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# 1

## Introduction and Overview of Book

Spain's economy, with its nominal 2005 Gross Domestic Product (GDP) estimated at US\$1,126 billion, is ranked 9th in the world; dwarfed by the United States at US\$12,456 billion, Japan at US\$4,567 billion and Germany at US\$2,795 billion, according to the International Monetary Fund<sup>1</sup> (IMF).

Despite her relatively small size, Spain now boasts world-class business entities such as Telefónica, the telecoms giant, Endesa, the electricity utility company, and Inditex, the clothes manufacturer responsible for global brands such as Zara. But in the forefront of Spain's multinational companies (MNCs) are Santander and BBVA, both banking giants.

Spain's Banco Santander Central Hispano and BBVA have become two of the largest banks in Europe. Now larger than German, French and Dutch institutions, the Spanish banks are competing with the powerful institutions of Britain, much like the fleets of Spanish galleons that competed against the English in the sixteenth century. (Universia-Knowledge@Wharton: 2005)

As shown in Table 1.1, in terms of assets Santander, including Banesto, was the 13th largest bank in the world with BBVA at 38th in 2006. They are also outstanding in 'value creation'<sup>2</sup> for their shareholders, as set out in Table 1.2.

In what Fernández and Carabias (2002; 2006; 2007) call 'value created for shareholders', Santander and BBVA are particularly outstanding, though all of the banks showed excellent results where the revaluation of euros invested in these banks in 1991 is concerned (Fernández & Carabias, 2007: 3). As a matter of fact one euro invested in

Table 1.1 Ranking of world banks in terms of assets

Current rank	Previous rank	Bank	Assets US\$m	+ or 2 (local curr)	Capital US\$m	Balance sheet
1	(1)	Barclays PLC, London, UK	*1,586,879	71.76%	2,786.27	31.12.05
2	(2)	UBS AG, ZGrich, Switzerland	*1,563,282	18.60%	660.9	31.12.05
3	(4)	BNP Paribas SA, Paris, France	*1,483,934	38.87%	11,442.56	31.12.05
4	(3)	The Royal Bank of Scotland Group plc, Edinburgh, UK	*1,300,124	29.80%	9,409.44	31.12.05
5	(6)	Cr dit Agricole SA, Paris, France	*1,251,997	30.19%	20,665.25	31.12.05
6	(5)	Deutsche Bank AG, Frankfurt am Main, Germany	*1,170,277	18.10%	1,674.92	31.12.05
7	(7)	Bank of America NA, Charlotte, USA	*1,082,243	–	2,836.40	31.12.05
8	(8)	ABN AMRO Holding NV, Amsterdam, Netherlands	*1,038,929	21.08%	1,260.91	31.12.05
9	(9)	Credit Suisse Group, Zurich, Switzerland	*1,016,050	22.91%	473.48	31.12.05
10	(10)	JPMorgan Chase Bank National Association, New York	*1,013,985	4.82%	1,785.00	31.12.05
11	(–)	Soci t G nale, Paris La D fense, France	*1,000,728	–	640.48	31.12.05

12	(11)	ING Bank NV, Amsterdam, Netherlands	*983,764	34.51%	619.25	31.12.05
13	(-)	Banco Santander Central Hispano SA, Santander, Spain	*954,361	-	3,688.54	31.12.05
14	(12)	UniCredito Italiano SpA, Milan, Italy	*928,285	-	5,704.46	31.12.05
15	(13)	Sumitomo Mitsui Banking Corporation, Tokyo, Japan	*916,710	-2.37%	6,253.69	31.03.05
16	(14)	The Bank of Tokyo- Mitsubishi UFJ Ltd, Tokyo, Japan	*865,663	8.22%	9,375.77	31.03.05
17	(17)	Caisse Nationale des Caisses d'Epargne et de Prevoy	*739,311	42.88%	8,014.14	31.12.04
18	(18)	Citibank NA, New York, USA	*706,497	1.72%	751	31.12.05
19	(22)	Fortis Bank NV/SA, Brussels, Belgium	*700,515	22.32%	3,670.49	31.12.05
20	(19)	Industrial & Commercial Bank of China Limited, Beijing, China	675,395	6.68%	19,412.07	31.12.04
21	(20)	HSBC Bank plc, London, UK	*663,385	32.12%	1,368.24	31.12.05
22	(21)	Mizuho Bank Ltd, Tokyo, Japan	663,014	0.96%	6,112.76	31.03.05

Continued

Table 1.1 Continued

Current rank	Previous rank	Bank	Assets US\$m	+ or 2 (local curr)	Capital US\$m	Balance sheet
23	(23)	Rabobank Nederland, Utrecht, Netherlands	*597,115	4.69%	-	31.12.05
24	(32)	Agricultural Bank of China, Beijing, China	*591,190	18.87%	-	31.12.05
25	(24)	Bank of Scotland, Edinburgh, UK	*586,543	25.23%	1,555.00	31.12.04
26	(25)	The Norinchukin Bank, Tokyo, Japan	*582,567	0.47%	11,520.19	31.03.05
27	(26)	Bayerische Hypo-und Vereinsbank AG, Munich, Germany	*582,122	5.59%	2,656.29	31.12.05
28	(-)	Calyon, Paris La Défense, France	*567,724	-	7,876.86	31.12.05
29	(27)	Dresdner Bank Group, Frankfurt am Main, Germany	*544,199	-	1,772.82	31.12.05
30	(28)	Lloyds TSB Group plc, London, UK	*531,767	8.91%	2,437.77	31.12.05
31	(29)	Mizuho Corporate Bank Ltd, Tokyo, Japan	526,193	-6.62%	10,071.61	31.03.05
32	(30)	Commerzbank AG, Frankfurt am Main, Germany	*524,724	4.70%	2,011.09	31.12.05

33	(31)	Bank of China Limited, Beijing, China	*515,972	7.30%	22,520.39	31.12.04
34	(37)	Landesbank Baden-Wp rttemberg, Stuttgart, Germany DZ BANK AG Deutsche Zentral-	*477,606	3.66%	5,855.49	31.12.05
35	(33)	Genossenschaftsbank, Frankfurt am Main, Germany	*473,730	12.74%	3,395.85	31.12.05
36	(34)	Wachovia Bank NA, Charlotte, USA	*472,143	–	455	31.12.05
37	(35)	China Construction Bank Corporation, Beijing, China	471,792	9.86%	23,467.65	31.12.04
38	(36)	Banco Bilbao Vizcaya Argentaria SA, Madrid, Spain	*462,833	19.11%	1,959.80	31.12.05
39	(39)	National Westminster Bank Plc, London, UK	*447,387	32.14%	2,880.69	31.12.05
40	(41)	Wells Fargo Bank NA, San Francisco, USA	*403,258	–	520	31.12.05
41	(38)	Bayerische Landesbank, Munich, Germany	*402,046	2.33%	5,775.85	31.12.05
42	(42)	Kreditanstalt fz r Wiederaufbau (KfW), Frankfurt am Main, Germany	401,411	3.81%	3,892.43	31.12.05

Continued

Table 1.1 Continued

Current rank	Previous rank	Bank	Assets US\$m	+ or 2 (local curr)	Capital US\$m	Balance Sheet
43	(43)	Royal Bank of Canada, Montréal, Canada	*398,981	10.16%	6,687.63	31.10.05
44	(44)	Danske Bank A/S, Copenhagen, Denmark	*384,604	18.49%	11,775.60	31.12.05
45	(45)	Nordea Group, Stockholm, Sweden	*383,993	16.24%	1,264.45	31.12.05
46	(49)	Abbey National plc, London, UK	*355,423	12.07%	254.08	31.12.05
47	(46)	Banque Française de Crédit Mutuel, Strasbourg, France	*352,516	15.66%	1,535.74	31.12.05
48	(48)	The Hongkong and Shanghai Banking Corporation Limited, Hong Kong, Hong Kong	*344,687	7.47%	2,901.14	31.12.05
49	(51)	Banca Intesa SpA, Milan, Italy	*322,641	-0.94%	4,241.57	31.12.05
50	(52)	National Australia Bank Ltd, Melbourne, Australia	*320,418	2.01%	8,771.29	30.09.05

\* Figures are consolidated: These bank rankings are compiled from balance sheet information included on BankersAlmanac.com available at 26th July 2006.

(\*) As of 31st December 2005.

Source: BankersAlmanac <http://www.bankersalmanac.com/addcon/infobank/widrank.aspx>

Table 1.2 Value creation by Grupo Santander, BBVA, Popular and Bankinter

	Market cap increase (*)	Shareholders' value increase (*)	Value created for shareholders (*)
Grupo Santander	85,770	53,575	20,704
BBVA	61,039	47,489	25,442
Banco Popular	14,881	3,866	13,426
Bankinter	17,306	5,131	3,765

(\*) In millions of euros between 1991 and 2006.

Source: Fernández and Carabias (2007: 3).

Santander, BBVA, Popular, and Bankinter in 1991 would have been worth €13.16, €15.57, €14.05 and €12.17 in 2006.

Be that as it may, in this book we centre our attention only on Santander and BBVA, for two main reasons. Firstly, their outstanding value creation for shareholders is a phenomenon meriting close scrutiny. Secondly, they championed the modernization of the Spanish banking system in the 1980s, brought about by three main factors: the pressure of their national environment, Spain's entrance into the EEC (European Economic Community), and finally the necessity to reach critical size (an explanation of the environmental and regulatory development will be further explored in Chapter 2). Therefore, the focus of this book is on how these two banks in particular outperform the Spanish financial system and their European competitors.

## Research questions

As an explanation of the successful modernization and globalization of the Spanish banks, we put forward the posit that Spanish banks work on an excellent business model, principally focused on operational efficiency in pursuit of cash flow generation.

The model's characteristics coincide with the Profit Arithmetic or 'PA' approach (Kase, Sáez-Martínez and Riquelme, 2005). In their study of outstanding business leaders, these researchers identified two different strategic models: long-term, corporate culture-biased Proto-image of the Firm ('PIF') and short-term, cash-generation-focused Profit Arithmetic ('PA').

## Business model and its historical background

This book attempts to provide data to confirm and information to explain this posit, and to expound on the systemic working of the model predicated on the three components, namely:

- 1) the bias for growth in retail banking;
- 2) the development of Information Technology;
- 3) a constant improvement of operational efficiency.

By combining these components, the two main banks of Spain improved their efficiency ratio in such a proportion that Spanish banks are currently the most efficient banks in Europe.

The model itself (with some variations from one bank to another) is a product of the evolution of the regulatory environment. Accordingly, we will first analyse some of the historical factors that influenced the evolution of the Spanish banking industry.

## Historical evolution of regulatory environment

Even though Spanish banks and savings banks (*cajas de ahorros*)<sup>3</sup> were aided by the Bank of Spain to develop their successful banking model, the main players such as Santander and BBVA have still had to cope with some adverse conditions. Accordingly, the Spanish financial system will be analysed from a macro and *meso* (intermediate between macro and micro levels) viewpoint.

The process of bank deregulation in Spain was begun in 1962 with a law liberalizing some interest rates, which was complemented with another law in 1971 lifting the barriers to opening new branches. In 1977 the arrival of foreign banks became possible, and in 1987 all interest rates and commissions were liberalized.

This deregulation led to a bank crisis spanning the period between 1978 and 1985. The first to fail was Banco de Navarra in 1978. In anticipation of further failures the government created the *Fondo de Garantía de Depósitos* (FGD) similar to the US's Federal Deposit Insurance (FDI) in order to be able to rescue and restructure failing banks before selling them.

Out of the seven larger banks, three had serious difficulties (Banesto, Banco Central and Banco Hispano) when they were asked by the monetary authorities to take over and integrate other banks in bankruptcy. For instance, Banesto took charge of three banks between 1977 and

1982: Banco Coca, Banco de Madrid and Banca Garriga Nogués. Partly because of this burden, Banesto faltered and its CEO, Pablo Garnica was forced to resign by Mariano Rubio, the then governor of the Bank of Spain. In the meantime, Banco Hispano had to clean up its finances.

The other four; Banco de Bilbao, Banco de Vizcaya, Banco de Santander and Banco Popular, were financially healthier and able to cope better with the need to expand before Spain's entry into the EEC in 1986. Banco de Bilbao enjoyed a good customer portfolio but at the end of the 1980s felt it necessary to grow in order to gain a greater market share, by accepting a merger with Banco de Vizcaya. Despite the fact that the latter had far fewer customers (ratio 1–6 at this time) this merger took place on an equal basis. The key reason for the merger was Banco de Bilbao's fear that Banco de Vizcaya, Bilbao's dynamic main rival, might overtake them in terms of market share and thus ultimately gain the upper hand.

In this competitive landscape Banco de Santander and Banco Popular seemed to be the best prepared to resist the opening of the Spanish financial market to competition from abroad, despite their being the two smallest banks of the top seven.

Banco de Vizcaya acquired Banca Catalana and the banks of Rumasa Group in 1983. Thus, of the seven large 'national' banks, four in particular fared better than the others during this period – Banco de Vizcaya, Banco de Santander, Banco Popular and Banco de Bilbao. Banco Hispano, one of the other three, saw its CEO resign as a consequence of the bank's poor performance.

The period 1977–1982 was characterized by the difficulties in the larger banks, the impending entry of European banks in Spain and the willingness of the Spanish authorities to foster mergers among Spanish banks for market consolidation.

The consolidation process was given a major boost in September 1989 when Banco de Santander launched the *supercuenta*, a demand deposit with around 20 per cent plus remuneration. The competitors were caught by surprise. Banesto, for example, rose to the challenge launching a similarly high-remuneration current account but its financial health was put in jeopardy because its finances were not strong enough to face the war of attrition that the launch had provoked.

The mergers that took place between 1987 and 1999 contributed to the emergence of two 'national champions' in the form of Santander and BBVA, which rank among the top twenty largest banks in the world, in terms of market capitalization. The former was created by the merger of Santander and Central Hispano (Banesto was acquired by Santander,

but has kept its independent status); and the latter comprises the former Banco de Bilbao, Banco de Vizcaya, and Argentaria.

### Business model framework

Our empirical research attests to the existence of a specific strategic configuration among the Spanish banks, although some individual variations exist (for example, if one compares Santander and BBVA).

As illustrated in Graphs A, B, and C, the configuration includes:

#### A. General framework consisting of:

*The CEO:* The top executive with short-term cash-flow generation-centered Profit Arithmetic (PA) approach (further explained in Chapter 3) enabling simplification of the situation and making sense of it. Rightly or wrongly, the entire organization can thus clearly see in which direction it is, or ought to be, heading. However, the PA approach does not mean that the top executive lacks a long-term vision. The key point is which of the two, in an extreme, trade-off situation, is given priority: cash flow in the short-term, or the long-term vision. As a matter of fact, we believe we can discern

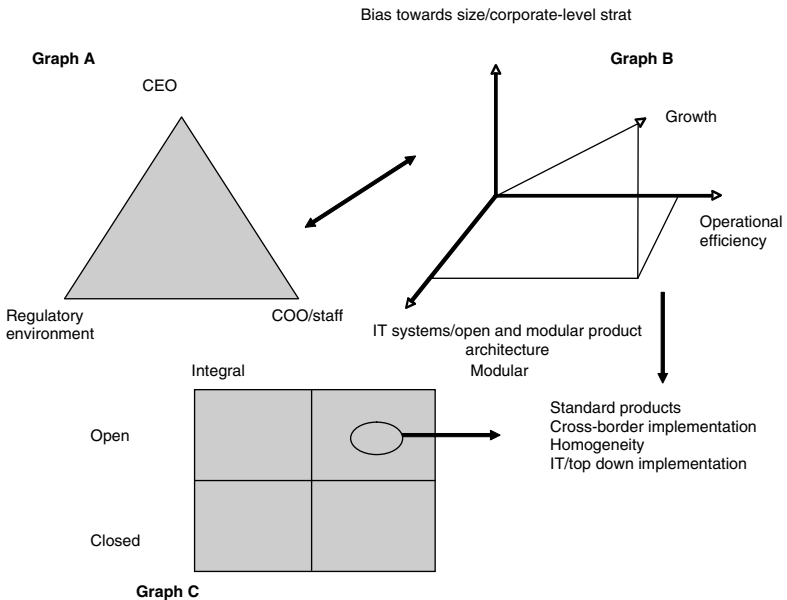


Figure 1.1 Business model framework

a specific direction in Santander and BBVA's strategic orientation, at least judged *ex post facto*.

*The CEO's team (COO/staff):* The historical pattern betokens the existence of CEO-COO/staff teams in Santander and BBVA which combine very well: Banco de Bilbao-Vizcaya's Ybarra (CEO) and Uriarte (COO), BBVA's González (CEO) and Goirigolzarri (COO), Santander's Botín (Chairman) and Sáenz (CEO) are outstanding examples.

From outside observation we cannot explicitly assert that the CEOs set direction and the COOs implement their superiors' decisions. We conjecture that, more often than not, the role of CEO and COO shifts between these key players.

*The regulatory environment:* We touched on this point earlier in this Chapter, but we ought to point out that the existence of a demanding regulatory environment favouring competition among the banks is one thing, but it does not explain the different outcomes the banks have achieved. We assume that the varying success of different banks, while facing the same business environment, can only be explained by the existence and influence of a leadership figure.

## **B. Basic business model comprising:**

The bias towards size resulting in focus on the dual strategy levels; business or competitive, and corporate-level strategies.

Discussions on whether size translates to economies of scale still seem to be going on. However, size must be a factor seriously taken into account by the incumbent CEOs. We have heard top executives of large Spanish banks expressing their conviction that growth in search of size has been the driving force behind their success.

Common sense argues in favour of size because it allows for the cost of technology, particularly in the research and development of Information Technology, to be spread among a larger number of operational units.

Be that as it may, the size, or rather the penchant for growth based on the conviction that size ultimately decides the survival of a bank, determines the behavioural pattern of bank management.

The growth of Spanish banks, first in Latin America (in parallel with other Spanish enterprises that entered the Latin American market around the same time), then in Continental Europe and perhaps ultimately in the US market, can only be explained by the inherent penchant for growth among the Spanish banks.

The centring on size and growth for size is something to be pursued at the level of corporate strategy rather than competitive strategy. The

difference between these two levels of strategy is that, at the corporate-level, you carry out the selection of business domain, rather than 'navigating' in the same existing domain (which falls to competitive strategy to take care of).

The growth for size was achieved in many cases by the acquisition of other banks, both inside and outside Spain. Decisions such as which banks to acquire, whether to grow organically or by acquisition, what value is created from the corporate centre, and so on, are typical questions answered by the corporate-level strategy.

By itself, a competitive strategy centred on the maximization of profit by pursuing cost leadership (the generic strategy developed by Spanish banks) may not be able to cope with concerns about size or growth. It needs to be complemented by corporate-level strategy.

### **The pursuit of operational efficiency**

The strategic use of an efficiency ratio (expenses as a percentage of revenue, or expenses divided by revenue) as a key performance indicator among a bank's staff and employees helps to harness the organizational energy of a bank.

The shrinking interest spread as the main income source for retail banks has made it essential for them to reduce their costs faster than the fall in the lending rate.<sup>4</sup>

It is true, though, that banks cannot reduce operational costs forever. At a certain point in time the diversification of income sources must necessarily be taken into account.

The efficiency ratio acquires an even deeper significance when combined with IT systems and the entire operational culture of the organization.

### **The strategic use of IT systems**

Spanish banks fundamentally understand that their business relates to customers and the handling of information and data about those customers. IT systems facilitate the flow of this information, the identification of interesting data and trends, the strategic combination of these data in search of competitive advantage, and so on.

Moreover, IT systems enable competitive advantages such as the transfer of financial products, exhaustively tested in Spain, to Latin America or other markets. As key indicators for the handling of these products become known, it is essential to be able to keep track of them, and IT systems can do just that.

The efficiency of payment settlement is also typically a function of time – the faster, the better – and therefore it is essential to have a homogenised IT system network throughout the entire organisation and across borders.

### **Product architecture orientated towards an open and modular type**

Another relevant feature of the transfer and implant of products into other markets is the product architecture.

The pursuit of operational efficiency is predicated on cost leadership, combined with the commercialization of similar products and services throughout the geographical spread, with subsequent savings in research and development expenses and learning-curve effects.

Offering the same or similar financial products and services across markets is facilitated by an open and modular product architecture.

This modular architecture assembles standard ‘parts’ and ‘components’ using standard production facilities. The actual interfacing of parts and components with each other and with the total product concept is not essentially important. A typical open and modular type of product is the PC (Personal Computer) for which the competitive advantage comes from finding standard but cost-efficient components and efficiently combining them.

The ability of Spanish retail banks to convert their product architecture into modular and open types allows them to capitalize on IT system advantages such as central management of costs and personnel, and to implement the same products across borders.

### **Organization of book and reading guide**

This book is organized into six chapters and four annexes.

Readers who wish to quickly go through the book to grasp the findings and theoretical framework expounded in this book are recommended to peruse Chapter 3 and Chapter 6.

Chapter 3 combined with Chapters 4 and 5 provides a fairly comprehensive idea of the theoretical framework, which is considered in detail in Chapter 3 and fleshed out and applied in the two later chapters.

This chapter, Chapter 1, gives an introduction and summarizes the framework of the book.

Chapter 2 presents the regulatory evolution of the banking industry in Spain, in the belief that it sets the backdrop to the emergence of Spanish retail banks as world-class competitors.

Chapter 3 describes in more detail the business model, as an 'ideal type' identified in the major Spanish retail banks. The regulatory environment, the existence of leadership figures, their cognitive processes, the use of IT systems, the pursuit of operational efficiency, etc., are explained along the way.

Chapters 4 and 5 detail two variations in the business model we identified in Chapter 3. The two main representative banks show some variations from that generic model, but the essential working is similar. We also look at the influence of other factors such as leadership figures, corporate culture, remuneration systems, internal power structures, strategic positioning (e.g. strategy setter or follower), the process of mutual replication of strategic steps, and so on.

Chapter 6 concludes and discusses our findings. The existence of one generic business model which branched into different variations in each of the competing banks does not guarantee the success of the Spanish banks forever. Since we're dealing with an idiosyncratic combination of leaders and their strategic approaches, and evolution in the regulatory environment, the model itself will necessarily undergo modifications, superficial or radical, in years to come. The existing leaders will be replaced by younger generations. The environment will evolve. Therefore, it will be relevant that further analysis be made of the business model and its modifications over time.

Annex 1 provides statistical validation that a basically similar strategic approach exists among Spanish banks compared to Japanese banks. Content analysis of the speeches by CEOs in large Spanish and Japanese banks is conducted, as is cluster analyses of Spanish and Japanese banks.

Annex 2a presents the behaviour pattern of Japanese banks and shows how they do not share a common approach. We attempt to provide circumstantial evidence that these banks lack a clear-cut strategic approach due to historical reasons, and this places them at a distinct disadvantage compared to Spanish banks.

Annex 2b describes the case of Suruga Bank, a small regional bank in Japan which, unlike other banks in Japan, pursues a strategy remarkably similar to the business model of the leading Spanish retail banks. The existence of a similar strategic approach in a different business environment and regulatory evolution may confirm the validity of the Spanish banks' business model in totally different national culture and business environments.

Annex 3 offers an analysis of the business model used by Banco Sabadell as an example of another Spanish bank validating the generic business model explained in Chapter 3.

Annex 4 provides an explanation of the research process and methodology adopted in conducting this project.

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