT systems Spanish banks have the lowest number of employees per branch — 6 as against 13 in Italy and 45 in the UK.

In line with their PA focus on cash flow generation and operational efficiency the Spanish banks are characterised, in their use of IT systems, by the emphasis on (1) internal advantage (*vis-à-vis* external advantage) and (2) proven technology (*vis-à-vis* ground-breaking pioneering technology).

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[4] We draw mainly on Gómez (2007).

Firstly, Spanish banks make use of IT systems fundamentally to improve their back-office operations, rather than to differentiate their products and services. Clients benefit from IT systems by way of better quality of service and not so much by external or apparent advantage of differentiated products or services.

Secondly, Santander and BBVA tend to take on proven technology in lieu of adopting a ground-breaking, revolutionary one. These banks introduce the technology that clearly yields immediate advantage and apply it across the board to all their operations.

In conclusion, for the Spanish banks technology constitutes an essential element of their business. However these banks tend only to consider technology to the extent to which it is beneficial for their operations — improvement in their efficiency, much in line with their PA mind-set.

Product Architecture Oriented to the Open and Modular Type

Spanish banks pursue their cost leadership advantage by commercialising similar products and services throughout their geographic spread, homogenising their offer. This gives rise to substantial savings in R&D expenses by applying skills and knowledge already learnt in one area, and the comfort of offering quality-assured products and services, as described in Nafría (2004). Product design is based in Spain and the bank's effective use of IT systems facilitates the introduction of these products into different markets.

The offering of the same or similar financial products is facilitated by the open and modular nature of the product architecture. Product architecture is the concept relating to the way in which the core components forming a product are combined (Fujimoto, 2003: 59). There are two types of product architecture: (1) modular and (2) integrated. The modular (and open) type allows the assembly of standard, ready-made components procured from external suppliers without much need to fine tune between them, in contrast, the integrated (and closed) type requires integration and optimisation of an interface between the components (Fujimoto, 2003, 2004).

The modular-type architecture is based on the combination and assembly of standard parts and components using standard production facilities (without modifying them too much); and the integration-type architecture obtains new product and new product functions by adjusting and adapting pieces and components to each other (Fujimoto, 2004a).

Product architecture can also be classified by open and closed types (Fujimoto, 2003: 89). An open type is basically the modular type but the interface between components is usually standardised across the industry. Product assembly is feasible without the need to interface the differences. A closed type is named as such because of the exclusiveness of the interface design.

The ability of the Spanish retail banks to convert their product architecture into the modular and open type enables them (1) to make the most of the IT systems advantage, i.e. the management control of costs and personnel, and (2) to implant the same or similar products and services in different geographical markets without the need to rely too heavily on the skills and capabilities of local staff.

The open and modular product architecture is very much in line with the trend in the use of IT systems to gain competitive edge. Moreno and Avendaño (2006: 13) list as future trends: (1) industrialisation and standardisation of IT systems (presumably facilitated by open and modular product architecture) and (2) the conversion of branches into 'supermarkets', i.e. places where standardised financial services are sold.

Conclusions

We have discussed and analysed in this article the framework and business model that favoured entering the world competitive landscape of the Spanish retail banks.

A major part of our thesis is that (1) the Spanish retail banks use the operational efficiency-based business model following the cash generation-centred Profit Arithmetic approach, (2) it fits the retail banking environment leading, and (3) therefore these banks have achieved amazing success in recent years.

One of the key aspects of the business model is its dependence on leadership by top executives, which means that this success, whether continued or not, is contingent on how their successors are chosen and how they cope with the challenge.

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