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## NATIONAL BANK (A)

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Martin Frost paced beside the vast glass walls of his Manhattan office, hardly noticing the panorama of rooftops spread out below him. One of 41 senior vice presidents of the National Bank, Frost, at 31, was the youngest person in the bank's history to reach this management level. He headed the bank's Operating Group (OPG). OPG was the back office of the bank that performed the physical work of processing National's business transactions and designing its computer applications and infrastructure, as well as managing the bank's real estate and internal building services. Today, musing about the forthcoming operating year and his plans for the next five years, Martin Frost was both concerned and angry.

He was concerned that his recent reorganization of the Operating Group, though widely recognized as a success, was not sufficient. His area still followed the traditional working procedures of the banking business, and OPG was still seen by the rest of the bank as a necessary evil that, tolerated by its more intelligent brethren, should muddle along as it always had. After a year with OPG and five months as its head, he still had few concrete measures of its performance. But most of all, Martin Frost was concerned that his initial concept (that OPG needed continuously higher levels of investment in technology to manage the banks' transaction systems to reduce paper and processing time) might be both impractical and irrelevant. Frost's new staff assistant, Karen Creighton, had been pushing hard for a change in management approach to one that emphasized budgets, costs, and production efficiency, instead of system development.

And, uncharacteristically, Martin Frost was angry. He looked again at the management report he had received the day before. Only now, in September, had he learned that his headcount had grown by 400 people in July and August. Maybe Karen Creighton really was onto something, with her stress on control and management.

The Operating Group was one of the six major divisions established in a reorganization five years ago. The five market-oriented divisions generated varying demands for OPG services. All of them were looking forward to continued growth in the coming year, and all were pressing for improved performance by the Operating Group.

National's Personal Banking Group (PBG), with 181 branches and 6,000 employees, provided a full range of services to consumers and small businesses in the metropolitan New York area. As the area's leading retail bank, PBG projected a 3% annual growth in the number of chequing accounts, and a 2% annual growth in the number of savings accounts over the next several years. In addition to an increase in the number of accounts, PBG anticipated continuation of the recent trend toward increasing levels of product cross-sell per household and adoption of direct banking services.

The Investment Management Group (IMG), with 1,700 employees, managed assets for personal and institutional investors, and provided full banking services to high net worth individuals. In the latter

category, the group currently carried some 7,000 accounts, and IMG hoped to increase this figure by 25% in the next four years.

The Corporate Banking Group (CorBG), itself subdivided into six industry-specialist divisions, served big business (generally, companies with more than \$40 million in annual sales), financial institutions, and government accounts within the United States. CorBG aimed at an annual growth rate of over 8%, but qualified its ambition. In order to gain market share in the increasingly competitive world of the major corporations, the bank would have to improve both the breadth and the quality of its services. Operating Group errors, CorBG said, had irritated many major account holders, and OPG's reputation for slow, inaccurate service made expansion of market share very difficult.

The Commercial Banking Group (CommBG) operated 16 regional centers in the New York area to serve medium-sized companies. Most did not employ their own professional finance executives, so they often relied upon the bank for advice as well as banking services. After negative growth in the recent recession, Commercial Banking projected an annual growth rate of about 10%.

The International Banking Group (IBG) operated some 300 overseas branches, in addition to managing several National Bank subsidiary units concerned with foreign investments, services, and leasing. IBG conducted its own transaction processing at its overseas centers. However, its rapid growth would nevertheless make new demands on the Operating Group in Manhattan. All business originating in New York was handled by Frost's people, through the head office infrastructure. The IBG complement of 160 New York-based staff officers was expected to double in five years.

Worldwide, National Bank Corporation had shown assets of \$23 billion in its financial statement last year. Earnings had been \$99 million after taxes. The corporation employed 34,000 people, having doubled its staff over the previous 10 years, while tripling its assets. National Bank's published goals for financial performance presented another source of pressure for improvement in OPG. Board Chairman Bruce J. Walters had recently committed the bank to a growth rate of 15% in earnings per share of common stock. President Gary James had made it clear to Frost that OPG was expected to contribute to this gain in earnings.

## **THE OPERATING GROUP'S FUNCTIONS**

As the bank had grown, so had its operations. Increases in services offered, in customers, in volume per customer, and in staff all meant added transactions to be processed by OPG. As the volume of transactions through the bank increased, so did the operations staff and budget. Currently, Martin Frost had some 8,000 people on his group payroll, and he would spend \$205 million on the direct production of the bank's back office processing. For several years, transaction volume had increased at an annual rate of 5%-10%. OPG's total expenditures had grown faster, however, at an average of 17.9% per year over the last 8 years.

OPG headquarters was a 25-story building on Wall Street, several miles south of the bank's head offices. The volume and variety of work flowing through this building were impressive. In a typical day, OPG would do all of the following:

- Transfer \$10 billion between domestic and foreign customers and banks
- Process \$4 billion worth of cheques, between 3 million and 4 million individual items
- Start and complete 3,000 jobs in the processing center, printing ten million lines of statements, cheques and other reports.
- Process \$200 million worth of bill and tax payments for major corporations and government

agencies (During the 16 weeks between February 1 and May 30, the group also processed 100,000 income tax returns per day for the City of New York.)

- Handle 350,000 telephone calls, 525,000 e-mails and 14,000 telegrams/cables/faxes
- Mail out 60,000 chequing account statements and 50,000 other items, requiring postage expenditures of \$40,000 a day.

## **OPERATING GROUP ORGANIZATION**

About a year ago, Martin Frost transferred from the International Banking Group into OPG to become a vice president of the bank and to set up a task force pointed toward reorganization of the group. He had assembled a team of young, technically oriented managers (most of them relatively new to OPG) to analyze and arrange the basic functions of the group. Systematically, this task force had examined the structure and function of each OPG subdepartment. The taskforce worked with the line managers to question where the subgroups fit in the organization, to whom their managers reported and why, what processes and technologies they shared with other groups; and how the physical output of each group affected the operation of the next sequential processing step. The result of this project was a complete realignment of reporting responsibilities, pulling together all those groups doing similar work, and placing them under unified management.

A leading member of OPG's systems management team during this reorganization effort was Jason Petite, who had followed Frost from the planning staff at the IBG. A graduate of Brown University (with a degree in Spanish literature), he set the keynote for the task force approach with his concept of basic management principles:

Managing simply means understanding, in detail, in meticulous detail, where you are now, where you should be, and how to bridge the gap. To know where they are now, managers must measure the important features of their systems. To know where they are going, managers must agree on their objectives, and on the specific desired values of all those measured factors. And to know how to bridge the gap, managers must understand the processes which produce their results. Significant change demands the participation of the people involved, in order to gain the widespread understanding required for success. Management is essentially binary. All change efforts will be seen as either successes or failures. Success follows from understanding.

Few major changes in equipment or physical space were required by the new organization, and the approach characterized by Petite's statement made the transition an easy one. By the end of that year, OPG was running smoothly under a four-area structure.

Area I was the operating part of the Operating Group. It included the people who processed the transactions that constituted the bank's business. Area I operated the computer network and systems for both face-to-face and direct banking channels, processed cheques for collection from other banks, posted the accounts for customers, transferred funds from one customer to another, and prepared customers' bank statements.

Area II encompassed system design and software for computer operations. It was the intellectual side of OPG, developing new computer systems and corresponding governance for the use of Area I. The subgroups in charge of operations analysis, management information systems, and data control also belonged to Area II, as did the programming group in charge of ALTAPS, a new automated loan and time

payment processing system.

Area III, quite removed from OPG's paper-oriented processing groups, was a freestanding organization in charge of National Bank's real estate, physical facilities, and building services. (When he was not concerned about processing transactions in the back office, Frost could worry about the quality of cafeteria food and the cleanliness of the bathrooms.)

Area IV was composed of the relatively low-volume, but growing, high-value transaction processing departments - stock transfer, corporate bonds, corporate cash management, mutual funds, and government services.

In addition to routine day-to-day operations, Frost was responsible for the long-range development of both computer infrastructure and applications. For several years, a subsidiary of the bank, with operations in Cambridge, Massachusetts, and California, had been working on the kind of internet-based systems and support that would be required to facilitate "straight through processing" that was beginning to replace paper-based processing. Frost had decided to maintain the separation of this advanced research and development activity from OPG. "Let's face it," he said, "when new systems arrive now, they come as a revolution, a total replacement of existing technology. We should develop the new systems, sure. But we shouldn't let them screw up the systems we need today and tomorrow in the meantime."

In September of this year, Martin Frost, feeling comfortable with the overall structure of OPG but impatient with its lack of measured progress, had assigned Petite to head Area IV. Petite's demonstrated skills in management of change held out the promise that this highly sensitive area, where any errors could cause major problems for the bank's most important customers, would soon be under more effective control. Now Frost was considering the future course of Area I, where even more people and dollars were involved.

Area I managed the largest single function performed by OPG. Some 3,000 employees handled the complex physical flow of paper and communications, working with the computer systems that enabled workflow, posting, distribution, and statement processing. The Area worked around the clock to ensure processing and reporting were managed as required to facilitate Branch operations and to satisfy Federal Reserve System rules. Encoders and system operators were generally women, who worked on an incentive pay arrangement. No direct record of accuracy was kept, and operators were not penalized for errors.

## **THE OPERATING GROUP STAFF**

By tradition, OPG was a service function to the customer-contact divisions of the bank. National Bank's top management attention was directed outwards, toward the market. OPG was expected to respond to change as generated and interpreted by the customer-contact offices. As a consequence, tradition held that the career path to the top in banking led through line assignments in the market-oriented divisions. "The phrase 'back office' is commonly assumed to mean 'backwater'," said Frost. "Operations is a secure haven for the people who have grown up in it. But everyone else thinks of it as the place of exile for the under-performers from the other divisions."

Most of OPG's management was made up of career employees who had spent 15 to 25 years with the group, often beginning their service with several years of clerical-level work before advancing to supervisory jobs. Through years of contact with "their" outside divisions of the bank, managers had built up rich personal acquaintances with the people they served and this was a source of strength for National Bank. Frequent e-mail and telephone contact reinforced these relationships. Wade Brandt, OPG's vice

president for administration and a veteran with 42 years' service with the group, commented on the close interaction between OPG people and the customer-contact offices:

Problem solving here is typically done on a person-to-person basis. For example, an account officer in International Banking, faced with tracing some amendment to a letter of credit, would know that Anna Lehman, an assistant vice president on the 22nd floor, could find the answer. He'd call or e-mail Anna, and yes, Anna would get him an answer. Whatever else Anna was doing in the Letter of Credit Departments could wait; when a customer needs an answer, our people jump. They're proud of the service they can give.

Recruits for the managerial ranks of the bank typically came directly from the college campus. Brandt described the process:

We hire people straight out of college. Most of them have little business experience. We shuttle them around in a series of low-level jobs, while they learn the bank. We don't have the glamorous jobs that IBG and Corporate can offer, but even so, there's a lot of prestige to working for National Bank, and the security we offer means a lot to some of these people.

## **MANAGEMENT SUCCESSION AND THE CHANGING ROLE OF THE OPERATING GROUP**

Brandt traced the recent succession of top managers at OPG:

The CEO of ten years ago, convinced the Policy Committee that our operating capabilities were becoming more and more important, that we simply couldn't afford to take them for granted. Our ability to manage transactions in a state-of-the-art fashion was critical if we were to compete successfully.

The first clear signals that management attitudes towards the Operating Group were changing came shortly afterwards, when Gary James was appointed executive vice president in charge of Operations. Mr. James was generally regarded as a prime candidate for the bank's presidency. It was plain that his appointment wasn't some form of punishment. He had to be here for a reason, and the reason had to be that Operations was, after all, an important part of the corporation.

It was Gary James who recruited Martin Frost to move from the International Banking Group to Operations, and who promoted Frost to senior vice president. That was another sign that things were changing," Frost said. "For one thing, nobody my age had ever made SVP before. But more important, I wasn't a 'banker' in the traditional sense. Most of Operations' management had been in the group for 15 to 30 years. I'd only been with National Bank for 5 years and none of that was with OPG."

Frost's undergraduate training had been in American literature and physical metallurgy. After a brief job with Goodyear Tire and Rubber and a tour in the Army, he had taken a master's degree in management at Massachusetts Institute of Technology. He then joined the IBG planning staff, where he applied systems

concepts to the international banking field with impressive results. His rise in the organization was not at all the usual pattern of career development, as the experience of other bank officers suggests. For example, a gray-haired senior vice president from the Corporate Banking Group reported: "I've spent all my life in the bank. I was trained by assignment to different departments every two years; then, when I went into a line position, I had enough experience to correct something by doing it myself. At the very worst, I always knew people in the other departments who could straighten out any problem."

A PBG vice president said: "I started with National Bank as a night clerk in Personal Banking. It was 10 years before I reached supervisory ranks, and by then, I'd had a lot of experience in credit and in operations as well."

A newly appointed assistant vice president in the Operating Group added: "I joined the bank as a naive liberal arts graduate, and spent three years in clerical work before making first-line supervision. After eight years as a supervisor, you get a pretty good feeling for what's happening around you."

About a year ago, to the surprise of no one, Gary James was named president of National Bank Corporation. Frost despite his youth, non-banking background, and all, was selected to head the Operating Group.

### **OPERATING GROUP COSTS**

Frost was concerned that too often, the method of meeting increased work loads in banking was to increase staff. If an operation could be done at the rate of 800 transactions per person per day, and the load increased by 800 pieces per day, then the manager in charge of that operation would hire another person. It was taken for granted. Financial reports would follow, showing in the next month-end statement that expenses had risen, and explaining the rise through the increased volume of work processed.

But beginning about ten years ago, the work load began to rise faster than the hiring rate could keep up. Moreover, operator productivity decreased. Backlogs of work to be done would pile up in one OPG department or another, and they could not be cleared away without overtime. Even with extensive reassignment of people and with major overtime efforts, some departments would periodically fall behind by two or even three weeks, generating substantial numbers of complaints from customers. Three or four times a year, special task forces would be recruited from other branches of the bank to break the bottlenecks of these problem departments. Trainees, secretaries, junior officers, and clerks would be drafted for evening and weekend work, at overtime pay rates. "The task force approach is inefficient, annoying, and expensive, but it gets us out of the hole," said Brandt. "A lot of these people don't *want* to work these hours, but it has to be done." OPG spent \$1,983,000 on overtime pay this past year.

There were other sources of expense in the Operating Group that did not show up on financial reports. Frost described a major area of hidden costs.

### **OPERATING GROUP QUALITY**

"Quality is something we have a tough time trying to measure," said Brandt. "But we can get perceptions that the level of service we're providing isn't acceptable. For all our outlay of expenses, it seems we are not improving, or even maintaining our performance."

Indications of poor service came to OPG in the form of customer complaints, usually voiced through

account officers from the market-contact divisions of the bank. Failures could take many forms, including loss of cheques after they had been posted, late mailing of statements, miscoding of cheques, payment of cheques over stop orders, misposting of transfers, and, on occasion, loss of whole statements. Since any kind of error could cause inconvenience to the customer, the people in direct touch with the market were highly sensitive to quality. These account officers frequently assumed the role of problem solvers on the customer's behalf, travelling to the Wall Street office to work directly with OPG staff to remedy specific errors affecting their accounts. A separate section had been set up to analyze and correct errors in customer accounts. Its backlog of unsolved inquiries was a major indicator or management of OPG's quality level. In the fall of this year, this investigations department faced a backlog of 36,000 unsolved cases. This was an astronomical number for banking where your reputation is based on accuracy and, in addition, put National Bank at risk for compliance breaches.

The importance of error-free operation to the customer-contact officers was pointed out by several officers from outside of OPG. A vice president from Corporate Banking Group said:

Sure, I know the volume of paper has gone up despite the technological advances we've made. I know we have over 1 million accounts, and most of them are handled for years without a mistake. But Operations has to perform at 100%, not at 99%. Errors can be terribly embarrassing to the customer. Repeated errors lose customers for us. Of all the cheques processed last month through one of our major government accounts, 600 cheques aren't showing up on the statement. There were 400 missing from the previous month's statement. Now how can I sell additional services to that account, when we can't even produce a correct monthly statement for them? I don't know if it's a glitch in the software or the processing, but this doesn't work for us.

An assistant vice president from Personal banking added:

We tell the customer that their cancelled cheque is their legal receipt, and then we lose the cheque. What am I supposed to tell them then? I can get them a copy of the cheque, but that's not very useful as a legal document, is it?

An account officer in the International Banking Group said:

Just getting a simple transfer through the books can generate a whole family of problems. Here's a typical case. A translator at 111 Wall Street miscodes the original transaction (it was written in Portuguese), and the transfer goes to the wrong account. When that customer inquires, we trace the error and reverse it. But before the correction goes through, a follow-up request comes in by e-mail from Brazil. It's a duplicate of the first request, and our people don't catch the fact it's a follow-up, so they put through another transfer. Now the same item has gone through twice. Where does it all end? My customer is tired of writing letters, e-mailing, and faxing about it.

And a CORBG vice president sighed: "If our operations were perfect, we'd have a tremendous tool to go out and sell against the competition."

## THE TECHNOLOGICAL FIX

An important issue for OPG was the extent to which its problems could be remedied through technology. Frost explained:

The customer-contact side of the bank, and, to some extent, the top management group, shows a natural tendency to press in the direction of great, massive, new, total computer systems, bringing the ultimate promise of technology into instant availability. But maybe we've all been brainwashed.

The Operating Group was, and had been for several years, at the state-of-the-art level of computer use. A new survey by the American Bankers Association seemed to verify this conclusion. Whereas the average large bank spent over 30% of its back-office budget on machine capacity, OPG spent less than 20%.

Frost paused beside his corner window and said:

Think about this for a minute. We've been running this operation as if it were a computer center. We've been hoping for some Great Mother of a software system to come along and pull the family together. Well, she's slow. None of us children has heard one word from her. Maybe she's not coming. What if it's *not* a computer center we have here? What other point of view could we take that would result in running the Operating Group differently? Better? What if it's a *factory* we've got here?

## THE FACTORY CONCEPT

Earlier this year, Frost had worked with Petite and Creighton to develop the implications of viewing OPG as a high-speed, continuous-process production operation. Creighton, working without an official title, had just joined Frost's staff after six years with Ford Motor Co., most recently as manager of engineering financial analysis for Ford's product development group. At the age of 35, with an Ohio State Bachelor of Science degree and an M.B.A. from the University of Florida behind her, Creighton brought a firm conviction to OPG that strict attention to budgets, measurements, and controls was the only way to run a production operation.

Now, in early September, Frost was trying some of these ideas on Brandt to get a sense of their impact on the traditional banker. Brandt had almost decided to carry a new program to the Policy Committee of the bank, and he wanted to anticipate their reactions.

We know where we want the Operating Group to be in five years' time. For this year and the next, we want to hold expenses flat. In spite of the rising transaction volumes we'll keep the same expense level as this year, and after that we'll let costs rise by no more than 6% a year. In five years, that will mean a \$70 million annual saving compared to uncontrolled growth at 15%. At the same time, we want to implement "straight through processing", improve service, and eliminate our bottlenecks and backlogs, like the jam-ups in investigations.

To accomplish those goals, though, we will have to put over a

fundamental change in outlook. We must recognize the Operating Group for what it is, a factory, and we must continually apply the principles of production management to make that factory operate more efficiently.

It is not important for the people in the factory to understand banking. We'll take the institutional objectives and restate them in terms of management plans and tasks that are quite independent of banking. The plain fact is that the language and values we need for success are not derived from banking, and we couldn't achieve what we want in terms of systems development and operations if they were.

To control costs, we must think in terms of costs. That means bringing in management people trained in production management, tough-minded, experienced people who know what it is to manage by the numbers and to measure performance against a meaningful budget. We have to infuse our management with a new kind of production-oriented philosophy, and the process has to start with new, outside points of view. Good production people in here can provide a seed and the present management staff can grow around the seed. Some of them will make it. Others won't. Our headhunters can find the top factory management people to start the ball rolling. From there on, it's up to us.

Our costs are out of control because we don't know what they are, let alone what they should be. Our quality is criticized when we don't have any idea what quality really is, or how to measure what we're already doing. Our processes run out of control and build up backlogs because our efforts are aimed at coping with transactions instead of understanding what made them pile up in the first place.

I'm not talking about turning the Operating Group *into* a factory. I'm talking about recognizing that it *is* a factory, and always has been. The function isn't going to change, but the way we look at it and manage it must.

Frost turned to Brandt, who had been listening intently, and said: "What will they say to that, Wade?"

Brandt smiled and his eyes sparkled:

They'll go for the stable budget idea, and, in spite of scepticism, they will hope you can do it. They'll love the idea of improved service, but they'll know you can't pull that one off if you're holding costs down. And the factory management idea?

There's one other bit of history you should know, Martin. The first engineer we ever hired to work here was an eager guy, really impressed by the challenge of managing back office operations. He poked around for a few days and then came back to the head office to declare that this wasn't a bank at all. It was a factory, he said. Nothing but a God damn paperwork factory. That was after just two weeks on the job. It was his last day on the job, too.

Frost grinned broadly and turned to face Creighton, "Are you ready to move out of the office Karen? This concept is going to fly, and we're going to need someone down at Wall Street who can make it happen. Why don't you get yourself ready to take over Area I?"