

A photograph of two smooth, rounded stones balanced on top of each other. The bottom stone is light brown and textured, while the top stone is dark grey and smooth. The background is a plain, light-colored surface.

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Creating a

Balanced Scorecard

For a Financial Services
Organization

NARESH MAKHIJANI | JAMES CREELMAN

Creating a Balanced Scorecard for a Financial Services Organization

NARESH MAKHIJANI AND



WILEY

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**Creating a
Balanced Scorecard
for a
Financial Services
Organization**

From James Creelman

*With hands big as shovels and a heart full of love . . .
my Father, my Father.*

To the memory of Robert Murray Creelman:
1933–2009.

From Naresh Makhijani

*To my brother, Rajesh Makhijani, nothing is impossible
and miracles will happen.*

Introduction

The seeds of this book were sown in 2008 when the world became all too aware of that hitherto obscure term “credit crunch.” As we watched financial institutions crumble and witnessed the devastating effect of the economic tsunami that ripped its way through global economies, a number of things became abundantly clear. That the world would likely spend many years recovering from what proved to be a “near depression,” and that financial institutions, most notably the banking sector, would need to go through a radical overhaul to be “fit for purpose,” for the new post-credit crunch economy.

What being “fit for purpose,” would look like also began to become clear as the credit crunch unfolded. And as researchers, analysts and economists told the story (or at least the early versions; the *actual* story has perhaps yet to be told), certain words and terms began to be regularly applied. Financial institutions would, it was repeatedly argued, need to become much more “accountable,” for their performance. Their day-to-day working practices and decision-making processes would need to be far more “transparent,” than had hitherto been the case, and there would have to be a greater understanding of the risks that were inherent in the products being sold and, of course, the strategic choices that were being made.

Moreover, organizations would need to better understand, and communicate to shareholders and other stakeholder groups the non-financial drivers of future financial performance and must be at least as much concerned with managing for the longer-term as driving short-term performance and demonstrate this. And perhaps imbued with the greatest emotions (especially from the general public, who is experiencing most of the fallout from the credit crunch in terms of job losses throughout the economy and massive cutbacks in public services), compensation systems would need to be overhauled to be more reflective of actual performance and the sustainable value that is built.

As we thought about a roadmap for recovery that could contend with these challenges, our thoughts continually anchored back to the Balanced Scorecard. Since its original launch in the early 1990s (and confirmed through our consulting and research experiences) the scorecard has

repeatedly proven to help organizations from various sectors and industries to overcome the myriad trials that financial institutions face.

In writing this book, and in our description of the Balanced Scorecard, we have been fully and constantly cognizant of the huge task facing the leaders of financial institutions (most notably of course from the banking sector) over the coming years and the intense scrutiny that will be under from a raft of stakeholder groups, such as shareholders, legislators, regulators and the general public. All will need a lot of convincing before they replace their trust in the beleaguered sector.

Sprinkled with case examples and advice from scorecard experts, this book provides a complete picture of how to build and implement the Balanced Scorecard within a financial services organization. Written as a practitioner's step-by-step guide the book explains how to build a causal Strategy Map of strategic objectives and select Key Performance Indicators, targets and strategic initiatives from one financial and three non-financial perspectives of customer, internal process and learning and growth, (the core components of a Balanced Scorecard) at both the strategic business unit and devolved levels. In addition to being a framework that enables the balancing of long-term performance stewardship while optimizing short-term efforts, a Balanced Scorecard also drives performance accountability and transparency deep inside the organization.

The following chapters also outline how to put in place the appropriate culture for managing with the Balanced Scorecard (particularly important as we make "risk management," an integral part of the strategic management process) and how to select the appropriate technology for strategy management (very important for making performance fully visible and transparent). Moreover, we also explain how to rework an incentive-compensation system so it reflects the drivers of future value creation as well as historic financial performance (the most emotive of the change requirements). And we also show how to link the Balanced Scorecard framework and methodology with other key management processes such as the annual budget and other planning processes, how to link strategic and operational processes and how to reengineer management (operational, strategic and boards of directors) review meetings to drive greater clarity, focus and relevance into performance assessments. We also explain how to build the internal capability (through an Office of Strategy Management) that will inculcate the capabilities to manage with a Balanced Scorecard and to make strategy "everyone's every day job."

This work reflects the many years experience and field observations of the two authors but would not have been possible without the involvement of others, which we here fully acknowledge. We would like to thank the case study companies that we profiled, and in particular the three from

Indonesia and their representatives: Dyah Nastiti Kusumowardani, 's Director of Strategy Planning, Bank Indonesia, Wahyu Eko Wardon, Head of Corporate Strategy, Bank CIMB Niaga and Falk Archibald Kemur, Head of the President's Office, ADIRA Finance. We would like to thank present and past OTI staff for contributing their knowledge and experience and all present and past OTI clients, who have continually shown enthusiasm for the Balanced Scorecard approach, have benefited from the results and enriched our understanding of how best to apply this framework and methodology within diverse sector settings.

We also acknowledge the thought leadership of people such as Andrew Smart of the U.K.-based management consultancy Manigent and Nigel Penny of the Singapore-based ClaritasAsia who were especially useful in shaping our understanding of how to integrate risk management with strategy management within the scorecard framework. Finally we would like to thank Professor Robert Kaplan and Dr. David Norton for their work in developing and evolving the Balanced Scorecard. We truly stand on the shoulders of giants.

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CHAPTER 1

The Curse of Living in "Interesting Times," The Credit Crunch, and Other Challenges

EXECUTIVE SUMMARY

1. The 2008 collapse of the financial markets that triggered the commonly termed "credit crunch" had a catastrophic impact on the financial services industry.
2. According to the Association of Chartered Certified Accountants, the principal cause of the credit crunch was a failure in corporate governance at banks, resulting in short-term thinking and blindness to risk.
3. We explain that the introduction of a properly architected Balanced Scorecard system can help overcome these failings.
4. Many of the "lessons" now being learnt by Western organizations as a result of the credit crunch were already understood in Southeast Asia as a result of the region's 1997 currency crisis.
5. Deregulation, the globalization of markets, and breathtaking advancements in information and communication technologies are also transforming financial services.
6. With many experts claiming that customer loyalty is essentially "dead" in financial services, it is interesting that some organizations from the sector are using the Balanced Scorecard to drive loyalty.
7. A case report on Canada's Scotiabank shows how it continues to succeed through using the Balanced Scorecard.
8. We provide a snapshot of the scorecard successes of the early pioneering financial services organizations: Chemical Bank and CIGNA Property & Casualty division.

INTRODUCTION

An ancient Chinese adage states that it is a curse to live in interesting times. If that is true then those working in the financial services industry (most notably the banking sector) have been “cursed” over the past few years. Without question they have lived in “interesting” times.

THE IMPACT OF THE CREDIT CRUNCH

The 2008 collapse of the subprime mortgage market that triggered the commonly termed “credit crunch” had a catastrophic impact on the financial services industry. In the middle of the first decade of this century, it would have been unthinkable that venerable and long-established organizations such as Lehman Brothers would be out of business before the end of the decade and that Merrill Lynch would survive only thanks to being taken over by the Bank of America. It would have been equally unimaginable that “darlings of the stock markets” such as the U.K.-headquartered Royal Bank of Scotland would only survive the decade thanks to massive bailouts from national governments.

The fallout from the collapse of banks and other financial institutions has had a profound and debilitating impact on all industries and sectors. As the full extent of the credit crunch took hold, many economists and other experts feared that we are entering a recession that might be as deep and long lasting as the great depression of the 1930s—itself essentially triggered by a collapse of confidence in the banking industry. Although, largely thanks to government bailouts as well as massive spending to get economies moving, we managed to avoid “depression,” the financial services sector will likely never be the same again and it will probably take many years before public, and perhaps more importantly, customer confidence is fully restored.

Even before the credit crunch, customer confidence in the financial services sector had badly eroded because of the uncovering of long-term issues caused by the systematic misselling of pensions and mortgages. Customer anger has been further stoked because to pay for the banking bailouts and the spending to avoid “depression,” there will be massive cuts in public sector in many countries (the U.K. being a prime example where for some years there will be severe cuts across government departments and public services. Many public sector workers will lose their jobs—and guess who they’re blaming?)

The Causes of the Credit Crunch

Let’s consider what caused the financial disaster that was the credit crunch. It is obvious that widescale inappropriate lending to people with poor credit

ratings had a dramatic impact on those who had invested in these securities. According to the global body of professional accountants, the Association of Chartered Certified Accountants (ACCA), the principal cause of the credit crunch was a failure in corporate governance at banks, resulting in short-term thinking and blindness to risk.

Before looking in more depth at the ACCA findings, note that “blindness to risk,” which has been noted by most experts as a key cause of the credit crunch (or perhaps more accurately a reckless attitude to risk management) has long been a cause for concern in financial services, especially banking. Indeed, as early as 2004, Alan Greenspan, chairman of the U.S. Federal Reserve noted that:

It would be a mistake to conclude that the only way to succeed in banking is through ever-greater size and diversity. Indeed, better risk management may be the only truly necessary element of success in banking.

Even earlier, in 2001, the influential Risk Management Group of the Basel Committee on Banking Supervision defined risk as: “the risk of loss resulting from inadequate or failed processes, people, and systems or from external events.”¹

ACCA’s policy paper, *Climbing Out of the Credit Crunch*,² examined five key areas of banking performance: corporate governance; remuneration and incentives; risk identification and management; management accounting and financial reporting; and regulation.

Within its wide-ranging and damning report, the failures identified for the first three of these areas are particularly interesting when considered through the lens of this book.

Corporate Governance “A fundamental role of the board is to provide oversight, direction and control but also to challenge where necessary. This does not appear to have happened in many of the banks,” the ACCA paper noted. “No doubt this is partly owing to a lack of understanding of the complexities of the business, but more training is probably only part of the solution . . . [but] what inhibited boards and managers from asking the right questions and understanding the risks that were being run on their watch?”

As we explain in this book, one of the key strengths of the Balanced Scorecard system is that it inculcates performance transparency and accountability into organizations: from the very top down to team and even individual levels.

The existence of a well-thought-out enterprise-level Strategy Map and accompanying scorecard of metrics, targets, and initiatives provides

corporate boards with an excellent and concise view of corporate financial performance and the nonfinancial drivers of that performance. As a governance tool this is clearly much more useful to corporate boards than the weighty and overly detailed board packs that they typically receive before board meetings.

Moreover, as we explain in chapter 2, it is possible to build strategy maps and scorecards for the corporate board and their constituent oversight committees (such as those for remuneration and incentives). This board scorecard system can have a powerful and positive impact on how a board discharges its corporate governance responsibilities.

Remuneration and Incentives In the paper, ACCA stated that although executive remuneration arrangements should promote organizational performance, the existing incentive and career structures of banks meant enormous rewards reinforced short-term thinking. “If not addressed, remuneration issues will continue to frustrate other attempts for reform,” the paper noted. “Risk management and remuneration and incentive systems must be linked. Executive payments should be deferred (e.g. held in an escrow account) until profits have been realized, cash received and accounting transactions cannot be reversed.”

Sukhend Pal, managing partner at the U.K.’s Centrix Consulting made an interesting observation on the role of incentive compensation and product complexity in the cause of the credit crunch in an article that appeared in a June edition of *Raconteur* (a supplement distributed within the U.K.’s *Times* newspaper).³ “The role of structured products created by derivatives specialists as investment, such as collateralized debt obligations, has been the root cause of the financial crisis,” he said. “Many [Centrix] clients have been seriously beguiled by the structure of these products that were expensive, highly complex and simply not appropriate. Yet, investment bankers sold them for their personal gain and sky high bonuses.”

In chapter 10 of this book, we describe how remuneration and incentives can be hardwired to performance against the Balanced Scorecard system. If a risk management theme is included within the scorecard (and it most likely will be for those involved in financial services), then how this affects present and future financial results should be a key determinant of remuneration and incentive payouts.

Risk Identification and Management The ACCA paper notes that:

Banks have highly sophisticated risk management functions yet recent events have tested them and found many wanting . . . In early 2007, few senior managers thought they were betting on